Journal of Contemporary African Studies
Publication details, including instructions for authors and subscription information:
http://www.informaworld.com/smpp/title~content=t713429127

The Doubling of Aid to Sub-Saharan Africa: Promises and Problems

Jane Harrigan

Online Publication Date: 01 September 2007
To cite this Article: Harrigan, Jane (2007) 'The Doubling of Aid to Sub-Saharan Africa: Promises and Problems', Journal of Contemporary African Studies, 25:3, 369 - 389
To link to this article: DOI: 10.1080/02589000701662434
URL: http://dx.doi.org/10.1080/02589000701662434

Journal of Contemporary African Studies, 25, 3, Sept.2007

Routledge
Taylor & Francis Group

The Doubling of Aid to Sub-Saharan Africa: Promises and Problems

Jane Harrigan

Although there is now a strong commitment to double aid to low-income countries, much work remains to be done to operationalise this in a way that maximises the effectiveness of the doubled aid flow. The quality of aid is as important if not more important than the quantity, and aid either poorly delivered or poorly utilised can lead to negative effects in the recipient country. This article focuses on some of the issues that will need to be resolved if the doubling of aid to Africa[1] is to help propel the continent into self-sustaining growth in a manner compatible with achievement of the Millennium Development Goals (MDGs).

The article looks firstly at the consensus that has emerged since 2002 regarding the way aid should be delivered and used. We refer to this as the Monterrey Consensus. We examine outstanding issues, including those concerning the possible negative returns to aid, problems of absorptive capacity defined in various ways, the modality of aid delivery, and the use of aid to build up foreign-exchange reserves. The next part of the article represents a more radical departure and questions aspects of the consensus itself. The final section offers a conclusion.

The Monterrey Consensus and Outstanding Issues

Although a consensus has been reached on aid it remains fragile with many unresolved issues. The Monterrey Consensus takes the form of a compact (Rogerson 2004:19) in which aid recipients recognise their responsibility for good governance and development priorities while donors agree to increase both aid volume and quality, including its harmonisation (Organisation for Economic Co-operation and Development: Development Assistance Committee (OECD-DAC) 2003), to support recipients' own choices about development priorities, while at the same time taking complementary measures to increase trade openness to least-developed-country (LDC) goods. The MDGs are accepted as the benchmark by which to judge this collective action and the Poverty Reduction Growth Strategy (PRGS) is seen as the main mechanism in low-income countries to achieve development priorities and mobilise donor funding.

The Monterrey Consensus, which was articulated at the Monterrey Conference on Financing for Development in March 2002, was the culmination of several

ISSN 0258-9001 print / ISSN 1469-9397 online/07/030369-21
DOI: 10.1080 / 02589000701662434

years of lobbying on financing for development and development goals. The concept of the MDG had been set at the UN General Assembly in 2000, The Zedillo Report to the UN had argued for a substantial increase in development funding (UN 2001:10) and this was repeated at Monterrey with a consensus formed as to how higher aid-volumes should be delivered.

Possible Negative Returns to Increased Aid

The commitment to increase the quantity of aid was expressed in terms of a doubling of aid, deemed necessary to achieve the MDGs. This implies a global increase from around $58 to $116 billion in a relatively short time. It remains to be seen if and how this will be delivered, but we assume, for the sake of this article, that it will be.

The aid sceptics argue that this doubling of aid will have little or no impact due to the diminishing and possibly negative returns to an increase. The empirical evidence for such a position is at best ambiguous. Numerous empirical studies have attempted to regress aid onto growth (see Griffen 1970; Papenek 1973; Mosely 1990) and the results vary from positive to negative coefficients.[2] In any case it is generally accepted that such aid effectiveness studies are fraught with methodological problems (White 1992). However, even if aid has tended to have positive effects on growth in the past, this does not guarantee that a large increase in aid will continue to do so if it is subject to diminishing returns to scale. Burnside and Dollar (2000) included an aid-squared term in their model and found that negative returns to aid set in once aid reaches 4 per cent of the recipient's Gross Domestic Product (GDP). However, similar work by Foster and Keith (2003) found that negative returns do not set in until aid reaches 20 per cent of recipient GDP ,while Lensink and White (2001) put the ratio at 50 per cent.

Table 1 shows the ratio of aid to Gross National Income (GNI) for most African countries in 2004.[3] We have also projected the ratio to 2015. The projections are based on the assumption that the 2004 level of aid will be doubled for each country by 2015 and that each country's GNI will grow by 6 per cent per annum. This projected 6 per cent growth rate follows the United Nations Conference on Trade and Development (UNCTAD) view that such a growth rate is both desirable and achievable to propel the continent into self-sustaining growth if jump-started with a large injection of aid (UNCTAD 2000).

We can see from **Table 1** that in 2004, 30 of the 38 countries in our sample exceeded the Burnside and Dollar 4 per cent ratio, 10 exceeded the Foster and Keith 20 per cent ratio and only one exceeded the Lensink and White 50 per cent ratio. More interesting, however, are the projections to 2015. It is easy to assume that if aid is doubled it will become a much larger share of GNI. Our calculations show that this is not the case so long as a healthy growth rate accompanies the aid injection. With a 6 per cent per annum growth rate, GNI also roughly doubles by 2015 so that the aid-to-GNI ratio remains virtually unchanged for all countries.

However, if we assume an annual growth rate of only 2 per cent per annum, the ratios deteriorate markedly when aid is doubled to each country. In that case, 18 countries would exceed the 20 per cent threshold and seven come close to the 50 per cent threshold.

