

Is Aid Oil?

An analysis of whether Africa can absorb more aid.

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1. Introduction

The Report of the Commission for Africa, *Our Common Interest*, has proposed a large increase in aid to the region. The underlying motivation for this proposal is an acute sense of Africa's needs. Africa's neediness cannot be contested: on past trends it will increasingly become the epicenter of global poverty. The controversial aspect of the Commission's proposal is whether additional aid will be effective in addressing these evident needs. Criticisms of aid expansion can be grouped into two camps. The more radical critique sees aid as having been a cause of Africa's problems, which expansion would intensify rather than resolve. This view, which in academic circles goes back to Peter Bauer, is widely held in the US, and is also probably the dominant position in British public opinion.¹ An apparently softer, but potentially equally debilitating critique sees aid as useful but subject to diminishing returns. On this view Africa is already around the point at which expansion of aid would be ineffective.

While extra aid is merely prospective, the current boom in the prices of natural resources is already delivering a massive increase in the resource transfer to Africa. This does not of itself make increased aid redundant: the resource boom is highly selective, with only around a third of Africa's population living in countries that are substantial beneficiaries of higher resource prices. Nevertheless, the two flows invite comparison. They are the two largest external resource flows to African governments and so potentially generate similar opportunities for investment and growth. The current surge in resource rents at least superficially provides a 'natural experiment' for the consequences of a large expansion in aid.

If this is so, the latest growth data provide a somewhat discouraging prognosis. During 2004 Africa's oil economies received an unprecedented bonanza in resource rents. If big unconditional resource inflows work, we should expect this bonanza to have decisively raised the growth rate of the non-oil part of their economies. In fact, during 2004 the growth rate of the non-oil part of the African oil exporters' economies was identical to the rest of Africa (IMF, 2005, Table SA2). The huge windfall to these countries did not confer any growth advantage whatsoever beyond the oil sector. The radical critics of aid would be unsurprised by this failure of an oil bonanza to induce growth, and would extrapolate this failure to aid. The key hypothesized causal mechanism is that both are 'sovereign rents', generating dysfunctional rent-seeking behavior.

However, at least as regards the detail of how revenues are transferred, aid and oil rents differ. Resource rents are unrestricted finance for governments, allocated on a near-random basis. By contrast, aid is provided in four purposive ways: technical assistance, projects, packages linked to conditions on past or prospective government behavior, and debt relief. These modalities of transfer bring with them both expertise and conditions in varying degrees. Aid allocation is purposive both between countries and within countries. The expertise and conditions that come with aid, together with its purposive allocation,

¹ See for example, 'Vast majority thinks Africa aid is wasted, poll shows', *The Daily Telegraph*, June 4th, 2005.

may be merely second-order qualifying footnotes to a basic equivalence of aid to oil, or they may give rise to first-order differences in consequences for development effectiveness.

While donors would like to think that their actions enhance the effectiveness of aid above that of natural resource rents, *a priori* either mode of transfer could be associated with superior development outcomes. The governments of developing countries frequently complain about the delivery modalities of aid. They criticize technical assistance as a waste of money. They criticize project aid for being uncoordinated, and requiring procedures that divert government attention. They criticize conditionality for undermining government autonomy and frustrating government priorities. Recipient governments would undoubtedly see resource rents as superior, dollar-for-dollar, to aid. The different allocations of the two revenue flows as between countries might also generate differences in average effectiveness. Again, however, the presumption that because aid allocations are purposive, aid should generate superior average outcomes to resource rents is not necessarily correct. Resource extraction companies have tended to avoid investment in the most politically disturbed environments. For example, although oil reserves in Chad and Sudan were discovered in the 1950s, they were not exploited until the twenty-first century. By contrast, aid has sometimes been targeted on highly problematic governments for strategic reasons, such as Western support for Zaire during the Cold War.

Although there are now literatures on the development effects of aid and resource rents, the two have not been explicitly compared. Section 2 attempts to make this comparison. Section 3 addresses the question as to why aid is so much more effective for development than oil revenues: evidently, and contrary to much popular perception, past aid modalities have been strikingly successful in adding value to the resource transfer. Section 4 addresses the question as to whether, given this success, there is scope for ‘scaling-up’ aid in the literal sense of simply increasing it proportionately across existing modalities. I argue that unfortunately the evidence points to the scope being rather limited. However, in Section 5 I build on the evidence of previous sections to propose six innovations that may have the potential radically to increase aid absorption.

2. Simulating a big push? The development consequences of resource rents and aid compared.

The current boom in the prices of natural resources is greeted with enthusiasm by the governments of Africa’s exporting countries. I have already noted that at least in the short term the consequences of this bonanza have been somewhat disappointing, at least for their non-oil economies. While these short term outcomes may merely reflect lags in economic responses, they conform to a global pattern. Indeed, global responses to resource rents are considerably more disturbing than indicated by this short term response in Africa. Far from extra time revealing benefits, it reveals costs. A new study measures resource rents annually since 1970 for each country, rents being the surplus of revenues over costs of production (Collier and Hoeffler, 2005). It finds that resource rents significantly *reduce* growth: the impact effect is negligible, but with a lag of around four

years the rents have a significantly negative effect. These new results are entirely consistent with the large existing literature on the adverse effects of resource revenues. In the 1970s the dominant explanation was Dutch disease. Recently, without rejecting Dutch disease as being part of the problem, more emphasis has been placed upon the adverse effects of resource rents upon governance. This focus on governance is pertinent for the African aid debate. Aid may potentially have similarly adverse effects on governance as resource rents. Further, around a third of Africa has sufficiently large resource rents for the governance problems generated by these rents to be critical.

Collier and Hoeffler provide an account as to why natural resource rents worsen governance. They find that resource rents subvert and indeed reverse the normally beneficial economic effects of democracy. In the absence of resource rents democracies grow more rapidly than autocracies, but with large resource rents autocracies outperform democracies. The critical level of resource rents beyond which democracies under-perform is around 8% of GDP. They suggest that resource rents tend to tip the balance between two different strategies of electoral competition. In a normal democracy parties compete to spend public revenues effectively on public goods, balancing the benefits against the costs of taxation. However, an alternative way of gaining votes is to bribe opinion leaders through private patronage. Where voters have strong ethnic loyalties and limited objective information, as is common in Africa, patronage politics is likely to be more cost-effective. In these conditions the only inhibition on the government from adopting patronage politics is if public revenues are protected from embezzlement by checks and balances. Electoral competition in conditions of ethnic loyalties and poor information drives political parties towards patronage, and only strong checks and balances can prevent it.

