THE BLEYZER FOUNDATION

Turning Transitions Into Prosperity

International Official Aid: Flows and Impact

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International Official Aid: Flows and Impact

Iryna Piontkivska

International capital flows play an increasingly important role in promoting economic development and growth in developing countries. However, developing countries could benefit more from foreign capital inflows if they were to carry out necessary economic reforms to improve their business environments. Total financial flows from developed to developing countries came from both public and private sectors, but the patterns of their allocation across developing countries are different. Since the early 1990s private capital flows, in particular foreign direct investments, have indeed become the largest and most stable source of foreign financing for developing countries. It is widely recognized that private capital flows into economies with attractive business environments; this explains why these capital inflows have concentrated only on a small group of countries that have already implemented a significant critical mass of necessary economic reforms.

At the same time, official development financing (or international aid) is supposed to be distributed according to poverty reduction or more broadly, the promotion of human well-being. Fuelling growth is considered as one of the most important means by which this objective can be achieved. However, though all donors view these objectives as primary for allocation of their financing, the quality of official development aid has been eroded by a combination of political and commercial interests on the part of most donor and recipient countries over the last decades. There are innumerable examples of aid ineffectiveness when massive aid flows failed to bring about sustained economic growth and higher standards of living to recipient countries.

In 1999, SigmaBleyzer initiated the International Private Capital Task Force (IPCTF) in Ukraine. Its objective was to benchmark transition economies to identify best practices in government policies that improve the investment climate and attract private capital. An Action Plan was developed and presented to the Ukrainian government which identified the economic policy actions necessary to improve the investment and business climate in Ukraine, attract additional flows of private capital to the country; support economic growth, and improve the quality of life for their citizens. In 2001, this effort was expanded to all countries of the FSU, and IPCTF ratings for all 15 countries of the FSU were developed. They are available from SigmaBleyzer and The Bleyzer Foundation.

The Bleyzer Foundation was established in 2001 in order to promote the IPCTF framework and help countries implement the policies necessary to successfully complete transitions to market economy.

The Foundation's Managing Director is Mr. Victor Gekker, who is supported by a team of economists and business analysts. The Advisory Board of The Bleyzer Foundation is chaired by Dr. Edilberto Segura and provides advice and guidance to the activities of the Foundation.

Chief Economist Edilberto L. Segura
Editor Rina Bleyzer Rudkin

In this report we analyze the overall trends in official aid flows to developing countries, the distribution of these funds across the developing world as well as their impact on the recipient countries' economies, with the aim of assessing the effectiveness of official development aid. The problem with aid is that it is misallocated because it is used not to promote economic growth but to support politically-oriented goals. These goals, however, are not sustainable per se. Our empirical analysis shows that aid has not had any significant impact on economic growth. The impact of aid on basic indicators of human development was also insignificant, suggesting that aid does not benefit the poor.

This report concludes that the bulk of foreign aid should be directed to support the creation and growth of a healthy and competitive private sector. Only efficient interaction of aid and private flows can produce a high quality stream of development financing that fosters economic growth and, consequently, reduces poverty. Over the long term, sustainable economic growth in developing countries would increase fiscal revenues, and governments of these countries would then become self-sufficient and be able to finance necessary investments in health, education and safety nets for the poor, rather than relying on aid.

Facts about Official Aid — Summary

Over 1980–2002, $1.5 trillion has been provided as official development financing (ODF) to developing and transition countries from all donors, out of which about 70% came from Development Assistance Committee member countries (bilateral), and 30% from multilateral institutions.

Over the same period, developing and transition countries received some $830 billion in the form of grants. The rest of development financing was provided as loans.

Out of the total official development assistance (ODA) to developing countries by all donors during that period, about 34% was used for social programs, 48% for public investment in infrastructure and production sectors, 6% for debt restructuring/relief, and 4% for emergency and distress relief aid. (Note: military aid is excluded from official development aid statistics.)

On a regional breakdown, the most favored destinations for ODA were African and Asian countries, which received about 70% of the cumulative ODA on a net basis over the last twenty years. In absolute terms, about $424 billion was provided to African countries (including $326 billion to Sub-Saharan Africa), and Asian countries received $428 billion over the same period.

Until recently, the United States has been the world's largest aid donor in absolute terms. In recent years, Japan has climbed to the top of the list,

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followed by the USA, France, Germany, and the United Kingdom. Prior to 1990, the Soviet Union was also among the top donors. In 1980–1989, the USSR was the fourth largest donor to developing countries, following the USA, rich Arab countries and Japan.

Following the end of the Cold War, the regional distribution of ODA flows witnessed no significant changes. In 1990–2001, African countries remained the largest recipients of official assistance accounting for the same 36% of the total ODA flows over the period. Post-communist countries (CEE and NIS) attracted 12% of the total ODA or about $80 billion during 1990–2001.

After a more than 40% increase in the ODA flows to developing countries in the 1990s, the amount of official assistance has dropped by about 19% over the last decade to $60.6 billion in 2002. Expressed as a share of the donor's gross national income (GNI), official aid fell from 0.33% in 1990 to 0.23% in 2002.

Over the last decade, the split in terms of ODA use has changed only slightly. Out of the total ODA disbursed to developing countries by bilateral and multilateral donors over the period, 36% was used for social programs, 33% for public investment in infrastructure sectors, about 8% for debt restructuring/relief, and 6% for emergency and distress relief aid.

History of Foreign Aid

At the Bretton Woods Conference of 1944, a group of about 50 nations agreed on some basic economic principles for a 'new world order' proposed by John Maynard Keynes. The International Bank for Reconstruction and Development (IBRD, or the World Bank) was established to help the post-War reconstruction of Europe and the development of less advanced countries. The International Monetary Fund (IMF) was created to assist countries in maintaining their balance of payments equilibriums. Together with the foundation of the United Nations, Bretton Woods laid the basic structure of the international monetary system and the multilateral financial agencies that have remained in place to this day.

In 1948, the US Congress authorized the use of two to three percent of the US Gross National Income (GNI) until 1953 to finance grants for the reconstruction of Europe, usually referred to as the Marshall Plan. That is how the present concept of aid was born. Three-quarters of the goods financed under this plan came from the US, mostly in the form of food aid. The recipients agreed to co-operate and make joint requests to the US. The organization set up to do this eventually became the Organization for Economic Co-operation and Development (OECD), whose Development Assistance Committee (DAC) includes all the major official-aid donor countries.

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The end of the Second World War also ushered in a Cold War with the Soviet Union, in which aid became a pawn. As a result, the direction of aid flows was determined primarily by political motivations — the West-East confrontation. In the mid-1950s and early 1960s, when many of the former European colonies were becoming independent, the idea of a so-called "Marshall Plan for the South" emerged. In 1960, the UN General Assembly adopted a resolution, which stipulated that one percent of the GNI of developed countries be devoted to aid in Southern Hemisphere developing countries. In 1960–70, there was a decade of rapidly increasing aid inflows to developing countries. However, most bilateral aid between individual countries was tied to narrow commercial or political self-interest in the donor country. Nevertheless, the one percent aid target was never reached. In 1969, a Commission led by Lester Pearson, the Canadian Prime Minister, called for 0.7 percent of developed countries' GNI to be given in aid, excluding commercial loans and military expenditure; the average was about 0.5 percent at the time. This target was unanimously accepted by the members of the OECD.

