Foreign Aid and the "Big Push" Theory: Lessons from Sub-Saharan Africa

By Farah Abuzeid

Foreign aid flows from developed to developing countries have been hailed as the solution to world poverty. However, the theory that holds that any aid is beneficial to any country no matter the circumstances demands further inspection. The influx of massive amounts of foreign aid can have deletrious effects on the governments of the recieving countries, and can end up doing more harm that good in several circumstances. However, discrimination by donor countries on the basis of standards of governance creates new complications. The current foreign aid paradigm should be overhauled, and the new system should take a more nuanced view of international development.

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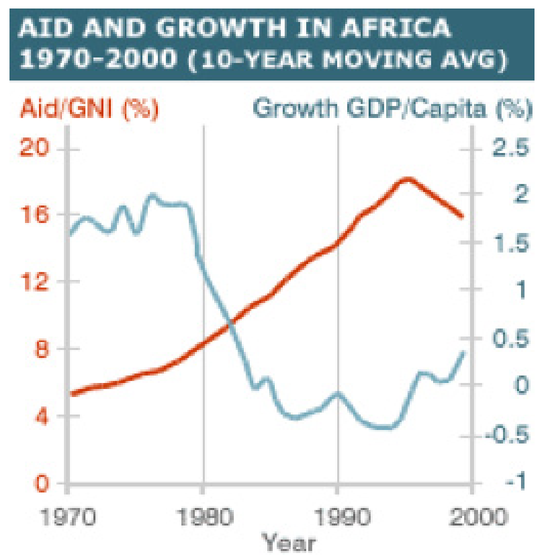
Developed countries give millions of dollars a year in foreign assistance to aid developing countries, but what are the effects?

Background

The term "foreign aid," for the purposes of this study, refers only to Official Development Assistance (ODA). ODA is defined as the flow of official financing to the developing world that is concessional in character, namely grants and loans with at least a 25 percent grant component.[1] ODA is generally administered with the objective of promoting the economic development and welfare of developing countries, and comprises both bilateral aid that flows directly from donor to recipient governments and multilateral aid that is channeled through an intermediary lending institution like the World Bank. This definition excludes debt relief, technical assistance, and other forms of aid.

Traditional development economics has long viewed foreign aid as a tool for overcoming the savings gap in developing countries. Based on the assumption that the Third World is poor because it lacks the capital necessary for making income-generating investments, mainstream economics literature suggests that aid can help developing countries by closing this financing gap that otherwise leaves them stuck in a "poverty trap." The "big push" argument portrays aid as the necessary catalyst for investment that would, in turn, lead to growth and presumably initialize an upward path to economic development.[2] This view of aid is perhaps most famously encapsulated by celebrity economist Jeffrey Sachs' *The End of Poverty*, in which he prescribes a comprehensive package of massive aid transfers and widespread reforms that aim to tackle multiple socioeconomic pathologies quickly and simultaneously. Shock therapy of this sort, Sachs argues, can end extreme poverty for the world's "bottom billion" by 2025.[3]

However, half a century of historical evidence of aid flows to Sub-Saharan Africa suggests that this "big push" paradigm does not actually work in practice. As home to a large proportion of the world's "bottom billion," Sub-Saharan Africa has attracted substantial amounts of foreign aid over the years. ODA flows to the continent currently stand at around $80 billion per annum and the figure is projected to reach $125 billion by 2010. In aggregate terms over the course of the last 50 years, foreign aid transfers to governments in Sub-Saharan Africa totaled a staggering $1 trillion.[4] Nonetheless, as shown by the figure below, over the same period of time, growth of GDP per capita in Africa actually registered a marked decline and was for many years even negative. With only a few exceptions, actual GDP per capita figures also declined across most of Sub-Saharan Africa. For example, World Bank calculations show that if theoretical models had predicted correctly, foreign aid transfers to Zambia, which began in the 1960s, would have by today pushed per-capita income to over $20,000. In practice, however, Zambian income per capita has stagnated at around $600 for years. This provides a stark example of the failures of foreign aid in Sub-Saharan Africa.



Source: Erixon, F. (2005b) "Why Aid Doesn't Work." BBC News.

