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# The Politics of Effective Foreign Aid

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growth, political institutions, exogeneity

## Abstract

There is little consensus on whether foreign aid can reliably increase economic growth in recipient countries. We review the literature on aid allocation and provide new evidence suggesting that since 1990 aid donors reward political contestation but not political inclusiveness. Then we examine some challenges in analyzing cross-national data on the aid/growth relationship. Finally, we discuss the causal mechanisms through which foreign aid might affect growth and argue that politics can be viewed as both (*a*) an exogenous constraint that conditions the causal process linking aid to growth and (*b*) an endogenous factor that is affected by foreign aid and in turn impacts economic growth.

## INTRODUCTION

Twelve years ago, the World Bank's report *Assessing Aid: What Works, What Doesn't, and Why* (1998) inaugurated a line of research that tries to determine the conditions under which foreign aid leads to economic growth. That study and the main research behind it (Burnside & Dollar 2000) emphasized that foreign aid spurs growth when recipient countries pursue "good" economic policies such as low inflation, low budget deficits, and high trade volume. This intuitive and appealing finding was initially highly influential, but it also generated a series of critical studies that argued foreign aid either led unconditionally to economic growth, did not lead at all to economic growth, or led to economic growth conditional on other factors (Hansen & Tarp 2000; Hansen & Tarp 2001; Lensik & White 2001; Clemens et al. 2004; Dalgaard et al. 2004; Easterly et al. 2004; Roodman 2007, 2008b; Rajan & Subramanian 2008). This research agenda has in many ways stalled amid criticism related to poor identification, self-inflicted endogeneity, and the general limitations of cross-country growth regressions.

Nonetheless, a very public debate has emerged between "aid optimists" such as Sachs (2004), who believe that substantial increases in foreign aid—the so-called "big push"—are necessary to lift the world's poor out of poverty, and "aid pessimists," such as Easterly (2006), who argue that piecemeal aid projects with narrow, easily measurable goals are the only effective use of foreign aid. To a certain extent, both sides ignore the politics of foreign aid. Optimists appear to assume that a massive scale-up in aid will be used as economic theories predict, ignoring the possibility that governments have incentives to divert aid funds for their own purposes. The pessimists, meanwhile, argue that donors should bypass recipient governments and give aid directly to the poor (Easterly 2006, p. 368), ignoring the political and technical difficulties of doing this. Neither perspective directly addresses the governance question, and many of the economists involved in the aid/growth

debate ignore the messy world of political institutions and political decision making except to underscore that, historically, much aid has been distributed to corrupt and badly governed regimes.

To understand how aid can promote growth, we need to think through the political processes that shape how aid is used in recipient countries and examine how foreign aid shapes recipient leaders' incentives to pursue growth-promoting policies and develop growth-promoting political institutions. Political leaders (and even nongovernmental organizations) who receive aid are located in different types of institutional settings that place different sets of constraints on their behavior. Understanding how aid is likely to be used in these different types of institutional settings will offer insight into whether and how aid promotes growth and development.

At the moment, there is no simple conclusion on the relationship between foreign aid and economic growth. There are basic reasons to believe that foreign aid—through the simple mechanism of injecting additional resources into an economy—should foment economic growth. There are also reasons to believe, however, that foreign aid—through indirect channels—can provide cover for governments undertaking poor economic policies, facilitate the persistence of political institutions that hinder economic growth, interfere with technocratic planning processes, or displace domestic business and investment. Therefore, in this review, we emphasize the importance of assessing exactly how foreign aid affects economic growth and clearly tracing the causal pathway(s) through which aid might positively or negatively lead to economic growth. We begin by briefly reviewing the literature on aid allocation and presenting some new evidence on donors' responsiveness to the political characteristics of aid recipients. Then we look at remaining challenges to identifying the true relationship between foreign aid and growth and suggest some possible directions in which this research program can evolve. Finally, we

discuss the pathways through which aid might affect growth and review how well empirical papers have done at identifying the pathways through which aid operates.

## THE POLITICS OF AID ALLOCATION

Critics of foreign aid frequently begin their argument by citing the abysmal historical record of foreign aid (Easterly 2001, Easterly 2006, Moyo 2009). Aid has failed to spur economic growth in the places where it could perhaps do the most good—the poorest countries in the world, particularly those of sub-Saharan Africa. A recent article, for example, begins by tabulating a cumulative \$2.3 trillion in foreign aid over the past 50 years, noting that there has not been much economic growth to show for it (Easterly & Pfitze 2008). To critics, this money is not only a colossal waste, but perhaps worse: a pernicious force that breeds corruption, deters democracy and good governance, and ultimately impedes economic growth.

One difficulty in assessing the effectiveness of foreign aid in fostering economic growth is that we know significant amounts of aid were never intended to bring about economic growth but rather were given to governments for geopolitical reasons. The literature on aid allocation shows that recipient-country need is only one factor among many strategic interests for donor countries (Frey & Schneider 1986, Schraeder et al. 1998, Alesina & Dollar 2000, Neumayer 2003a, Andersen et al. 2006, Easterly & Pfitze 2008, Dreher et al. 2009). With a few notable exceptions (Alesina & Weder 2003), research showing that donors rarely give aid nonstrategically conforms nicely with the pessimistic view of some of the aid literature (Easterly 2006, Moyo 2009).

Recent research examining how the determinants of aid allocation vary over time, however, suggests that this picture is a simplification. While Easterly & Pfitze (2008) state that the proportion of aid distributed to corrupt countries has not changed over time and

Neumayer (2003b) finds little evidence that donors respond in a consistent way to the governance characteristics of recipient countries, Dollar & Levin (2006) argue that some donors are quite good at giving aid to countries with sound policies and good governance, although only in the post-Cold War period. Hyde & Boulding (2008) find evidence suggesting that, at least in the 1990s, bilateral donors systematically punished undemocratic behavior by withdrawing aid to recipient countries failing to hold free and fair elections. Claessens et al. (2009) argue that the influence of strategic (or nondevelopmental) factors in aid allocation have faded over time.

