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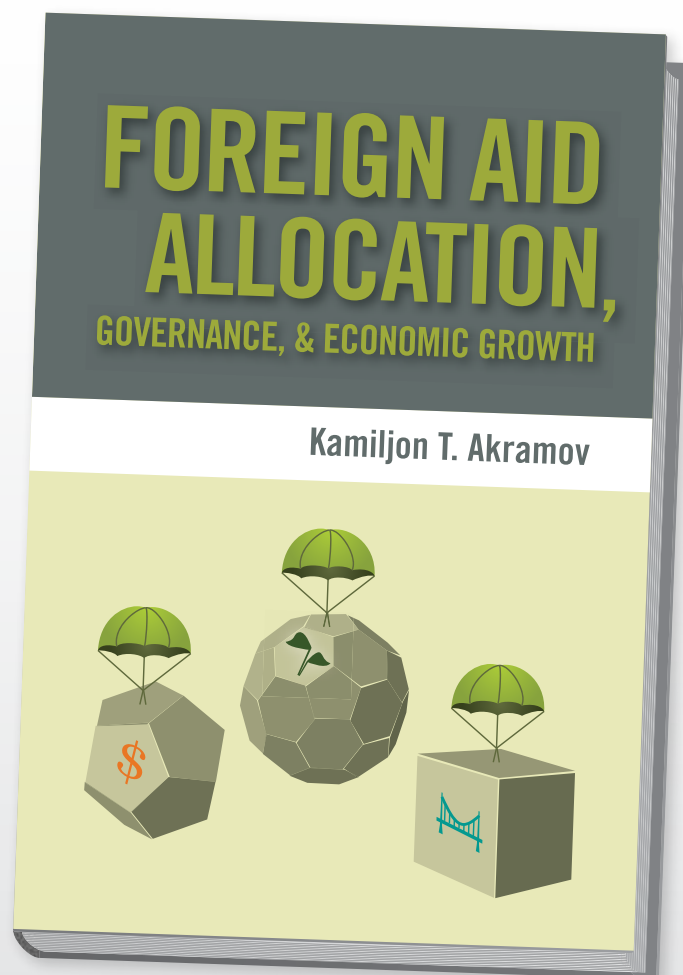
FOREIGN AID ALLOCATION, GOVERNANCE, AND ECONOMIC GROWTH

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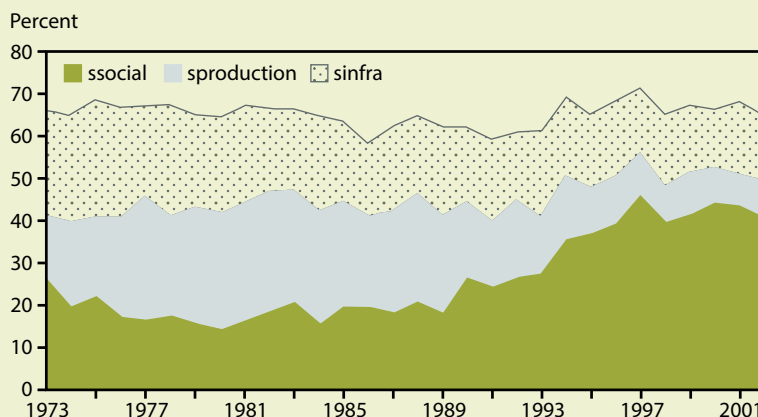
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Foreign aid to developing countries is a subject of heated debate among politicians, economists, and development specialists. Does aid promote economic growth and reduce poverty? Some argue that foreign aid has no effect on growth and may sometimes even undermine growth in aid recipient countries. Others suggest that foreign aid positively influences economic growth. Still others suggest that foreign aid has a positive impact on growth but this impact is conditional on a good institutional and policy environment. This debate has high stakes, given that foreign aid in the form of official development assistance (ODA) by leading donor nations reached over US\$120 billion in 2010, the highest level ever recorded.



This study contributes to the debate by taking a different approach from conventional analyses of the aid–growth relationship. Analysis of the aid–growth relationship shows no significant connection between aggregate aid and per capita GDP growth. Rather than treating ODA as a single category, the study disaggregates it into several different categories, based on which sector of a recipient’s economy the ODA is meant to help or promote. The study investigates whether changes in sectoral allocation of ODA influence the effectiveness of foreign aid in promoting economic growth. Although this is not an entirely new direction for research in this area, little is known about the possible causal impacts of aid to different sectors on economic growth. The results of the study are presented in *Foreign Aid Allocation, Governance, & Economic Growth*, recently published by the University of Pennsylvania Press for IFPRI.