In 1972, the World Bank called for a reorientation of aid towards the poorest 40% of the world's population; this new orthodoxy was called "targeting the poor." The oil crisis in 1973 hit the Southern Hemisphere hard, and the process of recycling the oil-producers' huge cash surpluses through Northern private banks into Third World loans began. In 1974, the UN endorsed the "New International Economic Order" called for by the group of 77 developing countries, who argued that aid was no substitute for a fair deal on basic economic issues like trade. In 1982, a major financial crisis hit Mexico, which threatened to default on its foreign debts, and aid levels stagnated well below the 0.7 percent target. The economic success of the "Asian Tigers"(South Korea, Taiwan, Hong Kong and Singapore — all of which had at one time been recipients of substantial aid) seemed to offer a new model of export-led economic growth in developing countries.

In the latest "new world order" after the collapse of communism, the acceptance of "structural adjustment" by recipient countries became a uniform condition of almost all official aid. A 'Washington Consensus' emerged in 1990 as the World Bank declared that though poverty persisted, only free markets could reduce it. Growing anxieties about the threat of social unrest resulted in a New Policy Agenda, which called for good governance and ownership of adjustment policies from recipient governments. An increasingly long list of conditions became attached to aid. Civil conflicts in recipient countries replaced the national contests of the Cold War and the proportion of the aid budgets devoted to peacekeeping and emergencies increased[1]. With end of the Cold War, the strategic value of aid declined, which, in addition to the fiscal pressures in donor countries, led to a significant decline in aid in 1990s. Despite recent reports of an upsurge in official aid in 2002, it is still a long way before the

[1] Based on Fuhrer, H. 1996. The Story of Official Development Assistance. Paris: OECD; and *New Internationalist* Issue 285 (1996).

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aggregate levels of aid recover to at least 1990 levels. Thus, many poor countries are now facing significant challenges in financing their further development and achieving sustainable debt levels (many poor countries are also heavily indebted countries.)

At the Financing for Development Conference held in Monterrey, Mexico in March 2002, the international community agreed on a set of international development goals for 2015, usually referred to as "The Millennium Development Goals." During the Monterrey conference, US President George W. Bush outlined a new US Government policy towards aid provision to developing nations and proposed a "new compact for development". The new compact, the Millennium Challenge Account, recognizes that development assistance can be successful only if it is linked to sound economic policies, which create the investment and business environment necessary to attract private capital investors to developing countries. The Millennium Development Goals include eradicating extreme poverty and hunger, achieving universal primary education for children everywhere, promoting gender equality, reducing child mortality, combating the spread of HIV/AIDS and other dangerous epidemic diseases, and also ensuring environmental sustainability.

The new goal the donor community set before itself lies in developing a global partnership for development that envisages comprehensive consideration of debt problems of developing countries to make their debt sustainable in the long-run, improving cooperation with the private sector to address special needs of developing countries, and developing further predictable and non-discriminatory trading and financial systems. In particular, the donor community committed to increasing the net official development assistance flow to developing countries to 0.7 percent of the DAC donors' GNI by 2015. So far, aid remains below the levels required to meet the Millennium Development Goals, underlining the importance of efforts to increase effectiveness of existing aid resources.

Definition and Classification of Official Aid

Official development financing (ODF) is defined as all official development-motivated financial flows that go from advanced economies (developed countries' governments) and multilateral financial institutions to the developing countries and countries in transition. ODF includes several subcategories such as official development assistance (ODA), official aid (OA), and other official flows (OOF). The Organization for Economic Co-Operation and Development (OECD) differentiates among different types of aid flows as follows:

Official development assistance (ODA) represents flows to developing countries and multilateral institutions provided by official agencies, including state and local governments, which are developmental in their intent, concessional in character and convey a grant element of at least 25 percent.

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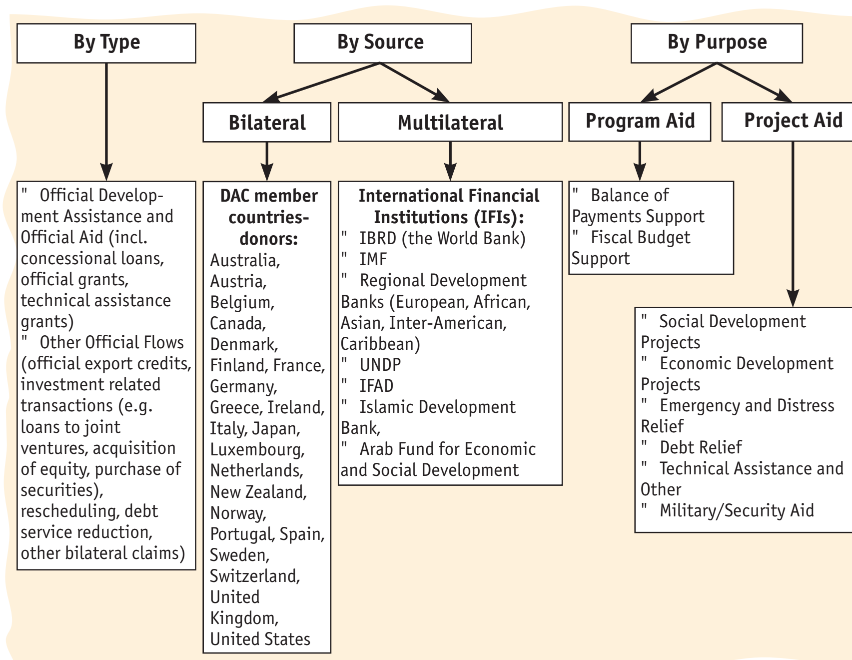
Official aid (OA)[2] comprises flows that meet the eligibility criteria of ODA, but are directed toward transition countries. ODA and OA aggregate balance of payment support, capital projects, food aid and emergency relief, peace-making efforts, technical cooperation, concessional funding to multilateral development funds, etc.

Other official flows (OOF) represent official transactions that do not meet the eligibility criteria to be recorded as ODA or OA. These transactions include official non-concessional loans, official export credits, official sector equity and portfolio investment, and debt restructuring undertaken by donor governments on non-concessional terms.

The chart below shows classification of official aid flows.

Official Development Financing Classification Chart



Dynamics of official aid flows

Over the last twenty years, cumulative net official development financing (ODF) flows to developing and transition countries made up $1.5 trillion[3], including $1.25 trillion of net ODA/OA disbursements.

[2] These are territories and countries included in the so-called Part II of the Development Assistance Committee (DAC) List of Aid Recipients. The list comprises middle-income transition countries of Central and Eastern Europe and former Soviet Union countries as well as some advanced developing countries ('Asian Tigers', Israel, Kuwait, Arab Emirates and others).