Table 1: Aid:GNI Ratio 2004 and projected 2015

	AID 2004	GNI 2004	AID:GNI 2004	AID:GNI 2015 6%	AID:GNI 2015 2%
Angola	1,144	17,677	6%	7%	10%
Botswana	39	8,331	1%	1%	1%
Burundi	351	643	55%	57%	88%
Cameroon	762	14,359	5%	6%	9%
Central African Republic	105	1,318	8%	8%	13%
Chad	319	2,647	12%	13%	19%
Rep. Congo	116	6,345	2%	2%	3%
Benin	378	4,054	9%	10%	15%
Ethiopia	1,823	8,001	23%	24%	37%
Gabon	38	6,029	1%	1%	1%
Gambia	63	394	16%	17%	26%
Ghana	1,358	8,470	16%	17%	26%
Guinea	279	3,469	8%	n/a	n/a
Guinea-Bissau	76	270	28%	30%	45%
Ivory Coast	154	14,482	4%	1%	2%
Kenya	635	15,471	1%	4%	7%
Lesotho	102	1,702	6%	6%	10%
Madagascar	1,236	4,238	29%	31%	47%
Malawi	476	1,772	27%	28%	43%
Mali	567	4,645	12%	13%	20%
Mauritania	180	1,240	15%	15%	23%
Mauritius	38	6,020	1%	1%	1%
Mozambique	1,228	5,203	24%	25%	38%
Niger	536	3,069	17%	18%	28%
Nigeria	573	60,072	1%	1%	2%
Rwanda	468	1,814	26%	27%	41%
Senegal	1,052	7,560	14%	15%	22%
Eritrea	260	911	29%	30%	46%
Sierra Leone	360	1,048	34%	36%	55%
Djibouti	64	716	9%	9%	14%
Namibia	179	5,876	3%	3%	5%
Sudan	882	18,070	5%	5%	8%
Swaziland	117	2,418	5%	5%	8%
Tanzania	1,746	10,802	16%	17%	26%
Togo	61	2,024	3%	3%	5%
Uganda	668	6,693	10%	11%	16%
Burkina Faso	610	4,821	13%	13%	20%
Zambia	1,081	5,225	21%	22%	33%

Although we do not know exactly when negative returns to aid set in, given the very different estimates, what the above calculations show is that as long as aid is accompanied by a healthy rate of growth then we will not see any deterioration in aid to GNI ratios. However, if growth is low, the ratios deteriorate significantly, raising the chances that negative returns to aid will set in for more countries. Hence, it is essential, if the doubling of aid is to have positive effects that the aid itself is used in a manner that generates economic growth.

The absorptive capacity issue and the disincentives effects of aid are both put forward to explain why countries might face difficulties in effectively using increased volumes of aid to generate high growth rates.

Absorptive Capacity

The two main problem areas for absorptive capacity are: the inability of the macro economy to absorb aid without distortionary effects such as inflation and real exchange rate appreciation, and the inability of a country's institutions and human resources to absorb aid. The former is usually referred to as the Dutch Disease effect.

Dutch Disease and the Real Effective Exchange Rate

The Dutch Disease effect is akin to the natural resource curse where aid replaces the natural resource. It assumes that the aid recipient is supply-constrained rather than demand-constrained, which is not unreasonable. In this context an inflow of aid will increase domestic demand which, in a supply-constrained economy, will result in inflation. Unless the nominal exchange rate is adjusted to compensate for this inflation the real exchange rate will appreciate. This will undermine the competitiveness of the country's exports and make imports artificially cheap in domestic currency terms.[4] Obviously, this will not occur if the nominal exchange rate is fully flexible or if the authorities sterilise the inflow of foreign currency in a manner that does not increase domestic demand. However, the latter case is tantamount to simply using aid to build up the country's foreign reserves rather than to provide purchasing power for real resources. This is an issue to which we will return. In addition, as can be seen from **Table 2**, many countries in Africa have pegged rather than floating exchange rate regimes so that the nominal value of the currency will not automatically adjust to real exchange rate overvaluation.

The reason why real exchange rate appreciation is deemed problematic in the context of aid flows is that it can create aid dependency. This can be seen if we return to the early two-gap models which provided the initial logic for aid flows (Chenery and Strout 1966). Chenery and Strout argue that growth in developing countries is likely to be constrained by one of two gaps – the domestic savings investment gap or the foreign exchange gap, with the former likely to be binding in early stages of development and the latter as development proceeds. Foreign aid can potentially plug either gap – it supplements inadequate domestic savings with foreign savings in the form of aid leading to higher investment and growth or it provides additional foreign exchange for growth-enhancing imports. However, if growth is ultimately to become self-sustaining then the aid must not just plug the gaps, it must generate a type of growth that narrows the gaps until aid is no longer required. If aid causes the real exchange rate to appreciate, though, this will undermine a country's export performance and may widen rather than narrow the foreign exchange gap, leading to a classic case of aid dependency.

Table 2: Current de facto exchange rate regimes in Africa

PEGGED EXCHANGE RATES (Fixed Peg and Horizontal Bands)

Benin	Eritrea
Burkina Faso	Guinea
Ivory Coast	Lesotho
Guinea-Bissau	Maldives
Niger	Mali
Senegal	Namibia
Cameroon	Seychelles
Central African Republic	Swaziland
Chad	Botswana
Democratic Republic of Congo	Equatorial Guinea
Gabon	Comoros
Djibouti	Cape Verde

FLOATS (Managed and Pure)

Ethiopia	Ghana
Mauritius	Sudan
Zambia	Kenya
Mozambique	Rwanda
Angola	Burundi
Gambia	Mauritania
Nigeria	Zimbabwe
Madagascar	Malawi
Sierra Leone	Democratic Republic of Congo
Tanzania	Uganda

Source: IMF Annual Report 2005

The prevalence of de facto fixed exchange rate regimes (24 out of the 44 IMF reporting African countries in **Table 2** have them) suggests that Dutch Disease effects are a real possibility in Africa if aid is doubled. Certainly there is evidence that natural resource windfalls have created such problems (Sala-i-Martin and Subramanian 2003).[5]

The appropriate response to the threat of Dutch Disease is not to cut back on aid promises but to see how the problem can be managed. Four of the most helpful remedies are given here, bearing in mind that the problem is caused by inflationary pressures causing the real exchange rate to appreciate:

Allow the nominal exchange rate to devalue or depreciate in response to the aid inflow;

Partially alleviate inflation by encouraging as much as possible of the increased demand to be channelled into import demand for which there is no bottleneck;

Allow aid to increase the country's foreign exchange reserves so that it does not lead to an increase in the domestic money supply and demand;

Use the aid inflow to alleviate domestic supply bottlenecks so that inflation does not result.