They indeed find that checks and balances significantly and distinctively raise growth in the context of large natural resource rents. For example, press freedom shows up statistically as being critical in mitigating the adverse effects of electoral competition. Unfortunately, although resource-rich countries most need checks and balances, they are least likely to have them: over time, restraints are gradually eroded by resource rents. The most likely mechanism for this erosion is that large resource rents radically reduce the need for taxation. An indication of this comes from comparing Africa's oil exporters with its other economies. On average there is no difference in government expenditure as a share of GDP: the governments of oil economies do not spend more, they tax less.² Scrutiny of government is a public good the supply of which is commonly provoked by the tax burden. The lack of scrutiny in countries with large resource rents makes it easier for public revenues to be diverted into patronage: not only are public revenues larger, but they are less well defended. Hence, on this thesis, resource rents subvert democracy by making patronage politics financially feasible. In such environments, trust must be placed not in the good faith of political parties, but in the efficacy of appropriate checks and balances that enforce accountability of politicians to citizens.

Where social conditions make patronage politics cost-effective, one financial parameter is critical in determining whether electoral competition takes this destructive form or

² See IMF, 2005, Table SA11.

facilitates development through public goods provision. This is the ratio of 'sovereign rents' to 'scrutinized revenues'. Here, 'sovereignty' refers not to the rights of the nation versus external actors, but to the rights of the government versus citizens. Sovereign rents are that part of public revenue over which there is no effective scrutiny. Given political pressures to raise finance for patronage, the government will be driven to use sovereign rents in this way. Political leaders who attempt to resist these pressures risk being replaced by those willing to do what is necessary to maximize electoral support. Conversely, 'scrutinized revenues' are that part of public revenue over which scrutiny is able to enforce spending on public goods.

Since patronage politics is expensive, the lower are sovereign rents the more difficult is patronage politics. Conversely, the larger are scrutinized revenues the more prominent is public goods provision in political debate. Hence, as sovereign rents are diminished and scrutinized revenues increased, there comes a point at which, even in social conditions of ethnic loyalties and poor information, the winning electoral strategy becomes effective delivery of public goods rather than patronage. The ratio of scrutinized revenues to sovereign rents determines the *incentive for effective government*. The key menace of sovereign rents is not that they are 'wasted' on patronage, but that they can destroy the normal incentive for effective government provided by citizen pressure.

I have described sovereign rents and scrutinized revenues as if there were two distinct *flows*, one subject to scrutiny and the other not. Sometimes, most notably in respect of aid, this may indeed be the case. However, more commonly, the ratio is determined by a generalized level of scrutiny across all public revenues: the level of scrutiny determines the proportion of public funds that can be diverted into patronage. The ratio may differ more across types of expenditure than across types of revenue: for example, it is probably easier to divert expenditures on capital projects into patronage than to divert expenditures intended for salaries. Differences in the intensity of scrutiny between resource rents and aid may potentially generate different consequences for growth. This is the issue to which I now turn.

Unlike resource rents, aid has generally been found to be effective in raising growth. Clemens *et al.* (2004) provide the most recent and systematic study. They find that economic aid (as opposed to aid for other purposes) has significantly and substantially raised growth in Africa. Bad as Africa's growth performance has been over the past three decades, it would have been markedly worse without aid. Aid evidently has very different effects from resource rents. Indeed, when aid is introduced alongside resource rents in the Collier-Hoeffler growth regressions described above, the hypothesis that they have the same effect can be decisively rejected. This suggests that the superior average results of aid are not simply due to better allocation among countries: within a given country aid and resource rents have distinctive effects. In turn, this tells us that the in-country modalities of aid have made an important difference.

Aid agencies are adding value to the transfers that they administer, and indeed doing so to a very considerable degree. The evidence of oil implies that aid agencies face an intrinsic problem: the baseline effect of resource transfers is negative and the agencies have to

offset this by purposive allocation and complementary inputs. Nevertheless, such an activity need not be forlorn: an analogy with the effects of hospitals might help to clarify the point. The baseline for hospital activity is also significantly negative. By bringing patients with a variety of illnesses together in a single building, a hospital transmits disease. Even in well-run hospitals, many people contract illnesses from others while there, and spread these illnesses when they leave. Nevertheless, societies rightly see hospitals as vital: the value-added of a well-run hospital far offsets this negative baseline effect. This seems to be the story with aid agencies. The radical critics of aid are correct in the sense that the effects they point to are adverse and important, as demonstrated by oil. But their overall assessment is as wrong as would be a proposal to close hospitals. Indeed, their critique would be far more usefully directed to reforming the governance of oil revenues: the task of making oil work more like aid is far more promising than the task of making aid work better.

Why does aid have such different growth consequences to resource rents? Whereas resource rents appear to undermine the political process, aid does not, enabling the additional resources to have a growth-enhancing effect through investment and other productive expenditures. This may be the net outcome of two opposing effects. On the one hand, we would expect aid to increase sovereign rents by reducing the need for taxation. However, offsetting this, aid comes with various donor-imposed mechanisms of scrutiny which may spill over onto other expenditures and so substitute for reduced pressure from citizens. To take this analysis further, I now consider the four modalities of aid delivery.

3. Why is aid more effective than oil?

Recall that aid is delivered through technical assistance, projects, packages with conditions, and debt relief. Each of these is so distinctive that their effects on sovereign rents and scrutinized revenues, and hence on the incentives for effective government, need to be considered separately.

3.1 Technical assistance

Technical assistance is not money in the hands of recipient governments. Thus it does not increase sovereign rents. Indeed, to the extent that it is effective, it is likely to increase scrutinized revenues and so increase the incentive for effective government, precisely contrary to the effect of resource rents.