[3] In 2001constant prices. Data source: International Development Statistics (IDS) online database on aid and other resource flows of OECD

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Over 1980–2002, developing countries received on average about $60 billion of official development financing (on a net basis) annually. Net official development financing increased 36% in nominal terms over this period, from $45 billion in 1980 to $61 billion in 2002, but there was a 19% decline in real terms. Until 1990, the overall trend in official development financing was increasing, but then it reversed over the next five years. In the 1980s, net ODF dynamics was increasing with a significant upsurge observed after the 1985 Mexico financial (debt) crisis. In 1990, net ODF reached its first peak of $75.5 billion disbursed to developing countries. A sharp increase in aid flows in the early 1990s could be attributed to the Gulf War of 1991, and a major part of additional funds provided to developing countries during this period was in the form of emergency and humanitarian aid, which is temporary in nature. Thus, these additional funds could hardly produce a significant positive impact on long-term development goals. Another upsurge in official flows to developing countries occurred between 1995 and 1999, which is attributed to the wave of financial crises in emerging markets (Asia, Russia.)

Official Development Financing and Private Capital Flows to Developing Countries

$ billion, current prices	1960	1965	1970	1975	1980	1985	1990	1995	2000	2001	2002
Net ODF	4.62	6.47	8.84	23.42	44.72	43.81	75.46	71.66	53.95	59.24	60.62
Net ODA/OA	4.26	6.16	6.88	18.11	34.22	32.51	57.59	58.79	49.95	51.95	63.27
Grants	3.65	3.84	4.10	11.03	21.04	24.09	45.09	46.58	41.44	42.85	50.66
Net Concessional Loans	0.61	2.33	2.78	7.08	13.18	8.43	12.50	12.21	8.51	9.09	12.61
Net OOF	0.27	0.32	1.76	5.54	10.16	10.78	18.08	12.68	3.79	7.53	-3.55
Export Credits	0.13	0.21	0.55	2.07	2.10	0.66	0.28	1.94	1.69	0.24	0.96
Net Private Flows	3.15	4.14	7.02	25.71	40.32	9.51	10.02	94.81	151.79	136.66	63.74
Net FDI	1.77	2.46	3.69	10.34	10.13	12.47	24.10	105.59	160.64	171.69	143.00

Source: OECD International Development Statistics (IDS) online database, WB World Development Indicators, 2003.

The above mentioned figures support the view that official aid flows play a very important role in crisis periods. However, following a so called "crisis bailout", official flows faded away. In 2002, net ODF was more than 30% below the 1990 level in real terms, while net ODA picked up 1% relative to 1990 level, mostly due to growth of ODA grants. Net ODA flows witnessed a decline during the 1990s if expressed as a share of DAC donor's GNP — from 0.33% in 1990 to 0.23% in 2002. However, the decline has not been constant; ODA flows recovered slightly following a sharp decline in 1997.

In contrast to the uneven dynamics of official development financing over the last decade, foreign direct investment flows to developing countries have surged from $24 billion in 1990 to $143 billion in 2002. In addition, experience over the last two decades showed that those countries that were able to secure larger inflows of foreign capital were able to achieve above average levels of GDP growth. This supports the view that foreign direct investment is indeed the largest and most stable source of foreign financing for developing countries (see also chart below.) However, most of these foreign direct investment flows have been channelled to a very limited

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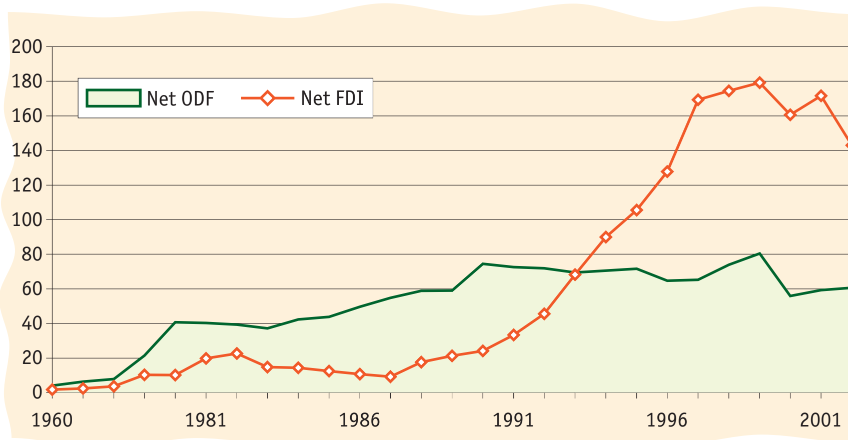
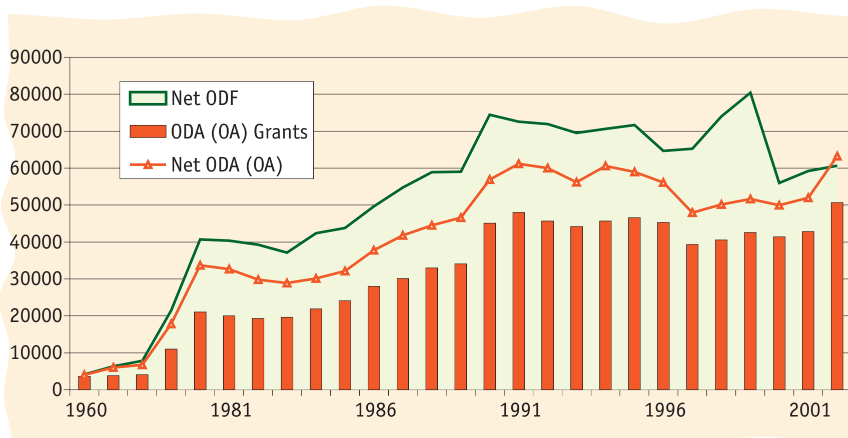
number of countries. For instance, in 2001, five developing countries (China, Mexico, Brazil, Poland and Chile) received 60% of the inflows of foreign direct investments. The main reason for this concentration of resources is that the rest of the developing world does not offer business environments that are attractive enough to be of greater interest to international investors. This implies that the forms and patterns of use of official development financing have to be designed in such a way as to help recipient countries' governments pursue sound economic policies that will create an attractive business environment for private capital investors.

Dynamics of Official Development Financing and Net Foreign Direct Investment Flows to Developing Countries, US$ billion



Source: OECD International Development Statistics (IDS) online database, WB World Development Indicators, 2003.

Dynamics of Official Financial Flows to Developing Countries 1960–2002, US$ million



Source: OECD DAC International Development Statistics (IDS) online database.

Most ODF is provided in the form of grants. The chart above shows that over the period of 1980–2002, grants constituted on average 75% of net ODF flows, including technical assistance grants. The rest was composed principally of concessional loans. The share of official grants increased from 50% in 1980 to 83% of net ODF in 2002. The share of loans in net ODA

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to developing countries fell from 30% in 1980 to 20% in 2002. This increase in the share of grants to developing countries is attributed to a marked increase in the amount of debt forgiveness for heavily indebted developing countries and increases in the amount of technical assistance. In fact, technical assistance amounted to about one third of net ODF in 2001. Technical assistance grants represent financial flows that are usually not reflected in developing countries' balance of payments, as most of them go to developed countries' residents (for example, payments for consultancy services provided by donor country residents, administrative costs of donors.)