There is a growing convergence of opinion in the academic community that aid has so spectacularly failed to achieve its intended outcomes in Sub-Saharan Africa because high aid intensity is actually associated with an erosion in the quality of governance. A country's aid intensity is defined as the total ODA transfers it receives as a percentage of its GDP, which is a proxy measure for aid dependence. A study by Bräutigam identifies a negative and highly statistically significant relationship between high aid intensity and institutional quality, as measured by the International Country Risk Guide's (ICRG) 18-point index.[5] She finds that this relationship remains robust even after controlling for economic decline, which is associated with a deterioration in the quality of governance. Although the study considers the possibility of reverse causality, namely, a donor tendency to direct more aid to countries with worsening institutions, Bräutigam finds no compelling evidence that this is the case.[6]

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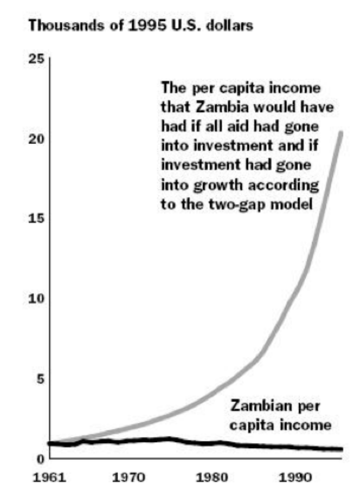
As such, her findings provide a strong indication that a high level of aid dependence over an extended period of time—as is the case in much of Sub-Saharan Africa—could have a retarding effect on growth and development due to harmful effects on the overarching governance structure and institutional quality of the recipient country.



Source: World Bank, The (1998d). "Assessing aid: what works, what doesn't, and why." Oxford: Oxford University Press.

Understanding the potential implications of foreign aid for quality of governance is paramount, because good governance and institutions are now recognized as a major determinant of economic performance. Hall and Jones argue that differences between countries in capital accumulation, productivity, and output per worker can ultimately be attributed to differences in "social infrastructure," which they define as "the institutions and government policies that determine the economic environment within which individuals accumulate skills, and firms accumulate capital and produce output."[7] Keefer and Knack corroborate this view by stressing that good governance, particularly in the form of predictable, impartial, and consistently applied rule of law, is crucial for the sustained and rapid growth in per-capita incomes of poor countries.[8]

Mechanisms

Scholarly literature in this field suggests direct and indirect mechanisms through which foreign aid transfers could be harming governance in recipient countries. Evidence demonstrates that aid can and does directly strengthen existing corruption patterns in contexts where high levels of corruption are already rampant. Indirectly, foreign aid could be harming governance through its tendency to (1) create multiple distortions in the public sector, (2) foster the emergence of a "rentier state" effect, and (3) delay pressures for effective reform.

Foreign aid can perpetuate existing corruption

There is no compelling evidence that donors pay attention to institutional quality or corruption considerations in their aid allocation decisions. Research has found no systematic evidence that bilateral or multilateral aid goes disproportionately to less corrupt governments.[10,11] In fact, one study provides considerable evidence that patterns of aid allocation by bilateral donors are far more robustly dictated by the political and strategic interests of the donors than by concerns over good governance in the recipient nations.[12] In more concrete terms, factors such as colonial history and voting patterns in the United Nations tend to explain more of the distribution of aid than do the political institutions or economic policies of the recipient governments. The Alesina and Dollar study illustrates that among the three biggest bilateral donors—the United States, Japan, and France—France in particular gives overwhelmingly to its former colonies, many of which are in Sub-Saharan Africa. A few donors, notably Australia and the Nordic countries, do show a tendency to discriminate in favor of less corrupt governments, presumably because they do not have colonial legacies and are therefore free from specific political pressures, but on the whole these donors remain the exception. Finally, international organizations like the IMF and the World Bank that dispense multilateral aid do not show any discriminatory tendencies against corruption in the recipient country.[13]