Alternatively, donors could allocate different types of aid to different types of countries. Bermeo (2008) shows that the type of aid donors distribute varies by whether or not the recipient country is relatively well-governed. Well-governed countries are more likely to receive development aid (e.g., for economic infrastructure), whereas poorly governed countries are more likely to get only emergency relief aid. This pattern, however, only holds for data from 2000–2005 and not for data from the 1980s, suggesting some change in donors over time. Similarly, Neumayer (2005) finds that food aid in the 1990s is largely driven by recipients' need and not by donors' strategic interests, and Winters (2009) shows that the World Bank varies the types of projects that countries receive according to their governance characteristics. Breaking down foreign aid into different components provides some evidence that donors have become “smarter” over time, either by responding to the governance characteristics of recipient countries when determining their overall aid allocations or by distributing different types of aid in response to governance problems, corruption, or antidemocratic behavior in those countries.

We add to this recent evidence here by looking at how changes in political institutions in recipient countries have been rewarded (or not) by OECD donors over time. We measure the outcome variable aid using the constant dollar figure from Roodman's (2008a) Net Aid

Transfers (NAT) data set, which improves on the net Overseas Development Assistance (ODA) measures used in most existing research (Roodman 2007). The NAT measure is aid net of payments on loan principle or interest, whereas net ODA is only net of payments on the principle. NAT also does not count the cancellation of foreign debt as an aid transfer, whereas the net ODA measure does. As Roodman describes, in 2003 wealthy donor countries canceled nearly \$5 billion of non-ODA debt owed by the Democratic Republic of Congo (DRC), which implied \$5 billion of net ODA but is excluded in the calculation of NAT because no new aid money was transferred to the government of the DRC. We take the logarithm of NAT to ensure that outliers do not drive the analysis and to allow us to interpret the results as elasticities.

To capture changes in political institutions, we use Coppedge et al.'s (2007) variables, *contestation* and *inclusion*. These variables are derived from common factor analysis of 11 measures of democracy and are meant to comprise the two dimensions of Dahl's (1971) definition of democracy. We create variables that indicate an increase or decrease in *contestation* and *inclusion* of more than 0.5: *MoreContest*, *LessContest*, *MoreInclusion*, *LessInclusion*. (The within-sample

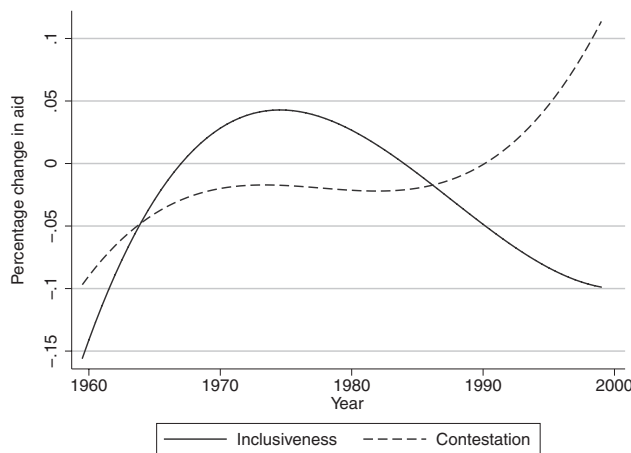
standard deviation is 0.91 for *contestation* and 1.05 for *inclusion*.) The data cover the years 1960–2000 but exclude countries with populations less than one million in 1980. To capture time trends we use a cubic function, and we interact the indicators for changes in political institutions with the time trend. This results in the following specification for *contestation*:

$$\begin{aligned} \log(Aid) = & \log(Aid)_{t-1} + MoreContest \\ & + LessContest + MoreContest * T \\ & + LessContest * T + T + \log(GNPpercapita) \\ & + \log(population) + \zeta_i + \varepsilon \end{aligned}$$

where  $T$  is the vector of time trends:  $T = (Time, Time^2, Time^3)$ ,  $\zeta_i$  is a vector of country fixed-effects, and  $\varepsilon$  is an error term. We use a similar equation for *inclusion*.

Figure 1 shows how foreign aid allocation has responded to increases in *contestation* and *inclusiveness* over time. The aid reward for increased *contestation* is increasing over the sample period, to the 5%–10% range by the mid-1990s. Donors' response to increases in *contestation* appears to be slightly negative for the 20 years preceding 1990 and strongly negative in the 1960s—suggesting that donors actually punished recipient countries for increased *contestation* during this decade. Overall, the reward for improved *contestation* appears to be increasing over time. The pattern for *inclusiveness* is less promising. The results suggest that donors actually punished increased *inclusiveness* with less aid in the 1960s and again in the 1990s. Although the patterns during the Cold War may not be too surprising, the responses of donors to improvements in *contestation* and *inclusiveness* appear to work at cross-purposes during the 1990s, rewarding increased *contestation* but punishing increased *inclusiveness*.

We take these patterns as a starting point from which to enter the debate about aid effectiveness, drawing two preliminary conclusions. First, we might only expect aid to have a positive effect on growth and development in the post-Cold War world, in which donors could at least plausibly be viewed as being less influenced by alliance politics (Bearce & Tirone 2009). This



**Figure 1** Foreign aid and improvement in *contestation* and *inclusiveness*. The graph shows time trends of the percentage change in aid resulting from an improvement in *contestation* and *inclusiveness* in the past two years.



calls into question the conclusions of empirical studies of foreign aid effectiveness that rely heavily on data from before 1990. Put another way, is it fair to judge the current state of foreign aid by looking at historical data, when we know that aid was distributed and used under conditions very different from those we face today?

