

Foreign aid is driven largely by political and strategic considerations of donor countries. Poverty levels and good policy management in recipient countries have little influence on the amount of foreign aid they receive. Discuss using empirical evidence.

Introduction

Official Development Aid (ODA) is defined as flows to countries and territories which are "...administered with the promotion of the economic development and welfare of developing countries..."¹. However, I would argue that this is not wholly the case. Most of the evidence points to the fact that the title statement is true. There have been many empirical studies on this matter; this is because if aid was actually administered with poverty levels and policy management in mind, it would undoubtedly be more effective. For example, Collier and Dollar (2002) derive a poverty-efficient aid allocation and find that it is radically different than actual aid levels. With the present allocation, aid lifts around 10 million people out of poverty every year; however, if donors followed the derived poverty-efficient allocation of aid, an additional 9.1 million people would be lifted out of poverty annually². Therefore, how donors allocate aid is an important issue.

A review of the evidence shows that bilateral and multilateral donors differs in allocation decisions. A report by the World Bank (1998) looked at bilateral and multilateral aid allocations between 1970 and 1993 and noted that they were dominated by politics, "...both the international politics of the Cold War and the internal politics of aid agencies."³ However, when Burnside and Dollar (2000) look at the same time period and distinguish between the motivations of multilateral aid and bilateral aid, they find that bi-lateral aid is most influenced by the donors' interests. However multilateral aid is more to do with population, income level and policy⁴. This distinction repeatedly appears in the literature.

Political and Strategic Considerations

Alesina and Dollar (2000) look at this issue, to see whether aid is more driven by political and strategic considerations, or whether the level of poverty was factored in. The time period used is

¹ <http://www.oecd.org/dac/stats/officialdevelopmentassistancedefinitionandcoverage.htm>

² Collier and Dollar (2002) pp. 1497

³ World Bank (1998) pp. 40

⁴ Burnside and Dollar (2000) pp. 848

1970-1994. They find that for bilateral aid (government to government aid), foreign aid is driven as much by political and strategic considerations, as it is the economic needs and policy performance of the recipients, in fact, it is arguably more important⁵. They find that the political and strategic variables had more explanatory power than measures of poverty, democracy and policy⁶. Looking at the particular political and strategic factors that influence aid giving, they find that whether the recipient country was a former colony of the donor is a major factor in determining aid flows. In fact, a country that has a relatively long colonial past receives 87% more aid. They also look at UN voting patterns to determine whether 'friends' of the donor countries receive more aid. They find that a country that voted often with Japan received more Japanese aid, though they note that it is difficult to tell the causality of this relationship. It could be that aid is used to 'buy' political support, though they suggest the more likely explanation is that it is more an indication of political alliances, though this still proves that at least for Japan, aid is very politically motivated. They do however find that *ceteris paribus*, most donors give more to poorer countries, though variation among donors related to this relationship is very large. For example, for France, there is virtually no relationship at all between the income level and aid.

Similar to Alesina and Dollar (2000), many other studies find that former colonies of donors receive more aid. Berthélemy and Tichit (2004) use a slightly updated time period of 1980-1999 and they too find that former colonial links have a big impact on aid flows. They also find evidence that aid increases with the level of trade between the donor and recipient, a point that I will discuss later. Neumayer (2003) studies aid allocations by multilateral agencies and does find evidence that poorer countries receive more aid than richer ones. However he also finds that the former colony bias observed in bilateral aid allocations is also evident in multilateral aid, "...countries with a longer experience of colonization by an OECD country receive more aid than others."⁷. Four regional development banks are also studied. It is found that whilst the Asian Development Bank gave more

⁵ Alesina and Dollar (2000) pp. 40

⁶ Alesina and Dollar (2000) pp. 41

⁷ Neumayer (2003) pp. 111

aid to former colonies of Western nations, the African and Inter-American Development Bank gave less aid to these countries.

A report by the Economic Commission for Africa (2004) notes that more than \$12 billion of total aid, including emergency assistance, to developing countries was tied to the donors exports. For example, the US makes sure 80 cents in every dollar of aid is returned back to them. Strings attached to US aid projects include the obligation of the recipient country to buy products such as Caterpillar and John Deere tractors⁸, this reduces the value of aid by 25-40%⁹. This obviously shows that much of aid is motivated by strategic interests. However, the Economic Commission for Africa (2004) notes that not all countries are guilty of this, for example, in 2001, over 90% of aid from Denmark, the Netherlands, Norway and the UK was untied¹⁰.

