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Policy, Institutions and Aid Effectiveness in Developing Nations: Literature Revisited

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Abstract
This paper is an attempt to investigate policy and institutions aid effectiveness from various contributions made by past scholars. It was found that good policy environment and institutions were good for aid effectiveness. However, aid was also found to enhance good policy especially where past and present policy is bad. This argument was however highly contested by a number of researchers saying that it's not policy alone that enhances aid effectiveness but other factors like external shocks. Political stability enhances aid effectiveness, though aid in repressive regimes was also found to be as effective to a given degree. The main lesson learned from this research is not to deny the role of policy and institutions in aid effectiveness but to consider its role in a dynamic and broader context.
Keywords: Aid, Effectiveness, policy, countries, institutions

1.0 Introduction

In their earlier paper, 'aid policies and growth' Burnside and Dollar (2000) had provided evidence that aid accelerates growth in developing countries with sound institutions and policies, but less or no effect in countries in which institutions and policies are poor. They found these results quite intuitive: a corrupt, incompetent government is not going to use aid wisely and outside donors are not going to be able to force it to change its habits. This evidence is supportive of the growing trend among aid agencies toward greater "selectivity" –that is, channeling relatively more aid resources to poor countries with reasonably good policies (Burnside and Dollar 2004).

The most important lesson learned about economic development and therefore the role of assistance (aid), is the significance of overall macro-economic environment for economic growth. Over the past thirty years, appreciation of the importance of appropriate trade and exchange rate policies of fiscal and monetary policies and of the overall incentive structure provided government policies has increased continuously (Killick, 1991). The most influential study to highlight the relationship between aid effectiveness and the domestic policy environment of recipient countries is by Burnside and Dollar (2000). Beuran et al. (2011) quoted Burnside and Dollar (2000) whose findings revealed that aid is effective in enhancing growth only in the presence of sound macroeconomic policies, namely well controlled inflation, the maintenance of structural budget balance or surplus balance, and position of trade openness; this implies that selectively allocating aid in favour of countries with sound policies would be most effective in supporting growth.

However, Baliamoune-lutz and mavrotas (2008) had challenged the idea of pegging aid on policy. They claimed that there are at least two problems with making aid dependent on policy (as defined in most of the literature). First, other macroeconomic policy variables may be as important (if not more important) for example interest rate or credit policy would be quite relevant if aid complements private investment. Secondly, the budget surplus enters with the positive coefficient, i.e. the higher the surplus, the higher (better) the policy index. At least in cross-sectional studies, this seems to be paradoxical. A country may need significant amount of aid when it has a large budget deficit so that its policy index would be lower (worse) than a country that has a lower budget deficit. In this case, aid could still contribute to growth inspite of poor policies. Also, one has to keep in mind that in developing countries (which are on the recipient side of aid) governments still fund a large share of investments (for example infrastructure) and expenditure associated with some of these investments may contribute to increasing budget deficits. Thus the policy index needs to be grounded in solid theories about how its components may affect the effectiveness of aid. This paper has the objective of looking at the impact of policy and institutions on aid effectiveness. The remainder of this paper is structured as follows: Section two provides literature review, Section three covers research methodology, section four covers economic policy and aid effectiveness, section five deals with institutions and aid effectiveness and section six provides conclusions and lessons for policy.

1.1 Objectives

- To determine the relationship between policy and aid effectiveness of developing nations
- To assess the relationship between institutions in developing nations and aid effectiveness

1.2 Statement of the problem

Recently, the ability of foreign aid to achieve its goals is called into question widespread conceptual and empirical literature suggests that foreign aid is ineffective. (Williamson 2009). This paper explores the failure of foreign aid relying on the role of both incentives and information. The success of aid depends on incentives faced by all parties in donor and recipient countries. In addition, both donors and recipients must obtain the necessary information to actually target and achieve desired goals. Most developing countries have weak institutions and bad policies, contributing to why they are poor. Thus, where aid is needed, it will be unhelpful because the necessary institutions are lacking. Where it can do some good, in those countries with good policies and institutions, it is not needed.

2.0 What Literature Says

Scholarship on the relationship between aid, economic policy, institutions and growth is voluminous. This section provides a brief survey of how aid effectiveness- economic policy and institutions debate has evolved. Given that institutions and policies are important for growth and that aid has had little systematic effect on institutions and policies, Burnside and Dollar (2004) introduced the hypothesis that the impact of aid on growth is conditional on these same institutions and policies. To investigate this empirically, they created a policy index based on several variables used in the empirical growth literature. Burnside and Dollar (2004) quoted their own earlier follow-up study, (Burnside and Dollar, 2000a), which added a rule of law measure to the index, and whose findings revealed that aid has a positive effect on growth in developing countries with significantly better than average institutions and policies, whereas aid had no positive effect on countries with average policies.

