

Can Aid Work? Written Testimony Submitted to the House of Lords

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ABSTRACT

The main body of this short essay comprises written testimony that Owen Barder submitted to Britain's House of Lords in response to a question about the effectiveness of foreign aid. In a brief introduction Barder draws upon his recent experience living in Ethiopia for three years to shed light on how he thinks about the question of aid effectiveness.

In the written testimony, he argues that the first step in considering aid effectiveness is to identify the aims of foreign aid. He enumerates three: sustained economic growth, improved quality of life, and the alleviation of suffering. Aid often demonstrably improves lives and alleviates suffering, he contends, but its effect on economic growth is ambiguous. It is perhaps better to ask not *whether* aid is effective, but *which* aid is effective, he writes. He argues that foreign aid, done well, does good, and offers ten recommendations to avoid common pitfalls and improve how aid is delivered.

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Can Aid Work?

Living in Ethiopia for the last three years, I saw aid working every day. I saw children going to school, health workers in rural villages, and food or cash preventing hunger for the poorest people. The academic debates about aid effectiveness seem surreal when you are surrounded by tangible, visible evidence of the huge difference aid makes to people's lives.

But on the whole, the sceptics are not disputing that kids are going to school because of aid. They are asking what effect that has on the country as a whole. Does it lead to economic growth? Does it drive up the exchange rate and so damage competitiveness? Do governments become dependent on donors and so less accountable to their own citizens? Does aid keep the bad guys in power?

It is possible that aid *is effective* in terms of providing people with basic services, and at the same time *not effective* at increasing economic growth. It is even possible that aid simultaneously does short-run good (better services) and long-run harm (worse institutions).

It was this difference between perspectives which made me want to respond to the call for evidence in an investigation into aid by the Economic Affairs Select Committee of the British House of Lords. This committee includes some well-known economists and other public figures, and has produced a number of influential reports, notably [an investigation into the economics of immigration](#). They are now examining the "Economic Impact and Effectiveness of Development Aid." They wanted short submissions, preferably under than six pages, which is not a lot of space to cover [wide-ranging questions](#) from whether aid affects economic growth to how the British government should improve its aid.

The submission, included below, begins by trying to address the question of *what aid is for*, which seems to be the source of much of the confusion about whether aid works. It then reviews the evidence about whether aid leads to economic growth (answer: we don't know) and whether aid improves people's lives (answer: yes it often does). The interesting question is not *whether* aid works, but *which* aid works. But there are also possible adverse effects of aid, and these are potentially serious. These appear to be mainly a consequence of *how* aid is given. The submission argues that they can largely be eliminated if donors give *better aid*. But that requires donors to overcome domestic political obstacles to reform of aid. The evidence finishes with ten suggestions for how to make aid work better.

It is a good discipline to be concise, but it is not possible to do full justice in six pages to the nuances of these issues. I've tried address the big questions with what I hope are balanced and dispassionate judgments. I hope you will let me know if you think I've got these right.

**Written Evidence to the House of Lords
Select Committee on Economic Affairs
“The Economic Impact and Effectiveness of Development Aid”**

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What is aid for?

1. Governments give aid for many reasons. As well as seeking to improve the lives of people in developing countries, they also want to increase the supply of global public goods (such as international law enforcement), project their prestige, promote the security of their citizens, win export contracts, and support their own suppliers. These goals are not mutually exclusive. In the UK the law requires that aid is used to contribute to poverty reduction but it does not prevent the Government from having regard to these other objectives when choosing which people in poverty to help and how.² In this submission the *effectiveness* of aid is considered with reference to its impact on people in developing countries, and not with respect to these other possible goals.

