Aid and development

Will it work this time?

By Fredrik Erixon

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Executive summary

For fifty years, proponents of 'aid' have argued that poor countries are poor because they lack the funds to invest in the infrastructure that would enable economic activity to take place, which in turn means that they are unable to attract investment. Originally used to justify mega-projects, such as roads and dams, these arguments continue today in modified form, ostensibly justifying investments in schools and hospitals.

Donors have justified aid with various theories and political motivations, but its core justification, the 'gap theory', is fundamentally flawed. This theory assumes that poor countries are trapped in a vicious cycle of poverty because they are unable to save and hence have insufficient capital to invest in growth-promoting, productivity-enhancing activities. But there simply is no evidence that this savings/investment 'gap' exists in practice.

As a result, aid has failed to 'fill the gap'. Instead, it has, over the past fifty years, largely been counterproductive: it has crowded out private sector investments, undermined democracy, and enabled despots to continue with oppressive policies, perpetuating poverty.

'Gap theory' premise fundamentally flawed

The reason countries are poor is not that they lack infrastructure – be it roads, railways, dams, pylons, schools or health clinics. Rather, it is because they lack the institutions of the free society: property rights, the rule of law, free markets, and limited government.

- In a majority of poor countries, the average poor person is typically unable to own and transfer property. Courts of law are slow, expensive and corrupt.
- Government plays a large role in the economy and government policies undermine incentives to engage in mutually beneficent economic activities.

A review of the evidence suggests that when money is given to the governments of countries that do not have these institutions, it is not spent wisely.

- Very often, aid is spent on projects that benefit the political leaders at the expense of the citizens.
- Almost always, the money crowds out investment by the private sector and – because government is not good at making investment decisions – it undermines economic development.
- Often it has bolstered corrupt regimes that would otherwise have been thrown out.

Aid fails to fill the gap – in Africa and elsewhere

Africa received approximately $400 billion of aid from 1970 to 2000.

- Aid as a percentage of Gross National Income (GNI) grew continuously in Africa between 1970 and 1995, starting at around 5 per cent in 1970 and peaking at around 18 per cent.
- There appears to be an inverse relationship between aid and growth (see Figure 1, page 8), and this is not unique to Africa. Growth is higher in periods when the aid-to-Gross National Income ratio falls.
- Aid does not finance additional investment for which the recipient countries failed to marshal domestic resources. It simply frees central government resources for spending on current consumption – which in turn fuels corruption.

- Paul Rosenstein-Rodan, a former deputy director at the World Bank Economics department, observed: “When the World Bank thinks it is financing an electric power station, it is really financing a brothel.” (page 10)
- Meanwhile, the savings ratio (savings in relation to national income) has actually fallen when aid has increased. Research clearly demonstrates a negative effect of increased aid on savings in Sub-Saharan Africa.
- If the governments of the World’s richest countries do increase spending on aid to Africa by $25 billion, the consequences could be devastating.

In contrast, Aid to Asian countries has generally been small (below one per cent of GNI). Nevertheless, the aid that was received may have crowded out projects that would have resulted in long-term growth – and thus may have had a negative impact there also.

Overall in Asia, aid has not had a significant and positive effect on economic development. Millions of poor people live in India and China, but their economies are growing despite the insignificant role that aid plays in their investments. (see Figure 4, page 10)

Case study: Tanzania and Kenya

Aid played a significant role in Tanzania’s and Kenya’s economies – each received approximately US$ 16 billion between 1970 and 1996.

Following their independence, Tanzania and Kenya pursued a variety of unsound economic policies which led to economic stagnation and extreme poverty.

- Kenya pursued ‘import substitution’ through restrictions on imports, price controls, the establishment of marketing boards and nationalisation of industry – all of which led to economic stagnation and had a devastating effect on the country’s citizens.
- Tanzania pursued *ujamaa*, or ‘African socialism’, which involved the nationalisation of trade, absolute price controls, and the abolition of private ownership. As a result, Tanzanians were even poorer than Kenyans.

The countries exemplify two failed development models, one more extreme than the other, but both heinous. While a few reforms have occurred in recent years, entrenched economic and political interests prevent truly meaningful reforms. In Kenya and Tanzania, aid effectively aggrandised the political elite and disempowered the common man.

Reforms in Africa: Uganda

Some have suggested that aid could act as ‘a midwife of reforms’ in countries that are already pursuing the right policies and/or where the government is dedicated to a reform agenda. Uganda may be one such country.

Uganda’s economy was destroyed by tyrant Idi Amin in the 1970s. Between 1971-95, its GDP per capita fell by 40 per cent, leaving many Ugandans in extreme poverty.

- In 1987, President Yoweri Museveni embarked on a liberalisation programme, which opened the economy to foreign investors, liberalised trade and financial sectors and privatised state-owned enterprises.
- Uganda’s average real GDP growth during the 1990s was 6.9 per cent. It’s per capita growth was around 3.5 per cent.
- Uganda’s reforms were assisted and at times led by donors – but Uganda has owned the process and reforms have been accomplished through a domestic political agenda, without significant interference from donors.
- Aid helped to lock in reforms once they had already occurred, and financed investments with good returns.
- However, a significant proportion of Uganda’s economy is still fuelled by aid, so if aid were to decrease in the near future, its GDP will fall significantly.

In a few cases and for brief periods, aid has provided impetus and support for governments to improve their governance – to liberalise, privatise and deregulate their economy. Yet even in those cases, growth that depends on aid is intrinsically fragile and reforms may be reversed.

Governance in Africa and the case of Botswana

Bad governance alone does not explain poverty in Africa, but the vast majority of countries in Africa are badly governed and bad policy is the most important factor to explain their continuing poverty.

Botswana experienced the exact opposite development of Africa in general.

- After independence, Botswana generally pursued a path of sound, market friendly economic policy rather than the socialism of its African counterparts.
- Property rights and a reasonably well-established system of law were instituted and enforced.
- The country has had less external interference in its economy.
- People have an interest in stable political development because inclusive economic institutions (such as property rights) have enabled them to participate in economic activity. Wealth from natural resources (diamonds) has thereby benefited the country as a whole rather than only benefiting the political elite.
- As a result, Botswana achieved the highest rates of real economic growth in the world in the last 30 years – with GDP per capita rising from around $1600 in 1975 to around $8000 in 2004 (in purchasing power parity terms).

Conclusions

Fundamentally, economic growth depends on qualitative, not quantitative, factors: the structure of property rights, the extent to which courts of law apply and enforce abstract, clear rules inexpensively and quickly, the size of government and its effectiveness in delivering public goods, and the openness of the economy to trade and investment with the outside world.

It would be more sensible to scale back levels of aid, provide aid only to governments that are already reforming, and make aid available for a strictly limited period of time. Other reforms, such as removing trade barriers and eliminating trade-distorting agricultural subsidies, would yield far more benefits than increasing aid.

Aid and development: will it work this time?

Campaigning to end poverty through foreign aid

In the last five years, a series of global campaigns have called for increases in foreign aid. In the run-up to the Monterrey Summit in 2002, for example, Kofi Annan and James Wolfensohn (then head of the World Bank) travelled around the globe several times to campaign for doubling spending on aid, claiming that this was necessary to reach the Millennium Development Goals (MDGs) by 2015. The call was repeated more recently by Jeffrey Sachs both in his capacity as Director of the UN Millennium Project and in his most recent book *The End of Poverty*.[1]

Pop stars such as Sir Bob Geldof and Bono have also done their bit, regularly ranting in the media, preaching the gospel of increasing government aid. Bono also hosted a tour in Africa by the former US Treasury Secretary, Paul O´Neill, who returned to Washington, DC with a back-of-the-envelope calculation about the possible benefits of increased aid to Africa.

NGOs such as Oxfam, many of them substantial recipients of aid moneys, have long promoted increases in aid and have become increasingly vocal on the issue over time. This year, a wide range of NGOs have banded together under the Make Poverty History™ brand. One of its central pillars is an increase in aid to 0.7% of wealthy countries' GDP (a goal devised long ago by the United Nations).

Aid ministers from Canada, the Netherlands, Sweden, the UK and several other countries have responded to the call for increased aid. Most recently, Prime Minister Tony Blair returned victorious from Brussels having persuaded the EU to commit itself to a doubling of foreign 'aid' – and he has sworn to make this a key focus of the G8 Agenda in Gleneagles in July 2005.

Gordon Brown, the UK Chancellor of the Exchequer, has proposed a new mechanism called the "International Finance Facility". The IFF would increase aid spending by enabling countries to borrow against future aid budgets. He has also proposed a so-called 'modern Marshall Plan' for Africa – although it bears little resemblance to the original Marshall Plan, which promoted democracy and the institutions of the free society.

The EU is lobbying for a revaluation of the IMF gold reserves in order to increase the volume of loans from the Fund.

French President Jacque Chirac has advocated an idea promoted by the far-left anti-globalisation lobbying group Attac. He suggested a new tax on international financial transactions and cross-border movements of other kinds, including air travel.

To put this into context, it is worth bearing in mind that official development assistance (ODA) from rich to poor countries has risen by over US$20 billion since 2001 and in 2004 stood at to US$78.6 billion.[2]

But does foreign aid do any good? And what good will any future increases in aid achieve? Will this new plan lift people out of extreme poverty once and for all, and launch a process of self-sustained growth? Or will it do little good, or even perhaps be counterproductive?

The best way to answer those questions is to analyse the historical impact and effectiveness of aid.

The idea of foreign aid

The main objective of foreign aid is to promote economic growth in poor countries and thereby lift people out of poverty. (In this sense, foreign aid is distinguished from emergency relief such as medical supplies, food, water and other items that might be supplied in the event of a disaster.) The idea dates back to economist John Maynard Keynes who in the 1930s argued that government could stimulate development by financing investments. Keynes' ideas for the domestic economy were taken up by a new breed of development economists who argued that investment in less-developed countries (LDCs) could be stimulated by injections of cash from overseas.