A second, albeit very tentative, conclusion from this descriptive analysis suggests that any improvements over time in the way donors distribute foreign aid may be the result of an increased focus on political contestation—essentially more elections and/or perhaps more competitive elections. If increased political competition is indeed the best way to ensure that aid money is well spent, then these results suggest a genuine improvement over time. However, recent work calls into question the helpfulness of donor-induced elections in countries with weak states and little social cohesion (Collier 2009). Some find that democracy actually increases the risk of political violence in poor (and hence heavily aid-dependent) countries (Collier & Rohner 2008), and the violence following the most recent Kenyan election is a sobering reminder of the need for caution (Ksoll et al. 2009). The singular focus on contestation may miss an important avenue through which aid can foster growth: inclusion. Theories that stress the redistributive implications of democracy suggest that democratic institutions credibly lock-in power for poorer voters who prefer more government redistribution—and presumably prefer more propoor government policy. If the mechanism through which aid promotes growth runs through government policies that better reflect the interests of the poor, and if inclusive political institutions are necessary to guarantee propoor policies, then the post-Cold War changes to aid allocation patterns may not actually change the aid/growth relationship. Nonetheless, the possibility that foreign aid distribution follows very different patterns before and after 1990 should lead us to think theoretically about what has changed in the modalities of foreign aid since the end of the Cold War.

We again emphasize that this is an area where the causal mechanisms that link aid to growth matter crucially. Is aid conditionality now credible to the extent that foreign aid can more forcefully encourage countries to pursue progrowth policies? If so, giving conditional aid to even poorly governed states (that have an incentive to trade reform for aid) may spur growth. Or does the allocation pattern instead reflect the fact that donors now have the freedom and know-how to target the right kind of aid to each kind of recipient, for example, forsaking direct transfers to governments in poorly governed countries and instead only sending disaster relief that bypasses the government?<sup>1</sup>

In the next section, we discuss the challenges of establishing exogeneity in aid/growth regressions. This is a challenge in many types of empirical studies, but it poses particular difficulties for those studying the effect of aid on economic growth, in part because donors may be likely to give aid precisely to those countries with poor growth records. The final section examines the causal mechanisms through which foreign aid might affect economic growth: Can aid improve growth-promoting capital spending? Can aid buy growth-promoting reform? This discussion helps us pinpoint how political institutions fit into the aid/growth nexus by positing that politics can be viewed as both an exogenous constraint that conditions the causal process linking aid to growth and an endogenous factor that is affected by foreign aid, which in turn impacts economic growth.

<sup>1</sup>This modality of aid-giving is fraught with its own problems. Donors must find appropriate nongovernmental partners to distribute aid. Operating outside of official channels makes coordination of relief efforts more difficult, and, at an extreme, external financing may displace efforts that governments would have made. For example, some observers blame international relief aid distributed directly to refugees in eastern Congo after the Rwandan genocide for strengthening the Hutu militias and genocidaires (Wrong 2001). On the other hand, a review of relief aid in Aceh following the December 2004 tsunami credits some of the humanitarian success to the Indonesian government's prominent role in organizing external funds (Masrafah & McKeon 2008).

### THE CHALLENGES OF ESTABLISHING EXOGENEITY IN AID/GROWTH REGRESSIONS

A perpetual challenge of cross-country growth regressions is to establish the exogeneity of aid to ensure that the equation does not simply pick up the extent to which growth outcomes affect the allocation of aid. The most common way to address this concern is to use instruments for aid, which in turn requires that the variables employed as instruments are correlated with aid but not causally related to growth. For example, the seminal Burnside & Dollar (2000) paper uses a set of instruments that includes indicators for some plausibly exogenous factors such as known strategic aid relationships, but it also includes interactions between their macroeconomic policy index and population and GDP per capita. It is not entirely clear why these policy interactions would be exogenous to growth, which may mean that their first-stage regressions violate one of the key criteria for instrument validity (Clark et al. 2006). Further, the instruments cannot be correlated with factors other than aid that are also causally linked to growth (Bazzi & Clemens 2009, Deaton 2009). Another variable frequently used as an instrument is arms imports. However, this variable is likely to be correlated with things such as civil conflict and coups that also affect growth, calling into question its usefulness as an instrument even before we consider the fact that aid might be causally related to military spending, coups, and conflict (Grossman 1992; Collier & Hoeffler 2002, 2007).

In addition, many aid/growth regressions use geographic or regional indicator variables as instruments. For example, dummy variables for Egypt or the franc currency zone are sometimes employed as instruments because they represent strategic aid allocation that is unlikely to be causally related to growth outcomes. However, these instruments have no temporal variation, which limits inferences about how aid affects growth over time. Werker et al. (2009) use oil-price fluctuations as an

instrument for aid from OPEC countries, in part because variation in oil prices over time circumvents this issue. They find that aid has no effect on growth but depresses domestic savings and increases consumption of noncapital imports.

Some scholars suggest that the political and strategic determinants of aid, such as rotating membership on the U.N. Security Council or colonial relationship with a donor, may provide useful instruments for aid because these factors are causally unrelated to growth (e.g., Powell & Bobba 2007, Rajan & Subramanian 2008). However, if we believe that strategic aid should have little effect (or even a negative effect) on growth, but that nonstrategic aid can increase growth, then using strategic variables as instruments for aid will only pick up the causal effect of the type of aid that is unlikely to be correlated (or negatively correlated) with growth (Bearce & Tirone 2009). If there is causal heterogeneity among the different types of aid (strategic and nonstrategic), then strategic instruments may be of little use in modeling the impact of the most potentially effective type of aid (Dunning 2008).