FIGURE 1 Sectoral allocation of official development assistance (ODA) commitments, 1973–2002



Source: The Organisation for Economic Co-Operation and Development (OECD), Development Database on Aid Activities: CRS Online (various years).
Notes: ssocial: share of ODA to the social sector; sproduction: share of ODA to the production sector; sinfra: share of ODA to economic infrastructure.

DISAGGREGATED AID AND GOVERNANCE

ODA can fall into one of three aid categories: (1) economic, (2) social, and (3) other, including emergency and food aid. Economic aid includes two major subcategories: aid to production and aid to economic infrastructure. Aid to the production sector funds projects in the agriculture, manufacturing, mining, construction, trade, and tourism industries. Aid to economic infrastructure is directed to networks and services that facilitate economic activity, such as energy distribution, road and railroad construction, equipment for communication and electronic networks, and financial infrastructure. Social aid includes ODA to education, healthcare, sanitation, and drinking water supplies. Economic and social aid together account for roughly two-thirds of total ODA and are intended by donors to build additional physical and human capital in recipient countries and therefore have the potential to promote economic growth. The third category is primarily intended for consumption in emergency situations, and is unlikely to foster economic growth.

The extent and direction of foreign aid’s impact on economic growth could be affected by the degree of a recipient country’s democratic governance.

Conventional wisdom suggests that foreign aid is likely to be most beneficial when combined with the accountability that comes from democratic governance. Thus, many donors take into consideration the degree of a country’s democratic governance in their aid allocation decisions. However, democracies sometimes may pursue policies that are hostile to economic growth, such as rent-seeking by interest groups. The study empirically tests whether the quality of democratic governance is a significant factor in aid effectiveness.

AID ALLOCATION AND IMPACT OF ECONOMIC AND SOCIAL AID

Analysis of the sectoral allocation of ODA shows that on average about two-thirds of total aid was allocated to the economic and social sectors. One important trend is that the share of development aid going to social sectors has doubled since the early 1980s, accounting for more than 40 percent of total ODA commitments by the early 2000s, while the share of ODA allocated to the economic infrastructure and production sectors dropped (Figure 1). For example, the share of total aid going to production sectors decreased about threefold between the early

1980s and early 2000s, dropping from 28–29 percent to about 7–9 percent.

The main reason for this trend was a declining commitment to agriculture from bilateral and multilateral donors, including the World Bank: over roughly the past two decades, the percentage of ODA allocated to agriculture fell from about 12 percent to 4 percent (Figure 2). This decline occurred for both economic and political reasons. Economic reasons include past failures of agricultural interventions and development efforts; falling international commodity prices in the 1990s contributed to these failures by making agriculture less profitable. Political reasons include pressure from domestic farm groups in donor countries that opposed supporting agricultural producers in their main export markets and environmentalist groups that saw agriculture as contributing to environmental problems. Increased commitment to the social sector and the need for emergency responses to numerous crises also contributed to declining support for the production sectors, including agriculture.

Further analysis of aid allocation trends shows that, while altruistic motives play a role, historical factors (such as colonial ties) and donors' geopolitical and commercial interests are important determinants of donors' aid allocation decisions. The study also finds that geopolitical and strategic considerations are more important to some donors (for example, the United States) than others (for example, Nordic countries).

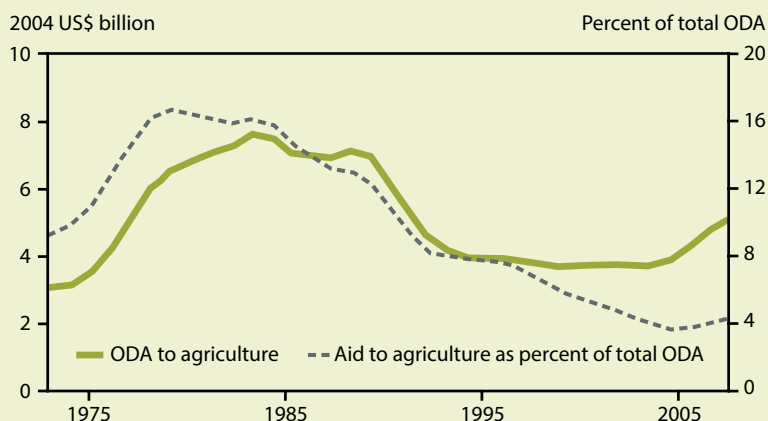
The study's findings indicate that economic aid does have a significant positive impact on economic growth. Both types of economic aid foster capital accumulation by increasing a recipient nation's stock of physical capital—such as machinery, buildings, equipment, or other physical inputs used in the production process—available for production and so contribute to recipient nations' economic growth. The combined results of various econometric analyses suggest that a 1-percentage-point increase in the ratio of economic aid to GDP increases the annual per capita economic growth rate by 0.27 percent in the long run. It seems that foreign aid intended to finance investment projects in productive sectors, such as agriculture, and economic infrastructure, such as roads, might promote economic growth by helping to increase the ratio of investment to GDP in aid recipient countries. This is plausible because less developed countries often do not have enough domestic savings to finance beneficial projects.

