Going Beyond the Averages: Aid and Development

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Abstract: One of the persistent, unresolved controversies of economic development is the effectiveness of development assistance —whether foreign aid contributes to economic development. This article argues that this controversy is largely an artifact of a methodology that focuses on the "averages" and pays inadequate attention to the specific characteristics of individual societies. For enhancing aid effectiveness, one needs to discard the one-size-fits-all approach, and adopt a more nuanced, tailor-made strategy based on a comprehensive understanding of specific countries.

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1. Introduction

One of the persistent, unresolved controversies of economic development is the effectiveness of development assistance —whether foreign aid contributes to economic development. There are two district dimensions to the aid effectiveness question: a micro dimension that relates to effectiveness of individual projects and programs and a macro dimension that relates to the broader, macroeconomic impact of foreign aid.

While evaluation results from donor agencies suggest that individual aid interventions are largely successful in most countries, the overall impact of development assistance on individual economies has been diverse. This divergence between micro and macro outcomes, which has been labeled as the micro-macro paradox, has been an important theme of the aid effectiveness controversy.

The macroeconomic analysis of aid effectiveness typically relies on cross-country growth regressions to infer whether development assistance has any impact of economic growth. This line of research to investigate the overall economic impact of foreign assistance has yielded few definitive results and remains at the maelstrom of international debates and controversy.

A major shortcoming of this body of literature is that it does not delve into the intricate complexities of aid ineffectiveness in individual countries. The current approach seeks to find the key to aid effectiveness in the vast array of quantitative data across countries within the framework of a single quantitative framework. However, despite the volume and econometric sophistication of this literature, it has provided surprisingly little illumination on the question. The state of the current literature was summarized succinctly in a recent article by Rajan and Subramanian (2011): “this literature does not provide robust evidence of either a positive or negative correlation between foreign aid inflows and the economic growth of poor countries.”

This deplorable state of knowledge has not catapulted economists into a closer examination into the pathology of aid effectiveness as it is hidden in the economy, history, society and polity of the aid-recipient countries. Economists have kept on ratcheting up the application of complex econometric methods and techniques as if the secret of aid effectiveness would be revealed on the sheer brute force of the techniques. This technical overamping of the writings has rendered the discussions increasingly opaque and incomprehensible, even to development specialists, let alone the larger development community. Policymakers, who are presumed to be informed and guided by the literature, are largely repulsed by the technical obfuscations and insiders’ quarrels that characterize much of the current discussions. Consequently, policymakers now find the easily accessible, albeit imperfect tract of “Dead Aid” by Moyo (2009) more appealing than the obtuse, over-caveated, inconclusive “scientific works” of academic economists.

This article is organized as follows. The next section provides a brief review of the economic studies on aid effectiveness, followed by a critical assessment of the literature. The article concludes with a plea for reframing the debate.

2. A Brief Review of the Literature

Research on foreign aid has always been marked by controversies. The first wave of research focused on the impact of foreign aid on domestic saving, which then was considered the most critical determinant of economic development. While the optimists held that foreign aid would lead to a dollar-for-dollar increase in savings, the pessimists argued that foreign aid would lead to unproductive government expenditure, corruption, and the crowding out of private savings. Experiences varied across countries. However, the "average" results from the regression literature indicate that the truth lies in between these two extremes: While aid increases savings, it does not increase savings dollar-by-dollar by the amount of aid.

This literature is considered crude by today's technical standard. In addition, it was believed that savings and investment as a measure of aid effectiveness was somewhat narrow, because savings-investments are a means, not the end of economic development.

The second wave of research focused on the relationship between aid and economic growth. An important earlier contributor is Boone (1996), who has been applauded for his technical econometric innovation –being the first to introduce the so-called instrumental variable method to his analysis—as well as for his forceful argument. He attributed the ineffectiveness of aid to raise growth to political-economic reasons. Boone reasoned that In a society where the political elite dominates the masses , aid is no more than an income transfer to the elite , which only increases the consumption of the rich to the exclusion of the poor , as the latter has no effective representation in the polity . Boone's conclusions , which apparently flounder in the face of the evidence to contrary in many aid-recipient countries that made significant strides in poverty reduction in the last thirty or so years, were no more than a broad-brush generalization of the situation in developing countries. Nevertheless, this conclusion resonated with many economists as well as the development community with a reservoir of skepticism regarding the impact of aid.

The next wave of research was spurt by Burnside and Dollar (2000), who argued that while aid generally was ineffective in promoting growth, it flourishes in good policy environments— in particular, when good macroeconomic policy prevails. This result received wide attention from both within and outside the economics profession for its apparent plausibility.