Perhaps because of this, technical assistance tends to be unpopular with recipient governments. Sometimes the fact that around a quarter of aid is in the form of technical assistance is depicted as a scandal, or even as a deceitful way of inflating the true aid figures. Nevertheless, such aid can potentially both build capacity in the public sector and substitute for the lack of it. A key test of such capacity building and substitution is whether it assists policy change. Potentially, technical assistance might *induce* reform, persuading governments of the need for change. Alternatively, when periodically,

reformers happen to attain political power but lack the capacity to design and implement effective change, technical assistance might *support* reform.

Recent research suggests that technical assistance does not induce reform but that it is highly effective in supporting it. Provided at the appropriate moment, technical assistance substantially increases the chances of success during incipient turnarounds from situations in which policies and governance are very weak (Chauvet and Collier, 2005).³ Further, since these configurations of weak policy and governance are otherwise highly persistent, the payoff to effective assistance is very high. The highest payoff is to large technical assistance programs provided early during incipient reform. A package worth 5% of GDP sustained for four years substantially raises the chance that the incipient reform will progress to major sustained change. On average, such a package would cost about \$1bn per country and the payoff would be around 15 times its cost. At present, technical assistance early in reform is typically supplied at far below this level. However, technical assistance can also be ineffective. When it is provided prior to any sign that reform has already commenced, it appears to have no significant effect on improving the chance that a turnaround will occur. Donors can spend their money preaching, but governments are unreceptive.

3.2 Projects

Aid in the form of projects is commonly criticized as cumbersome and uncoordinated. One attraction of projects is the partly illusory notion of accountability that it provides to donors. They can reassure their legislatures that aid has been spent on an identifiable set of activities that can then be evaluated. This can be illusory because of fungibility: many donor projects would otherwise have been financed by the government, and so donor money actually releases government finance for other priorities. However, where aid is very large relative to government budgets as is often the case in Africa, fungibility is reduced at least at the margin. For example, once government funding of the development budget has fallen to zero, as is the case in some countries, there is simply no further scope for fungibility.

Even in the absence of fungibility, some project aid can be embezzled and so augment sovereign rents. However, projects also augment public goods. Donor projects must go through due process. A reasonable indication of the counterfactual of African government expenditure in the absence of donor projects is provided by Nigeria. The combination of

³ Statistical analysis of the payoff to technical assistance during turnarounds must confront the problem of its endogeneity: if donors get the allocation of assistance right, they will direct it to the most promising turnaround situations. The resulting association between assistance and successful turnarounds can easily be misinterpreted: whereas in fact likely success is causing an inflow of assistance, the association may be seen as assistance causing successful turnaround. Chauvet and Collier control for this problem by using a standard set of instruments for aid. While some changes in aid reflect changes in the circumstances of recipients, other changes reflect changes experienced by the donor. For example, since Cote d'Ivoire gets a lot of French aid and Ethiopia a lot of Italian aid, when the French aid budget goes up and the Italian aid budget goes down, aid to Cote d'Ivoire is likely to increase relative to that to Ethiopia. Further, since donors differ in the proportion of their aid which is in the form of technical assistance, it is possible to isolate changes in technical assistance that are unrelated to circumstances in the recipient country.

oil, military regimes and a large population was sufficient to make project aid utterly marginal to Nigeria’s development. In Nigeria, even the elementary requirement of putting out government projects to competitive tender was abandoned. Such a requirement is standard to all donor projects. The demise of competitive tendering dramatically inflated the costs of projects in Nigeria, something that can be quantified thanks to its reintroduction as part of the current reforms. Competitive tendering has lowered the cost of projects by around 40% (Transparency International, 2005). Hence, the scrutiny inherent in projects is likely to have been markedly higher than that for the own resources of governments.

In addition to due process, donor projects bring sector knowledge and management techniques. Even governments that are making a huge success of development, such as China, are willing to pay for such knowledge. An indication of this is that China continues to borrow from the World Bank. China does not need the money, its reserves dwarf the resources of the World Bank and in any case it could borrow more cheaply on the markets. Evidently, it values the knowledge that comes as part of the lending package.

3.3 Conditionality

Donors have made various attempts to link aid to the behavior of African governments. One rationale has been to provide an incentive for behavioral change: in this case potentially the main pay-off to aid is the behavioral change it induces rather than the actual use to which the resources are put. A different and less ambitious rationale has been to channel aid into those environments where behavior is already most conducive to aid effectiveness. The potential array of design choices for conditionality is defined by the *time period* and the *indicator* on which aid is conditioned.

The time period can be *ex ante* or *ex post*: that is forward looking or backward looking. *Ex ante* conditionality, where it is credible, provides the strongest incentive effect because the donor specifies precisely both the amount and timing of aid that will be provided, and the government performance that is required. *Ex post* conditionality provides a more reliable means of channeling aid into specific behavioral environments, because the behavior is already in place before the aid is agreed. It may have some incentive effects but they are likely to be weak because in general governments do not know until some time after implementing change whether it will result in more aid.

The indicator on which aid is conditioned can be policies, outcomes, such as reductions in infant mortality, or governance. This two-by-three space gives six potential designs for conditionality (see Table 1).

Table 1: The Matrix of Design Options for Conditionality

	Policies	Outcomes	Governance
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<i>Ex ante</i>	World Bank in 1980s; IMF currently	European Union Currently	
<i>Ex post</i>	World Bank currently (IDA); DFID currently		US currently, (MCA)

Ex ante policy conditionality

In the 1980s the World Bank invented *ex ante* policy conditionality. The motivation was in part that it realized that the policy environments in which it was operating was often seriously deficient. Further, the emerging need for large scale defensive lending to prevent default could not be achieved through the slow and cumbersome modality of projects. It therefore developed an instrument aimed at improving policy through negotiated aid conditionality: aid was provided in return for the promise of policy reform. The resource transfer was termed *structural adjustment lending*. On the whole this was unsuccessful (Dollar and Svensson, 2000). The failure reflected two fundamental weaknesses. First, governments learned to game the system by renegeing on their promises. Aid was committed on the basis of a promise, yet the limited continuity in Bank decision-taking and the strong incentives to disburse made enforcement through future aid commitments incredible. In the event, some governments were able to sell the same promise of reform to the Bank several times. This weakness of conditionality is a straightforward instance of a class of problem known in economics as *time inconsistency*. The second weakness was that the coercive nature of the Bank's promotion of policy reform deepened government resistance to policy change. This is also a straightforward instance of a class of problem known in the psychology literature as '*reactance*' (Collier, 2001).