The logic of this new development theory was simple: investments are determined by savings – and savings are determined by per capita income. Since poor countries have low incomes and accordingly, low savings, they are caught in a 'vicious circle of poverty': they experience a 'low-level equilibrium trap' where higher income does not lead to increased saving but only results in higher population growth. Thus, it was argued, investment financed by foreign aid will dissolve this vicious circle and connect LDCs to the virtuous circle of productivity and growth.

Following this theory, it was assumed that donors can simply calculate the financing gap – that is to say, the difference between domestic saving and the level of investment required for a targeted rate of economic growth – and fill it with aid.[3]

A more complex, 'two-gap' model was subsequently developed by economists Hollis Chenery and Alan Strout. This model directed attention to two gaps in developing economies: the aforementioned financing gap, and the gap between import requirements for a targeted level of production and foreign-exchange earnings.[4] The first gap (the financing gap) means that a country has insufficient resources for investments, and the second gap implies that a country possesses insufficient foreign currency to pay for imports. Foreign aid was sold as the panacea that would bridge both gaps.

The two-gap model has several underlying assumptions which are pivotal to the idea of development assistance. First, it assumes that there is a linear relationship between investment and growth over the short- to medium-term and second, it assumes that the purpose of aid is to finance investment and not consumption. Without those assumptions, we would not have any aid to speak of, except for emergency relief. The central idea of aid is thus to provide 'a takeoff into self-sustained growth', as the late economist Walt Rostow said, and should therefore not be viewed as redistribution of wealth.

Since the 1960s, aid theory has developed and donor organizations have often changed the profile of their spending. In the 1960s, the dependency theory and the UN model of import substitution were popular. In the 1980s, the World Bank promoted 'structural adjustment' lending', the objective of which was to adjust economic structures and policies in poor countries to steer them towards economic development. In the 1990s, it was fashionable to emphasise conditionality, better selectivity and the policy environment in the recipient countries – in theory as well as in practice.

Regardless of which idea of aid has been the 'conventional wisdom' that informs the actions of donors, the gap theory has remained the core justification used by donors (bilateral as well as multilateral) to calculate the need for foreign aid and in campaigns that call for increased aid.[5] Reviewing key documents of the Canadian, Danish, Swedish, and British aid agencies, the gap theory is repeatedly expressed, as it is in central World Bank strategies.[6] Furthermore, in the new campaign for increased aid and in the work by Jeffrey Sachs for the UN's Millennium Project, the gap theory has been energised and is now back in full bloom.

In a recent report to the UN Secretary-General, Jeffrey Sachs and others involved in the UN Millennium Project's Task Forces have utilised the conventional form of a financing gap calculation. They concluded that to meet the MDGs, low-income countries need US$40–50 per capita in external funding in 2006 and US$70–100 per capita in 2015.[7] In a separate paper published by the Brookings Institution, Sachs and his colleagues write:

> *'We argue that what is needed is a "big push" in public investments to produce a rapid "step" increase in Africa's*

underlying productivity, both rural and urban [...] In particular, we argue that well-governed African countries should be offered a substantial increase in official development assistance to enable them to achieve the Millennium Development Goals, the internationally agreed targets for poverty reduction, by 2015'.[8]

How much additional assistance from donors do poor countries need to achieve this 'big push'? According to Sachs's calculations, Africa needs an extra US$25 billion a year until 2015. On a global scale, an additional US$75 billion of official development assistance (ODA) annually will be required.

Judging by current political developments, Sachs's vision may become reality. But will it achieve the goal of ending poverty by promoting economic growth?

Aid, investment and growth

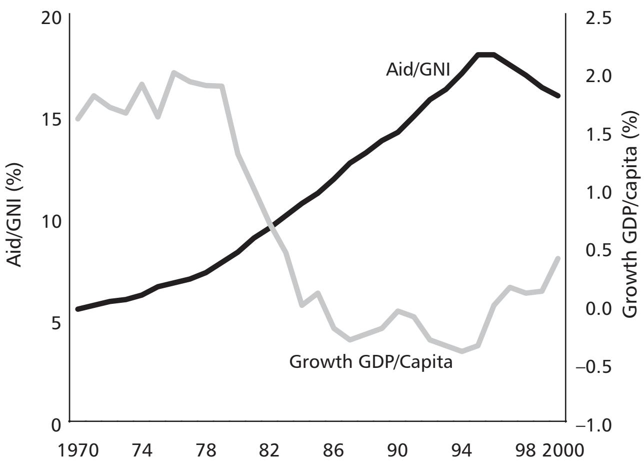
With four or five decades of documented data on the relationship between aid and development, it is not difficult to answer the trillion-dollar question: has aid led to sustained economic growth?

We start by looking at Africa – a continent of particular interest to those who wish to understand the effects of aid. Many African countries received substantial sums of aid over a sustained period and thus became a 'laboratory' for various donors and development theories. Nowhere else in the world has the aid-to-GDP ratio been as high as in Africa, particularly in Sub-Saharan Africa. So the historical experience of the effect of aid to Africa is therefore of great relevance when assessing the potential outcome of proposals to increase aid yet again.

The general story about aid and growth in Africa over the last 30 years is told in Figure 1. Aid as a percentage of Gross National Income (GNI) grew continuously between 1970 and 1995, starting at around 5 per cent in 1970 and peaking at around 18 per cent in 1995. During the 1970s, when the percentage of aid as a proportion of GDP was still relatively low, GDP growth per capita was high. After the oil price shocks of the late 1970s, the proportion of aid grew dramatically but GDP growth collapsed and was even negative for several years.

In light of this experience, it is quite clear that the gap theory of aid has missed a critical element in the development process. While these figures alone do not overthrow the idea of aid, bear in mind that Africa received approximately US$400 billion of aid from 1970 to 2000, and this makes the case for a 'smoking gun.'

Figure 1 **Aid and growth in Africa (10-year moving average)**

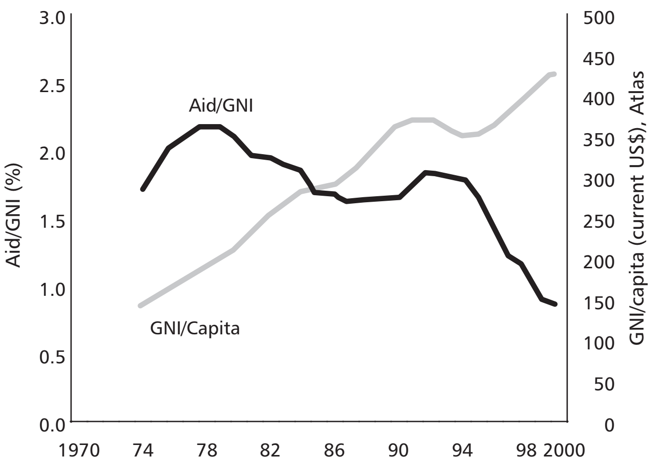


Source: World Development Indicators Online

The evidence for Asia (Figures 2 and 3) illustrates that Africa is not unique in lacking a linear – or even a positive – relationship between aid and growth. In fact, the conclusion from this information seems to suggest that on balance, growth was higher in periods when the aid-to-Gross-National-Income ratio fell. This does not necessarily mean that aid has been ineffective in all senses. Aid flows to Asian countries have overall been relatively small: aid to China and India has generally been below one per cent of GNI (Figure 4) and the existing aid might have had positive impacts in the short-term. But these impacts have not turned into increased growth and should not be considered genuine successes in the context of the gap theory of aid. Most likely, the aid simply replaced other sources of financing for existing projects. Indeed, the aid may have crowded out projects that would have resulted in long-term growth, in which case it should be considered to have achieved a negative impact.[9]

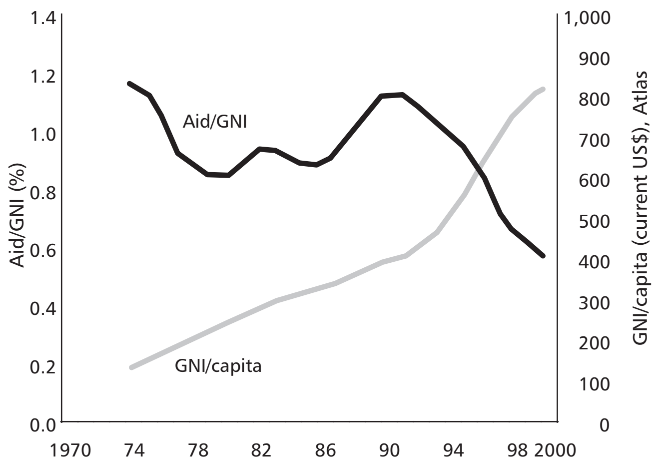
The overall pattern in Asia is that aid does not have a significant and positive impact on economic

Figure 2 **Aid and GNI/capita in South Asia (5-year moving average)**



Source: World Development Indicators Online

Figure 3 **Aid and GNI/capita in East Asia and the Pacific (5-year moving average)**



Source: World Development Indicators Online

development – and nowhere is this clearer than the economic development of China and India. China's economic boom started after its economic reforms of the late 1970s. Aid to China rose in the 1980s but decreased to trivial amounts in the early 1990s at the beginning of its rapid and sustained growth period. India experienced similar phenomena. Today, total aid spending in China and India is less than US$1 per capita. India has also rejected offers of aid from bilateral donors.