Official development assistance from bilateral sources significantly outweighs the amount of aid provided by multilateral institutions. Over the last twenty years, the median distribution of aid flows between the two sources has been roughly constant — about 70% of total aid flows came from bilateral donors, and about 30% from multilateral. In terms of bilateral financing, the largest donors in absolute terms are the USA, Japan, France and Germany. In 2000–2001, these four largest donors accounted for almost two-thirds of all aid flows to developing countries. In 2002, most donor countries reported a real increase in ODA, including almost 12% real growth of ODA from the United States (to $12.9 billion) primarily due to additional emergency and distress relief funds within its anti-terrorist campaign.

The table below shows the distribution of ODA grants across developing countries, both by geographical groups and by income levels. Because ODA grants represent the weightiest component of total official financial flows to developing countries, the pattern of their distribution across different parts of the developing world roughly parallels the distribution of total aid flows.

Distribution of ODA Grants Across Developing Countries, US$ million

US$ million, current prices	1960	1970	1980	1990	2000	2001	2002
Developing Countries	3,648	4,099	21,040	45,090	41,436	42,853	50,658
Geographical regions							
North Africa	611	395	811	6,135	2,150	2,106	2,328
South Africa	483	871	5,450	14,437	10,833	11,417	14,983
North & Central America	65	144	573	2,141	2,379	2,867	2,275
South America	130	248	659	1,551	2,253	2,448	2,767
Far East Asia	819	796	1,314	3,142	4,029	3,676	4,109
South & Central Asia	840	363	3,047	3,352	3,393	4,606	5,500
Middle East	243	380	4,763	4,627	3,028	2,356	3,941
Central and Eastern Europe	—	—	—	64	2,601	2,491	2,680
Former Soviet Union Republics	—	—	—	0	2,960	2,896	3,351
Income groups							
LDCs,Total (Least Developed)	301	696	6,502	12,351	10,422	10,700	13,863
OLICs,Total (Other Low Income)	1,080	955	2,905	6,831	6,339	7,876	8,355
LMICs,Total (Low Middle Income)	851	963	5,215	11,710	10,210	11,004	13,711
UMICs,Total (Upper Middle Income)	232	261	1,329	2,783	1,791	1,831	2,361

Source: OECD DAC International Development Statistics (IDS) online database.

On a regional breakdown, the most favored destinations for ODA flows have always been and still are African and Asian countries, which received about 72% of the cumulative net ODA flows to developing countries over the last twenty years. The poorest countries of Sub-Saharan Africa have always been among the largest recipients of development financing (most of which in the form of grants), but the progress in poverty reduction in this region has been extremely slow, thereby contributing to the growing perception that aid flows have failed to support development. During 1980-2001, African countries received $424 billion of net ODA (including $326 billion that was provided to Sub-Saharan Africa).

Over the 20 year period, Asian countries received $428 billion in net ODA, primarily on account of India and China, where the largest number of people in extreme poverty live. About 10% of total ODA to developing countries was channeled to Latin American countries during 1980-2001. Following the end of the Cold War, a number of former Soviet bloc countries became recipients of official aid. Between 1990 and 2001, countries of Central and Eastern Europe and former Soviet republics (CEE/NIS) received almost $80 billion of official development assistance from both bilateral and multilateral donors. This amount represented about 12% of the total ODA flows to developing and transition countries over the period. It is worth noting that aid to the CEE/NIS region has not crowded out official aid to African and Latin American countries. It is more likely that these funds came as a result of reduced aid to successful Asian countries that attracted significant amounts of private investments, and also lower amounts of aid channeled to Middle East countries as a result of reductions in emergency and distress relief aid programs. Over the last twenty years, ODA flows to Central Asia and the Middle East fell by 19% and 71% respectively, while aid to Latin American countries almost doubled over the same period. In 2001, Sub-Saharan Africa also received 17% more development assistance in real terms as compared to 1980.

If we look at regional distribution of aid in relative terms (e.g. aid per capita), it turns out that over the last decade the poorest world region, South Asia, has been receiving less than $5 per capita annually. In contrast, countries of the Middle East and North Africa, with almost three times South Asian per capita GNI, have absorbed on average $25 per capita annually over 1990-2000. Sub-Saharan Africa has been receiving almost $29 per capita (on average), and aid represented on average about 6% of per capita GNI over the last decade. Such uneven allocation of foreign aid relative to the needs of developing countries is at odds with the declared developmental priorities of ODA disbursements.

The table below shows the top 20 recipients of official assistance over the last twenty years, on a cumulative basis and in relative terms. It shows that, in relative terms, the largest recipients of aid were middle-income countries of the Middle East and North Africa. Low-income countries of Sub-Saharan Africa and South and Central Asia received almost 20% less on a per capita basis.

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The Largest ODA Recipients in 1980–2001

No.	Country	Net ODA/OA, US$ billion1980-2001 cumulative	GNI per Capita, US$		Aid per Capita, US$	
			1980	2000	1980	2000
1	Egypt	55.68	500	1,490	59.96	20.76
2	India	50.28	240	450	5.23	1.46
3	China	44.34	300	840	0.11	1.37
4	Bangladesh	37.99	150	370	25.61	8.94
5	Indonesia	35.80	470	570	12.34	8.23
6	Israel	34.70	5,390	16,710	417.25	128.33
7	Pakistan	27.72	290	440	24.82	5.09
8	Tanzania	22.29	238	270	56.04	30.33
9	Philippines	20.85	650	1,040	11.95	7.64
10	Jordan	17.80	966	1,720	735.21	113.04
11	Ethiopia	17.49	120	100	8.90	10.78
12	Sudan	17.17	400	350	53.05	7.25
13	Mozambique	17.17	323	230	21.34	49.57
14	Morocco	16.97	930	1,180	74.92	14.61
15	Syria	16.93	1,450	950	323.94	9.79
16	Thailand	16.80	670	2,010	18.19	10.55
17	Poland	16.77	3,934	4,190	—	36.12
18	Kenya	15.80	420	350	38.37	17.02
19	Russia	15.03	—	1,690	—	10.75
20	Zambia	13.82	600	310	89.48	78.81

Sources: OECD DAC, World Bank.

In the above list, two transition countries — Russia and Poland — entered the top-twenty list of aid recipients over 1980–2001, although these two countries have been receiving official development assistance for only the last 11–12 years. Distribution of official assistance and aid to developing countries by income groups shows that almost equal amounts of aid have been provided to least developed, low-income, and lower middle-income countries over the period of 1980–2001 in cumulative terms (some 22–27% of the total net ODA flows to developing countries).

The above country distribution of aid is the result of the fact that bilateral donors usually favor a limited set of countries, chosen primarily according to the priorities of the donor's foreign policy. For example, relatively large amounts of official US aid went to Egypt, Israel, Pakistan, Russia, and Poland. Japan allocates most of its aid budget to Asian countries, while French and British official assistance tend to flow to their former colonies. Although multilateral aid is considered to be free from political motivations, in practice, multilateral ODA flows roughly follow the dynamics of bilateral aid since most multilateral aid funds are dependent on the political will of these countries.

