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Aid Effectiveness: Research versus Practice
Never the Twain shall Meet?

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Abstract

This article argues that there is a huge disconnect between empirical research and policies and practices involving foreign aid. In particular, it argues that recent years have seen the growth of a large body of sophisticated empirical work which is long on techniques and short on substance. The literature is riven by controversy and insider drama and provides little illumination on vital policy issues concerning design, allocation, and delivery of foreign aid. For enhancing aid effectiveness, one needs to go beyond the current methodology that emphasizes the "average" and promotes a one-size-fits-all approach. This will require a more nuanced, tailor-made strategy that is grounded in a comprehensive understanding of individual countries. The paper calls for the convergence of the universes of research and policies both for a sophisticated understanding of the underlying issues and for devising appropriate policies for effective use of foreign assistance.

1 Introduction

The debate on aid effectiveness began as soon as the International Development Association of the World Bank was established in the 1960s and aid began flowing from the rich to the poor nations (Bauer 1966). Fifty years, multi-trillion dollars of foreign aid, and hundreds of scholarly articles and books later (Hansen and Tarp 2001), the same debate continues unabated: Does foreign aid actually help economic development?

Although economic studies that investigate aid effectiveness proliferated briskly in number and sophistication, surprisingly, they have provided 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."*

Yet, this deplorable state of knowledge has not catapulted economists into more in-depth examinations of the pathology of aid debacles which are often rooted in the economy, history, society and polity of aid-recipient countries. Instead, economists have continually ratcheted up the complexity of econometric methods and techniques, as if the secret of aid effectiveness will be revealed by the sheer force of the techniques. This technical doubling-down has made 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 obfuscations and insider quarrels over technicalities 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 and inconclusive "scientific works" of academic economists.

This article is organized is as follows. A synoptic summary of the state of the current literature is provided next, followed by a broad assessment of the literature and an outline of a policy-relevant approach to studying aid effectiveness. The last section offers a few concluding remarks.

2 Literature Review

Research on foreign aid has always been marked by controversy. In the early days of foreign aid, research focused on the impact of aid on domestic saving, which then was considered the most critical determinant of economic development. While optimists held that foreign aid would lead to a dollar-for-dollar increase in savings, 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 does increase 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 a bit narrow, because savings and investments are a means, not the end, of economic development.

The next round of research focused on the relationship between aid and economic growth. An important earlier contributor was (Boon 1996), who was 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 in which he attributed to political-economic reasons the ineffectiveness of aid to raise growth. Boone reasoned that in a society where the political elite dominate the masses, aid is no more than an income transfer to the elite group. That transfer 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 apparently flounder in the face of evidence to the contrary in many aid-recipient countries that made significant strides in poverty reduction in the last thirty or so years. His conclusions, which were a broad-brush generalization of the situation in developing countries, nevertheless, resonated with many economists as well as with the development community with a reservoir of skepticism regarding the impact of aid.

The next round of studies was stimulated by Burnside and Dollar (2000) who argued that while aid is generally ineffective in promoting growth, it flourishes in good policy environments: in particular, when good macroeconomic policy prevails. This result received wide attention from both inside 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 optimists and pessimists — between those who argue that aid is effective and those who argue that it isn't. 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, *selectivity* has become the bedrock of the World Bank's aid-allocation policy, a template that has been adopted gradually 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 reason is that their results are statistically fragile. Easterly, Levine and Roodman (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 fragile.

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 its volume increases. Still another story is that aid effectiveness relates to a country's structural vulnerability to external shocks: aid flows help to foster growth — or to contain negative growth — in countries that are vulnerable to external shocks. As Roodman (2007) has shown, although the above stories are all plausible, they are fragile statistically, much like the original Burnside-Dollar results.

More recent works by Rajan and Subramanian (2007; 2011) have dwelled on the impact of foreign aid on the quality of governance and the real exchange rate. These research works suggest that foreign aid can have an 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 these themes are, by no means, new to the development literature, the authors were lauded for their empirical innovations in their studies.

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 specter of 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 directly to improved accountability by supporting civil society, promoting decentralization, and increasing transparency in public expenditure.

The afore-mentioned research on aid effectiveness does not distinguish between different types of aid. It seems intuitively plausible that different types of aid have different ramifications for economic development. For instance, 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 than programs aid. Also, the impact of different types of aid may take different time horizons to unfold. Against such advantages of disaggregation, one needs to juxtapose the difficulties in accurately identifying the different types of aid and their time horizons. This was succinctly expressed by Rajan and Subramanian (2008) as follows:

> "There is, however, a more general concern with slicing and dicing up aid; it could become a fishing expedition where the researcher hunts for any sub category that has a positive (or negative) correlation with growth, and then finds an (ex-post) rationale to focus on that sub-category, depending on the researcher's biases. This is why the a priori theoretical rationale for focusing on a particular sub category is important. Unfortunately, fungibility renders most such rationales suspect."