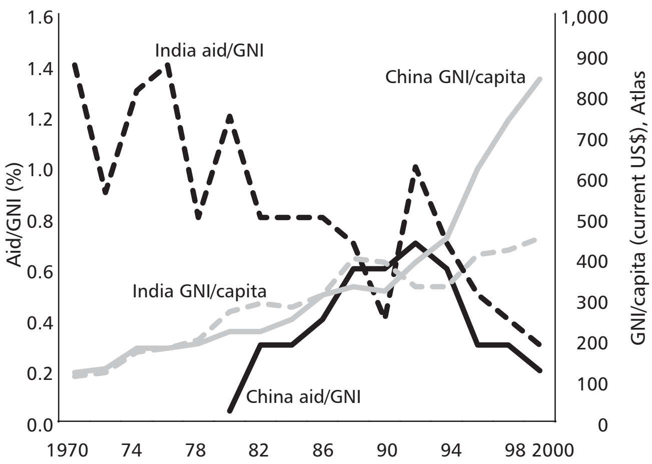
China and India also provide interesting counter-arguments to the investment gap theory. Both countries contain a large proportion of people living in extreme poverty – and they have managed to grow despite the insignificant role played by aid in investments. When measured as the share of gross capital formation (which translates into gross investments), aid has never been higher than two per cent of China's investments. According to rounded calculations by the World Bank, today's share of aid to gross capital formation is zero per cent in China, and slightly higher in India – one per cent.[10]

A further body of research casts doubt on the relationship between aid, investment, and growth. William Easterly, a former researcher at the World Bank, left the Bank after controversies about his book *The Elusive Quest for Growth*[11] – an extremely honest assessment of what donors have actually achieved by giving aid to poor countries for more than 40 years. In a separate study, Easterly analysed the link between aid, investments and growth in 88 countries between 1965–95,[12] and found only six countries which experienced a significant and positive effect of foreign aid on investment. Two of those countries, Hong Kong and China, had trivial amounts of aid, but the remaining four were countries with quite substantial inflows of foreign aid: Tunisia, Morocco, Malta and Sri Lanka.

Easterly then analysed the short-run relationship between investment and growth in 138 countries, and found only four countries that passed the test of a significant and positive relationship. The four countries were Israel, Liberia, La Réunion (a French territory) and Tunisia. Thus, the financing gap theory seems to fit only one country – Tunisia. However, it is quite plausible that this finding – one country in a sample of 138 countries which apparently fit the theory – could easily occur entirely by chance.

Writing a few years earlier, economist Peter Boone reached similar conclusions.[13] Using data for 97 recipient countries over a 20-year period, Boone found no significant correlation between aid and poverty

Figure 4 **Aid and GNI/capita in China and India**



Source: World Development Indicators Online

reduction – and he found no evidence that aid improves mortality rates, primary school enrolment or life expectancy in recipient countries.[14]

Like Easterly, Boone tested the link between aid and growth and found no relation at all between the volume of aid and growth, the vehicle of improving social welfare.[15] In fact, he could not find any significant effect between aid and investments in physical capital, an assumption which underpins the idea of aid.

Easterly and others conducted a later study of 34 African countries which confirmed those findings, showing no overall effect of aid on investments. Only eight countries showed a positive and significant relationship between aid and investment. In twelve countries the relationship was negative.[16]

This evidence strikes at the very heart of the idea of aid. How can the results be explained?

The overall explanation for Boone's conclusions is that foreign aid intended for investment may very well have been used for investment but, if it was, the recipient governments simultaneously lowered their own investment and transferred resources to additional consumption. Boone also found a strong correlation between the volume of aid and public consumption, indicating that such a transfer of resources had occurred.

Expressed differently, aid seems to be *fungible.* Aid does not finance *additional* investment for which the recipient countries failed to marshal domestic resources. Fungibility means that a country which receives aid then reallocates domestic resources and in this way, turns the purpose of aid upside-down. Paul Rosenstein-Rodin, a former deputy director of the World Bank Economics Department, expressed the essence of fungibility when he noted: 'When the World Bank thinks it is financing an electric power station, it is really financing a brothel'.[17]

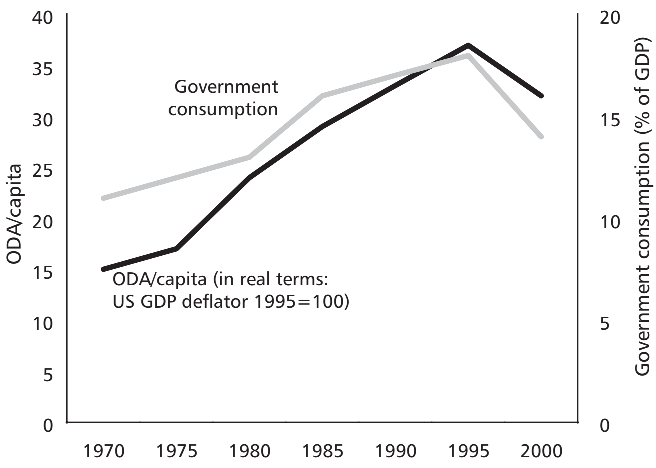
Several other studies used different methods to show how fungibility distorts development assistance. Many scholars have observed that the general pattern in Africa is that the savings ratio (savings in relation to national income) has actually fallen when aid has increased.[18] This phenomenon is partly explained by falling and negative economic growth: if a country becomes poorer, a larger share of its income will be used for consumption.

However, this is far from the whole story. Research clearly shows a negative effect of increased aid on savings in Sub-Saharan Africa.[19] Similarly, many studies point to the fact that government consumption in Sub-Saharan Africa has increased when aid has increased. Evidence presented in Figure 5 (which covers a time period when the compounded real per capita growth was negative) shows that government consumption rose during the decades of increased ODA per capita and subsequently decreased when aid was reduced.

Studies on aid to specific countries or sectors also indicate the presence of partial or total fungibility. Aid has been highly fungible in the Dominican Republic and Pakistan (meaning that an additional unit of aid did not lead to greater public expenditure in the areas where the aid was supposed to be spent), and partially fungible in Sri Lanka.[20] Of the countries studied, only in Indonesia has aid apparently been non-fungible.[21]

The overall pattern of different sectors seems to be similar. A study of 14 developing countries found no correlation between aid and the spending on health and education in the recipient countries.[22] A 1999 World Bank study on different sectors in 18 Sub-Saharan Africa countries between 1971 and 1995 broadly

Figure 5 **Aid and government consumption in sub-Saharan Africa (10-year moving average)**



Source: World Development Indicators Online

confirms these findings: aid is fungible overall and the extent of fungibility varies from sector to sector. [23]

Fungibility does necessarily not mean that aid is less effective, just that aid makes it possible for domestic money to be spent elsewhere. But it is easy to see that fungibility probably does mean lower effectiveness. Given the level of corruption in many developing countries and the general inefficiency of their governments – not to mention the lack of any coherent explanation as to why increasing current spending and government consumption would lead to economic growth – it almost goes without saying that fungibility detracts from the effectiveness of aid. Furthermore, fungibility also distorts the link between investment and growth, particularly when domestic saving is reduced as a result of aid.

In sum, the evidence shows that the 'gap' theory used to justify aid does not hold up to scrutiny. Unsurprisingly, therefore, aid has not fulfilled its goal of promoting development through investment. Instead money given as aid has been fungible, often freeing central government resources for spending on current consumption. This in turn has fuelled corruption, as government officials have sought personally to benefit from the disbursement of funds. Meanwhile, the ability to use aid to fund government projects has further removed democratic constraints on governments, who have been less responsive to the people they govern.

Two specific countries – Kenya and Tanzania – are interesting examples of the role that aid plays in development.

The path to poverty in Kenya and Tanzania

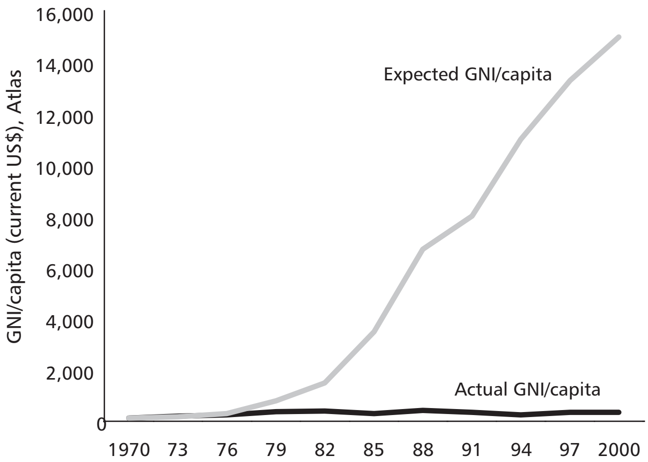
Kenya and Tanzania have much in common: both countries grew rapidly in the years immediately following independence in the 1960s but since the mid-1970s have been languishing. What explains this strange pattern? Why did these very poor countries not grow in the same way as countries such as South Korea and Taiwan – which are rapidly catching up with wealthy countries?

One way to evaluate the impact of aid in Kenya is to compare its actual growth rate with the growth rate which might have applied if the 'gap' theory (of aid-to-investment-to-growth) were valid (Figure 6). The 'Expected GNI/Capita' implied by the 'gap' theory shows that extreme poverty would have been eradicated by the 1990s, and by 2000 per capita GNI would have been in the same range as that of Spain, Portugal and New Zealand. In fact, GNI per capita has barely increased since the mid-1970s.

The story behind Kenya's sorry state of economic development is similar to that of most other Sub-Saharan African countries. Kenya started reasonably well after its independence in 1963; average per capita income growth was 2.8 per cent in the period 1964–70. The economy then faltered, and the Kenyatta government responded with economically unsound measures, including price controls and the introduction of marketing boards (which purchased agricultural products at government-set prices, lower than market prices). These and other policies worsened the country's macroeconomic situation.

The Kenyan government justified price controls and marketing boards as a response to price fluctuations for agricultural goods. Although these policies gave temporary relief, they soon distorted prices and adversely affected production incentives. Farmers

Figure 6 **Actual and expected GNI/capita in Kenya**



Sources: World Development Indicators, OECD International Development Statistics, various World Bank publications

increased production of crops that were uncompetitive in the world market and many acquired an unhealthy interest in perpetuating this scheme of subsidies.

By the end of the 1970s, Kenya's government (supported by the World Bank) increased the number and the importance of parastatals and state-owned enterprises (SOEs). As a result of growth in such entities, the share of public sector output in GDP rose from approximately 24 per cent in 1977 to 37 per cent in 1982. These entities soon became arenas for the endemic corruption that started under Kenyatta's rule, partly due to tribal tensions, but which later swamped the country during the era of Daniel arap Moi.