Over the last two decades, the share of tied aid declined, so the administrative burden of aid has become lower. Thus, the recipient governments are now assuming more leadership in promoting aid coordination. Usually, official aid flows coming from multilateral donors are untied (at least by

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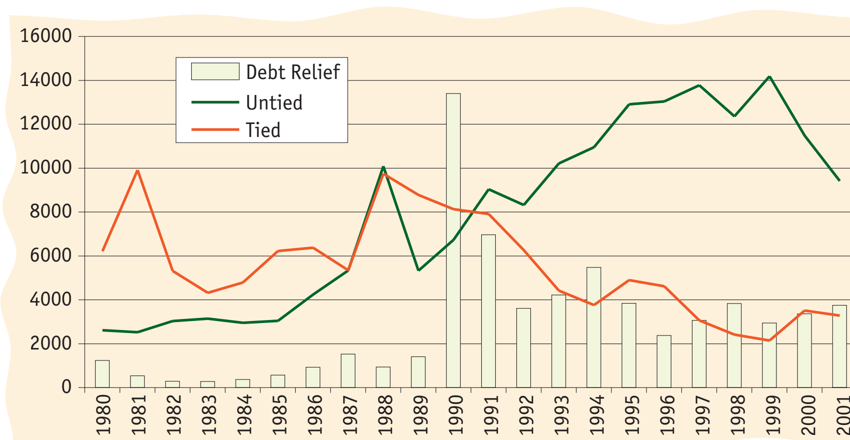
source), while bilateral aid could be tied by source as well as by end use. The chart below shows the change of tying status of bilateral aid over time. It demonstrates that in the late 1980s, bilateral donors started to abandon the practice of aid tying. The amount of aid tied by source fell from 37% in 1980 to 10% in 2001 of the total ODA provided by DAC donors. On average, the largest donors — the USA, France and the UK — tie the major part of their assistance to developing countries (only 35–40% of all aid came in untied form). At the same time, Japan and Germany provide more than 60% of their aid in untied form. Bilateral aid has subsidized the contracts of national firms doing business with foreign governments and it has rewarded foreign governments for favorable treatment of national firms. Inside donor countries, similar benefits occur. In Canada, for instance, the Canadian International Development Agency (CIDA) is quite explicit about its aid supporting 36,000 employees and notes that 70% of Canadian aid is spent in Canada. More than half of French aid is tied to domestic enterprises and Japan has used its aid to fund joint ventures and public works requiring employment of Japanese firms. Gradual untying of aid gave recipient countries' governments more discretionary power in coordinating aid efforts of different donors. However, aid flows from different sources still lack coordination and sometimes have contradicting objectives that, in combination with the low institutional capacity of recipient governments, substantially undermines the effectiveness of aid. Tight strings attached to aid can create highly bureaucratic procedures for acquiring aid resources, thus reducing their real value. For example, Van de Walle and Johnson (1996) found that in 1996, 600 development projects in Tanzania translated into 2,400 quarterly reports a year to supervisors, and more than 1,000 annual missions to monitor and evaluate the work. Naturally, each visitor needs to meet with key officials, and each wants the government to comment on reports[4].

Change of Tying Status of Bilateral Aid over time, US$ million



Source: OECD DAC International Development Statistics (IDS) online database.

[4] Van de Walle, N. and T. Johnson. 1996. Improving Aid to Africa, Washington, D.C., Overseas Development Council.

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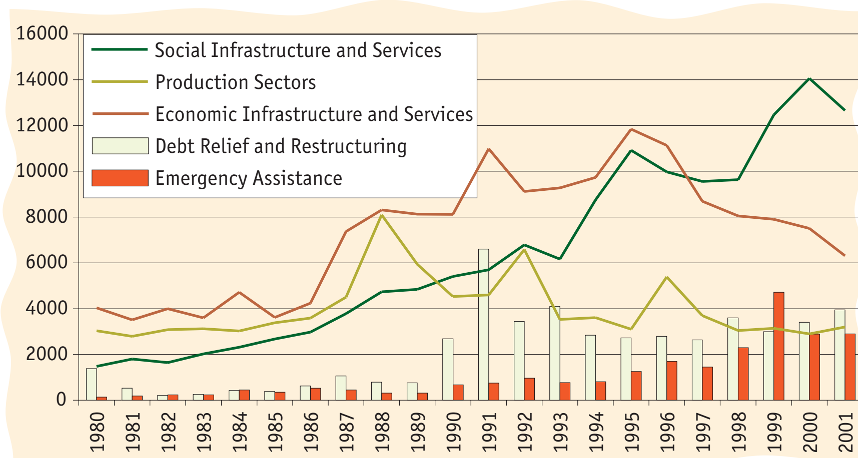
Uses of ODA Financing

The utilization of ODA funds has been changing over time as donors reconsider their priorities and perception of the recipients' needs. Over the last decade, there has been a clear trend towards allocating more aid to social programs (health, education, civil society, etc.), emergency and debt relief. As a result, donors have been gradually moving away from channeling large amounts of aid with clear economic development objectives since the late 1980s. The share of aid for economic development purposes (including public investment in infrastructure) fell from an average of 65% in the 1980s to 34% in the 1990s. The figure below shows the utilization of ODA provided by bilateral donors over the last twenty years:

Major Use of ODA by Bilateral Donors (on commitments basis), US$ million



Source: OECD DAC International Development Statistics (IDS) online database.

The main problem with this distribution of aid is that, without sustainable economic growth, developing countries just become dependent on foreign capital to support their social sectors. Over the long term, the developing countries would be much better off if international aid were to be used to increase growth and fiscal revenues. Governments of these countries would then have the funds to finance their social sectors. They would become self-sufficient, rather than relying on aid.

Foreign Aid Impact on the Economic Development of Recipient Countries

Foreign aid flows affect the recipient country's economy in different ways. Since official development assistance and aid is not just a flow of capital, but also transfer of other resources like technology, institution building, etc., it is quite difficult to assess the overall effect of aid in each particular country. There are a number of studies that have made attempts to evaluate the effectiveness of foreign aid in promoting

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economic development and reducing poverty in recipient countries. However, there is no common agreement on the effects of foreign aid on the recipient country.

On the one hand, there are many studies stating that aid has indeed promoted growth and structural transformation in many less developed countries. On the other hand, critics argue that aid does not promote faster growth but may in fact retard it by substituting for, rather than supplementing, domestic savings and investment and by exacerbating developing countries' balance of payments deficits as a result of rising debt repayment obligations and the linking of aid to donor-country exports. Also, aid is claimed to worsen income inequalities as it focuses on stimulating the growth of the modern sector, thus increasing the gap in living standards between the rich and the poor in developing countries. In general, the effectiveness of foreign aid depends on whether the transfer involved was used in a productive and socially meaningful way. Except for measures of specific aid project performance, there are no straightforward indicators of aid effectiveness. Aid performance varies largely by country and by sector. One of the most striking results of the aid effectiveness literature is the so-called income transfer paradox, which is donor enrichment and recipient impoverishment as a result of income transfer from rich countries to poor. Although the poor have improved their lot, these improvements have been less striking than the improvements attained by the rich. The rich are getting much richer, while the poor are still barely able to survive. The table below shows that over the last 40 years, while the ten richest countries were able to improve their real income per capita by 177%, the 10 poorest countries improved their income per capita by only 7%.