Finally, Roodman (2008b) points out that much of the empirical aid/growth literature uses a dependent variable that is endogenous by construction. Foreign aid is often standardized by GDP (Aid/GDP). Because the dependent variable is economic growth, or change in GDP, an increase in GDP may entail a decrease in Aid/GDP. Thus, by construction, the causal arrow points from growth to aid. To circumvent this problem, it may be better to standardize aid by population or simply to lag the aid variable. Bearce (2009) and Bearce & Tirone (2009) follow this latter strategy, in part because lagging aid also captures their causal mechanism; they argue that aid takes some years to cause economic reform, which in turn takes some time to affect growth. Rajan & Subramanian (2008) also experiment with different lags of aid, but they find no consistent effect on growth.

## HOW POLITICS ENTERS THE AID/GROWTH NEXUS

Researchers commonly cite two basic causal mechanisms through which foreign aid can affect growth. The first explanation, and the one most often used historically to justify large aid donations, argues that aid can increase capital spending in the recipient country (Rosenstein-Rodan 1943, Chenery & Strout 1966). Beginning with an early generation of development economists, implemented by the big-push theorists in the immediate postcolonial period, and finding favor most recently with Sachs (2004) and his colleagues at the United Nations, this mechanism suggests that aid will translate into capital spending and that this capital spending will in turn lead to growth. Poor countries in tropical Africa face a dearth of domestic savings and thus do not have the necessary capital to jump-start sustained growth. According to this argument, massive infusions of well-targeted aid will push these countries past the capital threshold and toward sustained growth. Sachs' study makes the bold claim that in tropical Africa more aid is precisely what is needed.

This causal mechanism has two steps—both of which entail assumptions about the role of politics. First, politics might condition the relationship of aid to capital. Corrupt politicians in recipient governments may pocket aid well before it makes its way from the treasury to the budget. As Collier (2009) notes, politicians in poor countries often use their positions in office to amass personal fortunes. Political science is rife with studies linking political institutions to corruption (Persson et al. 2003, Chang 2005, Chang & Golden 2007), and scholars have long noted a strong correlation between corruption and arrested economic growth (Mauro 1995, Ades & di Tella 1999, Treisman 2000). Combining these insights suggests that political institutions that breed corruption may affect the relationship between aid and growth. Even when aid makes its way into the budget, governments often spend the resources on consumption goods rather than investment (Boone 1996), which may explain why aid increases

spending even when government revenue declines (Remmer 2004).

Second, capital spending must promote growth. However, not all capital spending is equal. While development economists have been relatively successful in identifying types of capital spending *outcomes* that promote economic growth (e.g., Papageorgiou 2003), political scientists have constructed many theories to suggest when and why politicians spend on programs that are more likely to reach larger segments of society (Bueno de Mesquita et al. 2003) and promote growth (e.g., Stasavage 2005 and Hicken & Simmons 2008) and not simply result in inefficient patronage spending (Jackson & Rosberg 1984; van de Walle 2001, 2003; Golden 2003).

If capital spending were the only mechanism through which foreign aid affected economic growth, it would be relatively straightforward to use the insights from political science to understand how politics conditions the aid/growth relationship. The political institutions in a country—institutions that facilitate rent seeking or not, that facilitate corruption or not, that facilitate accountability or not—determine how aid resources get spent. In this scenario, however, institutions remain exogenous: They condition the relationship between aid and growth, but the effect of aid on growth does not flow endogenously through aid's effect on the institutions themselves.

Treating institutions as a conditional but exogenous factor follows the lead of Burnside & Dollar (2000), who posited that the correct macroeconomic policy environment was sufficient for aid to spur growth. Instead of pinpointing economic policies, the research linking political institutions to corruption and patronage spending suggests that giving aid to recipients with a good political or governance environment means aid will promote growth. Conversely, giving aid to a country with a bad environment simply wastes aid (Dollar & Burnside 2004). According to this logic, the worst-case scenario merely entails aid being wasted; that is, if political institutions are exogenous, aid is not “perverse,” “pernicious,” or a “curse.”

The second mechanism through which foreign aid can affect growth is by changing the political or economic institutions of an aid-receiving country. Many foreign-aid critics implicitly finger this mechanism when offering theories and evidence to suggest that aid is “pernicious” or a “curse” similar to a natural resource curse (Friedman 1958, Bauer 1971, Djankov et al. 2008, Moyo 2009). The relationship runs both directly through the impact of external resources on the domestic institutions handling those resources and also through the use of foreign aid as a tool by which donors can “buy” economic or political reforms.

The direct link between aid and institutions is seen in theories suggesting that aid creates incentives for increased rent-seeking behavior (Svensson 2000a, Hodler 2007). Under this scenario, foreign aid increases the size of the revenues available for rent-seeking, and more (nontax) revenue increases rent-seeking behavior (Torvik 2002), which in turn stunts growth by introducing economic and bureaucratic inefficiencies (Krueger 1974, Murphy et al. 1993). The other link between aid and institutions suggests that donors can threaten to withhold foreign aid unless the recipient country pursues economic reforms or improves governance (Svensson 2000b). This aid conditionality should result in national institutions and policies that improve economic growth.

We proceed by reviewing the evidence of the conditional impact of foreign aid depending on the quality of governing institutions; then we return to the question of whether or not aid affects the quality of institutions. We also discuss how conditionality has changed over time and how the composition of aid flows has changed.

### **Do Political Institutions Condition the Aid/Growth Relationship?**

Burnside & Dollar (2000) confirmed much of the conventional wisdom in the economic-development community at the time: Economic policy matters, and inducing orthodox neoclassical economic policy reform is not only good

for growth but also makes foreign aid more effective. [Some scholars have criticized the paper for being politically motivated, with the goal of endorsing neoclassical economic orthodoxy (Stein 2008).] This avenue of the research on aid effectiveness has since been dissected to the point where scholars, far from finding consensus on the relationship between aid and growth, can describe the state of the empirical literature as “anarchy” (Roodman 2007). In the most comprehensive set of panel and cross-section tests to date, Rajan & Subramanian (2008) find little consistent evidence that aid affects growth—one way or another. They analyze different time periods, various time horizons and lags, many types of assistance, distinct types of donors, and whether aid effectiveness is conditioned by geography or macroeconomic policy.