All of these solutions apart from the last are potentially problematic. Exchange rate devaluation can create severe socio-economic problems in low-income import-dependent economies by raising the domestic currency cost of essential imports. Allowing the increased demand to be absorbed as much as possible by imports is only a partial solution. Inevitably some of the increased demand will spill over to non-tradable goods leading to inflation and real exchange rate appreciation. In addition, increased demand for imports is likely to lead to an increased trade deficit financed by aid. Sterilising the aid inflow by using it to build up reserves does not add any growth-enhancing resource acquisition to the economy, although it is a form of saving it for the future.

The best response to the Dutch Disease problem is probably to ensure that aid is used to help alleviate domestic supply bottlenecks so that the associated increased demand does not lead to inflationary pressures. In addition, if we are concerned about narrowing the foreign exchange gap and generating self-sustaining growth, aid must be used in such a way that it produces additional foreign exchange earnings at the margin. Both of these conclusions may lead us to question the Monterrey Consensus with its focus on Poverty Reduction Growth Strategies and social welfare expenditure in health and education. Such expenditure, unlike that on productive sectors and economic infrastructure, does not, at least in the short and medium term, alleviate supply bottlenecks or generate foreign exchange. We return later to this controversial point.

Institutional and Human Absorptive Capacity

It is often argued that developing countries simply do not have the institutional and human capacity to absorb a doubling of aid. This is tantamount to saying that they will be unable to spend it wisely. The Commission for Africa examined this in terms of poor governance, rigid and unresponsive administrative systems, and lack of human resources. In essence, if there are absorptive capacity problems then as aid increases so will the transactions costs of this aid, reducing the real gain to the recipient economy. De Renzio (2005) has divided constraints into short- and long-term. The main short-term one is weak public expenditure management, while long-term constraints consist of deficiencies in institutions and the policy process and shortages of technical and managerial skills. At its worst, this scenario suggests that the increased aid will be used in corrupt and unaccountable ways. This is a real problem in Africa, where institutions and the bureaucracy remain weak and under-resourced. But it is not an inevitable problem.

Aid money itself can be used to help overcome the problem. The United Kingdom's Department for International Development (DFID) has articulated the view that increased aid will not inevitably come up against an absorptive capacity constraint, especially if some of the aid money is channelled into developing institutional and human resource capacity in the recipients. Work by Conyers and Mellors (2005) has provided good examples of experiences in several African countries where aid was channelled through government agencies and integrated into efforts to build the capacity of elected local councils in a manner that strengthened the links between central ministries and local government. However, as argued by Stockmayer (2005), the process of strengthening the civil service and bureaucracy cannot be done quickly in response to a doubling of aid even if part of that aid is used for the purpose. It is a lengthy, complex and delicate process. This suggests that donors need to think carefully, in each recipient-specific context, about how quickly they will increase aid flows and what trajectory this should take.

Disincentive Effects of Aid

Another common argument from the aid sceptics is that aid has disincentive effects that alter the recipient behaviour in adverse ways. Disincentive effects damage institutions, including governance and the legal system, both indirectly (by removing incentives to reform and undermining the tax system) and directly (by provoking a struggle to control rents associated with aid).

The work on natural resources by Sala-i-Martin and Subramanian (2003) suggest that negative growth effects do not tend to come about directly for example, due to exchange rate problems but indirectly through a weakening of economic institutions. Work which has applied the natural resource model to aid yields similar conclusions. Knack (2000) shows that as aid increases, both relative to GDP and relative to government expenditure, economic institutions deteriorate – with the latter proxied by worsening of risk to investors. Djankov *et al* (2005) looking at both natural resources and aid found that both worsen the quality of political institutions, and Knack (2000) found a similar statistically significant result.[6]

Although we must be careful in ascribing causation in the above studies, we need to ask how increased aid might undermine institutions and have other disincentive effects. For example, aid might support poor governments and remove the pressure to reform. This is akin to the moral hazard problem – recipients feel they can spend money without a hard budget constraint, confident that donors will bail them out. In that case, this poses a dilemma about aid allocation when aid is doubled. Should increased aid go only to strong committed reformers who perform well? If so, what about the weak performers and the poor who live in those countries, who will become marginalised and bypassed by the doubling of aid? Clearly donors need to think carefully about how they can deliver aid to weak and fragile states in a way that does not undermine the incentive to improve if we are to avoid a scenario that is already emerging where a select group of favoured countries in Africa receive a disproportionate share of aid. **Table 3** clearly shows this trend. In 1990 the 10 largest aid recipients in sub-Saharan Africa received 42 per cent of the continent's total aid. By 2004 the share of the 10 largest recipients had risen to 56 per cent. But it is important not to overplay the moral hazard argument. The evidence suggests that aid does not affect policy for better *or* worse (Killick 1998; White and Dijkstra 2003), and hence does not retard policy change.

Table 3: Share of total African aid to 10 largest recipients

	1990 $ million	2004 $ million
10 largest recipients	7,148	12,709
Africa total	16,840	22,847
10 largest as % of total	42%	56%

Source: OECD-DAC online database
Note: The 10 largest recipients in 1990 were Democratic Republic of Congo; Ethiopia; Ghana; Ivory Coast; Kenya; Malawi; Senegal; Sudan; Tanzania; and Uganda. In 2004 they were Angola; Ethiopia; Ghana; Madagascar; Mozambique; Senegal; Sudan; Tanzania; Uganda and Zambia.

Another oft-cited disincentive effect is domestic savings displacements. Early empirical work (Griffin 1970) found a statistically negative relationship between aid inflows and domestic savings in the recipient. As with the Dutch Disease effect this is worrying as it suggests that aid which is used to bridge the domestic savings investment gap can actually widen that gap leading to aid dependence rather than self-sustaining growth. The most usual explanation for this effect is the fiscal response to the aid inflow – in response to aid inflows to the government budget the government reduces the public savings efforts by reducing tax collection efforts and/or tax rates. Again, however, apart from the methodological problems that beset the empirical work on the relationship between aid and domestic savings, such an effect is not inevitable. Before increasing aid to individual countries in Africa, donors could see if past aid flows had been associated with a declining tax performance and if so ensure that part of the aid budget is used for tax reform.