Another trendy policy that Kenya adopted at the behest of various intergovernmental bodies (such as UNCTAD and the World Bank) was 'import substitution'. The theory was that a poor country such as Kenya would stimulate the development of a local industry by restricting imports of specific industrial goods.

Unfortunately, as all countries which have experimented with import substitution have learned to their detriment, the consequence of such policies is to insulate local manufacturers from competition, which means that they lack incentives to innovate and compete internationally. As a result, local consumers pay inflated prices for lower-quality goods, while the local industry is unable to sell at an international level.

Kenya's import substitution policy was strengthened in 1977 after the collapse of the East African Community, which effectively abolished all trade with Tanzania and Uganda. This trade isolation was devastating for the economy. Import duties rocketed. The price of consumer items such as shoes and cars increased sharply. Food shortages became acute during the droughts of the early 1980s and early 1990s. Kenya's production was saddled with old technologies and exports fell.

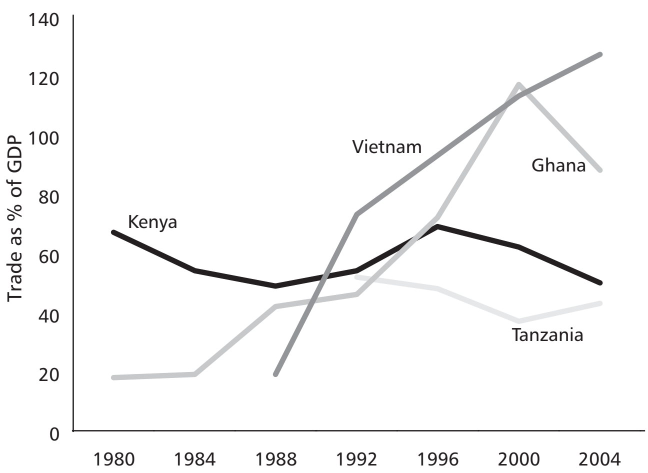
With the increasing cost of subsidising inefficient producers at uncompetitive prices, Kenya's fiscal deficit grew sharply and Kenya experienced a series of severe balance-of-payments problems. In addition inflation rose during the 1980s and early 1990s, peaking at 101 per cent in the second quarter of 1993. As a result of such poor economic policies the average per capita rate of growth fell to 1.1 per cent during the 1970s and 0.6 per cent during the 1980s.

Kenya was the first country to sign a Structural Adjustment Loan (SAL) programme with the World Bank in the early 1980s, and the first country to receive a conditional loan from the IMF.[24] As a result, trade policy started to change – but at a snail's pace. Arguably, the two SAL programmes in the 1980s only slowed the trend of rising tariffs and the increasing use of quantitative restrictions through import licensing. However, the fiscal balance was improved and the balance of payments was slightly restored.

For a few years after the 1993 election when new parties gained ground, there was a momentum to the reform process which led to financial and trade liberalisation, tax cuts, deregulation and privatisation. Since then, the governing principle of Kenyan trade policy has been export promotion rather than import substitution. This does not mean that Kenya operates under a free trade regime; on the contrary, tariffs are still high and the ratio of trade to GDP has declined over the last decade (Figure 7).[25] By contrast, Ghana and Vietnam – two fast-growing countries – have far higher trade/GDP ratios.

Donors and the SAL programmes in particular contributed to these reforms, but only marginally. The

Figure 7 **Trade ratio in Kenya, Tanzania, Ghana and Vietnam**



Source: World Development Indicators Online

impetus mostly came from citizens and entrepreneurs who became exhausted with their country's economic backwardness.

Sadly, these efforts to bind Kenya to the mast were not particularly successful. The reason is simple: Kenya has backtracked on reforms and breached contractual conditions. Indeed, these moderate reforms soon stalled and the disbursements were cancelled. Kenya had taken one step forward and one step back. *The Economist* once characterised Kenya's relation to donors as follows:

> *'Over the past few years Kenya has performed a curious mating ritual with its aid donors. The steps are: one, Kenya wins its yearly pledges of foreign aid. Two, the government begins to misbehave, backtracking on economic reform and behaving in an authoritarian manner. Three, a new meeting of donor countries looms with exasperated foreign governments preparing their sharp rebukes. Four, Kenya pulls a placatory rabbit out of the hat. Five, the donors are mollified and the aid is pledged. The whole dance then starts again.'*[26]

In the last decade, Kenya has been among the worst ten performers in Transparency International's (TI) annual index on corruption. A recent study by the Kenyan chapter of TI found the incidence of corruption well above 50 per cent in many ministries, city councils, parastatals, SOEs and other government bodies. The likelihood of encountering bribery in contact with the Kenyan Police was as high as 96.9 per cent.[27] As a result of years of poor government economic policy and persistent corruption, per capita income in Kenya actually fell during the 1990s.

The economy picked up after the government of Mwai Kibaki gained power in the December 2002 election but only at the margin. In 2003, Kenya's GDP per capita growth was zero and last year the real GDP is estimated to have risen by 2.2 per cent.[28]

Tanzania's post-colonial history began on an even less promising note than Kenya's. The country was led from independence in 1961 by Julius Nyerere, who like many post-colonial leaders led the struggle for his country's independence. In 1967, Nyerere announced that he was adopting a policy of *ujamaa*, an African version of socialism based on 'nationwide brotherhood' or 'familyhood'.

Ujamaa espoused a distinct anti-market philosophy that despised anything associated with capitalism and private ownership. Nyerere even claimed that changes in prices were a symptom of profit-making and hence of a capitalistic mentality, so he banned people from negotiating prices which differed from those dictated by the government on many goods.[29] All trade was nationalised and individual ownership of farms abolished.

As a result of these policies, Tanzania's inflation and fiscal deficit were generally higher than those in Kenya, and the country also suffered more frequent balance-of payments problems. Factor productivity was lower than in Kenya and the government share of total investments was higher for a greater period of time. Unsurprisingly, Tanzania was even poorer than Kenya and Tanzanians suffered badly from shortages.

Despite these problems, Nyerere became a popular figure in many Western circles. As ideological counterparts of Nyerere, many donors believed in his ideas of development and supported Tanzania with vast amounts of money. And not only did they believe in the development of Tanzanian socialism: Nyerere was a figure of international standing and a leading voice behind the call for a 'new international order' and the creation of the Brandt Commission, charged with the task of designing the world order after the supposed fall of global capitalism and the rise of international socialism.

Of course, hypocrisy was part of this admiration for East African socialism. A personal friend who grew up in Kenya in the 1970s remembers the usual visits from socialist friends who were living in Tanzania. They were aid workers who came every month to Nairobi on a bus tour with other aid workers to buy the necessities of life they could not find in Dar-es-Salaam.

Shiva Naipaul has described this hypocrisy in his masterly book *North of South*:

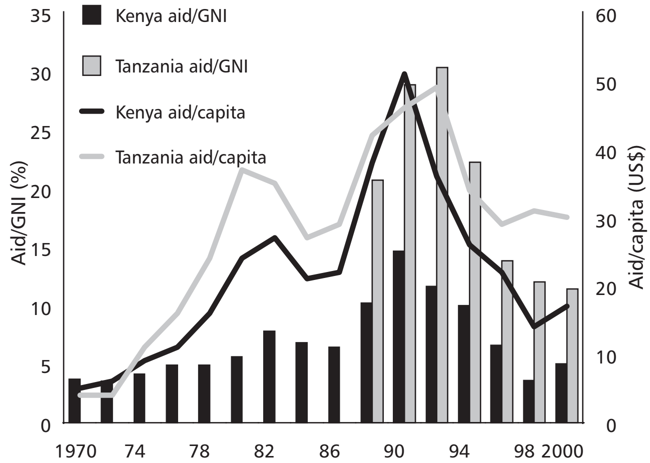
> *' "You will like Tanzania," the Asian girl had said. "You will find it totally different from Kenya in almost all respects." The girl had described herself as "committed" to Tanzania, and knowing she had recently returned from a pilgrimage to Cuba, I was not surprised by the categorical recommendation. "But if she's so committed," an unkind acquaintance of hers said to me afterward, "why does she come all the way to Nairobi to buy her underwear? Why isn't she content with the Chinese underwear they must sell in Dar es Salaam?" I could find no reply to the cruel question.'*[30]

In the 1980s, Tanzania suffered a severe economic crisis and was the object of numerous attempts at structural adjustment, driven primarily by the World Bank and IMF. But Nyerere was sternly against any form of adjustment, particularly if it involved economic liberalisation and macroeconomic stabilisation.

After Nyerere's withdrawal from politics in 1985, Tanzania entered the path of reform and the economy picked up a bit. It plummeted again when the government started back-tracking on reforms.

Since then, Tanzania has geared up its economic reform agenda but development has been patchy, and the effects of these reforms on growth have still to be fully realised. Average per capita growth in 1999–2003 was 3.6 per cent. Compared with the average per capita growth rate of 0.8 per cent in the previous five years, it is a significant improvement – but Tanzania has a long way to go before its citizens experience rapid and sustained growth.

Figure 8 **Aid/GNI and aid/capita in Kenya and Tanzania**



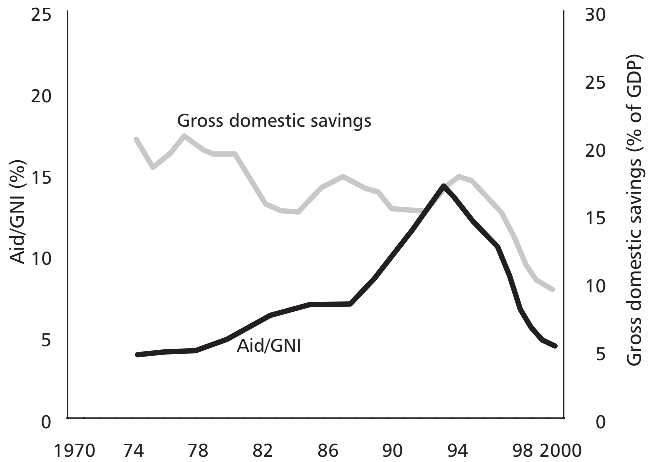
Source: World Development Indicators Online

What can we learn from this brief history of these two neighbours? Aid has played a significant role in Kenya's and Tanzania's economies; between 1970 and 1996 they each received approximately US$16 billion in official development assistance. The countries exemplify two brands of failed development models.