Burnside and Dollar (1997) found out that the positive impact of aid on economic growth depended on the presence of good policies (good fiscal, monetary and trade policies). However linking aid to policy can be controversial to say the least. It is asserted that such a link is empirically inexistent or is very weak once the sample, the control variables or the specifications change (Baliamoune and Mavrotas, 2008). Aid can also lead to the improvement of policy. This finding was not rejected by econometric estimations which found that the poorer the previous policy, the stronger the improvement of policy induced by a given amount of aid. Consistently, aid appears simultaneously more efficient when the present policy is good but also when past policy was poor i.e. likely to be improved under the influence of aid (Chauvet and Guillaumont, 2003).

Effectiveness of aid depends on the quality of the government of the country receiving that aid. This argument became influential with the publication of the World Bank's 1998 Assessing Aid Report, which claimed to show that aid was more effective in countries which had sounder policies. The econometrics behind this claim has since been debunked but the finding itself appears sound according to Burnside and Dollar (2004). It also ties in with the now- widely accepted view that domestic institutions are the primary determinants of domestic economic performance (Howes, 2011).

On the contrary, the Zambian case exposed an issue in which policy had led to ineffectiveness of aid. Zambian rural development policies, for example, frequently suffered from misplaced priorities while investing in rural access and building feeder roads could have a positive impact in reducing rural poverty, most government (and donor) road funding concentrated on the major road net work. In other areas such as the education and health sectors, implementation was inconsistent. The government's emphasis on building schools and health care centers in rural areas was not matched by a commitment to quality service delivery; as a result the bulk of resources were used in constructing facilities that function poorly, if at all, and access to education and health services remained limited.

In terms of microeconomic policies, the government had not devoted sufficient resources to interventions that enhanced productivity of the poor and their integration into the formal economy. Workers living near or below poverty line lacked the capital necessary to invest in vocational training or other forms of education even when the returns to education, clearly justified the expense. Entrepreneurs in poor areas tended to operate in the informal sector; in many cases procedural burdens –such as costly and time consuming requirements for obtaining a business license-discouraged them from formalization, which in turn limited the scale of the enterprises and reduced aggregate tax revenue. In this approach to the antipoverty programming, the Zambian government has consistently focused its resources on social sectors, whereas economic interventions such as the provision of more extensive and sophisticated agricultural extension services or efforts to bring informal businesses into the informal economy could have a greater and more lasting impact (Beauran et al., 2011).

Just like Howes, the findings of Dovern and Nunnenkamp also show that aid effectiveness is closely linked to the types of institutions in a given society. Their study reveals that total aid as well as aid in the form of loans and grants has a significant positive effect on growth accelerations in bad states, whereas the effect remains insignificant in good states. This pattern is exactly opposite to the World Bank's (1998) claim that aid is effective only in a country with favorable local conditions. The World Bank Study as well as supportive evidence subsequently provided by Burnside and Dollar (2004) come under attack. Dovern and Nunnenkamp's findings show that autocracy is positively correlated with the likelihood of growth accelerations. Dovern and Nunnenkamp (2006) quoted Hausmann, Pritchet and Rodrick (2005) whose findings showed that if more autocratic regimes tend to be more successful in initiating temporary growth accelerations, such regimes may also be more inclined to use aid to this effect, e.g. by investing aid flows rather than consuming them. Moreover, even the finding of Dovern and Nunnenkamp, is in conflict with most contributions to the aid effectiveness literature, at least one recent study point to the same direction.

A study by Cordella and Ulku (2004) had wonderful revelations. By focusing on the incentive effects of concessional capital inflows, they argued that less concessional capital inflows may weaken local adjustment efforts in bad states, e.g. recipient countries with weak institutions. They derived the hypothesis that the impact of concessionality on economic growth should be positive in bad states. The authors tested this hypothesis only with regard to concessionality of aid flows, finding that grants were indeed superior to loans in bad states. But their theoretical reasoning would also imply that aid was superior to non-concessional capital inflows e.g. debt related inflows from private sources.