However, the above-mentioned difficulties notwithstanding, a few recent studies have differentiated among different types aid and explored their implications for growth and investment. Unfortunately, they have not yielded unambiguous conclusions. One such study is by Clemens, Radelet, Bhavnani and Bazzi (2012) which focuses on types of aid that have early-impact on growth such as project aid and aid for budget support. They find that this category of development assistance has a modest, positive effect on growth and investment. This finding, however, runs counter to another study by Rajan and Subramanian (2008) who conclude that aid, regardless of categories and timing of impact, has no significant effect on growth.

To summarize, the extant body of empirical literature that explores the macroeconomic impact of foreign aid offers few unambiguous conclusions. However, this has not deterred many economists in their efforts at teasing out more robust and definitive conclusions from the existing body of data. One recent line of empirical work of this genre 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 can potentially overcome subjectivity to provide a more systematic and objective assessment of an existing body of findings. Even this type of meta-study has contributed little to resolving the persistent controversies or yielding useful policy insights. For example, a meta-analysis by Doucouliagos and Paldam (2009), which draws on data from sixty-eight previous studies, does 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 and statistically significant effect on growth.

3 Assessing the Current Literature

The aid effectiveness literature has seen a virtual hit parade of sophisticated econometrics, a gradual progression of econometric techniques 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. Given the vast differences across societies, the assumption of a standard regression model with homogenous parameters appears downright disingenuous. It's no wonder that 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, micro 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 which suggests that success at the project level does not ensure success at the macro level. Even if all the projects are successful it does not mean that they will ensure success at the macroeconomic level because of the so-called fungibility issue, i.e., aid money being used for purposes other than those earmarked. Third, it provides information only about the average impact, not about when and how it works. Finally, even with their considerable expense, RCTs provide at best local knowledge that may not apply to other contexts. This issue has come to be known as the problem of external validity. All this has prompted the suggestion that the secret of aid effectiveness is more likely to be revealed by trial and errors than by randomized control trials.

Given the shortcomings of the different econometric approaches to studying aid effectiveness, the existing literature offers little illumination beyond providing statistical codification of the obvious: foreign aid has been effective in some countries and ineffective in others — even though the global average may have swayed one way or the other. For policy purposes, what is salient for an individual country is an understanding of the possible impact of aid on its economy and how policies can be designed to

maximize this impact rather than the global average effect of foreign assistance!

The current empirical literature, in its bid to derive the average results, has paid too much attention to techniques and too little to the facts on the ground. It makes little or no distinction between countries. Irrespective of the stage of development, history, culture, or the polity, all countries are simply lumped together as mere data points in a grand regression exercise. The literature tends to ignore the commonsensical intuition that the impact of aid is likely to vary between countries, since much depends on the nature and state of social and economic institutions. As countries differ in their incentive structures, norms and values, and quality of governance, so do the economic and social outcomes of foreign aid.

4 The Way Forward

Analysis of aid effectiveness requires more than mechanical manipulation of data. It needs broad-based country studies, which are situated in their social, economic and political contexts, and a triangulation of different methods to determine aid effectiveness. The enquiry needs to include both macro and micro dimensions of foreign assistance as well as their ramifications for institutions and policies At the macro-level, analysis of aid effectiveness involves an examination of the metrics of development — the aggregate economic and social indicators of development such as poverty reduction, life expectancy, literacy etc. — in relation to the inflow of foreign aid. Effective use of aid should lead to steady improvements of social and economic indicators of the country. However, such improvement — or even sustained improvement — in these economic and social indicators should not be automatically equated with aid effectiveness, in the presence of other intervening factors. Take, for example, the case of Bangladesh. In the last decade or so, the country has experienced steady economic and social progress in the face of a declining flow of foreign aid (as a share of gross national income or national investment). This fact might lead one to conclude that foreign aid was highly effective in Bangladesh. However, this conclusion can be misleading. There were other intervening influences that may have confounded the impact of foreign aid such as the hefty inflow of foreign remittances, the emergence of an economically vigorous garment and apparel industry that attained global success, and a dynamic non-governmental sector that had an acknowledged effect in initiating and sustaining microenterprises and delivering social services. All of them had a salutary effect in improving the social and economic indicators of the country.