Kenya's economy grew moderately until Kenyatta instituted – and Moi reified – an isolationist import substitution model. Since then the country's economy has practically stagnated, as the vested interests created under import substitution have conspired with the government to resist opening the country to trade and investment. Aid has helped to maintain this disastrous economic structure by funding government consumption. In per capita terms, the aid flows to Kenya rose from US$15 in the 1970s to over US$50 in the 1990s. When it peaked in the early 1990s, aid constituted almost 14 per cent of Kenya's GNI and approximately 50 per cent of its government expenditures (Figure 8).

Tanzania's economy was stifled soon after independence by Nyerere's attempt to institute socialism. Its poor performance continued with the connivance of external donors whose contributions by 1993 amounted to approximately 30 per cent of GNI (Figure 8), and the vast majority of government expenditures were financed

Figure 9 **Aid and savings in Kenya (5-year moving average)**



Source: World Development Indicators Online

by donors. In spite of the dire condition of the Tanzanian economy and notional conditions on loans and grants from multilateral donors, it was not until the late 1990s that the government began to institute serious reforms and was then largely driven by a domestic constituency that had become completely disillusioned with *ujamaa* – the African socialism that led to African poverty.

Compared to other African countries or to other aid-dependent countries, Tanzania was unique but Kenya's aid ratio was average. According to the World Bank, the mean value of aid as share of government expenditures was 53.8 per cent in the period 1975–1995.[31] Meanwhile, the share of aid in capital formation increased in Kenya over the years. When it peaked in 1991, aid constituted more than 100 per cent of gross capital formation, and it was even higher in Tanzania. Thus, investment was mainly a donor-led phenomenon. Aid was mostly channelled through governments' respective budgets, reinforcing the role of the public sector in the economy and strengthening socialist tendencies. At the same time, gross savings were falling (Figure 9).

As aid was justified on the grounds that it was needed to fill gaps in savings and investment, donors effectively took control over the whole economy and undermined the processes that lead to both saving and investment. In countries like Kenya and Tanzania, donors also helped to crowd out private investors and thereby prevented entrepreneurship and economic development. Aid effectively aggrandised the political elite and disempowered the common man.

Aid dependency, behavioural change, and structural adjustment

Kenya and Tanzania provide ample evidence of the perverse consequences of providing aid. In the aid game, recipient governments have an incentive to shift their focus towards consumption and to deliberately widen the financing gap. So it is no surprise that governments in receipt of aid spend a large share of tax revenues on current consumption. A widening financing gap gives governments a bargaining tool in the game of demanding increased aid – and so the game goes on. In this way, countries such as Kenya and Tanzania soon became dependent on aid.

Aid dependency alters incentives and strategies, creating a politicised economy entrenched in every fibre of society. Rather than seeing opportunities to produce goods and services more efficiently, entrepreneurs see hand-outs from donors as the easiest route to wealth. Aid dependency thereby undermines wealth creation.

As with other forms of dependency, the only solution is to kick the habit through behavioural change. The chain that shackles poor countries is a lack of an appropriate enabling institutional environment. People are typically unable formally to own and transfer property; contracts are not readily enforceable; the courts are slow, expensive and frequently corrupt; government has its hands in every activity, controlling prices and restricting trade. In economic terms, the country suffers from a plethora of policies that undermine incentives to engage in mutually beneficial economic activities. Rather, the government encourages zero- or negative-sum activities wherein different groups compete with one another for a slice of a pie fixed in size by the donor providing it.

Appropriate policy reforms are necessary to achieve changes in incentives for producers, consumers, and politicians – basically for all segments of society – so that economic activity becomes a positive-sum game. Formalising property rights creates better incentives for people to use resources in a productive way, as well as enabling people to have access to credit so that they can invest in businesses. Price deregulation means improved incentives for producers to produce competitive products. Trade liberalisation enhances the incentives to produce higher quality goods at a lower price, thus enabling entrepreneurs to have a more export-orientated outlook. Democratic and constitutional reforms improve the incentives for politicians to put the welfare of the country ahead of their own welfare.

What is often also needed is a change of political regime.[32] It is uncommon for a regime that has pursued policies detrimental to development suddenly to be born again and change its policies. This is particularly true in Africa. Despite massive amounts of aid and donor attempts to change policy, the 'Big Men of Africa' did not change; they simply continued to loot their countries.

In fact, aid helped many of them to stay in power. Julius Nyerere and Daniel arap Moi are prime examples: these men probably would not have lasted in power nearly as long if donors had not propped them up with aid. In fact, several studies have concluded that aid to Kenya and Tanzania delayed critical reforms and thus the donors were unable to follow the Hippocratic principle of 'do no harm'.[33]

Donors, particularly the World Bank and the IMF, realised after the second oil crisis in the late 1970s that the economic structure of poor countries needed to change in order to prevent severe balance-of-payment crises. In the 1980s the World Bank embarked on a programme of structural adjustment lending, while the IMF introduced conditional lending.

The initial purpose of these programmes was to change the incentives for reform: if the World Bank and other donors provided finance to recipient countries over a long period, they should in return reform their economies, particularly the price regulations that prevented the efficient use of resources. After a while, the specific parts of this programme became trade liberalisation, price deregulation ('getting the prices right'), fiscal adjustment, macroeconomic stabilisation and a general move away from excessive state intervention in free markets.

Structural adjustment has been criticised, especially by opponents of free markets and critics such as Joseph Stiglitz. The critics have sometimes been correct in one critical observation: the structural adjustment process has not been successful. This does not mean that the policy features of the SALs were altogether wrong. On the contrary, there is not a single country in history that has achieved prosperity for its people through increased trade protection, price controls, mismanaged fiscal and monetary policies and increased state intervention. By contrast, poor countries that have liberalised their economies over a sustained period have experienced economic growth and increased welfare.

Most serious research on the topic has concluded that structural adjustment loans have been a failure. Why? The simple answer is that few countries in this programme adjusted anything very much, despite receiving many loans targeted for adjustments. That is also true for countries in the IMF's conditional programmes: the recipient countries did not fulfil their end of the agreements.

In a study of the economic performance of countries receiving structural adjustment loans between 1980 and 1999, William Easterly found no significant effect of macroeconomic adjustment. Although the economic performance of some countries improved, in many other countries it did not. Table 1 shows the 20 most substantial recipients of the SAL programme. It is clear that on average these countries did not perform any better than the average for all developing countries (the bottom row of the table). Comparing the minimum and maximum value for each indicator, there is also a high variance between these countries, indicating that they were selective in implementing the programmes (some countries did implement specific parts of the programmes, others did not).

In a comprehensive study on structural adjustment and conditionality, Tony Killick (a researcher at the Overseas Development Institute) found that the programmes had improved exports and limited the severity of balance-of-payment crises but had no effect on inflation and economic growth. One of the explanations was weak implementation of the SALs by both donors and recipients.[34] Many other studies confirm that conclusion. In general, the World Bank seems to have spent far more money on failed programmes. Once a bad loan was made to a country, the agency tended to

Table 1 **Successes and failures of repeated adjustment lending** (all data refers to averages for period from first adjustment loan until 1999 for the top 20 countries receiving adjustment loans)

	No. of adj. loans 1980–1999	*Growth/ capita (%)*	*Current account balance/ GDP*	*Government balance/ GDP*	*Black market premium (%)*	*Inflation rate*	*Real over-valuation (+)/ under-valuation (–)*	*Real interest rate (%)*
Africa								
Niger	14	–2.3	–7.6		2	2	19	15
Zambia	18	–2.1	–12.3	–13.4	77	58	135	–10
Madagascar	17	–1.8	–7.3	–3.5	21	17	–25	9
Togo	15	–1.6	–6.3	–3	2	5	5	10
Cote d'Ivoire	26	–1.4	–6.7	–1.3	2	6	62	13
Malawi	18	–0.2	–11.1	–7.8	38	23	1	3
Mali	15	–0.1	–9.9	–6.5	3	4		11
Mauritania	16	0.1	–9.4		85	7	94	3
Senegal	21	0.1	–8.5	–4.5	2	5	20	9
Kenya	19	0.1	–3.5	–4.5	15	14	9	8
Ghana	26	1.2	–4.2	–1	36	32	–48	–16
Uganda	20	2.3	–7.4	–3.1	96	50	–47	–18
Other developing countries								
Bolivia	17	–0.4	–6.8	–1.6	31	91	36	–20
Philippines	19	0	–2.8	–2	6	11	–21	6
Jamaica	18	0.4	–5.4	–12.6	20	20	–2	7
Mexico	20	0.4	–1.9	–3.9	10	41	–36	3
Argentina	30	1	–2.4	–1.8	23	164	11	–5
Morocco	22	1.1	–3.3	–5.7	4	6	–4	2
Bangladesh	18	2.4	–2.8	0	93	6	–41	7
Pakistan	20	2.7	–3.4	–6.9	12	8	–48	1
Min top 20	14	–2.3	–12.3	–13.4	2	2	–48	–20
Average top 20	19	0.1	–6.1	–4.6	26	24	–3	1
Max top 20	30	2.7	–1.9	0	96	164	135	15
Average all developing countries	7	0.3	–6	–4.6	32	32	1	0

Source: William Easterly (2002) What did Structural Adjustment Adjust? Working Paper 11. Washington, DC: Center for Global Development

disburse even more money to the country to solve the problem.[35]

There is also strong correlation between the number of loans and negative performance: the more adjustment loans a country received, the worse it performed. This reflects the politics of aid: donors want to salvage their failures with new loans, and this sends a message to recipient governments that they do not have to deliver reforms to get more loans. There are good reasons to believe that several governments had an incentive not to deliver reforms since they could obtain more money by *not* reforming. For example, a World Bank study on aid noted that 'the World Bank provided aid to support identical agricultural policy reforms five separate times' in Kenya.[36] Perversely, if they countries did reform, they could later repeal the reforms and thus be pledged a new loan. A study of ten African countries found that of the ten countries that undertook trade liberalisation, seven of them later repealed the reforms.[37]

The conclusion is simple: donors cannot buy reforms in developing countries. It is naïve to believe that foreign aid and conditionality can achieve what the domestic political process has not accomplished. That idea rests on the assumption that political leaders in poor countries actually are interested in reforms that are conducive to economic growth, and have the capacity to deliver those reforms. If we have learned anything from political history, it is that such a romantic view of the nature of politics is seriously ill informed – if not altogether dangerous.

