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Development Cooperation – Evaluation and New Approaches

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Preface

This volume represents some of the Proceedings of the Annual Meeting of the Research Committee on Development Economics *(Ausschuss für Entwicklungsländer)* of the German Economic Association *(Verein für Socialpolitik)* held in Cologne, Germany, in July 2004. The meeting focused on the effectiveness of, and new approaches in, development cooperation. Both issues have become increasingly important in recent years in view of the declining volume of budget funds allocated to development cooperation.

The first two papers deal with the effectiveness of development cooperation. *Philipp Harms* and *Matthias Lutz* discuss the macroeconomic effects of foreign aid. At a crucial moment of the aid effectiveness debate where economists have begun to question the recent consensus that the macro-economic productivity of aid mainly depends on the recipient country's policy environment, the authors shed new light on the issue. After a discussion of the main theoretical arguments justifying the assumption of positive growth effects of foreign aid, Harms and Lutz examine the more recent econometric studies on the growth effects of aid, particularly those that focus on the role of policies and institutions in recipient countries. They interpret the (in many ways contradictory) results, question the above-mentioned consensus, and draw their conclusions with regard to the orientation of future, hopefully more conclusive research on the macroeconomic effects of foreign aid.

The paper by *Rainer Thiele* is devoted to the closely related issue of the "optimal" allocation of aid among recipient countries, aimed to ensure maximum efficiency with respect to poverty reduction. Giving an overview of the relevant literature, he shows that the application of different allocation criteria can lead to dramatic variations in the poverty-efficient allocation of aid. Against the background of his lucid assessment on the robustness of the empirical results underlying the specification of the allocation rules, Thiele stresses the high payoff of additional research aimed at providing donors with more robust guidance and also makes suggestions concerning the direction of such research.

The following four papers are centred on new approaches towards a closer integration of the private sector into development cooperation. *Tilman Altenburg* discusses the perspectives of joint action with so-called lead firms in production networks. He shows to what extent these firms and local stakeholders pursue both complementary and conflicting aims, and identifies areas that are most suitable for cooperation. Finally, the author draws some practical conclusions concerning the creation of strategic alliances with lead firms and makes suggestions concerning critical aspects relevant for implementation, such as how to deal with the risks of corruption, abuse and windfall gains at the expense of the public purse, or how to minimize transaction costs.

Jörn Altmann discusses the paper by Altenburg and other ways of integrating the private sector into development cooperation. He highlights the impact of WTO agreements (GATS, TRIPS, TRIMS) on the future development of the private sector, both domestic and foreign, in low-income countries. Among the policies aimed to integrate the private sector into development cooperation, the author analyses the promotion of investment, co-financing, build-operate-models, capacity building via training, private capital funds, and micro-financing.

The paper by *Rainer Durth* focuses on the opportunities provided by tapping financial markets for bilateral development cooperation. In view of the ambitious and far reaching new approaches in development cooperation, as reflected in the Millennium Development Goals (MDG) or the Poverty Reduction Strategy Papers (PRSPs), the author emphasises that bilateral development cooperation should be reoriented with a view to consistently follow the criterion of complementarity to the activities of multilateral donors and private investors. In this context, he suggests that a particularly promising approach for bilateral development cooperation is to supplement the scarce concessionary funds by financial resources from the steadily growing international capital markets. Durth shows in some detail that the German government has already started on this path, with its new FC financing instruments that make it possible to provide the necessary financial basis, and at the same time to make the use of funds more individual and thus more effective.

Heiko Körner, in a comment on Durth's paper, expresses his doubts as to the basic philosophy underlying today's conception of poverty reduction programmes. He argues that the classical instruments of development policy are scarcely able to improve the situation of the poor in a sustained way unless the social processes are prevented which, in a kind of vicious circle, cause self-feeding and consequently persistent poverty in low income countries.

The last two papers deal with economic aspects of low and middle income countries' pension schemes from a human capital perspective. On the basis of theoretical models that make allowance for the fact that pension systems have an additional effect on the human capital of a society, *Oskar Gans* identifies economically viable pension systems and discusses potential ways of constructing efficient paths for adjustment. Against this background, he evaluates the real-world reforms of two emerging market economies, namely Chile and Malaysia, and deals with the need for human capital-based reform that may be derived from such an evaluation. In his analysis, he also takes into account German efforts at reform whenever this seems appropriate.

Rainer Marggraf discusses Gans' implicit microeconomic hypotheses regarding human capital formation. In his analysis of family decisions, he concentrates on the fact that individuals invest in human capital through children. He presents a family decision model that makes due allowance for this fact, and discusses implications for positive analyses of pension schemes.

Halle (Saale), January 2005 *Heinz Ahrens*

Contents

The Macroeconomic Effects of Foreign Aid

By *Philipp Harms* and *Matthias Lutz,*
Gerzensee and St. Gallen

A. Introduction

Foreign aid flows from DAC countries to the developing world stagnated during the 1990s, reaching a low point in 1997 at $48.5bn (*World Bank* 2004).[1] As these figures are in nominal terms, the trend in real terms has been even worse, whether adjusted for inflation or calculated relative to recipient countries' populations. Particularly striking is the drop in aid flows relative to donor countries' GDP. On this measure, rich countries reduced their aid contributions from around 0.34 per cent to 0.23 per cent of their output between 1990 and 2002 (*World Bank* 2004).

The 'aid-fatigue' reflected in these figures can be traced back to a number of economic and political changes (*Hopkins* 2000, *Robinson* and *Tarp* 2000): changes in industrialised countries' foreign policy priorities after the end of the cold war, a further weakening of old colonial ties, lower pay-offs for special interest groups due to the changing regional focus towards the commercially less interesting African countries, tighter budgets in donor countries, and a growing distrust of governments and international organisations in industrialised economies.