While not abandoning conditionality, donors recognized these failures and and by the late 1990s had substantially changed its design. The only agency left operating the *ex ante* policy conditionality mode was the IMF. Because of its core mission of responding to crises, the Fund did not have the option of change: of necessity it continued to direct its finance into situations in which the key problem was that policies needed rapid revision. However, the Fund took note of the ownership issue by reining back the scope of its conditionality to those policy changes that were demonstrably critical to the success of the program.

Ex post policy conditionality

The World Bank gradually shifted to *ex post* policy conditionality. That is, aid was allocated not on the basis of promises of policy change, but on the basis of attained levels of policy. The instruments for this were the Poverty Reduction Strategy Papers (PRSPs) which were to be drawn up by each country, and the Country Policy and Institutional Assessment, an annual rating of attained levels of policies which was used to guide allocations of the Bank's concessional lending, IDA. The term for such lending is *budget*

support. This reform substantially addressed both reactance and time inconsistency. Governments were now designing their own policies: governments were ‘in the driver’s seat’, and ‘owned’ their policies. Any promises they chose to make were to their citizens not to donors. Some major bilaterals, most notably DFID, followed broadly the same allocation principles.

Ex ante outcome conditionality

The European Union retained *ex ante* conditionality, but switched from policies to outcomes: governments promised to achieve certain outcomes such as reductions in infant mortality in return for aid. This also substantially overcame the problem of ownership: governments were free to attain outcomes with whatever policies they wanted as long as they delivered the donor-desired outcomes. However, the time-consistency problem remained and was indeed probably accentuated. To see this, consider what happens if a government breaches its commitments. It is possible to detect that a *policy* commitment has not been kept well before a failure in an *outcome* commitment can be detected, and even once such a breach has been detected the government can resort to the argument that the missed outcome was due to circumstances beyond its control.

Ex post governance conditionality

The US government switched to *ex post* governance conditionality, through its new vehicle, the Millennium Challenge Account (MCA). In this allocation mechanism the dominant consideration was the attained level of governance processes. Underlying the shift to governance conditionality were considerations both of legitimacy and efficacy. In terms of legitimacy, while policy conditionality was recognized as an intrusion upon national sovereignty, governance conditionality was concerned with strengthening the accountability of governments to their own citizens. So conceived, governance conditionality was intended to accelerate the process that elsewhere had taken centuries whereby governments came to share sovereignty with their citizens. In terms of efficacy, weak policies were diagnosed as generally reflecting underlying weaknesses in governance.

Mutual conditionality

Meanwhile, African governments themselves recognized that *ex ante* policy conditionality had not merely been an affront to their sovereignty, but had painted them into a deeply damaging corner in which they were seen as invariably resistant to reform. The resulting perception had probably contributed to the severe erosion in aggregate aid flows during the 1990s. The governments of Nigeria and South Africa, Africa’s two major powers and both newly democratic, led an internal movement for improvements in governance. Both through the power of their example, and through the peer pressure formalized in the review mechanism of NEPAD, they offered prospects of improved governance across the region. This was the basis for the Monterrey Consensus, in which African governments committed to improve governance and donors committed to increase aid. The purported spirit of these commitments was that of mutual trust rather

than of formal conditionality: donor distrust had been replaced by donor trust. However, the deal can equally be understood as the passage from donor mistrust to mutual mistrust. Because neither side trusted the other, each side committed to gradual processes of improvement each of which could be monitored. African governments committed to regular self-scrutiny of political and economic governance through the peer review mechanism of NEPAD, and donors committed to move towards the UN target of aid at 0.7% of GNP. Both parties committed to periodic monitoring at G8 meetings and at specially convened conferences. The recognition of mutual distrust has thus initiated a gradual shuffle towards the desired deal of improved governance matched by increased aid. The problem of reactance is addressed because there is no policy conditionality, and indeed no explicit conditionality at all. The problem of time inconsistency – this time for both parties - is addressed by the two processes being in tandem: each party must be able to demonstrate to the other credible evidence of progress at each review meeting.

However, the Monterrey Consensus introduces a new problem into conditionality: each side in this deal has very little control over its members and so is subject to a potentially severe free-rider problem. The limits of NEPAD's power to influence recalcitrant governments have been cruelly exposed over Zimbabwe. The limits of OECD coordination have been similarly exposed in a highly variable pattern of donor commitments. Each side has tried to assist the other to coordinate. The MCA, which was announced at Monterrey, can be seen as an attempt to reinforce the NEPAD incentives for improvements in governance. Similarly, the recent creation of an independent league table of donor country performance can be seen as a way of increasing pressure on recalcitrant donors.

3.4 Debt relief

Debt relief is primarily driven by the ethical confusion and bureaucratic duplication involved in providing aid while at the same time demanding debt repayment. However, the case for debt relief would be more compelling were oil revenues more effective than aid: debt relief is the aid modality that, unless carefully managed, comes closest to turning aid into oil.

Once debts are cancelled a government has no incentive to abide by any continuing conditions. HIPC arrangements have attempted to overcome this problem by having donors pay debt service into an account which only liquidates the debt at some future date, the liquidation being conditional upon adherence to certain conditions. However, it remains to be seen whether this will be a credible threat. Fundamentally, time-consistency problems can only be overcome by conditioning behavior upon flows rather than stocks. Not only does debt relief face a potentially severe time consistency problem, the criteria of allocation tend to favor precisely the bad policy and governance environments where resources are least likely to be effective. This is because large debts to GDP or exports tend to arise where the latter have been depressed due to the policy and governance environment.

The case for debt relief is, however, strengthened by four other considerations: unsustainable debt, odious debt, debt overhangs, and signals of international approval.