Chauvet and Guillaumont (2003) had tried to link political instability to aid effectiveness. They had tentatively advanced the following hypothesis: aid effectiveness may be influenced by political instability in two opposite directions. Indeed political instability should be considered as economic vulnerability i.e. as an exogenous negative shock likely to be compensated or ensured by foreign aid. But precisely because this instability is political rather than economic, and endogenous rather than exogenous, its effects are less likely to be compensated by resource inflow. It seems more likely that political instability works in the opposite direction and negatively influences the aid effectiveness: actually in a troubled environment, with violence, frequently changing governments, Coups d' Etats, riots etc…, aid may hardly contribute to growth. The same finding had been supported by Mcgillivray (2003) who by quoting Svensson (1999) revealed that democratic institutions (such as political parties, elected representatives, free speech and the right to organize) should provide a recurrent and institutionalized check on government power, encouraging governments to use aid productively and preventing them from using it unproductively. Thus it is hypothesized that aid will have greater impact on growth the greater the degree of democracy.

3.0 Methodology

This study relied on secondary sources. Empirical and conceptual literature was visited which gave the researchers an insight into the linkages between policy, institutions and aid effectiveness.

4.0 Economic Policy and Aid Effectiveness Linkage

There have been opposing views as regards the necessary conditions in recipient countries for aid to be effective. In this section, the focus is on a number of papers beginning with Dollar and Pritchet (1998) "Assessing Aid" Report which claimed to show that aid was more effective in countries which had sounder policies. "Assessing aid" Report argued that economic growth is the most effective mechanism we have to reduce poverty. The methodology used to support this argument is important so the authors had expanded upon it. Assessing Aid used empirical data to describe what aid can accomplish in good policy environments. The data indicated that in good policy environment and an average amount of aid dollars (about 2% GDP), an increase in aid equivalent to 1% of GDP promoted economic growth of 0.5% points. Move to mediocre policy environments and the observed growth effects of 1% increase in aid dropped to zero. There is also some evidence of negative correlation in the poorest policy environments though the statistical indicators were not significant. Linking these data to poverty reduction was a major goal of the report. The report's analysis found that a 1% increase in per capita income, one measure of growth, was correlated to a 2% reduction in poverty. So using transitive mathematics, the authors argued that in good policy environments a 1% increase in aid led to 1% reduction in poverty.

If this logic is followed, then aid will be most effective for poverty reduction when targeted to good policy environments. Historically, aid has been given to well and poorly managed nations alike, and in many cases, to decidedly "middle income" nations. The assessing aid analysis suggests that the ideal aid recipient would be a nation with good policy scores and a high poverty burden. Targeting aid to where it is most needed and where it will do the most good should lift the greatest number of people out of poverty. This more efficient allocation of aid monies has the potential to generate enormous improvements in the productivity of aid monies. The report projected that a 10 billion dollars increase in aid that is targeted to nations with sound policies could lift 18 more million people out of poverty than a blanket increase in aid to all nations. Burnside and Dollar (2000) investigated several questions regarding the interactions among aid, economic policies and growth. Their primary question concerned the effect of aid on growth. Consistently with other authors, they found that on average, aid has had little impact on growth, although a robust finding was that aid has had a more positive impact on growth in good policy environment. This effect goes beyond the direct impact that policies have on growth.

Apart from Burnside and Dollar (2000, 2004), other studies by Hansen and Tarp (2001) and Collier and Dollar (2001) also included policy in their growth examination. Hansen and Tarp used objective measures of macroeconomic policy. Collier and Dollar used the Subjective CPI score. All the two studies including those of Burnside and Dollar (2000, 2004) found that policy is directly important for growth. This is important common ground: better policy, in the sense conventionally used by the Bank, is indeed found to raise growth. While there have been some serious errors in policy advice and important questions remain unresolved, these studies implied that the broad thrust of Bank policy advice over the last two decades has been correct.

If policy is important for growth, it is likely that one route by which this occurs is that better policy raises the return on investment. Indeed, it is quite challenging to think of a credible model in which broad policy improvement raises growth but lowers the return on investment (although particular policies could have this effect). Since public and private investments tend to be compliment Collier and Dollar (2001) found out that better policy would raise the return not just on investment in general, but also on public investment. There is indeed strong microeconomic evidence for this proposition from Bank – supported public investment projects evaluated by the Bank's Operations Evaluation Department. Collier and Dollar (2001) quoted Isham and Kaufmann (2000) whose findings showed that there is a strong positive association between policy and the rate of return on projects. This was the relationship found at the macroeconomic level by Burnside and Dollar using the Bank's objective indicators of policy and by Collier and Dollar using the Bank's subjective CPIA score.

