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RENTS AND THE POLITICAL ECONOMY OF DEVELOPMENT AID

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Abstract

Empirical studies suggest little impact of foreign aid on growth on average. As aid can be viewed as a sovereign rent akin to natural resource rents, it is likely that rent seeking plays a role in explaining this disappointing outcome. The analytic starting point of this paper is the long chain of agents connecting donors in rich countries with beneficiaries in poor countries, making aid a contestable rent for recipients at both the international and the domestic levels. Thus, rent seeking can distract attention and divert resources from more important sources of long-term progress. Moreover, there are serious incentive problems on the donor side of the relationship. Empirically, the effects seem quite heterogeneous and hence more research is needed to further our understanding of this complex system.

Keywords: Aid effectiveness; Donor motives; Rent seeking; Governance; Resource diversion; Development distraction; Non-government organizations; Aid organizations; World Bank

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1. Introduction

In these circumstances, the best way to make money is through rent: natural resource rent, aid rent, policy rent. So the private sector will be rent seeking not value creating, it will go for the easy way and make money through rent (former Prime Minister Meles Zenawi of Ethiopia, quoted in de Waal 2013, p. 153).

The concept of rent seeking refers to a process in which resources are used to shift wealth instead of creating it.[1] It has been most frequently applied to situations where intervention by the government in the economy creates "artificial" potential profits that could be appropriated by several different actors, e.g. a monopoly established by law, or to lobbying for similar measures. Such profits have been coined rents, in analogy to the surplus that arises in the extraction of natural resources when other inputs have been paid according to their opportunity cost, i.e., the economic value generated by the resource itself.

[Table 1 about here]

Standard economic analysis of the effects of resource discoveries or booms often starts from the premise that the rent is equivalent to a gift of foreign exchange. On the face of it, foreign aid seems to be another such example.[2] It is by definition an external resource transfer. It is no doubt of importance to quite a few developing countries. At the extreme, the top three recipients in terms of income per capita in the most recent available year (2012) would be middle-income countries even if they produced nothing themselves, as the current

[1] The basic idea is usually attributed to Tullock (1967 [2008]), whereas the term rent seeking is due to Krueger (1974 [1980]).

[2] In fact, Collier (2006) dubs both natural resource rents and aid as sovereign rents.

World Bank cut-off between low and middle income countries is at $1035 (c.f. Table 1).[3] More generally, it seems reasonable to say that an industry is important if it constitutes more than 5 per cent of the economy. According to this standard, aid is important in 49 out of the 131 countries for which the World Bank has current data.[4] On average, it is of significance in both low-income and least developed countries.[5]

[Figure 1 about here]

While the impact of foreign aid on economic growth in developing countries remains somewhat controversial, the latest empirical studies point to the conclusion that the effect is on average small and probably not significantly different from zero.[6] Needless to say, an insignificant overall effect might mask sizeable heterogeneities across recipient-countries and types of aid, and the literature is now heading in the direction of more disaggregated studies that might be able to uncover such variation. Moreover, the welfare effects of such transfers are a wholly different matter. In principle, if all aid is consumed, no additional growth could coincide with a higher level of aggregate welfare.

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[3] The source for the data in Table 1 and Figure 1 is the World Bank's online database, accessed April 15, 2014; specifically, http://data.worldbank.org/indicator/DT.ODA.ODAT.GN.ZS and http://data.worldbank.org/indicator/DT.ODA.ODAT.PC.ZS .

[4] These are Tajikistan and all the countries to the left of it in Figure 1.

[5] The least developed country designation is based on a UN classification that, besides income, takes "vulnerability" and "human assets" into account. For these reasons, there have always been some lower middle income countries in this group. Presently, even two upper middle income countries (Angola and Tuvalu) and a high income country (Equatorial Guinea) are categorized as LDCs.

[6] Roodman (2007) demonstrates that the results of the most important studies published in the early parts of the 2000s were not robust, especially with respect to sample changes, and concludes that aid is probably not a decisive factor for development. The meta-studies of Docouliagos and Paldam (2008, 2010, 2011) can be said to generalize this result, establishing aggregate aid ineffectiveness in terms of growth. Rajan and Subramanian (2008) slice the data in many different ways, including time horizons not previously tested, without finding much of an impact (if anything, it is negative).