As such, the indiscriminate nature of foreign aid allocation is believed to have a direct impact on governance through its tendency to perpetuate existing corruption in recipient countries. Given that many of the largest recipients of ODA in Sub-Saharan Africa are also some of the world's lowest-ranking countries in many areas of governance, particularly with regards to corruption, foreign aid appears simply to increase the volume of funds at the disposal of already corrupt government officials and kleptocratic elites. This effect is corroborated by Alesina and Weder's finding that an increase in aid influx is associated with a statistically significant increase in corruption, and vice versa.[14]

Foreign aid creates multiple distortions in the public sector

The literature also suggests that aid indirectly harms governance by inducing an increase in the size of the government sector, which in turn increases opportunities for corruption. Studies show that ODA transfers in a corrupt setting ultimately end up funding wasteful government spending that is falsely labeled as "development expenditures."[15] Boone shows that while aid does increase government consumption, this does not typically benefit the poor because money is wasted on white elephant projects, military equipment, fraudulent procurement, and other expenditures that provide ample opportunities for graft, but do not typically generate any meaningful income to service the loan or to bolster growth.[16] Foreign aid has also been shown to be a convenient tool for leaders with short time horizons to adopt policies that may yield quick results, but are ultimately not in the best interest of development. One such popular policy is to increase the size of the civil service in order to slash unemployment rates, such that aid funds are wasted on paying unnecessarily large numbers of government employees for doing essentially nothing. This translates into a chronic tendency for the state to become over-extended.

Another potential distortion arises due to the fungible nature of foreign aid. This refers to the idea that donors often provide funding for projects that address specific needs in the country for which the recipient government has already earmarked resources from its own budget. The influx of foreign funding makes it possible for the recipient government to reduce its own allocation of resources in the sector that receives the ODA, and to reallocate those resources elsewhere.[17] Although the concept of fungibility itself is not necessarily harmful, especially if the extra funds are reallocated into productive uses within the economy, fungibility is problematic insofar as it increases the scope for corruption and rent-seeking. The fungibility effect makes it easier for corrupt officials to reallocate and conceal some of the "surplus" funding into wasteful expenditures and fraudulent or overinflated procurement costs that provide room for graft, because at the end of the day the initial announced objectives of these government funds are still met using the funds coming from foreign aid. In other words, the concept of fungibility suggests that as long as corrupt leaders have just enough results to show their donors, they are able to do as they please with the remainder of the funding.[18]

Aid influx has also been shown to distort the domestic balance of power in recipient countries, leading to the politicization of economic life and an increase in unproductive rent-seeking and lobbying activity. Bauer accurately notes that aid influx is not a simple transfer of resources because it does not descend uniformly onto the recipient population. Rather, it tends to accrue to specific elite groups of people who are already in power.[19] Specifically, aid tends to tip the balance of power in favor of the executive branch of government. By enhancing the economic and political power of the executive, foreign aid rent-seeking and lobbying activities become more lucrative for domestic interest groups, leading to an increase in the incidence of these unproductive activities and a spike in the costs and distortions commonly associated with them. Indeed, Svensson finds that an increase in government revenue in the presence of powerful and competing social groups leads to a lower provision of public goods because much of the influx is captured by powerful lobbyists.[20] A study by Lane and Tornell suggests that in an economy with powerful groups but weak institutions, as is the case in many African countries, the heightened lobbying and rent-seeking activity that follows a resource windfall causes a more than proportional increase in redistribution.[21] This "voracity effect" will, in turn, yield a lower rate of return to the investment and a net social loss.[22] Interestingly, one study shows that the mere *expectation* of aid may suffice in triggering the voracity effect.[23] Svensson finds reason to believe that foreign aid may influence the policies of the recipient government even without resources actually exchanging hands. This perhaps suggests that some recipients have come to take aid transfers for granted, which points to the existence of a "moral hazard" problem that will be discussed later.