The issue of grants versus loans is also of relevance to the domestic savings displacement hypothesis. Recent work has tended to find that grants have a more powerful effect than loans in reducing tax efforts in the recipient. Clements *et al* (2004) found that an increase in grants tends to suppress domestic tax revenue especially in the most corrupt quartile of countries, where they found that 95 per cent of grant money was immediately dispersed in the form of tax giveaways. By contrast, loans encouraged revenue-raising. Likewise, Odedokun (2004) found that grants either reduce the tax effort or encourage deficit financing as well as encouraging government consumption rather then investment. This is not necessarily an argument for doubling aid to Africa in the form of soft loans rather than grants but it does suggest that donors need to be more aware of the potential fiscal effects of grant-giving and work with governments to overcome them if we are not to see increased aid dependency based on a widening domestic savings investment gap.

The Use of Aid for Foreign Reserves

Recent evidence from UNCTAD (2000) shows that an increasing amount of aid inflows to Africa are being used for purposes other than current account financing, namely, for offsetting capital flight and accumulating reserves. Hence, the proportion of aid used for real resource transfers has fallen over the past two decades. Taking 16 African countries for the periods 1980–1989 and 1990–1998 the UNCTAD report found that in the first the weighted average net capital inflow devoted to foreign reserve build-up was only 0.7 per cent while in the second it had risen to 21.5 per cent. At the same time capital inflows used to offset capital outflows rose from 9.5 per cent in the first period to 23.5 per cent in the second period. This means that in 1990–1998 only 65 per cent of capital inflows were actually used to acquire real resources via financing the current account deficit. Given that much of the continent's net capital inflow was aid, this implies that a larger and larger share of aid is being diverted away from resource acquisition, reducing its investment and growth effects.

If this trend continues it will certainly undermine the effectiveness of doubling aid to Africa as a mechanism to kick start the investment-growth-domestic savings nexus. The data suggests that the recent build-up in reserves that has been evident in Africa is well in excess of that required to cover import needs; many countries now have reserves in excess of the normal recommended three months of import cover.

It would seem therefore that part of the build-up in reserves has been a defensive move to guard against speculative attacks on the currency and capital flight. The increased diversion of aid and other capital inflows to cover capital flight and accumulate reserves in Africa has coincided with a period in which the capital accounts of a number of countries in the region have been progressively liberalised.[7] This raises the question as to whether increased aid flows should be accompanied by the IMF orthodoxy of progressive capital account liberalisation in the region.

If aid is doubled and we see this accompanied by capital account liberalisation it is likely that an increasing proportion of this aid, over and above the already high 45 per cent, will simply be devoted to covering capital flight and accumulating reserves. This would seem to constitute a strong case against orthodox capital account liberalisation. Indeed, if the Dutch Disease effects are also prevalent, currency management will become extremely difficult for countries receiving substantial aid inflows at a time of capital account liberalisation. On the one hand, the aid inflow is likely to lead to inflationary pressures and a real exchange rate appreciation, which requires nominal devaluation to overcome. If, at the same time, the capital account is open, the perception of exchange-rate overvaluation is likely to lead to both capital flight and speculative attacks on the currency which will put further downward pressure on the currency. A vicious circle is likely to develop – the more open the capital account, the more aid will need to be channelled into offsetting capital flight and reserve build-up. However, the more this is done, the less aid will be available to acquire productive resources and hence alleviate domestic supply bottlenecks. As we have seen above, the failure to alleviate domestic bottlenecks will cause inflation in the face of large aid inflows boosting demand, leading to real exchange rate appreciation. The perception that the real exchange rate is overvalued will in turn lead to an increased likelihood of a speculative attack on the currency. The upshot is likely to be a currency crisis and excessive depreciation, which will lead to further inflation and lower growth. This scenario is a very real possibility in sub-Saharan Africa if the doubling of aid is accompanied by aggressive capital account liberalisation. The policy trick would seem to be to facilitate international capital flows in the form of direct foreign investment (DFI) and associated profit remittances without a full-scale capital account liberalisation which permits speculative capital flows.

Counter-Arguments to the Aid Sceptics

The fact that some empirical studies suggest that aid does not have a positive effect on economic growth is not in itself a strong argument against the doubling of aid. In the first place much aid, such as humanitarian relief, food aid and other consumption forms of aid, are not intended to increase economic growth. Likewise, we might also argue that the recent focus on social welfare expenditure and governance in aid programmes is not primarily intended to boost growth, at least not in the short and medium term.

Secondly, aid may have disappointing effects on growth due to features of the aid flows themselves. For example, erratic and volatile aid flows make economic management difficult for the recipient, making it harder to predict and manage exchange rate effects. Volatile aid flows are also difficult to plan for in a medium-term budget process, which might encourage the recipient to divert aid into consumption or tax giveaways. Work by UNCTAD (2000) has shown that capital flows to Africa, much of which consist of aid, are indeed volatile. The volatility in capital flows is something that can be addressed by a doubling of aid flows to Africa. In particular, part of the past volatility has been due to the volatility in private flows, and it is essential that aid acts in a counter-cyclical manner to compensate for this in the future and that capital account controls are maintained to the extent that excessive volatility in private flows can be avoided. Programme aid such as International Monetary Fund (IMF) and World Bank policy-based loans, which respond to current account and budget deficits, are often countercyclical unlike project aid, and this is something that donors should bear in mind when deciding how to disburse their increased aid. In addition, conditionality and budget support also need careful consideration as they can often tend to work in a manner that exacerbates rather than compensates for cyclical events. For example, adverse terms of trade movements can often undermine government revenue and budget performance. If this results in the IMF programme going off track, a country can then find bilateral donors suspending budget support in a manner that worsens the crisis. It is essential, therefore, that if budget support is to become a main means of disbursing a doubled aid volume, conditions are sensitively applied and external shocks such as a severe decline in the terms of trade are not allowed to trigger a withdrawal of donor funds. Rather than conditionality resulting in aid cutbacks in the face of exogenous shocks, donors should work out ways in which aid can be increased to a country at a time when it is facing such shocks; the IMF may well be able to help in this respect.

Tied aid is another area of aid quality that tends to reduce the developmental impact of aid and reduce the real value of the resource transfer. Although countries such as the UK have significantly reduced their aid-tying over the past decade, other donors have been much slower to do so. It is essential to further reduce aid-tying and ensure that none of the aid increase is in any way tied to donor imports.