Not all debt relief is a resource transfer. Indeed, were 'debt sustainability' to be taken literally as the criterion for debt relief, then it would not generate any resource transfer. The only debt that would be written off would be that which was *unsustainable* – it could not have been repaid. Such debt relief is strongly to be encouraged. Indeed, were official creditors subject to the same regulations as commercial banks, such debt write-off would be a legal requirement. However, to reiterate, by definition it would not produce a resource transfer to debtor countries. In practice, however, most debt relief does produce a resource transfer: the criterion of 'sustainability' is a political fig-leaf rather than an economic assessment.

Where debts have been incurred by unaccountable governments that are manifestly not likely to use the money for the benefit of their populations, the lender lacks moral authority: the debt is *odious*. A significant variant of this is where the borrowing government has borrowed advantageously thanks to penalty clauses which it has then chosen to breach, leaving successor governments with the legacy of the penalties. If lenders introduce penalties knowing that the borrowing government lacks the integrity to avoid triggering them, the resulting liabilities are odious.

Debt relief locks donors into a resource transfer. It thus tackles the time consistency problem as perceived by recipient countries and this extra certainty can have favorable economic effects. Government debt reflects future tax liabilities – the *overhang* effect - that can discourage private investment, since the investments will become the future tax base for the economy. Firms that invest in highly indebted economies are thus volunteering to be milked. By removing the uncertainty over how these debts will be repaid, debt relief thus encourages private investment.

Finally, whereas aid is a flow and so not particularly newsworthy, debt relief is an event. It therefore has the potential to provide a *signal* from the international organizations that the recipient government has already implemented changes that they judge to be important. Because the underlying behavioral changes are likely to have been incremental, they may also have failed to attract media attention. The key audience for such a signal is usually international investors, but it may on occasion be the domestic population which has lacked objective information on which to judge government performance. Evidently, such a signal effect depends upon debt relief being conditioned upon attained performance.

4. So should aid be 'scaled up'?

Were resource rents effective in development it would be a simple matter to raise aid effectiveness. There would be no difficulty in turning aid into oil: technically this could be done through either unconditional budget support or unconditional debt relief. Politically such a change would be popular with recipients and many NGOs and indeed characterizes the broad thrust of the current aid discourse. However, given the

considerably superior performance of past aid relative to resource rents, such a transformation of the modalities of aid would most probably reduce rather than enhance its effectiveness. The radical critics of aid are correct in arguing that large sovereign rents have been detrimental to development, but wrong in their casual conflation of resource rents and aid. So, have the existing modalities of aid created conditions whereby it can productively be scaled up?

4.1 What will be achieved on current modalities: evidence from past experience?

Given that aid as channeled through existing modalities is effective in the growth process, the evidence might appear to support a substantial scaling up. However, like much of the literature, Clemens *et al.* find that aid is subject to diminishing returns. They estimate that economic aid hits the point at which it ceases to contribute to growth when it is around 8% of GDP. Although some African countries receive less than this in economic aid, on average on this figure there would seem to be little scope for expansion. A few of the countries with aid inflows well below 8% are indeed 'aid orphans,' that is countries that have only weak historical ties with the important bilateral donors: here scaling aid up would be appropriate without qualification. However, other apparently under-aided countries either have serious governance problems such as Zimbabwe, or large resource rents, and in such cases donors may well be appropriately taking into account factors that are inadequately considered in the econometric models.

The evidence for diminishing returns is not overwhelming, but it the best assessment of the dispassionate empirical literature, and it has some plausibility. It suggests that aid to Africa has more-or-less reached its appropriate scale. In Section 5 I challenge this position head-on. First, however, I consider a more conventional justification for enhanced aid: times have changed.

4.2 Have recent changes invalidated past experience?

Improved policies and governance in Africa

There is reasonable evidence that policies and governance are improving in Africa. This is certainly indicated by the Country Policy and Institutional Assessment of the World Bank, an annual country-by-country rating system. The average CPIA score for Africa has risen considerably. While this might possibly reflect 'grade inflation' on the part of World Bank staff, objective performance as indicated by higher growth and lower inflation is also at a historic high. African governments might also point to the establishment of NEPAD and the AU as being indicative of greater concern with governance and as vehicles for its improvement. However, the NEPAD process of peer review is still in its infancy, and the earliest sensible evaluation would be around 2007. Although loosely modeled upon the OECD process of peer review, it is in some respects noticeably weaker: indeed, unlike the OECD, the mechanism is predominantly one of *self*-evaluation, rather than *peer* evaluation.

Whether improvements in policies and governance actually increase the absorptive capacity for aid is surprisingly controversial: the econometric evidence is mixed and hotly disputed. This may be due to a conflation of two distinct processes. As discussed above, there is evidence that aid can sometimes be highly effective in promoting policy turnarounds in the weakest policy and governance environments. It can also cushion adverse shocks in the most vulnerable countries. These may be muddying an underlying but highly likely economic relationship that better policies and governance raise the return to public spending. My own view is that to the extent that the improvement in African policies and governance is genuine it will surely have increased absorptive capacity for aid. Clearly, improvement is not region-wide. However, the aid allocation rules of IDA and many other agencies already incorporate appropriate selectivity. Hence, an improvement in the average CPIA for Africa warrants an increase in overall resources, which existing procedures can then be left to allocate.

Improved donor practices

The second justification for expanded aid is that donor practices have improved: administering and managing aid has become less costly to its recipients, and donors are allocating aid more appropriately. Underlying this is a change in the motivation for aid. Until the 1990s much aid was provided for political reasons associated with the Cold War with relatively little engagement from OECD electorates. The focus on the Millennium Development Goals both reflects and promotes a greater concern among both donors and electorates that aid should be effective in reducing poverty. The extent to which practices have improved and its effect upon aid absorption is as yet not quantified. Nevertheless, my expectation is that this has received more emphasis than is warranted. Most debate on aid absorption is donor-dominated and the discussion may reflect a self-absorbed focus on the minutiae of their operations.

