EGDI
Studies in brief
1|00

Aid Dependence and Governance

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Background

In the face of the pessimism that has grown up around aid, new research shows that with a good institutional environment large amounts of aid can have positive results in developing countries. Aid can help governments to more quickly and effectively meet their development objectives, and can improve the standard of living of the poor. Aid can be part of the solution.

Unfortunately, most developing countries do not have a good institutional environment, and in these countries, high levels of aid have a much less certain impact. There are many reasons why governance and the institutional environment may be poor in developing countries. Leaders with short time horizons or other priorities may see little point in the long-term task of building a capable bureaucracy. Decades of economic crisis have undermined bureaucratic capacity, weakened anti-corruption norms, and made it difficult for governments to pay enough to retain talented people. Many low-income countries have only recently emerged from civil wars. Yet there is another factor that may play a role: the large amounts of aid received by many low-income countries. Continued over long periods of time, dependence on aid may make it more difficult for good governance and better institutions to develop.

This study analyzes the political economy of aid dependence. Large amounts of aid delivered over long periods of time create incentives for governments and donors that have the potential to undermine good governance and the quality of state institutions. These incentives are not always acted on, but when they are, large amounts of aid may reduce local ownership, accountability and democratic decision-making, while fragmenting budgets and lowering tax effort. Large amounts of aid, delivered to countries with weak institutions *create* some of the institutional problems that lead to ineffectiveness. In aid dependent countries, donor agencies and foreign experts often take over many of the critical functions of governance: substituting their own goals for an absent leadership vision, using foreign experts and project management units in place of weak or decaying public institutions, and providing finance for investments whose operation and maintenance is neither planned for nor affordable. In these countries, aid has been part of the problem. And long-term dependence on aid creates disincentives for both donors and governments to change the rules of their engagement.

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Aid intensity and aid dependence

Aid dependence can be defined as a situation in which a country cannot perform many of the core functions of government, such as operations and maintenance, or the delivery of basic public services, without foreign aid funding and expertise. As a proxy for this, the study uses a measure of "intensity" of aid: countries receiving aid at levels of 10 percent of GNP or above. On average, low-income countries received just below one percent of GNP in aid in 1997. But aid equaled 10 percent or more of GNP in more than 30 countries with populations over one million. Trends in aid as a percentage of GNP indicate that aid intensity has been on the rise since 1975, although it appears to have leveled off slightly since 1992.

Good governance and aid intensity: statistical analysis[1]

Statistical analysis across a number of countries indicates that there is a statistically significant, negative relationship between aid intensity and quality of governance, even when controlling for economic decline. In a set of regressions, using data from the OECD on levels of aid and from the ICRG (1982-95) index of governance quality, the study finds that aid intensity has a separate, negative, and highly significant effect. Further tests show that there is no tendency of a reversed causality, i.e. that donors direct aid to countries with deteriorating institutions. The results indicate that high levels of aid delivered over long periods of time may affect growth and development through their impact on governance and institutional quality. This preliminary analysis suggests that it is important to examine more closely the problematic impact high levels of aid may have on governance and institutions in developing countries.

How did aid dependence get to be a problem?

Aid has become institutionalized in the system of international relations as one of the major ways in which countries with higher and lower incomes interact. The number of countries that receive high amounts of aid has been increasing. Some of this is due to the post-1989 inclusion of many former Soviet dependencies in the charts of recipients of aid funds, and the lingering effect of wars that were exacerbated by superpower conflicts. The economic and debt crises are also a significant factor in explaining the continued high levels of demand for aid, and in explaining its supply. In a vicious circle, the growing amount of official debt in poor countries creates the need for continued aid. Finally, this study suggests that part of the problem lies in the incentives created by the current system of aid, and the way they affect the collective action problems that are inherent in any reform attempt.

Aid dependence, incentives and governance

Reforms - whether of the aid system, or of governance in developing countries - are collective goods, and achieving them involves solving a set of difficult collective action problems. High levels of aid affect the incentive structure for those actors who must cooperate to solve these problems. When aid intensity continues over long periods of time, it can create aid dependence, with its associated attitudinal, behavioral, and political challenges. In these situations, aid becomes a permanent soft budget constraint. It can create a moral hazard problem, whereby governments receiving large amounts of aid may engage in riskier fiscal behavior, knowing they are likely to be bailed out. Aid dependence also affects the institutions – the sets of norms, codes of conduct, laws, and patterns of behavior – that structure the incentives for cooperation and provide the setting within which improvements in governance must occur.

In an aid dependent context, cooperation needs to take place among three main parties: governments, and the politicians and bureaucrats who people them; societies, which include interest groups and, more generally (in democracies), the electorate; and aid agencies. All three parties have an interest in "national development". But alongside this more general interest in development, each set of actors has particular interests that may conflict with the general interest.

For political leaders, political survival is an overwhelming interest, and in general, they will promote actions that increase their chances for survival even if they are detrimental to development. Bureaucrats are also driven by political survival – especially if they are not protected by career civil service rules. Career advancement is another interest, as well as the material benefits to be gained by the provision of private goods (such as jobs, contracts, etc.) from the public treasury. Interest groups and others in society have an interest in shifting the rules of distribution in their favor, in obtaining private goods and semi-public goods from bureaucrats and politicians, and in minimizing their payments for public goods. Employees of aid agencies have an interest in career advancement and (increasingly, given budget cuts) retaining their jobs, and they must also often answer to the interests of their domestic private sectors and their ministries of foreign affairs. Given these various interests, we can begin to see how aid dependence structures the incentives for action and affects the institutional context within which decisions are made.