In terms of aid quality more generally, recent research has looked at the quality of different donors' aid, calculating issues such as tying, the poverty focus of aid, the allocation of aid to countries with good policy and good institutions, and the amount given as technical assistance and project aid (both deemed negative features) (McGillivray 1989; Dollar and Levin 2004; Roodman 2004). The resulting indices of aid quality are reassuring for the doubling of aid in that they show that the countries that give most aid relative to their income score well, for example, Denmark, Norway, and the UK as opposed to those countries that give proportionately less, such as the USA and Japan. This gives some encouragement to the idea that as donors increase their aid effort, as they will have to if aid is to be doubled, the quality of their aid may improve.

Challenging the Monterrey Consensus

The above section has raised some of the problems that the Monterrey Consensus still needs to address – possible negative returns to aid, absorptive capacity issues, disincentive effect, project aid versus budget support, and the link between aid and foreign reserves. This section is more radical, challenging much of the conventional wisdom that has become part of the Monterrey Consensus. We look at the appropriateness of the Millennium Development Goals as a focus for the doubling of aid, while approaching aid delivery in terms of the Poverty Reduction Growth Strategies (PRGS), the policy of rewarding good performers, and the debate concerning grants versus loans.

The Millennium Development Goals

Firtly, the doubling of aid or securing the 0.7 per cent aid-to-GNP ratio for all donors will not guarantee fulfilment of the MDGs. However, more worrying is whether the MDGs will remain appropriate benchmarks for judging aid performance over the next decade. It is already evident that many low-income countries, even with a doubling of aid, will not achieve all the MDGs by 2015.[8] It has also been suggested that halving those living on less than a dollar a day is unlikely to be achieved until 2147 (Overseas Development Institute (ODI) 2004a). On the other hand it seems likely that a number of very large countries such as India and China will achieve the goals and be largely responsible for determining the global outcome (Rogerson *et al* 2004:20). In the words of Rogerson (*ibid*:21):

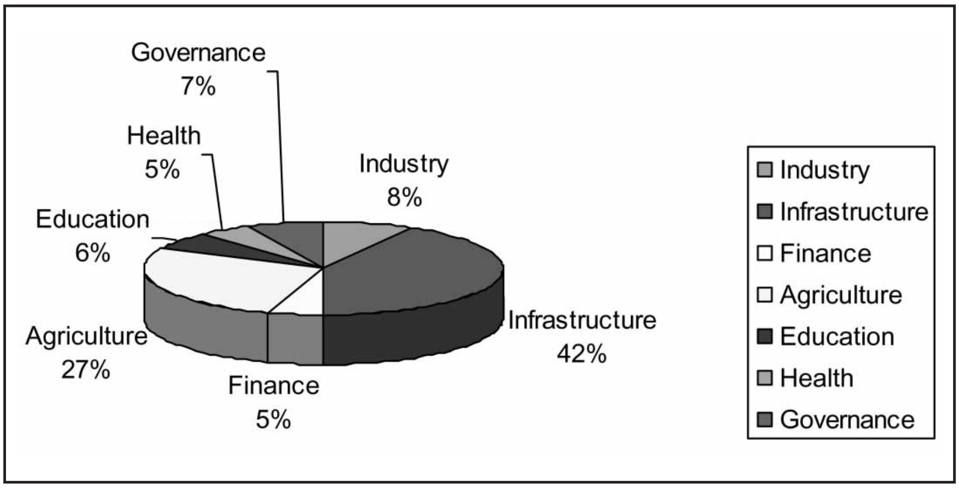
> The intermediate group, where greater efforts now could yet tip the balance, will shrink quickly – well before 2010 and probably much earlier. During our period of 2005–2010, therefore, and perhaps already by 2005–2009, the MDGs will probably cease to be effective reference points both for very successful and very unsuccessful countries, and may lose their potency for most of the undecided category. A new motivating set of benchmarks will therefore be needed.

Even if we continue to accept the validity of the MDGs as the benchmark for development performance and aid impact, we need to question the manner in which they have been interpreted by the donor community. The MDGs are a set of outcomes, not a strategy for achieving these outcomes. And yet there has been a tendency to regard them as synonymous with a particular social welfare strategy. It has become the accepted orthodoxy that the best way to achieve the MDGs is by prioritising expenditure, including aid funds, for the social sectors (Black and White 2003). But it is far from clear that such European-style social welfarism is the best recipe. Indeed, many African leaders are themselves beginning to question the strategy embodied in the orthodoxy of Poverty Reduction Growth Papers.[9]

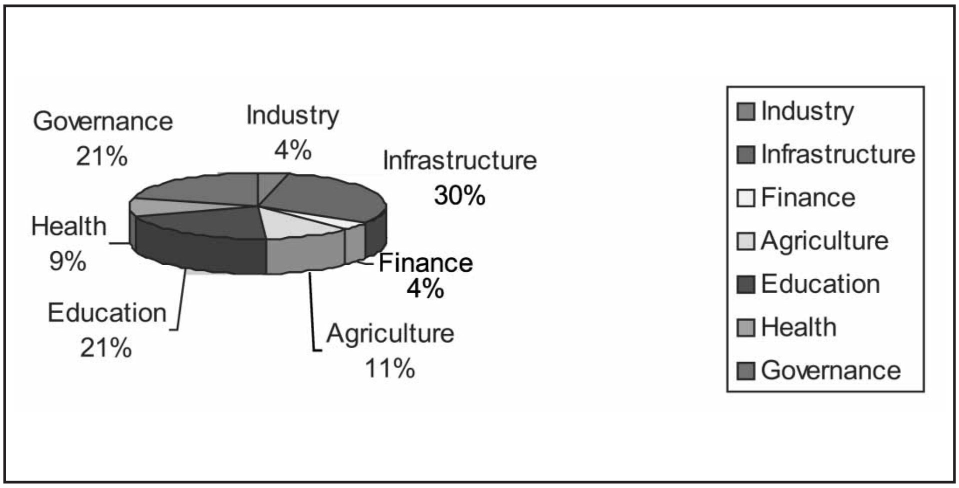
Trends in past aid allocation to Africa clearly show social welfarism in action, as most donors have channelled more and more of their aid funds into the social sectors at the expense of productive sectors such as agriculture, industry and economic infrastructure. For example, only the European Development Fund and the Japan Bank for International Co-operation (JBIC) have retained a significant focus on infrastructure finance in low-income countries throughout the 1990s (Rogerson *et al* 2004:15).