This literature, though, has only fleetingly looked at how the political or governance environment might condition aid effectiveness. Some of the first attempts to examine whether aid was more effective in more democratic or more free regimes found either null results (Boone 1996) or some mildly positive results (Svensson 1999). Both of these studies, though intriguing, only included data up to 1989. Using the same data set as many previous studies (Easterly et al. 2004), Wright (2007) found largely null results for three different measures of democracy (Polity, Freedom House, and a binary indicator), suggesting that democracy, at least as we frequently measure it, does not condition the relationship between foreign aid and economic growth.

However, others have found that some political environments are more conducive to effective aid. In a follow-up to their original article, Dollar & Burnside (2004) replace their macroeconomic policy index with a measure of institutional quality to show that foreign aid led to economic growth during the 1990s in countries with good institutions. Looking beyond economic growth, Kosack (2003) demonstrates a conditional relationship where foreign aid has a negative effect on changes in a country’s level of human development unless there



is a sufficiently high level of democracy in the country. Kosack & Tobin (2006) similarly show that aid to countries with high human capital endowments is positively correlated with both economic growth and improvement in human development indices. Their argument emphasizes the role of government preferences in using aid to boost human development: Governments that already promote human capital are likely to use aid to promote further human development. Mosley et al. (2004) and Gomanee et al. (2005) show that aid can positively affect economic growth and human development once they account for the spending priorities of recipient governments, and Baliaoune-Lutz & Mavrotas (2010) find that social capital, measured as ethnolinguistic fractionalization, and institutional quality condition the aid/growth relationship.

At the level of individual aid projects, Isham et al. (1997) find that World Bank projects perform better (in terms of their economic rate of return) in countries with better civil liberties. They provide evidence suggesting that the ability of citizens to engage in protest makes projects more effective. Similarly, Dollar & Levin (2005) show that World Bank projects are rated more satisfactory in countries that have higher-quality institutions (measured in several different ways). These papers support the contention that foreign aid will be more effective in the context of good institutions.

Some recent work looks even more specifically at the characteristics of particular governments and regimes. Wright (2008, 2010) separates aid-recipient nondemocracies and democracies to examine variation within regime type. In authoritarian regimes, Wright (2008) finds that a dictator's time horizon conditions the relationship between aid and growth: Dictators who expect to remain in power for a long time appear better able to make use of foreign aid for economic growth. Building on research on the consequences of personalist electoral institutions (Carey & Shugart 1995, Hicken & Simmons 2008), Wright (2010) shows that political institutions that provide an incentive to cultivate a personal

vote negatively condition the relationship between foreign aid and economic growth.

These studies focus on the incentives particular governments face over how to use foreign aid, positing that "good" incentives lead to "good" aid outcomes. Dollar & Burnside (2004) employ a cross-national measure of institutional quality, whereas Wright (2008, 2010) measures these incentives directly. Others directly measure government spending priorities (Human Development Index, propoor spending) and suggest that these condition the effect of aid (Gomanee et al. 2005, Kosack 2003, Kosack & Tobin 2008, Mosley et al. 2004).

One recent finding on the conditional effect of political institutions implies that regime type affects whether or not aid can buy economic reforms that spur growth. Bearce (2009) posits that foreign aid conditionality is more likely to induce recipient governments to pursue economic reform when the political cost of reform is relatively low. He also contends that these reforms are less costly for autocratic leaders, who do not face the same political pressures from reform "losers" as democratic leaders. Autocratic leaders, therefore, are more inclined to respond to aid by pursuing reforms, and thus aid is more likely to spur growth in authoritarian governments than in democracies. Bearce provides empirical evidence of this second step in the causal chain: He finds not only that aid increases growth, conditional on regime type, but that aid spurs economic reform, again conditional on regime type, *and* that this reform improves growth. This is one of the first studies to trace the causal mechanism from aid to another factor and then from that factor to growth, setting a high standard by showing empirical evidence consistent with each step in the causal chain.

### How Does Aid Affect Political Institutions and Governance?

A long-running argument in the foreign-aid literature claims that aid hinders political development by contributing to the development of "bad" institutions (Bauer 1971, Djankov et al.



2008). This view groups foreign aid together with other types of “unearned income” such as natural resource wealth to argue that nontax revenue enables leaders to forgo taxing the citizenry, which results in a decreased demand for representative democracy and good governance (Brautigam & Knack 2004; Moss et al. 2006; Morrison 2007, 2009; Djankov et al. 2008). This logic builds on the work of scholars such as Levi (1988), Tilly (1990), and North & Weingast (1989), who posit that democracy rests in part on the need for state leaders to generate revenue from citizens. In Western European political development, governments exchanged representative rule for the right to tax citizens, and these representative institutions, in turn, helped propel economic development (North 1990).

Foreign aid, therefore, severs the link between the ruler and ruled by reducing the “incentives for democratic accountability” (Djankov et al. 2008, p. 172) or appeasing demands from poorer citizens “and thereby prevent[ing] a . . . transition to democracy” (Morrison 2009, p. 113). Ultimately, this allows the government to forgo some of its responsibilities for public goods provision and equitable development (Moore 1998). Evidence also shows that aid reduces tax revenue and increases government consumption without increasing investment (Brautigam & Knack 2004, Remmer 2004). [However, Gupta et al. (2004) show that only grants (and not loans) adversely affect revenue collection.]