2. To understand whether aid is effective we need to be clear what it is intended to achieve. Aid is often regarded as having two purposes: *humanitarian aid*, to alleviate suffering usually in an emergency, and *development aid* to promote economic growth and sustained prosperity. But this is a false dichotomy: most aid falls into neither category. About 60% of bilateral aid, and 66% of British bilateral aid, is spent on improving services such as education, health, water and sanitation. This aid is not a temporary humanitarian response to an emergency, but a long-term contribution to the provision of key services and an investment in the institutions needed to provide them in the future. This aid may possibly strengthen economic performance in the long run, but it is not likely to lead to faster economic growth in the short or medium term. **The purpose of most aid is to improve the living standards of the citizens of developing countries by contributing to key services.**

Table 1: Bilateral aid in 2009 categorized by broad objective

	UK Aid	Aid from all donors
Aid related to growth		
Infrastructure, agriculture, production etc	18%	22%
Aid to improve living standards		
Health, education, water, NGOs etc ³	66%	60%
Humanitarian aid		
Emergency aid plus refugee costs	10%	12%
Administrative and unallocated	6%	7%

Source: Calculations by the author; OECD Development Assistance Committee CRS database

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² International Development Act (2002) <http://www.legislation.gov.uk/ukpga/2002/1/contents>

³ Budget support is assumed here to be used predominantly (80%) to support social sectors.

3. It is attractive to think that aid can accelerate sustainable economic growth and so ‘do itself out of a job’. But providing basic services to people who need them is also a legitimate goal in its own right, irrespective of whether doing so accelerates economic growth. There is a sound economic case for increasing total welfare by a modest programme of redistribution which gives very poor people access to essential services.

4. The effectiveness of aid can therefore be judged by the extent to which it brings about one or more of the following objectives, to which different people may attach different weights:

- a. **sustained economic growth** resulting in permanent improvements in living standards;
- b. **a better quality of life** for people in developing countries; and
- c. **the alleviation of suffering** by the provision of emergency humanitarian relief

Does aid lead to economic growth?

5. Economists have applied increasingly sophisticated econometric techniques to try to establish whether aid leads to economic growth. In the 1980s, some studies found a positive and significant effect of aid on growth, while others found no effect at all.⁴ These findings triggered a further wave of studies that sought to either disentangle or refute the results. Some scholars argued that aid does lead to growth in some circumstances—such as where there are good policies or export shocks, or where institutional quality is high.⁵ Other studies argued that aid works on average, but with diminishing returns.⁶ Recent studies continue both to challenge and to support the hypothesis that aid leads to growth. One study by researchers at the Center for Global Development found a strong, positive effect of a subset of aid on economic growth, with diminishing returns.⁷ An influential study by IMF researchers found no evidence of an effect under a number of model specifications.⁸

6. The most compelling conclusion from all this is that of David Roodman, who argues that it is inherently difficult to use cross-country regressions to assess the impact of aid on growth.⁹ The sample size is too small (about 80 countries) and there are numerous possible determinants of growth, many of which are highly correlated with each other and so difficult to distinguish statistically. Furthermore levels of income are an important determinant of aid volumes (donors give more aid to poor countries) so it is difficult to use statistical tools to distinguish the effects of aid on growth from the effects of growth on aid.¹⁰

7. The statistical difficulties of establishing a clear relationship between aid and growth should not be interpreted as evidence that no such relationship exists. Given the modest volumes of aid, we should not expect an impact on growth which is bright enough to shine through the statistical fog. The safest conclusion is that cross country growth regressions do not have sufficient statistical power to tell us whether aid leads to growth, still less to answer the more important question of which kinds of aid are effective and which are not.

⁴ Gupta and Islam (1983) and Levy (1988) found positive effects; Singh (1985), Paul Mosley et al. (1987), and Boone (1994) found no effect.

⁵ On good policy: Burnside and Dollar (2000); on export shocks: Collier and Dehn (2001); on institutional quality: Collier and Dollar (2002).

⁶ Hadjimichael et al. (1995), Durbarry et al. (1998), and Hansen and Tarp (2000), among others.

⁷ Clemens, Radelet and Bhavnani (2004).