The two charts below show the sectoral allocation of total aid to Africa in 1990 and 2004. There is a clear shift from productive sectors to social sectors and governance. In 1990 agriculture, industry, economic infrastructure and the financial sector received a total share of 82 per cent of aid. By 2004 this had fallen to only 49 per cent. Both agriculture and industry saw their share of aid halved. By contrast, the shares for health, education and governance have risen considerably. In 1990 these sectors received a total share of 18 per cent. By 2004 their share had risen to 51 per cent: it has more than doubled. The rise in the share allocated to education and governance has been particularly dramatic and has been at the expense of agriculture and industry, the region's two key productive sectors

African Aid Sectoral Allocation 1990



African Aid Sectoral Allocation 2004



Source: OECD-DAC online data base
Note: Data is for commitments from all donors.

Recently, USAID has questioned the social welfarism implied in the MDG approach:

> In overemphasising these particular goals we risk underemphasising the importance of equitable economic growth ... without which we cannot produce the tax revenues to sustain the social services that the MDGs embrace. What is necessary is a proper emphasis on economic growth as a necessary condition for social services, instead of vice versa. (Natsios 2006)

We might also argue that there are elements of inconsistency in the Monterrey Consensus. It was clearly accepted as part of this consensus that what developing countries needed was aid *and* trade, and Northern countries have committed themselves to facilitating developing country trade access to their markets. However, if markets are to be progressively and rapidly opened up to low-income countries then developing countries need to invest in their industrial and agricultural sectors as well as in economic infrastructure. It is difficult to see how Africa can take advantage of new trade opportunities when the share of aid to agriculture, industry and infrastructure has been halved over the past decade and a half.

The above debate is of critical importance for the doubling of aid in that it has major implications for the sectoral allocation of aid to Africa. Aid needs to be embodied in a development strategy and the critique of the MDGs suggests that perhaps the current one is not the most appropriate. However, if we are to argue for increased amounts of aid to be channelled into the agricultural and industrial sectors then this needs to be accompanied by clear plans for both sectors, that is, clear industrial and agricultural policies.

By the same token, we might also criticise the Poverty Reduction Strategy Papers (PRSP) approach to development, which has become enshrined as part of the current orthodoxy. PRSPs were accepted in the Rome Declaration on Aid Harmonisation as the main platform on which to harmonise aid in low income countries. This implies that these papers are indeed the correct platform. But our above critique has cast some doubt on this and suggests the need to at least consider a new rallying orthodoxy.

Rewarding Good Performers

Another accepted point in the Monterrey Consensus was that aid should go to good performers. This again has important implications for the allocation of the doubled volume of aid. If the consensus is accepted then the potential extra $58 billion should go to partner countries that are performing well. But this raises a number of moral questions. Firstly, it is not just good performers, but low-income good performers who have been accepted as the intended beneficiaries of the increased aid flow. This is obviously good news for Africa, but it does raise the important question of the neglected poor in middle-income countries. There are currently 350 million poor people living on less than a dollar a day in middle-income countries and at present there is no clear consensus as to how to deal with this issue and what role aid should play.

In fact, the neglect of middle-income countries that are increasingly able to access market-based funds and often prefer such funds to aid money (Klein and Harford 2005:33), as well as the bypassing of poorly performing fragile states in aid allocation is leading to a 'shrinking middle' reflected in a herd mentality among donors. It is the latter end of this continuum that is likely to squeeze the middle in Africa, that is, the large number of fragile or failed states deemed inappropriate as aid recipients, especially for budget support. It seems likely that this herd mentality will characterise the doubled aid flow. Already the Global Fund gives most aid to those countries best able to absorb it, while the Millennium Challenge Account has set strict non-negotiable criteria (which have not been discussed with other bilateral donors) that need to be met for countries to be eligible for its funding. Dollar and Levine (2004) have also found that the responsiveness of aid to good policies increased for most donor groups between the late 1980s and the late 1990s.

If the above tendency is to continue then important questions need to be asked, such as: What is a poorly performing state? Who decides on the criteria for defining such states? Are there not ways in which aid could be effectively channelled to poorly performing states? In addition, these prescriptive models of aid allocation effectively embody high levels of conditionality usually decided by the donor community.

There is a possibility that donor tensions will emerge on the issue of the herd mentality towards good performers when aid flows increase. Although it is clear that some donors such as DFID prefer such an approach especially in Africa, other donors may not. The UN agencies, for example, spread their aid more widely and still have 5,000–6,000 employees and 5,000–6,000 consultants in what has been referred to as "forgotten states" (ODI 2004b). At the same time USAID seems to be becoming increasingly concerned with fragile and failing states as a degree of geopolitical donor interest affects its aid allocation and failing rather than conquering states are perceived in the post-9/11 world as the main threat to US security (Natsios 2006:131–2).

The Monterrey Consensus also accepts that aid management should be based on results-based management. But, as has been argued by Eyben (2005), this often disempowers recipients who have little say in what strategies are to be followed and what results are to be used as the accepted criteria for judging the success of the strategy. As Killick has pointed out, despite the donor rhetoric on partnership replacing conditionality, we have a new form of conditionality embodied in the PRSPs which is not consensual (ODI 2004b). Killick argues that the number of conditions in World Bank and IMF programmes has only fallen slowly and that those that are legally binding have fallen least of all. Indeed, as policy-makers in Africa become increasingly uncomfortable with the social welfarism development strategy embodied in the PRSPs (see note 9) it seems they are responding by simply second-guessing what donors want to see in the country's PRSP even when they feel it is not appropriate.

It would seem, therefore, that despite the Monterrey Consensus there is still much work to be done on issues such as conditionality, appropriate choice of partner countries, and results-based performance management of aid if the doubling of aid is to be effective.

Grants Versus Loans

The Monterrey Consensus also accepts that most aid to low-income countries should take the form of grants rather than loans. However, the evidence presented earlier suggests that grants have a stronger tendency to displace the domestic tax and savings effort, and tend to finance consumption rather then growth-enhancing investment. Another argument against grants is that grant-giving bilaterals find their resources dwindling and this makes it difficult for bilaterals to replenish the funds of institutions such as the World Bank. This is deemed problematic in a fund-constrained multi-objective environment in which aid is a scarce public good. One strong argument in favour of loans rests upon the development bank model (Klein and Harford 2005:64–5):

> The return to the recipient from the loan would be reduced because the loan must be repaid, but the donor agency would immediately lend the repayments to the worthiest recipient awaiting a loan. By assumption, the relending of the money (reflows) has a higher rate of return than leaving it with the original recipient because the donor agency has a broader choice.