The heightened power of the executive branch often leads to a "strong president, weak parliament" syndrome, particularly in fledgling democracies. Bräutigam suggests that high aid dependency tends to reinforce strong presidentialism in recipient states, with few checks and balances on the president's decision-making power. This has significant implications for democratic consolidation, as it decreases the relative importance of the legislative branch and generally produces weak parliaments. It also restructures the accountability mechanism as something between the state and its donors, rather than the government and its citizens, and this, again, weakens the checks and balances on executive power.[24]

High aid dependence often leads to a strong presence of aid agencies and NGOs in recipient countries, which choose to "by-pass" the cumbersome government bureaucracy and consequently "poach" skilled bureaucrats away from civil service. In many cases, foreign aid donors fear that government agencies in recipient countries are ineffective and encumbered by corruption, and that government bureaucrats are unmotivated, underpaid, apathetic, or poorly trained. To maximize the chances that foreign aid will meet its targets, some donors will therefore choose to "by-pass" the government bureaucracy altogether and set up their own administrative network with better salary incentives.[25] Empirical data demonstrates that salaries in aid-sponsored projects are usually considerably higher than salaries available through government employment. In Kenya, for example, monthly salaries from a donor-funded agricultural project ranged between $3,000 and $6,000. When compared with the average government salary of about $250, it is easy to see how capable local talent in aid-receiving countries would be attracted to staff the resident offices of aid agencies and NGOs rather than taking up government positions.[26] This erosion of talent leaves the government bureaucracy in the hands of less qualified, untrained, unmotivated, or completely incompetent officials and therefore erodes the quality and effectiveness of government institutions.[27]

Foreign aid fosters the emergence of a "rentier state" effect

Aid as a source of government revenue parallels other types of rents. According to Adam Smith's classic definition, rents are "unearned incomes or profits reaped by those who did not sow."[28] Economically speaking, rents are "unearned incomes" because they exceed all relevant costs, and are therefore akin to a monopoly's supernormal profits. In context of the state, rents are incomes generated from external sources–such as foreign aid, or perhaps mineral export revenues–rather than extracted from the surplus production of the population through taxation.[29]

Experts warn that if rent windfalls, like foreign aid, coincide with the early stages of state formation, they can distort the institutional development of the state. This happens because aid influxes provide an easy source of government revenue, and thus reduce the need to build an effective bureaucratic mechanism to oversee the extractive and administrative functions of the state. The limited extractive capacity, in turn, tends to deepen the government's dependence on rents, and consequently creates a "rentier state" effect.[30] This theory is highly pertinent in the case of Sub-Saharan Africa, because the emergence of independent African states in the 1960s and 1970s coincided with high and growing volumes of aid transfers from their former colonizers. Ostensibly, this contributed to undermining the creation of a robust administrative and fiscal bureaucracy and other institutional capacities necessary for the formation of an effective, capacious state. Essentially, the influx of easy money allowed many newborn governments to "substitute aid dollars for state craft."[31]

The rentier state effect not only has serious implications for state capacity, but also for the quality of democratic institutions. This pathology stems from the fact that rentier states are less accountable to their populations because they are less dependent on taxation as a source of state revenue. Ross identifies a "taxation effect" commonly associated with the rentier state, whereby the government uses its rent revenues to essentially buy acquiescence by relieving social pressures that might otherwise lead to demands for greater accountability and representation. He also finds a "spending effect" on direct patronage of elites and on the suppression of opposition groups.[32] Both of these observed effects have demonstrably negative impacts on government accountability, equity, and civil liberty. Research confirms that foreign aid rents have a negative impact on democracy and suggests that the magnitude of this impact far exceeds the negative impact of the "oil curse." A study by Djankov, Montalvo, and Reynal-Querol estimates that the aid curse is an even bigger curse than oil when it comes to measures of democratic quality.[33] Calculations show that the long-run effect of aid dependence on democracy is quite substantial. Over a given period of time, a recipient country's democratic quality would deteriorate from average (relative to the average level of democracy in all aid-recipients) to completely absent, if the country's aid dependence averages 1.9 percent of GDP during that period.[34] This is a stunning finding, especially given that the 1.9 percent dependence average remains significantly lower than aid dependence levels of many governments in Sub-Saharan Africa. The negative impact of oil export dependence is far smaller: a country's democracy levels would deteriorate from average to non-existent if oil revenues average 12.5 percent of GDP over the given period.