Aid as a 'midwife of reform and good policy'

If it is not possible for donors to buy reforms in developing countries, and if – as demonstrated by a review of the evidence in the previous sections – structural adjustment lending was a bad idea, does this imply that every attempt to link aid to reform is worthless?

Not necessarily. Today, many scholars assert that aid can be effective overall if it performs as a 'midwife of reforms' in countries that already have the right set of policies and/or where the government is dedicated to reforms. According to this view, if aid is used more selectively and only given to countries with the right policy environment, it can finally achieve the goal of promoting economic growth. But is it true?

Uganda is often held up as the stellar example of how aid can work in countries that are committed to reform.

Political leaders in Uganda and many other African countries were particularly skilled at destroying their countries' economies. In 1972, the notorious buffoon and tyrant Idi Amin waged a war against the commercially dominant Asian community, confiscated foreign investments, regulated the economy *in absurdum* and in every other respect pursued policies that encouraged unproductive behaviour and inefficiency.

In 1971–85, Uganda's GDP per capita fell by 40 per cent, leaving many Ugandans in extreme poverty. Ugandans who had any money to speak of left the country. At the time of the regime change in 1986, after Yoweri Museveni and the National Resistance Movement overthrew the second regime of Milton Obote, 60 per cent of Uganda's private wealth was held abroad.

The first year of Museveni's presidency (1986) was a peculiar period in Uganda's history. It started with an absurd revaluation of the currency followed by a government campaign against the so-called 'Washington Consensus' which they regarded as an imperialistic policy. Instead, the government opted for a strategy echoing Nyerere's beliefs, pursuing economic co-operation with Libya, North Korea and similar countries. To no one's surprise, this strategy failed.

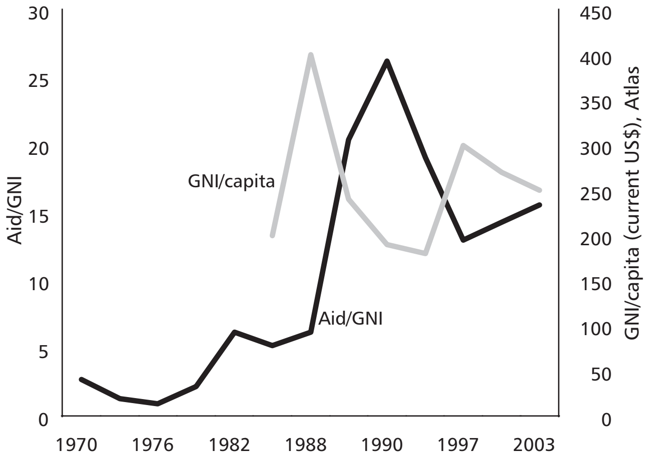
In 1987 Museveni's economic policy changed quite radically when he embarked on a liberalisation programme. Trade and financial sectors were liberalised, many state-owned enterprises were privatised, the country was opened up to foreign investors, the macroeconomic balance was restored and the economy was somewhat deregulated.

The strategy has been successful for Uganda. Average real GDP growth during the 1990s was 6.9 per cent. Even in per capita terms, growth maintained a steady 3.5 per cent during the 1990s, although it has fallen to 2.6 per cent the last five years.

The Ugandan era of reform is interesting not least because it was largely assisted and at times even led by donors. Large-scale financial aid to Uganda was resumed in the late 1980s and became significant in the 1990s. In 2000, aid constituted approximately 93 per cent of government expenditure. For the last decade, the share of aid to GNI has also been above the average rate for aid-dependent African countries. Aid peaked in 1992 at more than 26 per cent of the GNI but has since fallen (Figure 10).

The most important aspect of the aid inflow to Uganda was World Bank SALs and conditional loans from the IMF.

Figure 10 **Aid and GNI/capita in Uganda**



Source: World Development Indicators Online

The first SAL programme kick-started the reform era, but the Bank and the Fund consequently sold the concept of liberalisation to President Museveni. Since 1992 there has been Ugandan ownership of the process and important reforms have been accomplished without pressure from donors.[38] At times, the World Bank and the IMF have pressured the Ugandan government, but most of the time the country has behaved.

Thus, aid not only contributed to the reform process but also helped to lock in reforms once they had occurred. Aid was an auxiliary in diversifying exports and lowering export taxes, which formerly were a primary source of government revenues. Equally importantly, aid also financed investments with good returns. According to a conservative estimate by economist Paul Collier, aid constituted about 31 per cent of Uganda's growth during this reform era.[39]

While this is clearly an impressive track record, it also illustrates one of Uganda's current problems. Growth that is dependant on aid is intrinsically fragile. It threatens to unleash unsound political economy processes that surely will occur – if they haven't already – if Uganda continues with its present level of aid dependency. This fragility also results, to a large extent, from production that is not economically durable, which means that a significant part of recent growth is unsustainable. If Uganda's aid decreases in the near future, its GDP will fall significantly.

Uganda is not the only example of a country that has performed well and where aid has played a role in promoting policy reforms that have led to economic growth. According to a World Bank study, Bolivia, Ghana, and Vietnam also belong to the group of countries that have experienced sustained growth, assisted with massive help from the donor community. The key to success in all these countries is reform leading to a policy environment conducive to growth.[40] In an economy that is deregulating and liberalising and which has overall macroeconomic balance, aid can speed up the pace of reforms, lock in reforms that have taken place and act as a 'midwife' of good policies. However, the crucial element in this process is a unilateral drive for change.

Economists Craig Burnside and David Dollar discovered some interesting results of the impact of aid on growth in a 2000 study of 56 developing countries over the period 1970–1993.[41] In general, their study confirmed what others had found before them: overall, aid has no positive impact on growth. The authors did find a positive and significant impact of aid on growth in countries with good fiscal, monetary and trade policies. They also showed through a counterfactual calculation that the impact of aid on growth would in general have been positive if donors had rewarded countries with good policy instead of spending aid in accordance with their individual strategic interests.[42] According to another study of a similar stripe, targeting aid towards countries with reasonable policies and institutions could double aid effectiveness.[43]

The logic behind these findings is fairly simple. Growth and poverty reduction essentially rests on good policies. In countries that have already embarked on a reform programme, aid does not buy reforms but can be an auxiliary in sustaining the reforms and smoothening the process to additional reforms. Again, the crucial element in this process is domestic ownership of the reform agenda. When the reform policies demanded by donors are in tune with the agenda of the domestic political leadership, this situation reduces the friction between the two partners and they do not have to invest scarce resources in the game of aid negotiations.

However, more recent studies have contradicted the Dollar-Burnside thesis. One study, by economists William Easterly, Ross Levine and David Roodman, showed that if the period under study is extended by four years to cover the period 1970–1997, and adding data that have recently become available, there is no significant support for the idea that aid is effective even if the recipient country has a good policy environment.[44]

If one complicates things further by adjusting the definitions of 'aid' and 'good policy,' support for the Dollar-Burnside thesis dwindles further. For example: using the standard definition of aid – as measured by the OECD Development Assistance Committee – instead of a definition which excludes concessional loans (which Burnside and Dollar did), then aid no longer seems to have a significant impact on policy. The same result occurs if one uses alternative measures of good policy but otherwise uses the Burnside-Dollar approach and their regression method.[45]

The effect of aid becomes even worse if one tries to find the role played by aid in countries which need market-orientated reforms – defined here as limited economic activity by government, protection of property rights, sound monetary policy, outward-looking trade policy and efficient tax and regulatory policy. As shown in a recent World Bank study on the period 1980–2000 (the period of structural adjustment lending), aid discourages market-orientated reforms, particularly in the areas of sound money, regulation and property rights.[46] Overall, higher levels of aid tend to slow the pace of reform.

This is not to say that aid to poor countries with good policies is always ineffective. But it suggests that donors will experience an overall problem in starting and sustaining reforms, and providing the right type of aid to help strengthen previous aid and facilitate additional reforms.

One of the problems is the risk of 'aid overshooting.' The 'good policy' theory of aid suggests that once a country embarks on the reform route, the aid ratio of that country shall climb rapidly. The problem is that it can produce unhealthy incentives for the recipient government and if the amount of aid is too high, it can effectively derail the reform process. In other words, another version of aid dependency and its effect (or lack thereof) on behavioural change occurs. A study by Stephen Knack of the World Bank supports this analysis from a general governance perspective. According to the study, higher aid levels tend to erode the quality of governance when measured as indices of bureaucratic governance, corruption and the rule of law.[47] In other words, high levels of aid undermine incentives to reform.

This is what happened in Kenya during the short reform period after the first multi-party elections in early 1990s. Donors were blinded with the country's recent development and did not realise that an overly rapid increase in aid actually could hamper the reform agenda. Instead of pushing it forward, donors provided the Moi government with excuses for slowing down the reform process.