At the micro-level, analysis of aid effectiveness would entail an examination of the performance of aid-funded projects and programs. This can be gleaned from the post-project evaluation reports and portfolio assessments of donor agencies. This body of works reviews the success and failures of completed projects and programs of donor agencies and implementation risks associated with various ongoing projects and programs. They highlight various policy constraints and implementation bottlenecks. In the case of Bangladesh, a review of the country's performance at the micro-level suggests that while the country has improved its performance in aid effectiveness over time, many problems still abound.

Finally, at the meso-level, analysis of aid effectiveness entails an examination of the impact of foreign aid on the country's institutional and policy frameworks. In this connection, it is suggested that foreign aid has an adverse impact on institutional and macroeconomic frameworks. In particular, the real exchange rate and the quality of governance suffer. In the case of Bangladesh, for example, it seems foreign aid had little or no negative effect on the real exchange rate and on the country's international competitiveness. However, in governance, the experience had been more or less in conformity with prior expectations. Indeed, data suggest that the country has experienced some serious deterioration in some dimensions of governance (World Bank 2013). In particular, corruption remains a significant issue and has shown few signs of retreating. In recent years, the government became embroiled in some serious controversies about corruption in donor funded projects. The largest aid-funded infrastructure project for the construction of the Padma Bridge, costing $2.9 billion dollars, was defunded by the World Bank and other international donors for alleged corruption.

An in-depth country study is also an ideal vehicle for identifying various economic, social, political and cultural constraints that hinder effective implementation of development assistance. Such a study can be informed by the evaluation studies of international development agencies. These studies highlight important country-specific bottlenecks — including political-economic constraints — in the smooth implementation of foreign assistance projects and various institutional and policy improvements required to overcome them.

5 Conclusion

This paper argues that empirical research on foreign aid must be reframed. The focus of the research needs to 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? Research needs to focus on why, how and when foreign aid has worked in particular societies. Only by finding the mechanisms and

processes that explain why and how aid works in a particular society will it be possible to design and deliver foreign aid effectively.

This discovery would require going beyond the narrow analytics of cross-country growth regressions or for that matter RCTs. As a tool, cross-country growth regressions have proved to be too coarse to capture the complex mechanisms and processes undergirding aid effectiveness. Similarly, RCTs have their own shortcomings. They focus exclusively on the average impact; they provide little or no light on causality; and they also lack external validity. All these reasons make RCTs an unreliable analytical basis for formulating robust strategy and policies at the macro-level. 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.

Currently, there is a huge disjunction between research and practice, similar to what transpired in other sciences in earlier times. According to Mukherjee (2010), little interactions took place prior to the 1960s between those who studied cancer in the laboratory and those who treated cancer in the clinic: "The two conversations seemed to be occurring in sealed and separate universes." Researchers and the community of practice in foreign aid seem to similarly inhabit two separate universes. However, as the history of biomedical sciences suggests, the prospects of breakthroughs in intractable diseases are greatest when there is a tight feedback mechanism between research and practice. The field of foreign aid is no exception to this general rule.

Nevertheless, an enormous chasm persists between the universe represented by research and the universe represented by the community of practice in foreign aid. While the international community has embraced the millennium development goals for poor countries and adopted poverty alleviation as the overarching objective of economic development, these goals have found little reflection in the empirical analyses of mainstream economists working on aid effectiveness. The reasons for this benign neglect are manifold. Some resisted it on ideological grounds and argued that this shift of objective from economic growth to poverty alleviation was somewhat misguided.

According to Shleifer (2009), this shift would lower the accountability for donors and turn foreign aid into an international welfare program for developing countries. Some argued that growth and poverty were essentially the same — old wine in a new bottle. As Easterly (2003) puts it: "The aid bureaucracies define their final objectives as 'poverty reduction' (today's more politically correct name for 'growth')." However, it is wrong to equate the two; income and poverty indicators do not always move in synchrony. For example, even though Bangladesh has half the income of India on a per-capita basis, it outperforms India in almost all social and human development indicators (Dreze and Sen 2011). Finally, others cling to their old habits; as such a shift of focus from economic growth to poverty and human development would dislodge many economists from their academic comfort zone of growth empirics.

Nevertheless, such a reframing of the inquiry is important to make research more relevant. Economics is a social science that is meant to find cures for the economic maladies of societies, something that requires unrelenting search for answers and continuous experimentation with policies, something which is achieved through a process of trial and error. This process can be more fruitful if a closer interaction exists between research and practice.

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