Foreign aid can delay pressures for reform

By making corruption more lucrative, aid distorts the incentive structure for public actors, and may therefore delay pressures for institutional reform. Given what we know about the importance of institutional quality for economic performance, institutional reform is the key to development in many poor countries. Yet achieving reform requires solving a complex set of collective action problems. Theory suggests that reforms are akin to public goods in that they benefit the public at large, and it is difficult to preclude anyone from reaping these benefits. Often, the very goal of reforms is to improve governance and reduce corruption levels in the country. However, if aid makes corruption more lucrative by making available large sums of easy money, then the very agents who are supposed to bring about the necessary reforms will lose their incentives to act.[35]

Aid also creates a "moral hazard" problem in the recipient country by serving as a permanent soft budget constraint. The persistent influx of easy foreign aid money creates the impression that the recipient government is always likely to be bailed out when things go wrong.[36] Since recipient governments do not have to worry about answering to taxpayers, and are only bound by relatively loose accountability mechanisms to their donors, there is little incentive in the system for fiscal discipline and sound judgment. Essentially, aid serves as "insurance" for incompetent or corrupt leaders from the results of their actions and weakens their incentive to seek alternative revenue sources through wise policies that encourage self-sustaining investments. Furthermore, leaders (who tend to have short-time horizons) will be more likely to make risky or reckless decisions that might yield high short-term results, but may not necessarily have sustainable or desirable long-term effects. The problem is further complicated by the fact that the best long-term policies, like those leading to institutional and economic reform, tend to be less politically desirable because they necessitate significant short-term sacrifices, and require patience and longer time horizons to achieve results.[37]

Do these mechanisms have the same harmful effects on all foreign aid recipients?

New research suggests that foreign aid may not necessarily be harmful and that the existing institutional environment of the recipient country plays a big role in determining the success of aid-led development. An influential study by Burnside and Dollar finds that aid has a positive impact on growth in developing countries with good fiscal, monetary, and trade policies, but has little effect in the presence of poor policies.[38] In essence, a positive institutional setting in the recipient country means that the detrimental dynamics of aid flows on governance can be largely avoided. This adds another nuance to the complicated relationship between foreign aid and governance: while the absence of good governance aid is most likely to backfire and actually contribute to a further worsening of the recipient's institutional quality, high levels of foreign aid can be well used if the recipient country's institutions are strong. This finding could have enormous normative implications for guiding future policy about foreign aid allocation.

US Government

The Marhsall Plan serves as a positive example of foreign aid. But how applicable is it to current aid efforts?

Policy Implications

There appears to be emerging consensus in the international community that existing institutional quality in developing countries should be factored into donors' future decisions about aid allocation. A growing number of scholars are calling for greater selectivity in allocating aid to poor countries, because evidence seems to suggest that the "big push" theory of foreign aid can only have an impact after countries have already made substantial progress in reforming their policies and institutions. World Bank estimates suggest that a $10 billion increase in foreign aid flows would lift about 25 million people a year out of poverty if lending favors countries with sound economic management, but the figure drops to only 7 million people a year if lending is indiscriminate on the basis of governance quality.[39]

To be sure, the Burnside and Dollar finding remains far from uncontested. A number of reviews have questioned its significance. One such review by Easterly, Levine, and Roodman suggests that the outcome is not robust to the use of an expanded data set.[40] Additionally, the normative implication of the finding, namely that aid allocation should be predicated on good governance, is strategically thorny because it could potentially compromise the political interests of some of the large bilateral donors. Further, it is also a difficult policy to justify from a moral viewpoint, because it appears to leave poorly governed developing countries on their own.

Ostensibly, selectivity on the basis of governance quality in recipient countries could become a potential policy strategy for bilateral donors. Given the Alesina and Dollar finding that many bilateral donors already rely heavily on strategic and political considerations when making their foreign aid allocations, criteria predicated on issues of good governance seem as good a reason as any to discriminate among potential recipients.[41] In fact, programs like the US Millennium Development Account seem to indicate the emergence of an aid allocation trend that favors good governance. Complications could arise, however, if governance considerations clash with the strategic, political, or security interests of big bilateral donors like the US or France. These concerns will in all likelihood trump any consideration of governance. This strategy may be best left to more politically neutral donors, such as the Nordic countries and Australia, who already exhibit strong tendencies to discriminate on the basis of institutional quality.