In addition to these forces, a key reason for the drying up of aid flows has certainly been the perception – even among groups traditionally supportive of foreign aid – that aid has failed, at least partly. There have been reports of corruption and poor administration, with aid management tying up valuable resources in recipient countries (*Kanbur* 2000) and questionable aid allocation decisions among donors. Although many aid projects were deemed to be successful considered on their own (or better, with respect to their pre-defined objectives), there is the perception that the overall impact has been less than the sum of its parts, something that *Mosley* (1987) referred to as the 'micro-macro paradox'.

A very illustrative example of the observations that have fuelled aid scepticism is given by *Easterly* (1999). Predicting the impact that aid should have had on output on the basis of the still widely-used two-gap model he compared this with the actual performance of a large set of countries. In his paper and subsequent

[1] Due to a rise in 2002, they have just caught up with the levels seen in the early 1990s (at around $58bn).

book (*Easterly* 2001) he presents the corresponding figure for Zambia, a country where the prediction diverges from actual performance to a particularly striking extent. While we have not found it possible to completely replicate his figure with newer data, the visualisation of the gap between the supposed aid effect and reality is still striking (see Figure 1). By 2001 Zambian GDP per capita was only about a fifth of what would have been predicted had all aid gone into investment and all investment into growth.[2]

Such a blatant discrepancy is no surprise to those economists who have always been sceptical about the ability of aid to lift developing countries out of poverty. Thus, the late Peter Bauer kept emphasising the corrupting and counterproductive effects of aid: "Because aid accrues to the government it increases its resources, patronage, and power in relation to the rest of society. The resulting politicisation of life enhances the hold of governments over their subjects and increases the stakes in the struggle for power. This result in turn encourages or even forces people to divert attention, energy, and resources from productive economic activities to concern with the outcome of political and administrative processes and decisions" (*Bauer* 1991, p. 45).

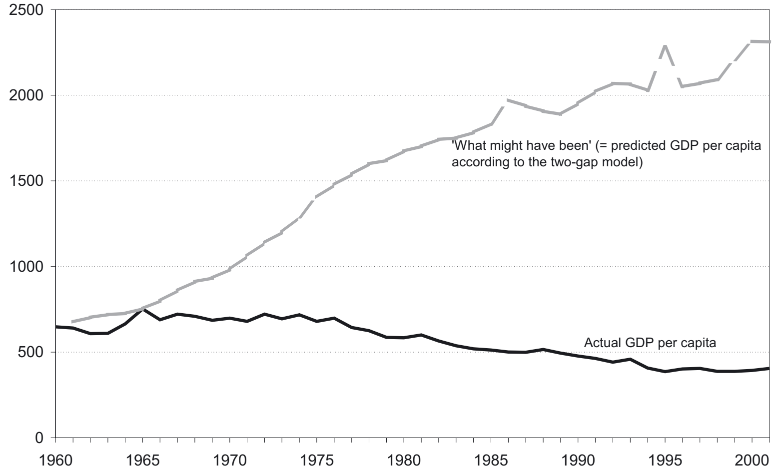

Figure 1: Zambia, GDP per capita (PPP-adjusted):
What might have been and what actually happened

2 The 'what might have been' series was calculated by taking actual GDP per capita (in constant US$) in 1960 and projecting future values using a hypothetical growth rate equal to the sum of actual investment and aid inflow (as a share of GDP) divided by a presumed capital-output ratio of 3.5 minus the population growth rate.

So does recent aid experience prove Bauer right? To answer this question, one needs to assess whether the Zambian example can be generalised. Is the apparent failure of aid in this case an exception or does it apply to the average developing country? Is aid *per se* ineffective, or can we identify some fundamental forces that are responsible for the failure of aid in some countries and its success in others? These are the questions that we want to address in this survey.

The raison d'etre of our paper is that it summarises the state of knowledge at a crucial moment of the aid effectiveness debate: while the optimistic assessment of foreign aid among economists gave way to frustration as Zambia-style failures became increasingly visible during the 1990s, a new consensus seemed to emerge towards the end of the past millennium, which identified 'good policies' as a pre-requisite for successful aid. This view, which was brought forward in a paper by *Burnside* and *Dollar* (2000) swiftly dominated conventional wisdom and became extremely influential in shaping policymakers' views and decisions. However, the consensus that "money matters – in a good policy environment" (*World Bank* 1998, p. 28) has started to unravel as more and more studies question the validity of the *Burnside-Dollar* paper. This makes it important to identify those insights that do not break down upon closer scrutiny and to identify the potential consequences.[3]

The rest of this paper is structured as follows: the next two sections summarise the main theoretical arguments that have been brought forward to justify the positive growth effects of aid. Section B contains a simplified version of the basic two-gap model which still forms the main motivation for aid employed by the multilateral institutions. Section C shows that aid may also be beneficial in helping a country emerge from a poverty trap. Section D looks at the evidence on the growth effects of aid leading up to *Burnside* and *Dollar* (2000). In Section E we survey the current research debate in the wake of the Burnside and Dollar paper, which focuses on the role of policies and institutions in recipient countries. Section F concludes this paper.

B. Using aid to overcome 'gaps'

I. Basic theory

The origins of the two-gap model are associated with *McKinnon* (1964) and *Chenery* and *Strout* (1966). Although no longer popular in the academic literature – *Easterly* (1999) calls it a 'dead model' – it is still widely used by policy-makers; in Easterly's words, the 'ghost of the financing gap' is still well alive in policy circles. One example is its use as part of the *Revised Minimum Standard Model*

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[3] Other recent contributions that have addressed these questions are *Hansen* and *Tarp* (2000, 2001), *Easterly* (2003), *Roodman* (2003) and *Langhammer* (2004).