Sadly, the same situation has recently been repeated in Kenya. A short period after Mwai Kibaki was sworn in as the new president of Kenya in January 2003, the World Bank released money that had been postponed due the endemic corruption under the reign of Moi. The Bank also promised new money to finance free primary schooling and free public health care. Surprised by how quickly donors had decided to renew aid to Kenya again, the largest Kenyan daily newspaper ran an article with a refreshingly apposite title: 'The World Bank eager to spend again'. In addition to the trigger-happy World Bank, several bilateral donors showed up and promised new aid money. The result of this open season of aid soon became obvious to most observers: the government lost the reform momentum and Kenyans are still waiting for promised reforms to the country's economy.

Whatever the academic merits of this new aid policy, the most pressing question is still unanswered: do donors have an interest in – and the organisational capabilities for – restructuring aid programmes and prioritising aid towards countries with good policies? Notwithstanding the few positive examples of refocused aid discussed above, the answer is no.

The new aid policy implies that the donor is greatly aware of the policy environment and political order in the recipient country. Donors have generally not passed that test. So far, Uganda has succeeded with the aid-led reform agenda because of the absence of serious political conflicts over the reforms, especially after 1992, and because of the domestic consensus for liberalisation. On the other hand, the World Bank and the IMF have allocated significant capacity for monitoring aid and thus have been provided with necessary information, quite unlike the situation in Kenya where the government concealed vital facts.

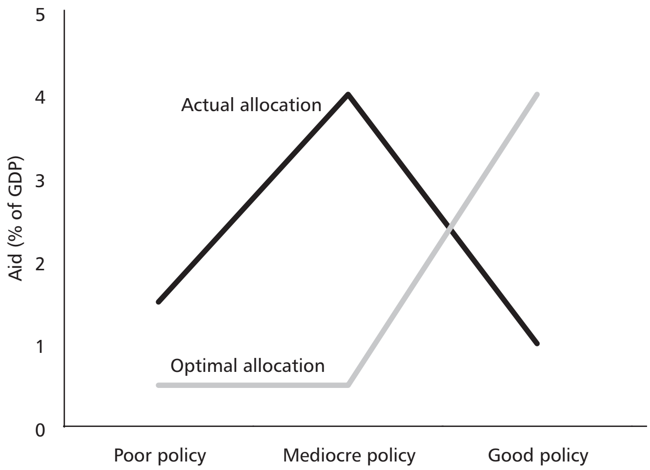
Furthermore, such an aid policy would presuppose the donor's ability to select countries with a proper policy environment and, inversely, the ability to abandon a country if it is back-tracking on reforms and damaging the institutional environment. Frankly speaking, such sensitivities have never ranked high on the agendas of donors.

Nor are donors following the new policy. If the new aid principles were put into practice, aid would increase if the recipient country enhanced its policy setting. But based on an estimate on the actual allocation of aid in 1996 (Figure 11), aid did not increase in tandem with this idea. There are good reasons to believe that this is still the case: a study from the World Bank's Operations Evaluation Department in 1998 found that only *one* of 41 low-income countries receiving aid had a satisfactory policy environment.[48]

Moreover, a tacit principle in many aid agencies is to give aid to those countries who 'need' it most – and those countries happen to be attached to destructive economic policies. The reason they 'need' the aid is the same reason that they should not be given it! In order to make the new policy live and breathe, donors would have to change internal structures and practices thoroughly. That has not happened. The current odds also favour the status quo because donor countries, the World Bank, the UN and others seem to be motivated by other principles when allocating aid.

The trendiest projects now receiving aid money are targeted at achieving the UN's Millennium Development Goals (MDGs). The problem is that aid directed at the MDGs, regardless of its effectiveness, is unlikely to be made conditional on improving the policy environment of recipient countries. Nor are most aid agencies dedicated to growth-promoting policies. Aid agencies

Figure 11 **Actual and optimal allocation of aid (1996)**



Source: Paul Collier and David Dollar (1998), Aid Allocation and Poverty Reduction. Washington DC: World Bank

today are governed by what former OECD economist David Henderson has called 'global salvationism' and dedicated to the practice of 'do-everything-development,' a phrase coined by William Easterly. In between the principle and the practice is a vision that donors can and should solve all the problems – but not the causes – of poverty.

The religion of investment

The new drive for aid is again based on the old financing-gap view combined with a version of savings-trap theory developed by economist Jeffrey Sachs. The latter is loosely based on a sort of 'good policy' theory: The underlying assumption is that poor countries, particularly in Africa, are locked in the savings-trap *despite* having good governance and some policies conducive to growth. In *Ending Africa's Poverty Trap*, Sachs explains this idea:

> *'The standard diagnosis is that Africa is suffering from a governance crisis. With highly visible examples of profoundly poor governance, for example in Zimbabwe, and widespread war and violence, as in Angola, the Democratic Republic of Congo, Liberia, Sierra Leone, and Sudan, the impression of a continent-wide governance crisis is understandable. Yet it is wrong.*

> *Many parts of Africa are well governed even though stuck in poverty.'*[49]

It is true that bad governance alone does not explain poverty in Africa. It is also true that a few countries in Africa are well-governed. However, the vast majority of African countries are badly governed and bad policy is the most important factor behind their continuing poverty.

To support his view, Sachs produced a table describing governance ratings in 33 countries in Sub-Saharan Africa.[50] The table has three governance indicators: The first shows that 8 of the 33 countries are ranked as having good governance according to a World Bank index.[51] The second, based on the Transparency International index, shows 10 of 20 rated countries being assessed as 'Good'. The third is the Freedom House rating and shows 4 of 33 countries being 'Free' in the terminology of Freedom House.

To summarise the argument, only 4 of 33 countries pass the test of having good governance, low corruption and being free. Is this a conclusive argument for Africa not having a continent-wide governance crisis?

A closer look at the indicators reveals some surprising results. According to the indicator allegedly based on Transparency International's index, Sierra Leone is categorised as having 'good' governance in 2003. Meanwhile, Zimbabwe and Sudan were rated as 'average'. However, the 2003 Transparency index reveals that Sierra Leone had a score of 2.2 out of 10 and Zimbabwe and Sudan were only very slightly better with 2.3 out of 10.[52] Apparently, Sachs used the index only as the basis for his own rating, which he obtained by performing a regression analysis of corruption in African countries against income per capita.[53]

In other words, Sachs' index *presumes* that poor African countries are badly governed and so should be rated relative to one another and taking into account the level of poverty. This is clearly absurd.

Sachs' index says nothing about whether countries actually perform well or badly. Again, this is hardly a convincing argument and the best explanation of African poverty is still bad policy and bad governance.

Still, this criticism does not prevent the savings-trap idea from being true or equally, the theory of under-investment in poor countries from being a proper description of real problems. This leads us back to the issue of the role of investment in development and the question of whether the aid-to-investment-to-growth idea is a workable strategy for donors.

Given the vast amount of criticism of the financing-gap idea, it is peculiar that so many scholars and aid workers continue to believe it is a panacea. Surely this gap orthodoxy cannot purely be based on economic reasoning. It seems to be something more and it is arguably not far-fetched to speak of an obsession, even a profound investment 'religion': donors, recipients and scholars on the outskirts of the aid business have all desperately been searching for the Holy Grail of investment, the key that would unlock the mysteries that surround it.

Donor studies and research reports about poverty are full of passages about low investment levels. For example, according to an oft-quoted study, Africa invested only 9.6 per cent of its GDP during 1960–94, while the investment/GDP ratio in other developing countries was 15.6 per cent.[54] Investment is undoubtedly a precondition to long-run growth, but aid-financed investment is not a quick fix for LDCs. Nor does the investment level *per se* explain economic backwardness.

But is it correct to say that low investment has not at all been a constraint on African development? In fact, that seems to be true. An intriguing study resulted in three interesting facts. First, the public investment rate in Africa was similar to the rate in other developing countries. Second, public investment is not at all correlated with growth in Africa. Third, and more surprisingly, not even private investment is correlated with growth if one excludes Botswana from the sample.[55]

The reason for excluding Botswana is that the country experienced the exact opposite development of Africa in general, because it has achieved high rates of real growth during the last decades. In fact, no other country in the world has grown faster than Botswana in the last three decades – not even China. As a consequence, Botswana's GDP per capita rose from around $1,600 in 1975 to around $8,000 in 2004 (in purchasing power parity terms) – well above all other Sub-Saharan African countries. Aid dependency has decreased (also when measured as aid per capita) relatively fast and GNI per capita has risen sharply (Figure 12).

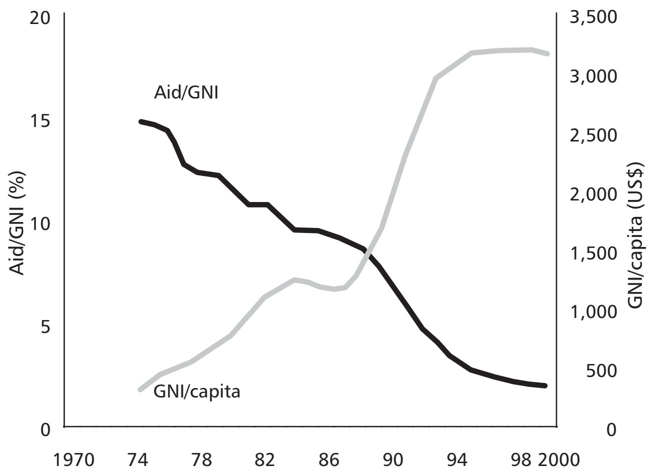
It is not difficult to explain Botswana's economic success – it's the policy, stupid! Soon after independence, Botswana headed for a generally sound economic policy instead of running along with other African countries on the route to socialism.

Property rights, as well as a reasonably well-established system of law and contract, were instituted and enforced. Botswana did experiment with price regulations but not to a large extent. The marketing boards soon lost power and were not used to extract resources from the rural sector to the urban elite (which has been the case in most other countries). In comparison to other countries, the country's fiscal policy has been disciplined and Botswana did not allow the parastatal sector to grow out of control. In fact, while this sector has caused severe problems in many other countries, it has remained small and unproblematic in Botswana.