⁸ Rajan and Subramanian (2005, 2008).

⁹ Roodman (2007, 2008).

¹⁰ Roodman’s *Guide for the Perplexed* (2007) offers a non-technical introduction to the statistical issues.

8. Nor does the inconclusive evidence on the effects of aid on growth mean that donor countries are powerless to promote sustainable economic growth in developing countries. Industrialized nations have many other policy choices which are at least as important as giving aid. These include action on trade policy, climate change, immigration, conflict resolution, arms sales, corruption, research and development, technology transfer, illicit financial flows and international tax cooperation. The UK ranks poorly (16th out of 22 countries, a fall from 5th place in 2005) in the *Commitment to Development Index* which assesses how the policies and actions of rich countries affect developing countries.¹¹

Does aid improve living standards in developing countries?

9. There is extensive evidence to show that significant aid does reach intended beneficiaries and provides them with key services. The quality of life in developing countries has improved appreciably over the last fifty years, even in countries where incomes have stagnated or fallen back, and aid has contributed significantly to these gains.¹² For example, about 80% of the world's children now get basic vaccinations, saving about 3 million lives a year, and over half of vaccinations in low-income countries are financed by foreign aid.¹³ The UK Department for International Development estimates that each year British aid pays for 11 million children to go to school – more children than the UK government educates at home but at 2.5% of the cost.¹⁴

10. Advances in rigorous impact evaluation have enabled us to measure more precisely the difference made by specific kinds of intervention. For example, a project in Kenya to provide deworming drugs reduced pupil absenteeism by a quarter and proved far cheaper than alternative ways of boosting school participation.¹⁵ Evaluations like this enable us to identify the effects of individual programmes, financed partly or wholly by aid. But we cannot say for certain whether the existence and extent of each programme was entirely due to aid, nor can we say with certainty whether offsetting or complementary choices were made as a result of aid. Aid is fungible, whether provided as projects or financial assistance. Nonetheless, with at least the degree of rigour with which we assess the impact of domestic spending, we can make a clear link between aid and quantified and significant improvements in the well-being of people in developing countries.

Unintended consequences of aid and limits to absorptive capacity

11. Large-scale foreign assistance may also have wider impacts which are detrimental to long-term development. The possible aggregate effects include undermining the development of domestic institutions, eroding the accountability of the government, entrenching interest groups that present obstacles to development, and driving up the real exchange rate and so making the export sector uncompetitive.¹⁶ There are documented examples of all these possible consequences of aid but not enough evidence to determine whether they are sufficiently common and significant to out-weigh the benefits of aid. If these effects are disproportionately worse at high levels of aid, then there may be diminishing marginal returns from aid, and this could imply a limit on the amount of aid that developing countries can absorb before it starts to do more harm than good.

¹¹ Center for Global Development, *Commitment to Development Index* <http://cgdev.org/cdi/>

¹² Kenny (2011)

¹³ See Claudio Politi and Alaina Thomas (2010).

¹⁴ DFID (2011).

¹⁵ Miguel and Kremer (2004).

¹⁶ Glennie (2008); Rajan and Subramanian (2009).

12. In principle donors should be able to limit, and perhaps eliminate, these unintended but foreseeable consequences of aid by improving the way they manage aid. The internationally-agreed agenda for better aid effectiveness sets out some necessary steps.¹⁷ For example, donors could help countries to manage the macroeconomic effects of aid by making aid much more predictable and less volatile. They could avoid undermining institutions by channelling aid through government systems instead of separate project implementation units. They could limit their effect on domestic accountability by making aid significantly more transparent, and eschewing externally imposed policy conditions. In practice, however, progress has been glacial, because donors face domestic political constraints which limit their ability to make the necessary improvements.¹⁸

Focus aid on its comparative advantage

13. Aid constitutes only a small proportion of the resources available to developing countries, although it contributes a significant proportion of external resources in sub-Saharan Africa.