5. Potential innovations in aid modalities: complements to scaling up

Thus, so far, the more moderate critics of aid expansion appear to be correct: aid is useful but the scope for proportionate ‘scaling-up’ is limited. The limits to scaling up should not surprise us. If a mouse were ‘scaled up’ proportionately to the size of an elephant it would collapse under its own weight: increased size usually requires radical change in design. The present composition of aid may well be appropriate for its present scale, but not for a substantially larger scale. I now turn to six innovations that have the scope to yield quantum changes in aid absorption. The first four are new ‘funds’. Unlike the new Global Funds they are not specific to some narrowly defined activity such as primary education, nor would they require new bureaucracies. Rather, they would be additional money that donors would allocate to specific countries in particular circumstances: they would reflect changes in country allocation criteria. The remaining two innovations are complementary policies that both donors and African governments could feasibly adopt to address particular constraints on aid absorption.

5.1 Fund 1: Finance for big pushes

While diminishing returns are plausible in theory and appear on average to hold in practice, there are circumstances in which, at least over a range, aid can be expected to yield *increasing* returns. The theory underlying this is sometimes referred to as the theory of the big push: it depends on the existence of complementarities and thresholds. Potentially complementarities and thresholds could apply to a variety of development goals. However, for Africa the critical problem has been a lack of economic growth and this is the objective on which I will focus.

Complementarities in the growth process imply that if several things are done together the returns to all of them are higher. Improved ports may only be useful if the rural road network is improved so that produce can be transported, and the extra produce may not be forthcoming unless credit facilities are enhanced. If each of these improvements can be made incrementally, then the economy can shuffle forwards: slightly better ports induce slightly better roads, which then feed back onto the returns to roads. However, the process of creeping improvement might be arrested altogether if there are also important thresholds.

Thresholds in the growth process imply that only once some scale of change is reached does investment become effective. One threshold that may be very important for some African countries is the point at which the country becomes competitive in global markets for manufactures. There is now strong evidence that there are powerful economies of agglomeration in manufacturing. Given that Asia already has such agglomerations, this creates a threshold that currently shuts Africa out of global markets in which it might well be competitive if only it could reach the necessary scale. Note that when Asia broke into export manufacturing it did not face competition from established low-wage producers and so did not encounter such a threshold problem. A key attraction of manufacturing exports as a growth strategy is that because African countries are so small relative to the global market, once they were over the threshold of competitiveness they could in effect grow without limit. EPZs could be used as focal points for infrastructure and business services that lower the costs of exporting.

The conjunction of complementarities and thresholds requires coordinated leaps: no investment looks to be worthwhile in isolation. Aid can provide both the resources and the coordination to make these leaps. Although the potential is largely speculative, the effect of such aid would be remarkably easy to monitor. By benchmarking the costs in an activity against the global competition it would be clear by how much costs would need to be lowered, and by monitoring these costs it would be apparent whether aid investments had achieved the objective.

A different type of threshold is that once growth rates become exceptional, they get noticed. Africa has not been devoid of economic success stories, but its successes, notably Botswana and Mauritius, have been very small countries. Were a few larger countries to grow rapidly, especially if the growth took the economy well beyond any previous point so that it could not be belittled as a mere recovery, the pioneers would become role models. In economic terms, beyond some growth threshold success

generates learning externalities. It is not possible to quantify such benefits, but the process has obviously been important in both Asia and Latin America.

The big push postulates a range of increasing returns. This has a radical implication for aid allocation: *aid should be concentrated in a few countries at a time*. It would obviously be sensible to concentrate aid in those countries whose governments had developed ambitious but credible growth strategies. For example, if the key objective is to break into global manufacturing markets it would be sensible to concentrate on countries that are coastal, and that do not have large resource rents with attendant Dutch disease effects. Further, it would be sensible to concentrate on those countries that currently have manufacturing costs that are closest to competitive global levels. Such a strategy of concentrating aid would raise some political difficulties. However, for any one country it would essentially be temporary: aid would be big until the country was over the threshold, and then donors would move on down the queue of potential recipients. If the theory of the big push is correct, such a sequenced selectivity would be in the interests of all recipients.

There have been no recent experiments with such big push aid and so it is not possible to verify empirically whether such a strategy would work unless it is tried on an experimental basis in some countries. Within a chosen country donors would simply need to align their support around a growth strategy which could be part of a PRSP. The more difficult part is a significant increase in country selectivity. The most difficult part is that choices as to which countries were being favored would need to be common across donors.

5.2 Fund 2: Venture capital for turnarounds in failing states

As we have seen, technical assistance is effective in supporting turnarounds. Situations of incipient reform could have been supported more speedily and more substantially with technical assistance, and subsequently with more finance. This requires changes in donor allocation procedures and evaluation methods.

In terms of procedures, donors need to be able to respond swiftly to turnarounds with large increases in technical assistance. In effect, the provision of technical assistance should be organized more akin to emergency relief than to normal projects. Without changes in aid evaluation, aid agencies are unlikely to put more money into turnarounds. Like most bureaucracies, aid agencies are risk averse: staff avoid situations in which their decisions lead to visible failure. Much of the time, even with appropriately supportive aid, turnarounds will continue to abort. The rationale for support is not that it has a high probability of success, but that where it does make a difference the pay-off is massive. Such uses of aid need to be evaluated in ways analogous to a venture capital fund. That is, staff decisions are not assessed investment-by-investment, but rather on the overall return on a portfolio of decisions. The current attention to 'results orientation' in aid agencies may have the inadvertent consequence of increasing risk aversion, and so aid for turnarounds probably needs a distinct fund which would be evaluated only as an aggregate.

Post-conflict situations, of which Africa now has several, could also productively absorb considerably more aid than has typically been provided. Such situations are distinctive not only in their manifest need for reconstruction, but in their need for policy reform.

Typically, countries emerge from conflict with a legacy of very poor policies. However, whereas poor policies are usually highly persistent, in post-conflict situations they are fluid. Starting from the same level, substantial turnaround is around four times more likely if the situation is post-conflict (Chauvet and Collier, 2005). Indeed, by the end of the first post-conflict decade, as long as there is no relapse into conflict, policies (as measured by the CPIA) are typically above the developing country average (Collier and Hoeffler, 2004). Aid is found to be more productive in the growth process during this decade than in other periods. Although some post-conflict situations, such as Bosnia, have attracted large aid inflows, the more typical situation is that there is an initial spurt of aid for the first couple of years after which it tapers out. Collier and Hoeffler find that this is not the pattern most conducive to growth: the peak phase for aid to accelerate development appears to be during the middle of the decade rather than at the beginning. Perhaps, in the early post-conflict period, although needs are great, the capacity to spend money effectively is limited and so large aid is more useful after institutions have been rebuilt. Overall, they find that aid flows to post-conflict situations could productively be substantially increased relative to historical levels.