Aid dependence and political leadership

Political leaders must continually balance their pursuit of policy objectives (including development) and their primary goal of remaining in power. In order to do both, they must strike bargains with other power-holders in government, society, and in aid agencies. Aid dependence gives aid agencies extraordinary power in these negotiations, but this can backfire. Aid dependence can make reforms less likely to occur. It can contribute to a "strong president, weak parliament" syndrome, distort political accountability, weaken government ownership of reforms (and thus reduce their likelihood of enactment, or of being sustained), contribute to the short time horizons and uncertainty that plague efforts at cooperation in poor countries, and may reinforce patronage practices. By-passing central governments and shifting large amounts of aid to NGOs or local governments may not alleviate any of these problems, but simply cause them to appear in another form.

State capacity, bureaucratic competence and corruption

The goal of governance reforms is primarily to increase the quality of public institutions and to reduce corruption. Yet large amounts of aid and technical assistance enable bureaucracies to continue functioning without at the same time creating any incentive for them to cooperate with efforts to increase meritocratic appointments, reduce corruption in procurement and provision of services, or cut back on unsustainable numbers of public employees. In addition, aid dependence means that countries are deeply exposed to some of the most criticized practices in the aid system: by-passing instead of building capacity, poaching talented staff from government offices, providing unnecessary and unwelcome technical assistance. This directly affects the institutional context within which bureaucr acies operate, and has created some significant barriers to the development of more effective states. Finally, high levels of aid tend to lessen pressures that might push the development of bureaucratic accountability. In aid dependent countries, accountability for the funding is valued most highly by those who provide the bulk of the funds: the donors. Many aid dependent countries have not developed the capacity to carry ca carry out extensive audits. Instead, donors substitute their own accountants and reporting, creating an enclave of accountability that rarely grows beyond its borders.

Taxing and spending: budgeting and fiscal management

Budgets in many aid dependent countries have collapsed under the weight of many hundreds of projects and policy conditions. Yet aid dependence itself inhibits the budget restructuring required by economic crisis. Aid dependence tends to exacerbate problems of budget fragmentation, repetitive budgeting, and cash flow management. Budgets that are essentially aggregates of donor projects are divorced from planning and policy objectives. Continued provision of large amounts of aid over long periods of time removes the hard budget constraint from government calculations of what is affordable and sustainable in policy choices, and genuinely hard budget constraints are essential for keeping government commitments at sustainable levels. Finally, countries that are heavily dependent on aid tend to have lower levels of tax effort, suggesting that large amounts of aid may serve to reinforce inadequate revenue collection efforts.

Cases of successful aid relationships

Taiwan and Botswana are today regarded as success stories, countries that have reduced their once high dependence on aid dramatically, while raising the standard of living of their populations. Although there are many differences between these two, their experiences have several things in common. Both countries began receiving aid during a period when their governing institutions were weak, and they – and their donors – used aid to build centralized government institutions that then became critical for managing the aid relationship.

Both also enjoyed good leadership. Good leaders are those that have that have good ideas and prove able to muster the political support they need to implement those ideas. Among those ideas were economic policies: both decided to rely on their private sectors as the engine of growth rather than nationalizing local and foreign firms, and both emphasized earning foreign exchange by investing in exports. These policies built the foundation for later self-reliance.

Conclusions: Changing incentives and reforming institutions

Aid can have a good developmental impact in countries with good leadership and good institutions. However, the current system of aid provides few incentives for leaders and bureaucrats in aid dependent countries to undertake the difficult public sector reforms necessary. The study advocates a number of changes in the current system in order to improve the situation.

Supply aid more selectively. Principled selectivity should be based on performance in three criteria: 1) the pursuit of macro-economic stability and fully accountable budget management (including plans for increasing foreign exchange and domestic revenue generation over time); (2) progress toward establishing the rule of law, a meritocratic civil service and reducing corruption; and (3) progress toward improving the social welfare of the poor.

Supply aid as debt relief and general budgetary support. This contributes to a hard budgetary constraint, and governments maintain control and ownership. It involves the transfer of resources without the high transaction costs of program and project negotiations, and without the costs of paying for expensive technical assistance.

Plan for the transformation of aid agencies. While a shift toward general budgetary support for selected countries is still far in the future, reformers may press for four elements in order to change incentives in aid agencies: 1) greater accountability regarding failed projects and bad loans; 2) more "pooling" of aid resources to improve recipient ownership, donor coordination and partnership; 3) shift from supply to demand-oriented funding, along the model of foundations; and 4) more "market discipline" through more competition in the aid system, for example through removing benefits of "tied aid" for donor country firms and de-linking technical assistance from direct donor funding.

Develop a timetable and an action plan for a gradual winding down of aid. Over time, the terms of aid should harden and approach market terms, to continue to create an incentive for countries to rely on their own revenue generation.

[1] The regressions and much of the analysis in this section was done by Stephen Knack; see further Knack, S. 1999, "Aid Dependence and the Quality of Governance: a Cross-Country Empirical Analysis", IRIS Center Working Paper, May, College Park, University of Maryland

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