Some argue that foreign aid presents a moral-hazard problem for recipient governments because they face little incentive to pursue growth-friendly policies if they know that donors will continually give them aid so long as they remain poor (Svensson 2000a). This claim suggests that recipient-country governments have an incentive to remain poor in order to receive more foreign aid, so they deliberately pursue policies that hurt growth. As Easterly said in a now-famous quip, “The poor are held hostage to extract aid from the donors” (Easterly 2001, p. 116). Evidence suggests that countries are more risk acceptant when they expect large

aid inflows. For instance, loan recipients pursue monetary expansion and have higher budget deficits when they have exhausted less of their borrowing potential from the International Monetary Fund (IMF) (Dreher & Vaubel 2004).

However, we need to examine whether the causal mechanisms that link aid to poor governance and arrested political development vary across types of aid, types of donors, and types of recipient governments. In many cases, researchers outline the underlying causal mechanisms they claim are at work without directly testing the arguments. As described above, aid might reduce the need for taxation, thereby reducing the demand for democratic accountability (Knack 2004, Djankov et al. 2008); or aid might increase the power of the president in democracies (Brautigam 2000); or aid might increase political instability by “making control of the government and aid receipts a more valuable prize” (Knack 2004, p. 253)—reasoning similar to Grossman (1992). However, this research does not test these channels (taxation, presidential power, or coup attempts) of the aid curse; it only suggests that one of these explanations must be true if a negative correlation exists between aid and democracy.

Some recent research explicitly models the causal mechanisms that link aid (and nontax revenue generally) to political development. For example, Morrison (2007, 2009) argues that nontax revenue allows authoritarian governments to reduce the “demand for democracy” by increasing redistributive transfers to poor citizens who might otherwise press for democratization. This theory has observable implications both for the effect of foreign aid on regime stability and for its effect on redistributive policies under authoritarian rule and taxation under democracy: Aid increases regime stability, increases social spending in authoritarian countries, and decreases the tax take in democracies. If this is true, the effect of aid on political development might prop up both democracies and autocracies. Further, this theory implies that aid, while deterring democratization in authoritarian polities, may

do so precisely by increasing the welfare of the poorest citizens. Morrison advances our knowledge of the political effects of nontax revenue by carefully specifying a causal story and then providing empirical evidence consistent with at least three different implications of the theory.

Smith's (2008) model posits that when leaders are faced with a revolutionary threat, they can respond by either increasing or decreasing the supply of public goods, depending on the (a priori) size of their support coalition. In regimes with large coalitions, an increase in nontax resources such as foreign aid or oil revenue provides leaders with the incentive to increase the supply of public goods, even though this may enhance the capacity of citizens to revolt by reducing the costs of mobilizing mass political actions. However, increased provision of public goods also decreases the desire for revolution by increasing the citizens' stake in the current regime. Alternatively, when leaders in small-coalition regimes meet with an increase in free resources, they respond to threats by decreasing the supply of public goods with little concern for deteriorating economic performance and declining tax revenue. In these regimes, the survival benefits of preventing revolution by further reducing public goods provision outweigh the potential benefits of reducing the desire for revolution by increasing public goods provision. Therefore, in small-coalition regimes, nontax resources should decrease public goods spending. This finding is the opposite of Morrison's prediction of increased public goods spending in authoritarian states.

By highlighting varying causal mechanisms, as Morrison and Smith do, we can think through more carefully how aid affects political development in different contexts instead of simply searching for average effects. That said, Smith's theory does not account for the differences between types of nontax revenue, even though oil revenue and foreign aid are obtained through very different modalities (Collier 2006). Further, foreign aid can come with strong conditions from donors, and oil revenue is not necessarily exogenous to

tenure- or power-maximizing decisions of government leaders (Dunning 2010).

The empirical literature on aid and institutions is mixed. Consistent with aid critics, some researchers have found that aid is associated with decreases in institutional quality (Brautigam & Knack 2004) and democratization (Djankov et al. 2008), or that it has relatively little effect (either way) on democratization or changes in political institutions (Knack 2004). However, others have found that aid is associated with higher levels of democracy (Goldsmith 2001), in particular during the post-Cold War period and in authoritarian regimes with large support coalitions (Wright 2009).

One explanation for these seemingly contradictory results may simply be that the pessimistic findings generally estimate the average effect of foreign aid on political institutions or governance, whereas the more optimistic results stem from examining conditional effects. Dunning (2004), for example, replicates Goldsmith's (2001) finding that foreign aid is correlated with increases in democracy in Africa but then shows that this finding is only the result of post-Cold War processes, presumably the result of increasingly effective aid conditionality.

### **Aid Conditionality: Variation in Donors, Recipients, and Time Periods**

Donors often attach policy conditions to the aid that they provide. As Riddell (2007) describes, this is "one of the most controversial issues in the debate about whether aid works: the relationship between the overall impact of development aid, the policy advice given by donors, and the policies pursued by aid-recipient governments" (p. 231). The general goal of conditionality is to induce governments to undertake economic (or possibly political or institutional) reforms that will spur economic growth. (Critics of these reforms, however, suggest that liberalizing reforms are simply an attempt to open developing countries for the benefit of rich countries.) These reforms might



include lower budget deficits, fewer trade restrictions, or more secure property rights.

Conditions are often attached to large programmatic loans, such as direct budgetary support, balance-of-payments support, or structural-adjustment lending. Unlike project loans, where money is allocated for the clear purpose of building a specific dam or improving irrigation systems in one area of the country or something similar, this type of lending—which tends to involve much larger dollar amounts—is meant to “support” the required reforms. Essentially it serves an equivalent function to the government borrowing money on open capital markets for its annual budget, except that it comes with specific conditions attached and below-market interest rates. The money might be used, for example, to compensate the “losers” of the reforms if the reforms are politically costly (Heckelman & Knack 2007, Bearce 2009, Bearce & Tirone 2009). However, the appropriate price of particular reforms remains unclear. For example, should donors give \$100 million, \$250 million, or \$500 million if they want a country to privatize its pension system?