Past studies had found that contrasting performances between otherwise similar economies seem largely explicable in terms of Riddlell's authoritative 1987 re-examination of the case for aid support for the consensus that policy environment is a major determinant of the effectiveness of aid as certainly correct. In line with the shift within the main stream macro-economic 1980s towards greater attention to supply side issues and to the micro foundations of macro actions, there is now wide recognition of the intimate connections between the macro-economic environment and the performance of agriculture, industry and other key sectors of the economy. The modern approach to exchange rate management, with its emphasis on real exchange rate has drawn added attention to the quality of overall macro management (particularly the avoidance of inflation) as conditioning what can be done with exchange rate instrument. Much the same is true of discussions of financial policy with the literature on financial repression drawing attention to the influence of the macro environment of the development of financial system and with the avoidance of rapid inflation seen as necessary if positive interest rates are to play their role in stimulating the financialisation of saving and raising the productivity of investment. The policy environment is also seen as potentially influential on the supply of entrepreneurship, through tax and other policies affecting profits, the extent and nature of business, the influence of the public finances and other policies on the availability of business finance and the provision of infrastructure and training. More generally, macro-economic stability is seen as raising supply responsiveness by increasing the reliability of price signals and encouraging long term investment.

Macroeconomic environment also strongly affect the developmental returns that can be obtained from aided projects. This emerges strongly from Bank's Operations Evaluation Department (OED). Some of the most frequently cited determinants of project performance it states……. were in principle within the control of governments. The experience evaluated for this review emphasized the great extent to which the fate of projects depends on sectoral and macroeconomic policies. Indeed it was because it saw ill chosen policies, as causing increasing numbers of its past projects to fail that the World Bank moved into policy- related lending from the end of the 1970s (Riddell, 1987).

Indeed Burnside and Dollar's studies and others cited above have been very influential among donor agencies since they provided the donor community with policy criterion for allocating aid, namely that aid should be allocated on a selective basis to those countries that have adopted good policies in view of the central finding of the study that aid works only in a good policy environment. Collodel (2011) quoted Burnside and Dollar (2000) who argued that aid influenced growth, but the impact of aid was conditional on the quality of the recipient's macroeconomic policies. The effectiveness of aid therefore depended on how it is used by the recipient country. For instance, in a country with poor policy environment, aid might be used to fund public consumption or unproductive investments, instead of productive ones. That is, aid is wasted. If aid is invested productively, it can increase domestic production, and have a positive influence on growth. However, if aid is used for public consumption, there is little increase in productive output, and therefore aid has less impact on growth. However, Burnside and Dollar's findings were disputed by many who purported to show that aid works irrespective of policy (Hansen and Tarp, 2000, 2001 and Dalgaard and Hansen, 2001). Admittedly poorest countries are also those with the least capacity administratively, institutionally and in terms of policy making. This overall capacity deficit imposes a major constraint on their policy making and implementation ability including the areas of aid negotiation, management and utilization. However, correlating aid effectiveness with policy efficiency ignores several other factors recipient country. As a result issues such as allocative priorities of the donors, mismatch between the aid flows and national needs, predictability of flow, lack of balanced mutual accountability, and trends in global aid do not get necessary attention. That it is not only policies of the recipient countries but it is the way aid is prioritised, channeled and processed are the main reasons contributing to aid ineffectiveness and has been recognized in the Paris Declaration for the first time (Baliamoune and Mavrotas, 2008).

Adding to the list of those who challenge Burnside and Dollar's findings, Sasilu (2007) quoted Collier and Dehn (2001), Guillimount and Chauvet (2001), lensink and White (2001), Collier and Dollar (2002), Easterly, Levine and Rodman (2003), Hans Lutz (2004), and Murphy and Tresp (2006). Some of these authors confirmed that aid only works in a good policy environment while others found that when particular variables are added, the coefficient on the interaction between aid and policy became near zero and / or statistically insignificant. For example Collier and Dehn (2001) as part of their contribution to entrench the brilliant research work of Burnside and Dollar (2000) incorporated export price shocks into their (Burnside and Dollar's) work, showing a significant and negative relation between negative shocks and economic growth. They argued that the adverse effects of negative shocks on growth can be mitigated by offsetting increases in aid. Therefore they suggested that targeting aid towards negative shock expressing countries could be more effective than towards good policy countries. Using a 2.5% cut off in their sample size of 113 countries, they found 179 positive shocks and 99 negative shock episodes. They indicated that the change in aid interacted with positive shocks is insignificant at the 1% level. Additionally; incorporating shocks into Alesina-Dollar (1998) regression, they showed that so far, donors have not taken shocks into account in aid allocation. Finally they claimed that aid effectiveness might be increased significantly if both policy and adverse export price shocks are considered in determining aid allocation. Dalgaard et al.(2004) quoting Easterly et al. (2003) who re-estimated the exact Burnside and Dollar model using an updated and extended data set, also ended up concluding that aid -policy interaction is insignificant.