GDP per capita (constant 1995 USD), Average for Ten Richest and Ten Poorest Countries

	1960	1970	1980	1990	2001	Change, 2001 vs. 1960
Ten richest countries*	$13,951	$21,629	$27,715	$31,965	$38,671	177%
Ten poorest countries*	$152	$174	$180	$180	$163	7%
Gap, times	92	124	154	178	237	159%

*by GDP per capita (constant 1995 USD) Ten richest countries as of 1960 include: Switzerland, Denmark, Luxembourg, Sweden, United States, Netherlands, Norway, New Zealand, France, Austria Ten poorest countries as of 1960 include (excluding China): Togo, Nigeria, Kenya, Pakistan, India, Burkina Faso, Nepal, Lesotho, Burundi, Malawi

Source: World Bank, World Development Indicators, 2003

On a regional basis, in terms of growth in income per capita, only the East Asia and Pacific region has been able to perform better than the OECD countries. The regions that have performed less well are the poorest countries in Sub-Saharan Africa, Middle East and North Africa, and the former centrally planned economies that are still in the process of transition to a market economy. As we noted earlier in this report, the former two regions are among the largest recipients of aid flows.

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GDP per Capita (constant 1995 US$) by Region

Regions	1960	1970	1980	1990	2001	Change, 2001 vs. 1960
OECD Members	9,969	15,301	19,736	25,174	29,897	200%
Latin America & Caribbean	2,058	2,618	3,695	3,406	4,131	101%
Central Europe & CIS	—	—	—	2,705	2,316	–14 %
Middle East & North Africa	—	—	1,909	1,760	1,988	4 %
East Asia & Pacific	150	190	297	511	990	562%
Sub-Saharan Africa	475	612	660	587	569	20%
South Asia	186	225	240	334	474	154%

Source: World Bank, World Development Indicators, 2003

Income inequalities between developed and developing countries have also led to disparities in the quality of life between developed and developing countries, providing additional support to the argument of low aid effectiveness. For example, since 1960, infant mortality in higher income countries was reduced from 35 to 5 deaths per 1,000 births. But for low income countries and highly indebted countries, the reduction in infant mortality has been less significant and still remains very high at about 80–100 deaths per 1,000 births, as noted below:

Infant Mortality Rate, by Income Group (per 1,000 live births)

Income Groups	1960	1970	1980	1990	2001	Improved by
High Income	35	22	12	8	5	76%
Middle Income	118	79	54	40	31	61%
Low Income	148	128	110	91	81	37%
Heavily Indebted Poor Countries (HIPC)	165	139	113	105	99	29%
World	119	94	78	63	56	40%

Source: World Bank, World Development Indicators, 2003

Life expectancy at birth has improved in all countries. It has reached 78 years in high income countries. For low income countries, the improvements are very significant, but life expectancy in these low income countries is still relatively low at less than 60 years of age, as demonstrated in the table below.

Life Expectancy at Birth, by Income Group, Total (years)

Income Groups	1960	1970	1980	1990	2001	Improved by
High Income	69	71	74	76	78	13%
Middle Income	46	61	66	68	70	52%
Low Income	43	48	53	57	59	37%
Heavily Indebted Poor Countries (HIPC)	41	45	49	52	51	25%
World	50	59	63	65	67	33%

Source: World Bank, World Development Indicators, 2003

A similar picture of disparities emerges with illiteracy rates. Although progress has been made in all countries over the last few decades, the table below shows that higher income countries have made more significant gains than poorer countries, with illiteracy rates at present at only 3.4%. On the

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other hand, illiteracy rates are still very high in low income countries at about 40%.

**Illiteracy Rate by Income Group,
Adult Total (% of people ages 15 and above)**

Income Group	1970	1980	1990	2001	Improved by
High Income (selected OECD countries*)	13.4	8.7	5.7	3.4	75%
High Income (selected Non-OECD countries**)	21.4	14.6	10.5	7.3	66%
Middle Income	34.5	25.6	18.5	13.1	62%
Low Income	64.0	55.6	47.0	38.1	41%
World	44.1	36.1	28.9	22.9	48%

* Selected OECD countries include: Italy, Korea Rep., Portugal, Spain, Greece
** Selected non-OECD countries include: Barbados, Brunei, Cyprus, Hong Kong, China, Israel, Macao, China, Malta, Netherlands Antilles, Puerto Rico, Qatar, Slovenia, United Arab Emirates

Source: World Bank, World Development Indicators, 2003

Another finding in recent aid effectiveness studies is that determinants of the marginal impact of aid on economic growth appear to be more or less outside the direct control of the recipient countries. Developing countries' economies can be highly vulnerable to external and climatic shocks, such as sharp changes in export prices, trade restrictions imposed by trading partners, or natural disasters (floods and droughts). These shocks can have substantial adverse effects on growth. Collier and Dehn (2001) found that a 40% reduction in export price reduces growth by 1.4% unless it is mitigated by an increase in aid[5]. Aid appears to be most effective when it is delivered so as to prevent or cushion adverse effects of negative shock on the recipient country economy. However, donor countries sometimes pursue trade policies that contradict their foreign aid programs in a particular country, thus contributing to poor aid performance. For example, in the mid-1980s the USA allocated a bulk of their aid to promotion of export-oriented and labor-intensive industries in Bangladesh. As a result, Bangladeshi textile and apparel exports to the USA increased sharply, but shortly after that the US authorities introduced trade restrictions on apparel imports to the country[6]. There are also other examples of contradictory trade policies promoted by developed countries. While encouraging developing countries to open their markets, developed countries' keep their markets largely restricted for exports from developing countries (or selectively restricted). For example, industrial countries spend more than $300 billion a year in agricultural subsidies, which is over six times more than the amount they spend on foreign aid. According to World Bank estimates, by gaining unrestricted access to industrial countries' markets, developing countries can increase their national incomes by up to 5%, calculated relative to the baseline income forecast in 2015[7].

[5] Collier, P. and J. Dehn. 2001. "Aid, shocks and growth". World Bank Working Paper #2688, Washington, D.C.

[6] Anne O. Krueger. 1993. Economic Policies at Cross-Purposes: The United States and Developing Countries. Washington, D.C., p.63.

[7] World Bank. *Global Development Finance*. 2003. p. 131.