Further, the stock of public roads, bridges, communication systems, and other infrastructure is essential to the development of an efficient private sector. There is broad evidence suggesting that investment in public infrastructure (roads, bridges, and so on) reduces the cost of private capital and increases its marginal productivity, which, in turn, encourages private investment. ODA might thus prompt both domestic and foreign private investors and donors to invest more in the country.

In theory, social aid might affect economic growth by building additional human capital. The study uses the secondary school enrollment rate in recipient countries as a proxy for human capital. It finds no statistically significant relationship between social aid and secondary school enrollment, however. Using alternative proxies for human capital—primary school enrollment or average years of schooling, for example—does not reveal a statistically significant relationship between social aid and human capital accumulation in aid recipient countries, either. Whatever economic growth has resulted from increased human capital, social aid does not appear to have contributed to it.

One explanation for this is that education must have credible future economic advantages for parents to send their children to school. Foreign aid can increase the number of schools available, but cannot increase enrollment in them if the expected labor-market benefits of additional schooling

FIGURE 2 Official development assistance (ODA) to agriculture, 1973–2007



Source: The Organisation for Economic Co-Operation and Development (OECD), Development Database on Aid Activities: CRS Online (various years).
Note: ODA to agriculture is smoothed using a locally weighted regression.

remain relatively low. Such benefits of education depend mainly on labor-market expectations and are limited by the pace of economic development. If one accepts this notion, foreign aid can do very little to increase school enrollment in developing countries without long-term improvements in economic incentives for education.

GOVERNANCE AND AID EFFECTIVENESS

Some argue that by providing institutionalized checks on governments, democratic governance will encourage them to use development assistance more productively. Data on political rights and civil liberties indicators compiled by the organization Freedom House make it possible to assess whether the democratic quality of governance in aid recipient countries is a significant factor in fostering aid effectiveness. Freedom House's data allows the author to categorize aid recipient countries around the world as "free," "partially free," and "not free."

Analysis of donors' aid allocation decisions suggests that countries with better democratic governance are more likely to receive higher amounts of aggregate per capita foreign aid. Disaggregating aid shows that donors choose to provide relatively more social aid to "partially free" and "free" countries than to "not free" countries. There seems to be almost no difference among these three groups of countries in the per capita aid allocated for economic uses, however.

The study's findings on aid's conditional impact are striking. They suggest that democratic governance does

not guarantee aid effectiveness in promoting economic growth in aid recipient countries. It seems that economic development, at least in its early stages, can be promoted even under nondemocratic but pro-market regimes as long as they secure property rights and invest the ODA received in physical capital accumulation and economic infrastructure.

FUTURE STEPS

The research presented here has important implications for future ODA policy, because it suggests that the effectiveness of foreign development assistance can be improved by adjusting aid allocation. During the last 30 years, economic aid, especially aid to agriculture and other production sectors, has declined as a percentage of total foreign aid, falling to less than 10 percent in the early 2000s. Promoting growth in less-developed countries will involve increasing ODA flows to agriculture and other production sectors. While some progress has been made in reversing this trend—donor interest in agriculture has increased in recent years and aid to agriculture accounted for up to 5.9 percent of total ODA commitments in 2010—further increases are necessary to promote overall growth and significantly reduce poverty in nations where agriculture accounts for a major part of the economy. Such aid increases can also help improve agricultural productivity, boost food production, and enhance food security in less-developed countries. To be effective, though, changes in ODA have taken into account the prevailing needs and conditions of recipient countries, and balance attention to different sectors of economy.

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