Returning to the findings of Berthélemy and Tichit (2004) that aid increases with the level of trade between the donor and recipient, Younas (2008) also finds evidence of this. The study looks at whether donors direct their aid to recipients who import more manufacturing goods. The empirical results show that this is the case. He notes that donor countries tend to export more capital goods - which make up a large share of manufacturing exports in these donor countries, therefore donors seem to have their economic interests in mind by encouraging their imports through aid. His results also suggest that over the long run, donors show minimum interest in reducing economic hardships and poverty in poor recipient countries¹¹. He notes that it would seem donors are more interested in increasing their trade benefits, and less interested in responding to adverse income shocks in the recipient countries. Finally, it would seem that in order to maintain their influence, donors tend to give more aid to recipients who receive more aid from other countries. Conflicting evidence of this linkage between aid and trade comes from Dollar and Levine (2006) whose study I will discuss in more detail later in the paper. They find that the trade variable is not a factor for most donors, however there are some major exceptions. For France, Portugal and Japan, aid and trade are highly correlated.

⁸ Deen, T. (2004, July 7).

⁹ Economic Commission for Africa (2004) pp. 17

¹⁰ Economic Commission for Africa (2004) pp. 36

¹¹ Younas (2008) pp. 671

Poverty and Good Policies

In line with Alesina and Dollar (2000), Younas (2008) also found that donors do care about the well being of recipient countries. As income per capita falls, aid per capita increases. Aid is also found to increase with an increase in infant mortality. However, Nunnenkamp et al (2004) found that poor recipients received a lower share of multilateral aid in the most recent period they studied. They also found that multilateral institutions were hesitant to adjust their allocation of aid in light of a recipients change in income status. Interestingly, they found Japan to actually have a bias against the poorest countries. Taking Alesina and Dollar's (2000) research a step further, Nunnenkamp et al (2004) also include a measure for absolute poverty. They found that the focus on countries with higher absolute poverty was strongest in UK and Danish aid, however it was weakest for French and US aid. Dreher et al (2011) found that new donors are to blame for the comparatively weak targeting of aid¹². They found that compared to old donors, Asian and Latin American donors are bias against needy recipients. On the other hand, Arab and Central European countries were found to "...give less aid to richer countries, however there poverty orientation is significantly weaker than that of old donors."¹³. New donors' reactions to disasters are also significantly weak compared to old donors. Although new donors do not seem to allocate aid efficiently to the neediest, Dreher et al (2011) found no clear cut pattern of aid allocation being driven by self-interest or merit. Some groups of donors gave more aid to more corrupt countries, whereas other donors favoured less corrupt countries, I will come back to corruption later in the paper. Finally, with the exception of Latin American exports, there is also no evidence that new donors have selfish interests.

Thiele et al (2007) look specifically at whether the allocation of aid is targeted in line with the Millennium Development Goals (MDGs). These are 8 goals to be achieved by 2015 to help the world's poorest countries. Goals include eradicating extreme poverty and hunger, combatting HIV/AIDS and other diseases, and achieving universal primary education. Looking first at the allocation of aid aside from the MDGs, it is found that the allocation of aid is significantly affected by

¹² Dreher (2011) pp. 1959

¹³ Dreher (2011) pp. 1960

per capita income, with the exception of France. In terms of the MDGs, Japan and the US performed poorly in allocating aid to target the MDGs. Although France is notoriously bad at allocating aid to the poorest countries, it did seem to take into account some of the MDGs, for example fighting HIV/AIDS and achieving universal primary education, however it was the only donor not to take hunger into account. In terms of health, they also found the donors allocated aid to target the more publicised MDGs, like HIV, whereas issues like immunisation against measles received less attention.