On the other hand, discrimination on the basis of institutional quality does not seem a feasible strategy for multilateral donors like the IMF or the World Bank. Many multilateral donors are not allowed to discriminate on this basis. Additionally, the promotion of good governance through aid provision is not generally the primary concern of the aid financing given out by these institutions. For example, the primary focus of the IMF's mandate is to promote macroeconomic and financial stability by fostering international monetary cooperation, exchange rate stability, and helping countries overcome economic difficulties. Although it plays a large role in channeling global foreign aid flows to developing countries, and thus provides a significant portion of the aid transfers that have proven so problematic for many Sub-Saharan economies, an organization like the IMF cannot withhold its assistance to countries in need on the basis of their poor institutions. Multilateral organizations, therefore, must look for other ways to improve the effectiveness of their lending.

It must first be made clear that regardless of whether greater selectivity becomes the *modus operandi* of foreign aid lending, the implication of the Burnside and Dollar finding is not to suggest that poor countries with weak institutions cannot be helped at all. The intention is simply to suggest that injecting more money into these countries is often not the answer, because a shortage of capital is frequently not the main problem. In fact, foreign aid aimed at achieving growth and development in these situations more often than not becomes part of the problem. Before any meaningful or sustainable aid-led growth can take place, foreign assistance must aim at catalyzing the institutional reform and cultivating the "social infrastructure" that makes growth possible. As such, in poor governance environments, donor resources are better suited to the transfer of ideas through technical assistance, expertise, and consulting services, rather than the transfer of funds.

However, it is crucial to keep in mind that there is only so much that external actors can do to foster internal institutional reform in the Third World. Given the considerable failures of past attempts to impose Western reform initiatives, such as the Washington Consensus, on developing countries, care must be taken to make foreign assistance as organic and tailored to the local context as possible. Above all, this is necessary as to ensure that foreign involvement does not come to be viewed as an ideological struggle and provoke a local backlash. As such, efforts are best catered to strengthening local civil society, and empowering people by helping then learn how to help themselves.

A lengthening of actors' time horizons will be critical to the success of this shift in thinking about the role of foreign aid. Since institutional reform cannot be achieved overnight, both donors and recipients alike must have the foresight to devise long-term solutions, the diligence to implement them, and the patience to await their slower but more sustainable outcomes. This thinking often appears counterintuitive because people naturally view positive feedback as an indication that their efforts are working, and tend to grow weary when these results do not appear quickly. Precisely because the outcomes of reform are much slower and much less perceptible in the short-run, reform efforts will often appear ineffective and self-defeating, but the international community must not succumb to the temptation of donor fatigue. If this fact is simply kept in mind, the problem can be largely overcome.

It is also paramount to highlight foreign aid and assistance as a temporary measure. Current expectations that aid funding will always be forthcoming play a significant role in engendering the moral hazard problem that plagues many aid-dependent countries, which in turn leads to poor incentives for self-help, and the selection of unwise or risky policy design. If, however, aid is portrayed as a temporary form of financing that will gradually be phased out according to a known timeframe, there will be built-in incentives to create and nurture productive, self-sustaining investments and adopt constructive policies.

Conclusions

Sound policy and good economic management matter more than foreign aid for developing countries. As the record shows, without good institutions, aid is likely to have a detrimental impact on the quality of governance in a recipient developing country. In the absence of these strong institutions, assistance efforts should be dedicated to improving the quality of governance before they can be effectively devoted to any economic development effort.

Finally, foreign aid transfers should henceforth pledge to abide by the Hippocratic oath to "do no harm." Although more progress has been made over the course of the last 50 or so years in alleviating poverty than during any comparable period of time in history, poverty remains a huge global challenge. Over one billion of the world's people continue to live in conditions of absolute poverty, subsisting on less than $1 a day.[42] As such, even if development economics have not yet found ways to help them, global actors should at the very least take every effort not to make their condition any worse. If foreign aid is hurting rather than helping them, then it is clearly in need of being restructured, such that policy and incentives can be better coordinated to achieve the desired outcomes. In the meantime, research efforts must continue to search for the answers. §

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