Besides the plausibility of the message, there are other reasons for its popularity: First, it strikes an apparent balance between aid-optimists and aid-pessimists. Second, it provides clear directions for policy that are not inconvenient to donors, since it shifts the onus for aid effectiveness onto recipients. Burnside and Dollar's findings have been interpreted by donor agencies as evidence that aid needs to be allocated selectively. Indeed, this *selectivity* has become the bedrock of the World Bank's aid-allocation policy, a template that has been adopted quickly by other international development institutions.

Notwithstanding its tremendous influence on donors, the Burnside-Dollar paper has been assailed for both analytical and policy reasons, the first and foremost being that their results are statistically fragile. Easterly et al. (2004) have shown that the Burnside-Dollar results tumble when the dataset is expanded by years and countries. Subsequent efforts by Dollar and his collaborators to resurrect their results with different indicators of good policy environments have proved to be equally futile.

In recent years, a number of authors have argued that available data is equally consistent with other plausible statistical stories, with distinctly different implications for aid allocation. One such story is that the effect of foreign aid varies across geographical locations—it is simply less effective in tropical countries. Another story is that aid is on average effective, though its effectiveness tends to diminish as the volume increases. Still another story is that aid effectiveness relates to a country's structural vulnerability to external shocks: Aid helps to foster growth—or to contain negative growth—in countries that are vulnerable to external shocks. Roodman (2007) has shown that although the above stories are all plausible, they are statistically equally fragile, much like   the original Burnside-Dollar results.

More recent works by Rajan and Subramanian (2008, 2011) have dwelled on the impact of foreign aid on the quality of governance and the real exchange rate. They have found that foreign aid can have adverse influence on the growth of manufacturing in developing countries through its unfavorable impact on the quality of governance and the real exchange rate. While the authors were lauded for their econometric innovations in their studies, these themes are, by no means, new to the development literature.

It may be noted that the appreciation of the real exchange rate-- and the so-called Dutch disease— is by no means an automatic outcome of foreign aid: the Dutch disease   can be averted by appropriate macroeconomic policy response. When aid flows to the traded-good sector or when aid is invested in the highly productive non-traded sector, the appreciation of the real-exchange rate is not an inevitable outcome of the inflow of foreign aid. As a matter of fact, as Fielding and Gibson (2012) have noted, the long-run impact of foreign aid on the real-exchange rate across Sub-Saharan Africa has been diverse and heterogeneous—indeed, some countries have experienced real-exchange rate depreciation.

Similarly, inflow of aid does not necessarily lead to lapses in accountability or poor governance. Indeed, there are many instances where aid has contributed to improved accountability through its direct support for strengthening civil society and for increasing transparency in public expenditure.

In the face of inconclusive results, efforts at squeezing more robust and definitive conclusions from the data continue. One recent line of empirical work this regard is meta-analysis—the regression of regression analyses. Meta-analysis synthesizes the results from the existing body of empirical studies with the putative purpose of controlling for heterogeneity among studies. One presumed advantage of meta-analysis is that it potentially can overcome subjectivity to provide a more systematic and objective assessment of an existing body of findings. Even this type of meta-studies has contributed little either to resolve the persistent controversies or to yield useful policy insights. For example, a meta-analysis of Doucouliagos and Paldam (2009) , which draw on data from sixty-eight previous studies , do not discern any significant impact of foreign aid on growth; however, Mekasha and Tarp (2011), using the same dataset , reach the opposite conclusion that foreign aid has had a positive, statistically significant effect on growth.

3. Assessing the Current Literature

The aid effectiveness literature has gone through a gradual progression in terms of econometric methodological sophistication from rudimentary OLS to two-stage least squares applied to cross-country panel data, to the complex dynamic panel GMM methods, with all their bells and whistles, applied to time-series data. However, the basic fact remains that given the vast differences across societies, the assumption of a standard regression model with homogenous parameters is downright implausible from the perspective of both historical experience and economic theory. No wonder, growth regression analysis has yielded few robust *causal relationships* of any policy significance.