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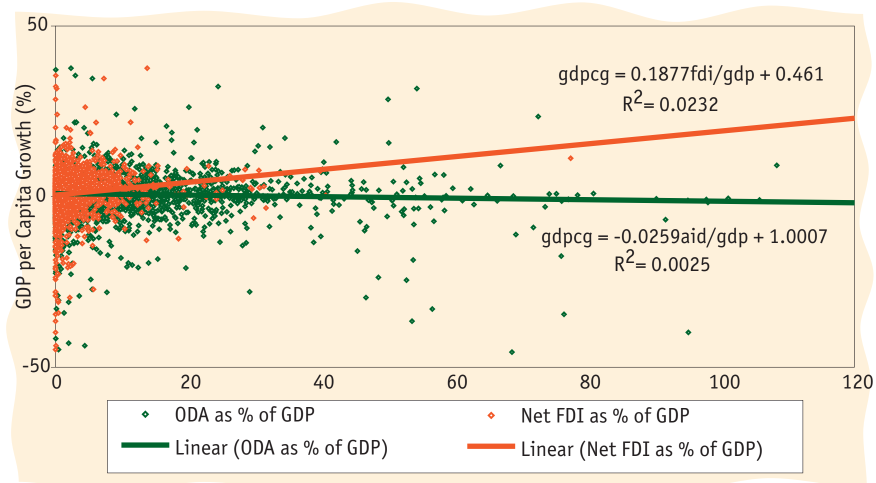
In order to have a clear idea of aid performance in developing countries, it is useful to look at the statistical correlation between indicators of aid and economic well-being. By plotting per capita GDP growth in 76 developing countries against relative measure of net ODA (aid as % of GDP), we can see that there is no clear relationship between aid and growth. The trend line, however, shows that the relationship between aid and growth is negative. For comparison, we add foreign direct investment inflow to developing countries to the scattergram, and its trend suggests that larger FDI inflow into developing country is associated with a higher growth rate of per capita GDP.

Aid and Net FDI vs. GDP per Capita Growth in Developing Countries (sample of 122 developing countries, 1980–2001)



Traditionally, foreign aid impact on the recipient's economy is assessed on both a macro and micro level. In general, micro effects of foreign aid are examined on the basis of individual projects performance, which are easier to monitor. The macroeconomic impact of aid is subject to hot debates, and there is no definite conclusion whether aid works on a macro level. The discussion of the impact of aid on growth is concerned mainly with the extent to which development aid increases investment in physical and human capital in recipient countries because foreign aid is referred to as a capital flow.

In theory, economic growth is a function of initial conditions, quality of business environment, government policies, and external shocks (changes in terms of trade or weather conditions). Our empirical model explains growth in developing countries as a function of initial conditions, government policies, official aid and foreign direct investment inflows, and error term captures external shocks. Following other empirical studies on aid performance, we perform regression analysis including the measures of financial depth, fiscal balance, inflation and public debt to capture the effect of government policies, and the initial level of income per capita in the country. To perform this empirical exercise, we use the data on 76 developing countries over the period 1980–2001 from the

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World Bank and OECD[8]. The dependent variable is the growth rate of GDP per capita. We divided our sample of developing countries into three sub-samples based on income classification of countries by the World Bank, and then ran regressions for each sub-sample. The logic behind this exercise is that countries that fall into each income category have a more or less similar economic position, thus the effect of aid flows may be different in countries with different income levels.

The table below shows the regression results. It is clear that official aid impact on economic growth has been mixed. In regression 1, aid has no statistically significant effect on economic growth in developing countries, whereas foreign direct investment and indicators of government policies have a very strong association with economic growth. In particular, a one percent increase in net FDI inflow explains about 0.1% of GDP per capita growth in developing countries. Inflation and public debt levels are found to have a negative effect on economic growth, which is quite reasonable since many developing countries in the sample accumulated unsustainable debt levels (on average 53% of GDP) and had hyperinflation periods in their development history (average annual inflation growth in the sample is equal to 79%). At the same time, financial depth and budget balance have positive impact on income per capita growth.

Estimating Effect of Aid on Growth
Dependent variable: growth rate of per capita GDP (%)
Sample period: 1980–2001

	Regression			
	All Developing Countries (1)	Low Income Group (2)	Lower Middle Income Group (3)	Upper Middle Income Group (4)
Initial GDP per capita	0.303	1.066	-1.789*	1.391
	(1.8)	(1.8)	(-2.2)	(1.7)
Aid (% of GDP)	0.004	0.034	-0.162*	0.487*
	(0.2)	(1.0)	(-2.3)	(2.3)
Net FDI (% of GDP)	0.096**	0.199*	0.097	0.114
	(2.4)	(2.0)	(1.2)	(1.0)
Financial Depth (M2/GDP lagged)	0.013**	0.126**	0.002	0.012
	(3.3)	(5.2)	(0.1)	(1.2)
Inflation (% annual)	-0.0004*	-0.0003	-0.0007	-0.012
	(-2.0)	(-1.6)	(-1.2)	(-1.4)
Budget Balance (% of GDP)	0.134**	0.121*	0.131	0.116
	(4.8)	(1.9)	(1.5)	(1.7)
Public Debt (% of GDP)	-0.026**	-0.023**	-0.022*	-0.017
	(-6.3)	(-3.7)	(-2.0)	(-1.1)
R-squared	0.14	0.17	0.09	0.15
# of Countries	76	32	21	22
# of Obs	672	256	207	208

Notes: * — significant at the 5% level;
** — significant at 1% level; t-statistics in parentheses.
Estimation methodology: pooled least squares with cross section weights.

[8] Descriptive statistics of the data presented in the appendix.

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Regression 2–4 repeat regression 1 but with different sub-samples of developing countries. The results show that the statistically significant effect of aid on economic growth is observed only in the case of middle income countries. However, it turned out to be negative for lower-middle income countries (to which average aid flows constituted about 7% of GDP), suggesting that official aid to this group of countries appears to even be counterproductive. At the same time, aid flows to upper-middle income countries is associated with a statistically significant positive effect on growth. These countries have been receiving much less aid and have access to international capital markets. Thus, it lends support to the argument that aid to upper-middle income countries was used in a relatively more efficient way. It may well be the case that more official aid programs in the latter subset of countries were aimed at improving the business climate, and these countries were able to attract more private capital (e.g. Chile, Mexico, Brazil, Poland) as compared to other developing countries.

Our empirical analysis shows that aid has no significant impact on economic growth; thus, aid had no significant impact on the basic indicators of poverty/human development (infant mortality, primary schooling, and life expectancy), suggesting that aid does not benefit the poor. This result lends support to the argument that much aid is simply consumed, and that it increases the size of government but has no significant impact on human development indicators (Boone, 1996). Recent studies of aid and economic growth have found that aid has a positive and significant impact only in countries with sufficiently reformed policies and institutions (Burnside and Dollar, 2000). However, Nunnenkamp (2002) cast doubt on the robustness of the estimation procedure used by Burnside and Dollar, because repeating virtually the same econometric procedure did not yield the same results as reported in the Burnside and Dollar paper[9] (on which the World Bank "Assessing Aid" report is based). With a simple modification, the authors obtained results opposite to those claimed by Burnside and Dollar.

Concluding Remarks

The ultimate goal of international aid flows is poverty reduction or more broadly, the promotion of human well-being. Unfortunately, the above evidence shows that actual distribution of aid flows has largely been determined by criteria other than poverty reduction or even growth promotion. Although all donors view these objectives as primarily for allocation of their financing, the quality of official development aid has eroded by a combination of political and commercial interests on the part of most donor and recipient countries over the last decades. For example, the sharp increase in aid flows in the early 1990s is attributed to the Gulf War of 1991, and a major part of additional funds provided to developing

[9] Burnside, C. and D. Dollar. 1997. "Aid, policies and growth". Policy Research Working Paper #1777, The World Bank, Development Research Group, Washington, D.C.