However, this argument is based on two assumptions – that the original loan is productive so that the original recipient can repay, and that the aid agency allocates the reflow of money in a more productive way than the original recipient could have used it. If either of these points do not hold, this would not necessarily constitute a case for moving from loans to grants; but it would make a strong case for donor agencies improving their aid effectiveness and allocation.

On the other hand, the argument against offering aid in the form of loans, especially to low-income countries, is that it can encourage the build-up of unsustainable indebtedness. But evidence suggests that in recent years developing countries have been taking a rational approach in their demand for sovereign debt, with considerable help from multilateral lenders.[10] This is reflected in a shift in sovereign lending from private sources to the multilaterals, who offer lower interest rates and longer maturity rates (Klein and Harford 2005:49).

The above suggests that there are arguments both for and against the use of loans and grants and that a blanket assertion that the doubling of aid should always take the form of grants is not necessarily wise. Certainly, if the doubled aid flows are not forthcoming, the use of loans rather than grants would enable a smaller amount of money to go much further. Individual country circumstances also need to be taken into consideration when deciding on the best mix of loans and grants.

Conclusion

Savings and foreign exchange gaps have widened in Africa since the 1980s (UNCTAD 1999). This is the result of numerous factors, including low growth, adverse movements in the terms of trade, increases in imports brought about by trade liberalisation, and capital flight. Aid has been used to plug these gaps in the past, but has generally been insufficient in volume. If aid is to double, it is essential not only that it plugs these gaps, but actually results in a type of growth that narrows and eventually closes the gaps so that aid is no longer required and growth has become truly self-sustaining. If aid is to help do this, it must kick-start a growth process that generates both domestic savings and foreign exchange. In the past aid has often tended to widen rather than narrow the gaps, leading to aid dependency, the antithesis of self-sustaining growth.

The most radical part of this article has challenged the Monterrey Consensus as the current aid orthodoxy and asked whether aid delivered in those terms will be able to deliver the type of growth that is necessary. We have questioned the MDGs as benchmarks for the doubled-aid effort. More importantly, we have suggested that the type of social welfarism that has become embodied in the MDGs will simply lead to achievement of the goals in an aid-dependent manner without generating the domestic savings, tax, and foreign exchange necessary to make aid superfluous. In this respect we have suggested that serious consideration needs to be given to the future sectoral allocation of aid with a refocus on agriculture, industry and economic infrastructure. This is not to deny that the MDGs are essential goals, but to question the current strategy being used in the attempt to achieve them. This position has naturally also led us to question PRSPs as the main platform for aid delivery in low-income countries. Instead we have suggested that a new rallying call is necessary for the productive sectors of the economy from which the poor can benefit. This will require clear strategies for agriculture and industry, two currently neglected sectors in much of Africa. There is considerable scope to improve the productivity in both these sectors in a manner which can help to mobilise both domestic savings and foreign exchange. But this will not happen automatically simply by pouring aid money into these sectors. It will require a strong lead from the state. Doubling of aid will inevitably expand the absolute size of the public sector, so there is no reason why the state cannot take on such a role.

Another major point of orthodoxy we have challenged is capital account liberalisation. We have suggested that if the doubling of aid is accompanied by an aggressive capital-account liberalisation in aid recipients, this is likely to lead to major problems. It will increase the likelihood of capital flight and speculative attacks on the currency. This will require even greater amounts of aid inflows to be diverted away from real resource acquisition to cover capital flight and build up defensive reserves. This in turn will mean that less aid is available to overcome domestic supply bottlenecks leading to higher levels of inflation and Dutch Disease effects on the real exchange rate. Exchange rate overvaluation will in turn increase the likelihood of a speculative attack on the currency. The potential for a vicious circle to develop whereby increasing amounts of aid are diverted into defensive reserves and covering capital flight becomes a very real possibility in this scenario. It is essential, therefore, that capital-account policies be given serious consideration when aid is doubled, and systems be found that permit DFI and appropriate remittances without leading to capital flight and destabilising capital flows.

In addition to the more radical questions, we have also examined some of the unfinished business of the Monterrey Consensus and looked at the position of the aid sceptics. We have considered the possible negative returns to aid, the absorptive capacity issues, and the possible disincentive effects of aid. None of these problems are insurmountable and indeed an improvement in the quality of aid itself will do much to overcome them. On unfinished business, we have suggested that more thought needs to be given to the issue of rewarding only good performers and linked to this the debate between project aid and budget support. Despite the current fashion for budget support we have suggested that creative ways need to be found for delivering non-fungible project aid to weak and failing states but in a manner that does not undermine the development of the fiscal process. We have also argued that there should be flexibility in the debate concerning grants versus loans even in low-income countries.

Our final response to the aid sceptics is to ask them to consider the counterfactual, that is, what will happen to Africa if aid is not doubled? Rather than addressing such a question we will pose the opposite scenario. In the words of UNCTAD (2000:35):

> A judicious combination of a big push in external official financing and a reorientation of domestic policies on the basis of the lessons drawn from the experience of the past three decades appears to be the only viable way of securing rapid and sustained growth in the region, and eventually eliminating its dependence on aid.

Notes

1. Henceforth Africa is used to refer to sub-Saharan Africa excluding South Africa.
2. For recent evidence that aid has a negative effect on growth see Djankov *et al* 2004, Odedokum 2003, Sawada *et al* 2004.
3. Due to ease of data availability we use aid to GNI rather than GDP ratio. This does not greatly affect the results.
4. For a fuller explanation of causes of the Dutch Disease effect see Foster and Keith 2003.
5. For a review of the literature see Djankov *et al* 2005.
6. Knack (2000) found that a country receiving more aid than three-quarters of the other countries in the sample over a period of five years would expect to see a decline in its democracy index of between 0.6 and 1.0 on a scale of 1 to10.