In addition, Botswana was lucky to have natural resources (diamonds) that boosted export revenues. Many other African countries with a wealth of resources have suffered from the 'resource curse' and the average person has not benefited from the wealth that such resources might bring to the country. Due to relatively good governance and 'inclusive' economic institutions (property rights have given a large part of the population an interest in stable political development) Botswana has made something good out of its natural resources.

This is of immediate relevance to the discussion about investment in Africa. The bottom line is the 'qualitative' dimension of investment. Fundamentally, what matters for investment is the structure of property rights, the extent to which the courts of law apply and enforce abstract, clear rules inexpensively and quickly, the size of government and its effectiveness in delivering public goods, and the openness of the economy to trade and investment with the outside world. Proximally, these translate into factor productivity, incentives, the organization of production, technology, to name just a few important aspects. These determine the effect of investment on growth.

Figure 12 **Aid and GNI/capita in Botswana (5-year moving average)**



Source: World Development Indicators Online

Several empirical studies show that investments in Africa are less efficient than investments in other comparable regions. It has been estimated that the incremental capital output ratio (ICOR) – a measure of investment efficiency showing the ratio of investment to additional output – of Africa is only one-quarter of the East Asian ICOR and roughly one-half of the ICOR of other LDCs.[56] According to another study, one-third of the growth gap between Africa and other LDCs can be explained by lower investment rates. The remaining two-thirds of the gap is due to slower productivity growth.[57]

These 'qualitative' dimensions are particularly important in public investment, partly because public investment constitutes more than half of the total investment in developing countries. Equally importantly, public investment is also a special version of capital formation that differs quite substantially from private investment. Because it is channelled through political institutions, it changes the nature of the investment process, even the investment itself, as well as the prospects for returns on the investment.

A short visit to an industrial estate in Kenya, Tanzania or several other African countries will usually provide sufficient evidence of inefficiencies in public investment. Many public investments in industries or infrastructure have been dismal failures. Tellingly, when World Bank economist Lant Pritchett travelled to Tanzania in the 1990s he visited an aid-financed industrial estate with public enterprises. He witnessed 'structures [that] were mostly rotting hulks, there was little workable machinery, and few workers still bothered to show up'.[58]

Unfortunately, Pritchett could not visit the infamous Morogoro Shoe Factory – a true white elephant – because the manager was in therapy, 'too depressed by all the visitors trooping through'. This shoe factory, carrying a US$40 million price tag, was financed by the World Bank but never produced more than 4 per cent of its planned production capacity. There are numerous examples of 'cost-overrun and production-underrun' investments, a beautiful euphemism for money wasted on corruption, inefficient management and bureaucratic inertia.

A nuclear plant in the Philippines built under the Marcos regime had an investment cost of more than US$2 billion – yet never even opened. Ajoukuta Steel in Nigeria swallowed US$4 billion but it has never been finished to planned capacity. However, after the end of the last military government in 1998, reports asserted it had generated payoffs of about US$2 billion to various government officials.

Anecdotes aside, Pritchett suggests that the usual measurement of investment is methodologically flawed and accordingly provides an unsatisfactory picture of the true state of public investment. He concludes that only eight per cent of the official measured growth of machinery and equipment in Africa during the last 30 years was actually translated into tangible machinery and equipment. Given the problems attached to this kind of analysis, the figure could easily be disputed. However, Pritchett's findings nevertheless reveal an important aspect of public investment (and to some extent also private investment) – one invested dollar or pound does not necessarily translate into one dollar or pound of economically valuable capital.

These anecdotes also serve to remind us of the risks of investment which is mostly financed by aid and falls under the auspices of the public sector: aid then tends to underpin the growth of the public sector and government consumption. This can encourage unhealthy political-economic processes in the recipient country.

A special version of this pattern is the effect which aid has in boosting bureaucracies. In 2001, Tanzania produced 2,400 reports and studies on different aspects of present and future aid in order to please donors. A former minister of finance in Kenya estimated that he spent 75 per cent of his time in discussions with donors. Moreover, public investment projects too often become magnets for corruption, especially in countries already characterised by bad governance. One does not have to spend much time in a poor country to realise that the ultimate in corruption is construction projects (buildings, roads, dams etc.) that continue over a long time period, without effective control mechanisms for money spent.

Aid has also financed many parastatals and SOEs, and hence supported the next-best opportunity for corruption. Aid agencies have over the years also employed a large part of the well-educated elite that formerly was in the bureaucracy and thus weakened the educational quality of its staff.

To be fair, all of this should be interpreted carefully. Aid has in a few cases and for brief periods provided impetus and support for governments to improve their governance – to liberalise, privatise and deregulate their economy. But even in those few cases, aid has often been given for too long and has led to dependency, which eventually tends to undermine the improvements that have taken place. Moreover, it is indisputable that aid overall underpins structures and practices which often turn out to be a Klondike for kleptocrats.

Conclusions

To most observers it is quite clear that the idea of providing a takeoff into sustained growth by foreign aid has been a dismal failure. Overall, aid has not promoted economic growth, nor has it led to improved policies in developing countries. Rather, there is much evidence supporting the view that aid largely has backed political regimes with little interest in growth and development. Most donors have failed to follow the Hippocratic principle of 'do no harm'.

Political leaders today campaigning for increased aid certainly know this. The small or even negative effect of aid on economic development was the main reason for the falling aid levels in the 1990s and the general aid fatigue. Since then very little has happened in the realm of aid in regard of effectiveness. Serious research and evaluations of aid cannot point to any significant change in the structure of aid that gives support to the argument that this time, increased aid will actually deliver the goods. When the G8 or the EU countries commit themselves to double aid spending there is no discussion about how aid can be more effective. If the G8 countries commit to double aid spending, there will be little or no discussion about how that aid can be more effective.

That is why we should treat with great concern the current push for massive increases in aid. There is a great danger, even a strong likelihood, that such aid will assist mostly in the corruption of governments that are already doing much harm to their citizens, promoting bad policies and undermining democracy and the rule of law. It is therefore irresponsible, to say the least, to push for increased aid spending without having an idea how to make it useful in growth promotion and how to avoid its many pitfalls.

Based on the foregoing, it would be much more sensible to scale back the levels of aid considerably; provide aid only to governments that are already reforming and which agree to continued reforms; and make clear that aid will be available only for a strictly limited period.

At the same time, rich countries should open up their markets to receive exports from developing countries. The welfare gain to Africa alone that would be achieved by a free trade regime in agriculture is roughly the same as all countries' official spending on development assistance today.

Trade has proven to be instrumental to increased welfare. Aid has not.

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5 The presence of the gap model in donor organizations is studied Easterly, W. (1999). 'The Ghost of the Financing Gap: Testing the Growth Model Used in the International Financial Institutions.' *Journal of Development Economics* vol. 60, number 2, pp. 423–438; and Easterly, W. (2002). *The Cartel of Good Intentions: Bureaucracy Versus Markets in Foreign Aid*. Working Paper No 4. Washington, DC: Center for Global Development.

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9 The direct impact of aid is the project efficiency. It is difficult to find general conclusions about project

efficiency because few bilateral projects are evaluated, and an overall problem is that evaluations are often very subjective and do not provide the full picture. In evaluating an aid-funded school, for example: should it be evaluated technically after the construction work is finished, or should the evaluation be carried out six years later to see if the children attending the school received an education? Or should the evaluation be done earlier to see if the school employs educated teachers?

The Operations Evaluation Department of the World Bank evaluated approximately 25 per cent of all projects in 1990–99 (evaluations were done three to six months after final disbursement) and found a 59 per cent failure rate in the investment programmes. In East Asia, the failure rate is 40 per cent and in South Asia and Africa, 65–70 per cent. Another study from the Asian Development Bank also shows that when independent actors carry out evaluations a few years after the project been finished, the results are generally worse – and never better – than the Bank's own evaluations. For more information about project efficiency, see IFIAC (2000) *International Financial Institutions Reform: Report of the International Financial Institutions Advisory Commission*. Report to the US Congress. Washington, DC: US Congress.

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As far as I know, there is only one empirical study claiming that aid has definitely had a positive effect on growth – Hansen, H. and Tarp, F. (2001). "Aid and Growth Regressions." *Journal of Development Economics* vol. 64, number 2, pp. 547–570 – and that the effectiveness is not determined by the policy conditions in the recipient country. That is, regardless of policy, aid leads to higher growth. As also pointed out by the authors, there are some methodological problems attached to this study.

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International Policy Network

Aid and development

Will it work this time?

By Fredrik Erixon

This study examines the impact and effectiveness of foreign aid over the past 50 years. It challenges some of the fundamental assumptions that have encouraged the governments of wealthy countries to give taxpayers' money to the governments of poorer countries.

While rock stars, politicians and the UN claim that aid must be doubled if we are to end poverty, the evidence shows that aid has generally failed to achieve its stated goals. Meanwhile, it has undermined democracy and delayed policy reforms that would have benefitted the poor. In the worst cases, aid has sustained some of the most oppressive political regimes in history. African countries such as Kenya and Tanzania illustrate the dismal failures of aid.

Meanwhile, India and China – home to many of the world's poorest people – have achieved rapid and sustained economic growth despite receiving trivial amounts of aid.

Aid was founded on the fallacy that poor countries lacked the capital to invest in development. We now know that self-sustaining economic progress can only occur in places which have institutions that foster the creation of capital. These are the institutions of the free society: property rights, contracts, the rule of law (administered by a transparent and honest judiciary), and limited government.

Increased spending on aid would not eliminate global poverty and improve human welfare. More likely it will do the opposite, undermining these free institutions and thereby perpetuating poverty.

Instead of increasing aid, current spending should be scaled back and spent only on countries that have made a firm commitment to reforming economically, and especially to the installation of the institutions of the free society. Aid should only be given if the recipient government proceeds with its planned reforms, and should be given for a strictly limited period to discourage dependency and corruption.