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countries during this period was in the form of emergency aid, which was temporary in nature. Another upsurge in official flows to developing countries occurred in 1995–1998, which is attributed to the wave of financial crises in emerging markets (Asia, Russia).

Official aid flows may play a very important role in crisis periods. But these funds are unlikely to have a significant impact on long-term development goals. There are many reasons for the failure of aid to induce sustainable growth in developing countries. Among the most important are:

1. **Political rather than developmental objectives of foreign aid allocation by donors** provide perverse incentives for recipients, thus making it more difficult for these countries' governments to implement the necessary economic reforms. Many developing countries that failed to meet their reform commitments kept receiving substantial amounts of foreign aid, the effectiveness of which was quite low.

2. **Lack of ownership of development assistance projects and programs by recipients.** By and large, donor agencies lead the process of development in the recipient countries; they determine the amount of aid to be delivered in the particular country, the terms of their use, the main beneficiaries and partners of the aid projects, etc. Recipient countries' governments are therefore more concerned with fulfilment of tasks formulated by donors rather than the outcomes of aid projects for their citizens.

3. The practice of **aid tying** by donors also diminishes its effectiveness. A significant portion of bilateral ODA is tied by source as well as by end use. On average, the largest donors — the USA, France and the UK — tie the major part of their assistance to developing countries (only 35–40% of all aid came in untied form). Tied aid has less real value because of highly bureaucratic procedures that donors want the recipients to follow for acquiring such aid resources.

4. **Lack of coordination among the donors in their aid activities** in each particular country leads them to launch and implement aid projects and programs that have divergent and even contradicting objectives, which confuse the recipients and diminishes the effectiveness of the aid resources. Contradictory objectives, combined with low institutional capacity of recipient governments, substantially undermine the effectiveness of aid.

5. Many developing countries **lack the administrative capacity to absorb large aid inflows**, which results in low efficiency of donor's resources. If recipient countries' governments have low institutional capacity, foreign aid flows are unlikely to be allocated in a productive way. In this case, much more aid will be spent for consumption rather than investment purposes, therefore increasing the country's dependence on foreign aid and contributing to corruption. Tight strings

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attached to aid can also overload the administrative capacity of aid recipients as they create highly bureaucratic procedures for acquiring aid resources, thus reducing their real value. For example, a recent Overseas Development Council study found that in 1996, 600 development projects in Tanzania translated into 2,400 quarterly reports a year to supervisors, and more than 1,000 annual missions to monitor and evaluate the work. Naturally, each visitor needs to meet with key officials, and each wants the government to comment on reports.

6. **Inefficient terms of aid use.** More substantial aid resources go to social development programs than to economic development programs and projects that contribute to an environment conducive to growth and wealth creation in the recipient country.

7. **Aid Fungibility.** Foreign aid is often allocated into provision of public goods and services, thus substituting for the corresponding efforts of the recipient governments, which lack budget resources to implement these functions. However, with constant aid flows to key public sectors, recipient governments tend to underestimate the amount of resources they should invest into public infrastructure, even when sufficient budget resources become available.

8. **Trade barriers imposed by developed countries for the developing countries' exports.** While promoting trade openness in the developing countries and encouraging the recipient governments to implement policies conducive to the development of export-oriented sectors of the economy, donors keep their markets largely restricted for inflows of goods produced by developing countries (this includes subsidized production of goods in developed countries; it concerns primarily agricultural sector).

All the above suggests that ineffectiveness in the use of ODF is common, and as a result, massive aid flows have failed to bring about sustained economic growth and higher standards of living to recipient countries. It is unlikely that official aid will be able to bring sustainable economic growth to developing countries in the future. This would require improving coordination, increasing ownership and reducing aid dependence, which requires mutual actions of donors and recipients. Unfortunately, donors do not have unified criteria and conditions for giving aid, and as a result, the present mechanisms for implementing aid conditionality are seriously flawed. Furthermore, given political interests of donor countries, the amount of aid allocated to private sector development and other economic development projects is unlikely to grow.

We believe that in the future, except for special financial support in periods of crisis, the bulk of foreign aid should be directed to support the creation and growth of a healthy and competitive private sector. As noted earlier, it is only with a healthy and growing private sector that the government will be able to raise the budget and other resources to finance

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necessary investments in health, education and safety nets for the poor. With a well-developed private sector, the developing countries themselves will be able to deal with most of their social issues. The need to obtain external financing for this purpose would be minimized. In terms of priorities, the bulk of international aid should be channelled to create favorable business environments that would spur private sector activities.

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Appendix

Descriptive statistics of the dataset used for estimation

	mean	median	max	min	std dev
All developing countries					
GDP per capita growth	0.8	1.3	100.8	–51.9	7.1
GDP per capita	3,888.4	3,130.0	14,720.0	350.0	2,955.1
Aid (% of GDP)	9.4	5.4	185.2	–0.5	13.1
Net FDI (% of GDP)	2.5	1.0	145.2	–82.8	5.6
Financial depth (M2/GDP)	38.5	30.5	157.0	4.1	28.3
Inflation (% annual)	79.0	10.0	23773.1	–11.4	962.2
Budget balance (% of GDP)	–3.5	–3.0	20.6	–31.3	4.7
Public debt (% of GDP)	53.3	44.8	289.8	0.0	38.9
Low income group					
GDP per capita growth	0.06	0.8	100.8	–51.9	8.0
GDP per capita	1,340.2	1290.0	2,910.0	350.0	609.6
Aid (% of GDP)	14.8	11.1	185.2	0.1	15.9
Net FDI (% of GDP)	1.8	0.5	145.2	–82.8	6.9
Financial depth (M2/GDP)	24.0	22.1	55.0	4.1	10.6
Inflation (% annual)	140.6	10.6	23,773.1	–11.4	1,484.4
Budget balance (% of GDP)	–4.8	–4.7	4.6	–31.3	4.0
Public debt (% of GDP)	70.0	59.9	289.8	2.1	44.0
Lower-middle income group					
GDP per capita growth	1.15	1.23	79.71	–27.92	6.20
GDP per capita	3,969.0	3,540.0	11,290.0	970.0	1,917.9
Aid (% of GDP)	6.69	2.56	56.85	–0.29	8.95
Net FDI (% of GDP)	2.45	1.15	39.78	–4.21	3.79
Financial depth (M2/GDP lagged)	41.8	36.4	138.1	9.3	25.6
Inflation (% annual)	59.6	8.8	7481.7	–1.4	515.9
Budget balance (% of GDP)	–3.8	–3.0	9.9	–19.9	4.4
Public debt (% of GDP)	48.9	44.7	190.1	0.0	32.7
Upper-middle income group					
GDP per capita growth	2.0	2.7	35.5	–43.7	5.9
GDP per capita	6,777.1	6,650.0	14,720.0	1,630.0	2,856.4
Aid (% of GDP)	2.3	0.7	26.8	–0.5	3.7
Net FDI (% of GDP)	3.7	2.4	30.7	–12.2	4.6
Financial depth (M2/GDP lagged)	47.1	38.3	157.0	7.3	32.4
Inflation (% annual)	22.8	10.0	343.0	–1.3	40.0
Budget balance (% of GDP)	–1.9	–1.7	20.6	–15.8	5.2

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