Just as the big push approach is attractive because of the externalities that follow from having some strong successes in the region, so turnarounds are particularly attractive because those states that are currently failing generate large costs for their neighbors. Indeed, funding for turnarounds is the most promising way of using aid to address the problem of failing states, about which there is widespread global concern.

5.3 Fund 3: Aid in the context of weak governance: an alternative to social funds

Where African governments are even moderately accountable to their citizens, donor conditionality is inappropriate: donors should be supporting credible government-conceived strategies. Unfortunately, in some African countries governments are far from being accountable to their citizens. At present, such countries receive little aid and given current aid modalities this is probably appropriate. The main aid modality designed for these environments is 'social funds'. These finance projects channeled directly to communities rather than through the government. In effect, they pretend that the government was not there. The issue is whether donors might devise a more effective alternative.

Donors should not attempt to play the role of substitute citizens. However, there may be scope for redesigning conditionality so as to change the incentives in the weakest governance environments towards greater accountability to citizens. Recall that I have suggested that based on the evidence from resource rents, the roots of weak governance are the circumstances in which patronage politics trumps the delivery of public goods. Potentially, aid can be used to address this problem rather than to compound it. To do this aid would need to reduce the finance available for patronage and increase expenditures

on public goods. This can be thought of as *ex ante* governance conditionality. If feasible it offers the enormous advantage of channeling aid resources into the countries with the greatest needs for public goods, while at the same time addressing the problems of weak governance.

As implied by Table 1, the option of *ex ante* governance conditionality has not yet been tried to any extent. This is surprising because it is far more legitimate than other forms of conditionality. The essence of governance conditionality is that aid is being used to increase accountability not to donors, but to citizens. The sovereignty of the government is being limited, but not the sovereignty of the country. Such struggles to limit the sovereignty of governments occurred throughout the now-developed world. International pressures are generally judged to have played a crucial role in these struggles: external military threats forced governments to raise tax revenues, and this in turn empowered citizens to demand that governments create checks on their own power. Clearly, this is neither a feasible nor a desirable process in modern Africa, but other external pressures may be needed as a substitute.

The arrangements put in place for the management of revenues from the Chad-Cameroon pipeline provide a rare illustration of how *ex ante* governance conditionality might work. The arrangements actually addressed how resource rents should be used, but the principle could equally well be applied to aid flows. Indeed whereas the circumstances in which oil revenues came to be restrained are unique, the application to aid could readily be generalized to many other situations. Chad is a pre-reform environment in which resources under the sole control of the government are likely to be badly used. This was the rationale for the Revenue Management Law which required that 80% of the resource rents were to go into a special fund. Money from this fund could only be spent upon a specified set of social priorities, and this money must be incremental to government spending. To ensure that spending was incremental, the law required the government to allocate at least the same proportion of its non-oil revenue on these priority sectors as it had done in 2002, prior to the oil, namely 42%. The money in the special fund could only be released from the fund on the authority of a *college* including representatives from civil society, who would verify that all expenditures were indeed for the approved purposes. The money into the fund was released from an escrow account on a quarterly basis. This arrangement was time-consistent in the key sense that because verification was continuous the government did not have stronger incentives to make promises than it had to fulfill them.

These arrangements provide a possible model of *ex ante* governance conditionality in environments where governance is weak but needs for public goods are great. As in that model, aid would come as budget support, but would be limited to particular parts of the budget. As in that model, aid would be matched by the government's own resources, channeled into the same system month-by-month, on which draw-downs from the aid-funded resource flow would be conditioned. At the core of this system would be independent scrutiny such as that provided by the *college*, which would verify and authorize each item of expenditure from the resources provided. A key advantage of such an arrangement is that it would expand resources devoted to public goods provision, at

the same time as it squeezed sovereign rents of the government, and hence the finance of patronage. At some point the winning political strategy would switch from patronage to public goods provision. Once this switch occurred, the aid could gradually evolve into unrestricted budget support.

Not all governments where governance is weak would opt for such arrangements, although on the evidence of Chad some clearly would. However, the different choices would reveal where the improvement of governance was more and less tractable. One lesson to be learnt from the past failures of conditionality is to recognize that the instrument is indeed likely to have limits to its effectiveness. Unlike past experience, the choices of governments would reveal the likely limits before resources were committed.

5.4 Fund 4: Aid to cushion terms of trade shocks

A final potential use of aid is to cushion adverse terms of trade shocks. Whereas most non-African developing countries have diversified their exports away from a narrow range of primary commodities, several African countries remain highly vulnerable. Uganda, Ghana and Madagascar, each with governments implementing economic reforms, have been hit by large adverse terms of trade effects at politically vulnerable moments. There have been some experiments with using aid to provide direct insurance for African exporters. However, such an approach is administratively complex and misses the point that large shocks generate macroeconomic effects. The depreciation of the real exchange rate in response to a shock cushions exporters and transfers the income loss to other agents in the economy: it is thus like an automatic domestic insurance arrangement. What is most needed is therefore not a scheme targeted on individual exporters, but rather one that cushions the entire economy. Much the easiest way of doing this is for aid flows to governments to be countercyclical to the terms of trade. The essence of such a scheme is that it should be swift, and for this it needs to be as near to automatic as possible. Past aid schemes for cushioning shocks such as Stabex fail this test. One study finds that adverse terms of trade shocks have large adverse repercussions for growth but that timely aid can offset these effects, implying exceptionally high returns to aid (Collier and Dehn, 2001).

5.5 Complementary policies 1: offsetting Dutch disease

One likely reason for diminishing returns to aid is Dutch disease. Dutch disease occurs when aid reduces the competitiveness of the tradable sector. Many analysts of the growth process stress the importance of a depreciated real exchange rate, (Hausmann, Pritchett and Rodrik, 2003), and the Dutch disease effect of aid is a recurrent concern of the IMF (Rajan and Subramanian, 2005). There are four means of avoiding this problem.