When looking at good policy, it is sensible to look at whether donors allocate aid according to the institutional quality of the recipient countries. Dollar and Levin (2006) note that "A government that provides a sound framework for growth and poverty reduction is also one that is more likely to use financial resources well to complement policies with necessary public investment..."¹⁴. Bad economic governance is considered unfavourable as aid may not be well used in these countries. In terms of the link between aid and economic governance- as measured by an index of property rights and rule of law-, a change in behaviour is observed over time. In the earliest period studied, total aid, including multilateral and bilateral had a strong negative relationship with economic governance. For the latest period studied - 2000-2003, the relationship turns to be significantly positive for multilateral aid, showing a tendency towards selectivity in terms of economic governance.

More empirical evidence from Alesina and Dollar (2000) supports the notion that the allocation of aid is influenced by good policy. They consider the openness of the recipient country to be a good indication of economic policy. They find evidence that donors like Japan, Nordic countries and the UK seem to 'reward' good economic policy by allocating more aid to more open countries. However they note that this effort is undermined by donors other objectives like providing more aid to former colonies. However Nunnenkamp et al (2004) found that once adjusting for outliers, recipients with good policies were often treated less favourably than those without. They also look at the response of donors to a change in institutional quality and policy conditions in the recipient countries. They note that this response proved to be disappointingly weak.

¹⁴ Dollar and Levine (2006) pp. 2036

Another measure of good policy is the level of corruption in recipient countries. If donors provide more aid to countries that have high corruption levels, it would imply that donors place less importance on good policies. Alesina and Weder (2002) find interesting results that more corrupt countries do not seem to receive less foreign aid. These results are robust to specification changes. When they look at donor by donor results, they find that Nordic countries allocate their aid better than most others, they note this is due to the fact that these countries have no former colonies, so are more 'free' to pick their aid allocations. In stark contrast is the US, where it would seem more of their aid goes to more countries that are corrupt. The US is also one of the donors who have a lot of interest in the Middle East, so may be using aid as a political tool¹⁵. Going back to Nunnenkamp et al (2004), they found that none of the major donors responded to changes in the control of corruption in a way that would make aid more effective.

Japan seems to consistently come up as a country that differs in its aid allocations. In fact, Katada (1997) focuses a whole paper on the goals Japan tried to pursue using foreign aid to Latin America. These goals were: 1) serving its own political and economic interests in Latin America, 2) collaborating with the US in support of US maintenance of power and dominance in the region and 3) improving the Japanese-US relationship by satisfying the US' interests in Latin America. In terms of Japan's own interests in aid allocation in Latin America, it is found that the more Japanese immigrants a Latin American country has, the more aid it receives from Japan. With respect to the second goal, a strong positive relationship was found between the trade relationship the recipient had with the US, and the amount of foreign assistance from Japan. Countries that traded more with the US received more foreign aid from Japan. This also satisfies the third goal. However, even though there is overwhelming evidence of strategic and political motivations in this case, there is also evidence that Japan took the economic needs of the recipient into account. The poorer the country, the more Japanese aid it received. Similar to Alesina and Dollar (2000), Katada (1997) also found that the more open a recipients economy is, the more money it will receive from Japan, suggesting Japan do take good policy into account.

¹⁵ Alesina and Weder (2002) pp. 1135

Conclusion

On the whole, it would seem most donors seem to have relatively similar aid allocation patterns. However, countries that consistently come up as anomalies are France and Japan. For example Japan was the only country who allocated more aid to 'UN friends', and the relationship between income per capita and aid was virtually non-existent for France, Japan also seems to have a low elasticity to income. Japan and France are also in the few countries that seem to place a lot of importance on trade linkages with recipient countries.

The level of trade between the recipient and the donor seemed to be a big factor in determining aid allocation, generally with a positive relationship being found. Aid also seems to be allocated more to former colonies of donors. Looking at the level of corruption, the evidence seems to be very mixed, therefore, with respect to corruption, the issue of whether donors reward good policies is ambiguous. However, Alesina and Dollar (2000) consider openness to be a measure of good policy, and find that donors reward countries that are more open. Dollar and Levine (2006) also find that in recent years, aid seemed to be more selectively allocated to countries with better economic governance.

Katada (1997) notes that "There is more to disbursement and allocation of aid than a simple donor-recipient bilateral relationship that is based on recipients' economic needs."¹⁶. Reviewing the evidence, this overwhelmingly seems to be the case. Though most studies do seem to find a link between aid and per capita income, it does seem to be that in most cases, there are underlying strategic and political motivations for aid.

¹⁶Katada (1997) pp. 941

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