As the macro aid-effectiveness literature has failed to make any meaningful contribution to the understanding of the intricacies of aid effectiveness, it has led many to explore alternative approaches. One such approach is the evaluation of aid projects, programs and policies through randomized control trials (RCTs). Under idealized conditions that seldom obtain, RCTs can overcome some of the methodological shortcomings of the macro aid effectiveness literature and provide impact evaluation of micro-level aid interventions. However, the RCT approach has its own limitations. First and foremost, it cannot analyze the effect of an economy-wide policy change such as trade liberalization. Second, it is now well known that there is a “micro-macro” paradox, implying that the success at the micro, project level may not translate into success at the macro-level. Even if all the projects are successful, they do not mean that they will ensure success at the macroeconomic level of because of the fungibility of aid. Fungibility refers to the situation when the recipient diverts its own resources from sectors and projects where foreign aid is given. This diversion of resources to unproductive expenditures does not help boost growth despite the inflow of foreign aid. Third, it only provides information about the average impact, not about when and how it works. Finally, even with considerable expense, RCTs offer local results that may not apply to other contexts. It is come to be known as the issue of external validity. All this has prompted the suggestion that the secret of aid effectiveness is better revealed by the old-fashioned alchemy-way of trials and errors than randomized trials.

The current empirical literature on aid effectiveness has paid excessive attention to sharpening the method but little to the context and substance of it. As is universally known, the large picture of aid effectiveness is simply as follows: it has been effective in some countries or some sectors and ineffective in others, irrespective the global average, which may swing one way or the other over time.

The single-minded pursuit of the global average has led to the neglect of substantial economic issues. The research in this area has largely ignored the distinction between different types of aid (with some solitary exceptions that include: Clemens et.al, 2004). It is obvious that different types of aid have different ramifications for economic development. For example, emergency aid may not have as much impact on growth as infrastructure aid; similarly, social sector aid is likely to have a different impact on human-development indicators from programs aid. Also, the impact of different types of aid may take different time horizons to unfold.

The current literature makes little or no distinction between countries. Irrespective of the stage of development, history, culture, and the polity: all countries are simply lumped together as mere data points in a grand regression exercise. It is intuitively obvious that the impact of aid is likely to be different in different countries, depending on the nature and state of social and economic institutions. As countries differ in their incentive structures, norms and values, so do policy outcomes.

4. Conclusion

There is a need to reframe the economic research on foreign aid. The focus of research in foreign aid should go beyond the current obsession about the “average”: does foreign aid work on “average”? Or what is the “average” effect of a particular aid intervention? It needs to delve into why, how and when development assistance has worked in particular societies. Only by finding the mechanisms and processes that explain why and in what context aid works would it be possible design and deliver foreign aid in an effective manner. In other words, the current approach has been too mechanical to yield useful insights into the mechanics of effective development assistance.

A useful research agenda on aid effectiveness would require going beyond the narrow analytics of growth regressions or for that matter RCTs. Cross-country growth regressions have proved to be too coarse a tool to capture the complex mechanisms and processes behind aid effectiveness. An effective aid policy requires country-specific insights, which can be gleaned only from in-depth country studies that capture the flavor and texture of individual countries, nuances that are lost in mechanical manipulation of data. Similarly; RCTs share some of the shortcomings of cross-country regressions. Its focus on the average impact, its inability to identify causality, and its general lack of external validity: all these make RCTs a poor gauge to guide aid strategy at the macro-level.

Finally, there is a huge discontent between research and practice. The international community has adopted poverty alleviation—in particular, the millennium development goals—as the overarching objective of economic development for developing countries. However, as far as the mainstream economists are concerned, business as usual persists. They continue to focus on economic growth as the metric of effectiveness of foreign aid. There are three apparent reasons for this. First, some argue that this shift of objective from economic growth to poverty alleviation is misguided. According to Shleifer (2010), this lowers the accountability for donors and turns foreign aid into an international welfare program for developing countries. Second, there is a widely-shared presumption that growth and poverty reduction is the same: It is old wine in a new bottle. As Easterly (2003) puts it: "The aid bureaucracies define their final objectives 'poverty reduction' (today's more politically correct name for 'growth')." It is; however, wrong to equate the two as income and poverty indicators do not always move in sympathy. For example, while Bangladesh has half the income of India per-capita, it outperforms India in almost all social and human development indicators. Third, it is analytically convenient to address economic growth than poverty and human development in their multi-dimensionality. This shift in metric from economic growth to poverty and human development would dislodge many economists from their academic comfort zone of growth empirics—which is a standard fare in mainstream economics.

Nevertheless, such reframing is important to make the work more relevant. Economics is a social science that is intended to find cures for the economic maladies of societies, something that requires continuous experimentation with policies and practices, something which is achieved through a process of trial and error. This process, which is context-specific, can be speeded up if there is a closer interaction between research and practice.

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