4.1 Institutions and Aid Effectiveness

Experience suggests that aid given for political purposes to countries with poor governance- such as cold war allies- has had little development effect, whereas aid provided to countries with better governance and a commitment to strong development policies- such as South Korea, Botswana, or Thailand- has had stronger impact (Radelet, 2004). This was reinforced by Santiso (2001) who asserted that the quality of democratic institutions is also believed to affect effectiveness of aid by providing accountability mechanisms in the management of external resources. Santiso quoted Svesson (1999) whose findings revealed that in the long-run, growth impact of aid was conditional on the degree of political and civil liberties in the recipient country. Aid had a positive impact on growth in the countries with institutionalized and functioning checks on governmental power.

A study carried out by United Nations Development Fund for Women (2008) found out that in Ukraine and Krygzstan, political instability and weak governance systems had negatively impacted on efficient planning and the use of country systems by donors. In Kryzstan, in particular, only 3 percent of aid allocated to the public sector was carried out through the country's public finance management system by 2008. Concurring with the United Nations Development Fund for Women (UNDFW) that political instability contributes to ineffective aid, Pandey (2011) asserted that insecurity in Nepal, particularly in the Terai region, which had escalated since 2006, with the emergency of numerous armed groups (taking advantage of the security vacuum) had led to economic down-turn with many larger businesses scaling down and development projects (including aid supported ones) affected.

Stern et al.(2008) however found out that aid is not effective even in liberal political regimes. Boone (1996) attributed these poor results (of aid effectiveness in good political regimes) to the fungibility (its tendency to leak into purposes other than those intended) of aid and the 'distortionary 'policies of politicians who favoured their own 'elites'. There were only small differences when comparing across political regimes: liberal regimes did not use aid any differently from the most repressive regimes. Further, stern and others quoted Burnside and Dollar (2000, 2004) who in contrast (by supporting Radelet, Santiso and Pandey) found that aid was effective and did lead to growth if accompanied by sound institutions and good policies (controlling inflation and openness to trade) and institutional quality (defined in terms of property rights and the efficiency of government bureaucracy). This stream of work became the basis of 'selectivity' rather than 'policy conditionality' as the criterion for aid allocations- a criterion that persist despite substantial doubts that have been directed at the underpinning research. Collier and Dollar (2001) had attempted to show that aid was more effective in high poverty environments. Their analysis showed how aid allocation might be more 'poverty efficient', i.e. less subject to the diminishing returns because with better policies and sounder institutions, larger amounts of aid can be productively absorbed.

5.0 Conclusions and Policy Lessons

By focusing on aid effectiveness, policy and institutions the present paper finds the following: First, for aid to be effective, the policy environment and institutional set up of the recipient country should be good. This means that a country which possesses good policy environment and institutions is likely to put aid to proper use. That is why the World Bank has taken policy as one of the pre-conditions to be considered before extending aid to any country. However, this finding has been contested by a number of researchers who claim that policy is not the only factor influencing aid effectiveness. It has also been evidenced that aid may influence policy. The poorer the previous policy, the stronger the improvement of policy induced by a given amount of aid. Consistently, aid appears simultaneously more efficient when present policy is good and when the past policy is poor. Secondly, political instability being an unfavorable factor in enhancing growth, leads to aid ineffectiveness. Bad governments may not have the capability to use aid effectively. But aid can be as effective in authoritarian regimes as in liberal regimes. Thirdly, economic vulnerability to external shocks, which is by itself a negative factor of growth, is a factor enhancing aid effectiveness (which is higher in more vulnerable economies). Then retaining economic vulnerability as one of the criteria for aid allocation is necessary to maximize the effects of aid on growth and consequently on poverty reduction. In summary the main lesson from this paper is not to deny the role of economic policy and institutions in aid effectiveness but to consider their role in a dynamic and broader context.

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