Table 2: Development finance aggregates (2009)

\$ billion	Developing countries	Sub Saharan Africa
Total ODA	128	42
Government expenditure	5,509	267
Foreign direct investment	247	28
Private portfolio flows	120	4
Remittances	308	21
<i>Memo: GDP</i>	<i>18,066</i>	<i>892</i>

Sources: OECD DAC; IMF World Economic Outlook; Migration and Remittances Unit, World Bank

14. Other financial flows such as domestic revenues, private investment and remittances are unlikely to benefit disadvantaged groups as much as they do more powerful groups in society. This may entrench existing inequality and marginalisation. These sources of funding are also likely to underinvest in the supply of global public goods. By contrast, aid can be used to reach women and girls and the poorest communities, and to increase the provision of global public goods. The greatest value from aid may be obtained by systematically targeting it on objectives to which it makes a distinctive contribution and which other sources of finance are unlikely to reach.

15. Economic growth and private investment are key drivers of development and poverty reduction, but it does not follow that they should be high priorities for aid. There are other sources of finance for investments likely to support these goals. Donors wanting to give more priority to growth can also look to their 'beyond aid' policies such as trade and technology transfer.

¹⁷ As set out in the Paris Declaration (2005) and Accra Agenda for Action (2008).

¹⁸ Barder (2009).

Ten suggestions for better aid

16. The analysis thus far suggests that donors should target resources on objectives which other sources of finance will not reach, and find ways to overcome the political obstacles to effective aid so as to minimize the possible adverse effects of large aid flows.

17. Britain's reputation for providing high-quality development assistance is a considerable asset for its prestige and influence overseas. The quantitative indicators in the Quality of ODA (QuODA) index tend to confirm the view that Britain's aid is among the best in the world.¹⁹ But the competition in this league is not strong, and changes are needed by all donors, including the UK, to improve aid and to reduce its unintended consequences. Ten proposals are listed below, for which further analysis and evidence can be provided on request.

1. Spend more aid through the multilateral system.

Multilateral agencies are, on average, more effective than bilateral agencies.²⁰ They impose a smaller burden on recipients, and are less susceptible to political volatility. There is a collective action problem analogous to traffic congestion: even if a private car is the most attractive choice for a particular journey, in general people would reach their destination more quickly and cheaply if everyone were using public transport. Similarly, aid as a whole would be more effective if more of it were provided as core funding for multilateral organisations. Yet only 27% of all aid (and 34% of British aid) is spent through contributions to multilateral organisations.²¹

2. Make aid more predictable.

The loss associated with lack of predictability of aid has been estimated at 15% to 20% of its value, using financial market models to put a price on uncertainty.²² At current levels of global aid, this means a loss of about \$16 billion a year. Donor governments enter into long-term commitments to purchase battleships or to pay pensions: they should do the same to increase the productivity of aid.

3. Make aid transparent, accountable and traceable.

Transparency and traceability do not solve the problem of proving the overall impact of a particular aid programme – because of fungibility and other broader effects of aid. But full transparency does narrow the scope for corruption and waste, improve service delivery and reduce administrative costs. It would also make aid administration more accountable to taxpayers in donor countries. The net benefits of transparency are conservatively estimated to be worth about \$3 billion a year, and may be substantially larger.²³

4. Build the accountability of governments to their parliaments and citizens

An unwanted consequence of aid is that it can undermine the accountability of governments to their parliaments and citizens. Donors could reduce this risk by strengthening and using recipient countries' own systems for budget allocation, execution and accountability, and being transparent about aid, so that recipient country parliaments can hold their governments to account for how resources are used. More

¹⁹ QuODA is produced by the Brookings Institution and the Center For Global Development. <http://cgdev.org/quoda>.

²⁰ Birdsall and Kharas (2010). <http://cgdev.org/quoda>.