Conditionality is important with project lending as well. Given the fungibility of aid funds (Feyzioglu et al. 1998), there may be the simple pair of conditions that project aid be used for its intended purpose and that the government not divert resources that it otherwise would have spent in that sector. The fear is that aid funds might allow the government to channel resources to sectors (e.g., military spending) that are likely to hurt rather than catalyze economic growth (Collier & Hoeffler 2007). Also, macroeconomic conditionality associated with programmatic lending might lead to better investment project outcomes. Isham & Kaufmann (1999) refer to this as the “forgotten rationale for policy reform” and provide evidence showing that the economic rates of return for World Bank projects are higher in countries with better macroeconomic fundamentals.

Although donors have always attached some conditions to their aid, the heyday of conditionality was the 1980s and early 1990s, the era of structural adjustment. Whereas World Bank

loans came with an average of seven conditions in the early 1980s, at the peak of conditionality in 1993, they came with an average of around 45 different conditions attached (World Bank 2005). Some critics of conditionality argue that it rides roughshod over national sovereignty and amounts to a form of paternalistic neocolonialism (Murray 2005), while others claim that conditionality has simply been ineffectual in removing macroeconomic distortions or stimulating economic growth (Easterly 2005). Today, in the era of country partnerships and recipient-driven development brought about by the 2002 Monterrey Consensus on Financing for Development and the 2005 Paris Declaration on Aid Effectiveness, donors frame conditionality in terms of helping countries to choose which reforms are most important to them rather than as an imposition from Washington, DC, or elsewhere. This more participatory approach evolved, in part, from the experience of having reforms revoked (World Bank 2002). Building a political consensus behind reforms can potentially make them more sustainable and hence effective (Morrison & Singer 2007).

Setting aside the questions of whether particular economic reforms do spur growth, how the set of reforms for a given country is chosen, and whether increasing project proliferation hampers aid effectiveness, the argument that conditionality can affect growth depends on (a) the donor’s credibility in imposing conditions and (b) the recipient’s incentives and capacity to respond to conditionality by pursuing reforms. To understand whether and when conditionality can work, various scholars have examined how trading aid for reform varies by donor, recipient, and time period.

In an early work examining the political economy of structural adjustment, Dollar & Svensson (2000) find that democratic governments and governments that faced fewer crises were more likely to undertake reforms that the World Bank proposed, whereas governments that had been in power longer were less likely to undertake reform. They also find that ethnic fragmentation has a nonlinear relationship with reform. Using these political-economy

variables, the authors correctly predict the direction of 75% of reform outcomes and note that adding donor variables makes no improvement to their models' predictive power. Building on Kono & Montinola's (2009) insight that current aid has a higher marginal effect on political survival for democratic leaders than for dictators, Montinola (2008) posits that aid can buy fiscal reform in democracies but not in autocracies. Using similar reasoning, Girod (2007) argues that postconflict resource-poor countries have no option but to pursue the political and economic reforms outlined by donors because these governments lack other revenue sources. Resource-rich postconflict governments, she argues, have the capacity to resist requested reforms. Thus, postconflict aid is most likely to spur growth in resource-poor countries. Bearce (2009), in contrast, argues that aid can successfully buy reform in autocracies but not in democracies because reform losers can more effectively block economic reform in democracies.

All these theories argue that the political costs of complying with aid conditionality and the political benefits of aid itself vary by recipient country. However, none of this research addresses the capacity of recipient governments to pursue and implement economic reform. World Bank negotiations with officials in the former Zaire produced laughable (and ultimately tragic) anecdotes of donor officials pressuring President Mobutu Sese Seko to pursue reform while his army melted away and the state collapsed (Prunier 2009). Ultimately only some recipient countries have sufficient state capacity and control over their own territory to absorb aid and implement reform (Herbst & Mills 2009).

Other researchers focus on variation among donors, arguing that some donors in some time periods can more effectively impose credible conditions on aid. Heckelman & Knack (2007) examine the direct link between aid and economic reform and find that during the period 1980–2000, aid slowed economic policy reform in recipient countries. However, the negative effect of aid appears to be concentrated in the

1980s, suggesting that conditionality may have been more effective in the post–Cold War period, presumably because of changed donor attitudes. Bearce & Tirone (2009) examine the aid-reform bargain from the donor's side to posit that aid can only incentivize economic reform in recipient countries where donors do not have strategic goals. Thus, bilateral aid during the Cold War was ineffective in promoting reform because donors could not credibly commit to withdrawing aid from strategically important recipients even when reform was not forthcoming, but in the post–Cold War era, donors can make more credible threats to withdraw aid. Girod (2008) also focuses on the distinction between donors, arguing that because multilateral donors are not beholden to strategic interests, they can distribute aid for developmental purposes and effectively target aid to countries that pursue economic reforms. Multilateral aid is therefore likely to spur growth, whereas bilateral aid will not. Using data from the 1990s, however, Stone (2004) finds that IMF conditions are less likely to be enforced in recipient countries with strong ties to donor governments that maintain privileged influence on the IMF executive board, such as the United States, Britain, and France. This suggests that the poor record of IMF aid in Africa might be the result of poorly enforced conditionality rather than the use of the wrong policy conditions (Vreeland 2003). Similarly, Crawford (1997) argues that donors have been inconsistent in applying the same standard to all recipients—even in the post–Cold War environment.

Vreeland's (2003) argument focuses on how IMF program participation provides recipient governments with domestic political leverage to redistribute income upward, which hurts growth. Dreher's (2006) analysis goes one step further to examine how both IMF program participation and compliance with IMF conditionality affect economic growth. He finds that overall participation in IMF programs reduces growth but that compliance with loan conditions increases growth. Dreher implicitly focuses on variation among donors. These arguments about IMF program participation

implicitly address domestic politics and could be expanded by looking at variation among recipients.