First, incremental aid can be targeted to expenditures that reduce some of the costs that are faced by important parts of the tradable sector, such as transport costs and power costs.

Secondly, the import content of aid can be increased. Both technical assistance and infrastructure projects have much higher import content than expenditure on government salaries and so have a smaller impact on the real exchange rate, dollar-for-dollar. It is notable that the social priorities favored by donors during the past decade neither reduced costs in the tradable sector nor directly raised the demand for imports.

Third, recipient governments can offset the increase in the supply of imports implied by aid, with an increase in the demand for imports. The instrument for achieving such an offsetting increase in demand is trade liberalization. Where Dutch disease is a real concern, donors may need to confine large increases in aid to those governments which coordinate aid increases with trade liberalizations. Note that the purpose of the liberalization would not be to open markets to firms in donor countries, but rather to prevent the exchange rate effects of aid from contradicting its objectives. This could, for example, be achieved by a trade liberalization in favor of other developing regions: Africa currently has higher trade barriers against other developing regions than against the OECD. Since virtually all recipient governments currently impose fairly high trade restrictions there is plenty of room for increases in import demand.

Fourth, developed countries could reduce their current trade barriers to developing countries. This would raise the price received by exporters in aid-receiving countries and so would offset the disincentive to exports created by an appreciation in the exchange rate.

5.6 Complementary policies 2: donor coordination without harmonization

To the extent that improved donor coordination matters, the present approach of 'harmonization' is on the past record unlikely to deliver much change. After all, with largely the same players the European Commission failed to achieve harmonization of product standards despite many years of effort. A simple approach to reducing the demands placed upon recipient administrations is for donors to adopt a mutual recognition of each others procedures. Mutual recognition was the key procedural advance that enabled the European Union to develop an integrated market for goods: if a product was accepted as meeting conditions for sale in the market of any member country it was accepted in all of them. The strategy of mutual recognition replaced harmonization, which, though attractive in theory, proved impossible to achieve in practice. The history of aid coordination to date has in effect been that the unattainable holy grail of harmonization has impeded more practical alternatives. With mutual recognition, a recipient government would be free to adopt whichever donor system was most compatible with its own procedures. Other donors would then adopt that system for that country. Donors would find themselves running different systems in different countries, but this administrative burden is probably within their competence. The problem at present is that it is the weak administrations of recipient countries that are confronted with the burden of multiple systems. However, if donors found the burden of multiple systems intolerable, this would be the only incentive for harmonization that is likely to prove effective.

Beyond coordination and mutual recognition, much the most effective way of coordinating aid is to pool resources financially, letting a single agent decide how to use them within certain agreed limits. To a degree this is done already. Donors pool funds into IDA, leaving the World Bank to implement. They also pool resources into budget support, leaving the government to implement. However, for political reasons bilateral donors retain most of their funds for their own projects. One political reason is that projects provide at least a semblance of accountability. For example, when the government of Malawi was criticized in the international media for purchasing a fleet of Mercedes, DFID was able to claim that this had not been financed by British aid because all aid to Malawi was in the form of projects. Were budget support to be redesigned in such a way as to provide much greater accountability, effectively precluding such uses by recipient governments, it might be possible for donors to devote more resources to it.

6. Conclusion

If aid is like oil the economic case for a major expansion of aid to Africa is disturbingly weak. The evidence strongly indicates that on average aid has been much more effective at promoting development than oil. Since both are transfers to governments, the profound difference in their consequences must lie in the details of how aid transfers are made.

Even though aid is not like oil, the scope for substantial expansion may nevertheless be limited by diminishing returns. The available evidence suggests that if aid is simply scaled-up proportionately, the incremental aid might indeed be much less effective, dollar-for-dollar, than existing aid.

There is, however, scope for innovations. Additional aid could support four strategies that have to date been neglected: a big push through concentrating large resources in the most promising environments; assistance for turnarounds; in the weakest environments finance for public goods channeled through required improvements in governance; and finally aid to cushion terms of trade shocks. Each of these would generate externalities across the region. Investing aid in accentuating success would provide African role models for the rest of Africa to follow. Investing aid in the weakest environments would reduce the crisis situations that spill over onto neighbors. There is also scope for complementary policy changes that would mitigate Dutch disease and reduce the transactions costs associated with aid projects.

The evidence for these innovations varies. The most speculative is the big push. However, fortuitously, it lends itself to being an evaluated experiment. The country-sequenced strategy implied by the logic of scale economies simulates a pilot experiment, and since success involves being a role model for the region, performance is inherently observable to donors. There is thus a good case for trying the approach, recognizing that it may have to be abandoned. The venture capital model of financing incipient turnarounds is, by contrast, the most difficult to evaluate, but there is reasonably robust statistical evidence that it would have a very high payoff. The attempt to use *ex ante* governance conditionality to build new institutions for channeling money into the weakest and most needy environments is new territory but not inherently risky. The

money would only flow where the new institutions of governance ensured it would be genuinely accounted for, and provided some prospect of increased accountability to citizens. The provision of aid for macroeconomic insurance against shocks would begin to address the evident problem that the poorest countries face high levels of risk and so need some contingent financing. While the evidence for a high pay-off is currently limited, the lack of contingent financing instruments can only be rectified by a phase of experimentation. The evidence for the complementary policies is analytic rather than empirical and essentially straightforward.

Something surely needs to be done decisively to raise African growth rates: the continued marginalization of Africa in the world economy would have incalculable consequences that it is in our common interest to avert. The new strategies look sufficiently promising to be worth trying. New strategies do not come with guarantees, but in the face of problems that have proved intractable there is no alternative to such strategic experimentation.

Finally, I note that in this article I have used the gulf between the development consequences of aid and oil to consider aid. However, the more important implication from the aid-oil contrast is for oil. If oil could be turned into aid the development consequences would be enormous. Oil and other resource rents are in aggregate much larger flows to developing countries than aid, and their effects to date have been on average significantly negative. Raising the development effectiveness of oil revenues and other natural resource rents must, however, be the subject of a separate paper.

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