7. For example, Egypt, Kenya, Mauritius and Uganda moved to complete capital-account liberalisation by the end of the 1990s and in all except Kenya capital flight rose substantially compared to the 1980s. There is also evidence of substantial volatile capital flows in Kenya, Tanzania and Uganda seeking arbitrage gains of the sort that contributed to the East Asian currency crisis of 1997 (Bhinda *et al* 1999).
8. For example, only 5 to 6 cohorts of children can enter education between now and 2015 meaning that we can already predict which countries are unlikely to achieve the education-related MDGs.
9. For example, not long after coming to power in 2005 Godal Gondwe, Malawi's new Minister of Finance openly questioned whether prioritising social expenditure over the productive sectors was the best way of achieving social welfare objectives such as the MDGs and stated that a stronger direct emphasis on growth via productive expenditure might be a much more efficient strategy for achieving the MDGs. Likewise, the government of Uganda is also now challenging the orthodoxy.
10. Between 1975 and 2002 the share of bilateral debt has fallen from 71 to 40 per cent in low-income countries and the share of multilateral debt has risen.

References

Bhinda, N., Griffith-Jones, S., Leape, J. and Martin, M. 1999. *Private Capital Flows to Africa*. The Hague: Fondad.

Burnside, C. and Dollar, D. 2000. "Aid, Policies and Growth", *American Economic Review*, 90,4:847–68.

Chenery, H. and Strout, A. 1966. "Foreign Assistance and Economic Development", *American Economic Review*, September.

Clements, B., Gupta, S., Pivovarsky, A. and Tiongson, E. 2004. "Foreign Aid: Grants Versus Loans", *Finance and Development*, September:46–9.

Commission for Africa. 2005. *Our Common Interest*. Report for the Commission for Africa. London: Department for International Development.

Conyers, D. and Mellors, R. 2005. "Aid Ineffectiveness in Sub-Saharan Africa: The Problem of Donor Capacity", *IDS Bulletin*, 36,3.

De Renzio, P. 2005. "Increased Aid vs Absorptive Capacity: Challenges and Opportunities Towards 2015", *IDS Bulletin*, 36,3.

Djankov, S., Montalvo, J. and Reynal-Querol, M. 2005. *The Curse of Aid*. Washington, DC: World Bank.

Dollar, D. and Levine, V. 2004. *The Increasing Selectivity of Foreign Aid, 1984–2002.* Policy Research Working Paper 3299. Washington, DC: World Bank, Development Research Group.

Eyben, R. 2005. "`Donors' Lending Difficulties: Results, Relationships and Responsibilities", *IDS Bulletin*, 36,3.

Foster, M. and Keith, A. 2003. *The Case for Increased Aid*. Report to the Department for International Development, Vol.1. Chelmsford, United Kingdom.

Griffen, K. 1970. "Foreign Capital, Domestic Savings and Economic Development", *Bulletin of the Oxford Institute of Economics and Statistics*, May.

Killick, T. 1998. *Aid and the Political Economy of Policy Change*. London: Routledge.

Klein, M. and Harford, T. 2005. *The Market for Aid*. Washington, DC: International Finance Corporation.

Knack, S. 2000. *Aid Dependence and the Quality of Governance: A Cross-Country Empirical Analysis*. Policy Research Working Paper 2396. Washington, DC: World Bank, Development Research Group.

Lensink, R. and White, H. 2001. "Are There Negative Returns to Aid?", *Journal of Development Studies*, 37,6:42–65.

McGillivary, M. 1989. "The Allocation of Aid among Developing Countries: A Multi-Donor Analysis Using a Per Capita Aid Index", *World Development*, 17,4:561–8.

Mosley, P. 1990. "Aid, Savings and Growth Revisited", *Bulletin of the Oxford Institute of Economics and Statistics*. May.

Natsios, A. 2006. "Five Debates on International Development: The US Perspective", *Development Policy Review*, 24,2:131–9.

Odedokum, M. 2003. *Economics and Politics of Official Loans Versus Grants*. WIDER Discussion Paper 2003–2004. Helsinki: World Institute for Development Economics Research.

______ 2004. "Multilateral and Bilateral Grants Versus Loans: Issues and Evidence", Special Issue, *World Economy*, 27,2:239–63.

Overseas Development Institute (ODI). 2004a. http://www.odi.org.uk/speeches/future_of aid/meeting_report_21january04.html.

______ 2004b. http://www.odi.org.uk/speeches/future_of_aid/meeting_report_20February04.html.

Organisation for Economic Co-operation and Development–Development Assistance Committee (OECD–DAC). 2003. *Harmonising Donor Practices for Effective Aid Delivery: Good Practice Papers*. DAC Guidelines and Reference Series.

Papenek, G. 1973. "Aid, Foreign Private Investment, Savings and Growth in Less Developed Countries", *Journal of Political Economy*, January–February.

Rogerson, A., Hewitt, A. and Waldenburg, D. 2004. *The International Aid System 2005–2010: Forces For and Against Change*. London: Overseas Development Institute.

Roodman, D. 2004. *An Index of Donor Performance*. Working paper 42. Washington, DC: Centre for Global Development.

Sala-i-Martin, X. and Subramanian, A. 2003. *Addressing the Natural Resource Curse: An Illustration from Nigeria*. IMF Working Paper 03/019. Washington, DC: International Monetary Fund.

Sawada, Y., Kohama, H. and Kono, H. 2004. *Aid, Policies and Growth: A Further Comment*. Faculty of Economics: University of Tokyo.

Stockmayer, A. 2005. "The State and Governance: The Main Bottlenecks for Absorbing Massively Increased Aid?", *IDS Bulletin*, 36,3.

United Nations (UN). 2001. *Report of the High-Level Panel on Financing for Development*. New York: UN.

United Nations Conference on Trade and Development (UNCTAD). 1999. *Trade and Development Report*. Geneva: UNCTAD.

______ 2000. *Capital Flows and Growth in Africa*. Geneva: UNCTAD.

White, H. 1992. "The Macroeconomic Impact of Development Aid: A Critical Survey", *Journal of Development Studies*, January.

______ 2005. "The Case for Doubling Aid", *IDS Bulletin*, 36,3.

White, H. and Dijkstra, G. 2003. *Programme Aid and Development: Beyond Conditionality*. London: Routledge.