Finally, scholars have modeled conditionality as strategic interaction between donor and recipient. Svensson (2000b), for example, examines a conditionality game with one donor and multiple recipients, while Stone (2002) introduces investors as a third player in addition to donor and recipient. In practice, recipient governments often deal with two or more donors of different types. Sometimes this occurs sequentially, as in Ethiopia, when Col. Mengistu Haile Mariam switched from Soviet to U.S. sponsorship; other times recipient countries were able to obtain aid from different donor types simultaneously. In the 1960s, Tanzania received Western aid for public health and education while simultaneously convincing the Chinese to build a railroad. During the Cold War period, aid from the Soviet Union and the Soviet bloc countries (and to a lesser extent China) was the main alternative to Western aid, whereas recently Chinese aid to Africa has increased substantially as the Chinese economy has grown (Tull 2006, Lancaster 2007, Woods 2008). This has brought renewed concern that other authoritarian countries, such as Iran, have entered the aid game, presumably to the detriment of democracy (Freedom House 2009). Models with two competing donor types could provide insight on how aid affects economic reform if the two donor types have different conditions or different levels of enforcement. To date, though, we lack systematic cross-country data on non-Western aid that is comparable across time with Western aid to empirically test such a model. However, this should not stop us from thinking through the implications for aid in a world of competing donors. The recent rise in aid from non-Western authoritarian countries points toward the possibility that a world with only one (Western) type of donor might have been a relatively rare historical episode in the 1990s, sandwiched between longer periods with at least two types of donors—Soviet bloc aid during the Cold War and current Chinese aid (Lancaster 2007).

Recently, Zimbabwe's unity government of President Robert Mugabe (Zimbabwe African National Union-Patriotic Front) and Prime Minister Morgan Tsvangirai (Movement for Democratic Change) has secured promises of nearly \$1 billion in aid from China but only \$500 million from Western donors. In a seeming replay of the Cold War, Kyrgyzstan has recently accepted aid from both Russia and the United States in exchange for permission to plant military bases on their territory.

### Types of Aid

Thinking through whether and how conditionality works or fails and understanding how the presence of non-Western aid affects the behavior of recipient countries raises the larger point of how different types of aid may be useful for testing distinct claims about the causal mechanisms that link aid to growth. Most studies examining the relationship between aid and growth use some form of the OECD Development Assistance Committee data, aggregated across all sectors and all donors (Burnside & Dollar 2000, Easterly et al. 2004, Roodman 2007). However, researchers may better capture the causal process by analyzing aid by type or donor. For example, Girod (2008) and Montinola (2008) argue that conditionality is only likely to work when the donor is not faced with competing strategic interests, and thus these authors look at multilateral aid. Clemens et al. (2004) suggest that we should not expect all types of aid to be positively correlated with growth, and thus they disaggregate aid by type. They distinguish between short-term aid (budget support, infrastructure investment, and agricultural and industrial support), which could plausibly increase growth in the near term, and other types of aid such as disaster relief (which should be correlated with negative growth) and education spending (which should be correlated with long-term but not short-term growth). They find that short-term aid does lead to economic growth unconditionally and with diminishing returns. In contrast, Rajan & Subramanian's (2008) comprehensive survey

of aid/growth regressions examines aid's long- and short-term effects as well as different lagged specifications but yields little evidence that any type of aid systematically increases growth.

Disaggregating data by type, sector, and purpose also allows researchers to more precisely assess the causal effect of aid on particular outcomes, such as health (Gebhard et al. 2008, Ravishankar et al. 2009), education (Dreher et al. 2008), the environment (Hicks et al. 2008), and democracy (Finkel et al. 2007, Stevens et al. 2007, Nielsen & Nielson 2008). The Project-Level Aid Database (PLAID) codes individual development assistance projects committed by bilateral and multilateral donors since 1970. These complete and consistent project-level aid data have already begun to bear fruit. For example, Hicks et al. (2008) use them to explore why environmentally "friendly" aid has increased over time and why many "unfriendly" aid projects persist. The PLAID data not only specify project purpose but also code the particular organizational beneficiary of the aid within the recipient country. This will allow researchers to examine one of the most pertinent issues in the aid debate (Easterly 2006): whether giving aid directly to governments or skirting governments in favor of nongovernmental organizations is the best way to distribute aid.

## CONCLUSION

Since Burnside & Dollar (2000) opened the aid/growth floodgate a decade ago, we have seen a profusion of cross-country regression analysis trying to determine what effect, if any, foreign aid has on economic growth. In this vast literature, scholars have changed model specifications, first-stage instruments, treatments of outliers, lag structures, definitions of aid, interaction terms, and more in attempts to find a

robust link between aid and growth. In this article, we have emphasized that, for all that has been done already, much work remains, especially in explicitly recognizing how politics enters into the aid/growth relationship.

First, we pointed out that international politics affects aid allocation as well as the credibility of aid conditions. In looking for a relationship between aid and growth, we need to be attentive to whether or not international politics constrains how aid money can be used and whether or not a recipient government thinks future aid money will be forthcoming.

Second, we discussed the ways in which governments might use an influx of revenue, depending on the political institutions that exist. From studying the politics of redistribution and the politics of rent-seeking, political scientists have a comparative advantage in analyzing the causal pathways through which aid might lead (or not) to capital investment, economic reform, and ultimately economic growth. We have stressed throughout this article that many studies in the aid/growth literature have come up short in specifying exactly how aid could lead to growth. Future research must pay more attention to what happens to the money once it enters a country's national budget. This becomes more pressing if aid agencies do not even know where their aid money goes, much less how it is spent (Ravishankar et al. 2009).

Some scholars have thought a lot about how aid affects the governing institutions and politics of recipient countries. This work is and will continue to be a crucial part of studying aid and growth. Foreign aid is not only exogenously affected by political institutions but also—particularly in countries with a sizeable aid-to-GDP ratio—endogenously determines the form of those institutions.

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