²¹ OECD DAC Database: <http://stats.oecd.org/qwids/>

²² Kharas (2008)

²³ Collin, Zubairi, Nielson, and Barder (2009).

attention is also needed to strengthening feedback loops so that public services are accountable to the citizens whom they are intended to serve, and not only to top-down evaluations of aid.²⁴

5. Focus on results and simplify aid

Linking aid to results would send more aid to where it has the greatest impact. A focus on results should be the basis of simplification and cutting red tape, and increased recipient country ownership. Rigorous results measures should substitute for, and not be additional to, burdensome processes to monitor inputs and activities. The *Cash on Delivery* proposal is intended to allow developing countries to develop, implement and be domestically accountable for their own programmes, while allowing donors to be sure that they are disbursing only for results that have been achieved.²⁵

6. Invest more in global public goods, especially new technologies

The returns from investment in global public goods are potentially much greater than from country-level aid.²⁶ Research and development are particularly important, because the patent system does not provide adequate incentives for private sector investment in products most of whose beneficiaries are poor. Donors should invest more in development of technologies of value to developing countries, including in health, agriculture, energy and information technologies. Other important global public goods include protecting the environment, biodiversity, international law enforcement, financial stability, peace and security, and disease surveillance and control.

7. Focus aid on women and girls and chronic poverty

Investments in women and girls represent among the very best value for money for aid. For example, doubling the rate of secondary schooling for girls has been shown to lead to a significant fall (64%) in infant mortality.²⁷ Aid should be targeted to reach the 400 million people living in chronic poverty – families who will otherwise be stuck in an intergenerational cycle of poverty.²⁸ These groups are unlikely to benefit from other resource flows.

8. Leverage the private sector

Where there is a market failure, or the market is of too little value for the private sector to be involved, it may be more efficient to use public funds to change incentives at the margin than for the public sector to step in and provide those goods and services itself. For example, five donor governments and the Bill & Melinda Gates Foundation have encouraged private investment in new vaccines by making an Advance Market Commitment which stimulates private sector engagement in pneumococcal vaccines for developing countries.²⁹ This approach of using aid to change the incentives of the private sector has wide application in many other situations.³⁰

9. Use innovative finance to increase the productivity of aid

Innovative finance mechanisms have potential to increase the productivity with which aid is used. They can improve incentives of implementing agents (e.g. payment by results), enable optimization over time (e.g. bringing forward vaccination), secure value from commitments (e.g. bringing down prices by entering into long-term contracts) and diversify risk (e.g. through insurance schemes). There is

²⁴ See Development 3.0 by Shanta Devarajan, World Bank Chief Economist for Africa
<http://blogs.worldbank.org/african/development-30-0>

²⁵ Birsdall and Savedoff (2010). See <http://www.cgdev.org/section/initiatives/active/codaaid>

²⁶ Conceição (2003).

²⁷ Levine, Lloyd, Greene and Grown (2009).

²⁸ Chronic Poverty Research Centre, 2009.

²⁹ Barder, Kremer, and Levine (2005).

³⁰ Kremer and Peterson Zwane (2004) and Elliott (2010)

considerable scope for innovation of this kind. Donors should not, however, be lured into ‘innovative finance’ proposals which have no effect on the productivity of aid but serve mainly to increase aid budgets by bypassing donors’ own budget processes.

10. Learn more and fail safely

The aid system lacks sufficient mechanisms to innovate, test ideas, fail safely, iterate and adapt.³¹ These are key characteristics of a successful complex adaptive system. Donors should create more incentives and funding for rigorous impact evaluation, especially through randomized controlled trials where possible. They should build a culture and political context which accepts and learns from failure, and which scales up successful programmes. Aid programs should be judged by the performance of the portfolio as a whole, and not judged by the performance of each individual investment. These are challenges not only for aid agencies but for the legislators, auditors and media who hold them to account.

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³¹ Harford (2011). Barder (2010).

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