However, supposing that the ineffectiveness of aid in raising growth on average hides some success stories, it follows that there must also be cases where aid has had a negative impact. If no effect is a disappointment in light of the original normative rationale for foreign aid – fostering economic development - backsliding is clearly even worse. Furthermore, there are indications that aid could have perverse effects in other dimensions too. For example, Bjørnskov (2010) finds that in democracies aid worsens the income distribution and Djankov et al. (2008) claim that more aid results in less democracy.

The starting point of this chapter is that it is worthwhile investigating potential reasons why a gift from abroad paradoxically might have no or even a negative effect on the economic development of the recipient. As is the case for natural resource rents, economic mechanisms such as volatility and the Dutch disease could be part of the explanation.[7] However, I focus on the inefficiencies that arise due to the extremely long "chain" linking the original donors (citizen-taxpayers in rich countries) and the ostensible beneficiaries (poor people in poor countries). Figure 2 gives a stylized depiction of this highly complex system. The downward-pointing arrows symbolize flows of "aid funds," starting at the top with the taxes and private donations of individuals. The aid budget of a donor country government mainly derives from the taxes paid and is in turn divided among different actors, most importantly bilateral and multilateral aid agencies. These channel their funds through recipient country governments and donor and recipient country non-governmental organizations (NGOs), or spend them directly on projects in the field.[8] Resources are

[7] Rajan and Subramanian (2011) is one recent study presenting evidence suggesting that aid adversely affects the growth rates of industries producing tradable goods by causing an appreciation of the real exchange rate. The simulations of Arellano et al. (2009) demonstrate that the welfare costs of aid volatility can be quite substantial.

[8] To avoid cluttering the figure, I have made a number of simplifications. Some of the most important are the following. In recent years, public-private partnerships like the Global Alliance for Vaccines and Immunisation have become important players in the health sector in particular. This is an example of private foundations being major financiers for some purposes. Also note that donor countries use "international" NGOs as well, mainly

consumed in each “link” of this chain and as a result a substantial share of aid never reaches the recipient country, much less the poorest segments of it.[9] Moreover, the beneficiaries have no institutionalized way of reporting back to the citizens of the donor country whether aid works for them or not; in this system, the feedback loop is broken.[10] An important consequence is that accountability for results is much weaker at all stages than in the welfare systems of the donor countries.

[Figure 2 about here]

In the next section, I analyze the donor part of the chain, discussing citizens, governments, official aid agencies, and NGOs in turn. Section 3 is devoted to various issues on the recipient side. Section 4 contains concluding comments. The main conclusion is that not only is some aid diverted to unproductive activities, such transfers can also distract recipients from the pursuit of development. These effects do not appear to be ubiquitous, however, so there is still plenty of room for research into when aid works, when it does not, and why. Still, any progress in our understanding of this system is unlikely to generate strong incentives for change.

2. Donors

2.1. Citizen-taxpayers

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from other donor countries. The number and nature of bilateral agencies vary among donors belonging to the OECD’s Development Assistance Committee (DAC), and include government ministries as well as executive agencies. The multilateral agencies make up a quite heterogeneous category, ranging from financial institutions like the World Bank to the specialized agencies of the UN. In addition to “in-house” units and NGOs, official agencies use private contractors to implement projects. For a more detailed view of the complexities of the system as seen from the recipient side, see Figure 9 of World Bank (2008).

[9] The administrative costs of aid are not my concern here. A good chunk of these costs are payments to the evaluation “industry,” comprising accountants, auditors, consultants, think-tanks, and academic researchers, mostly located in the donor countries.

[10] This was first pointed out in Martens et al. (2002).

The aid chain starts with private individuals in donor countries. In some ways, the problematic aspects of aid start here too. The mostly rich-country citizens who are the original source of aid can be said to donate in two ways: through compulsory taxation and through voluntary contributions to NGOs. Their intrinsic motivation for making donations is of course most directly relevant in the second case and can be categorized in terms of whether they are outcome-oriented or not. Reducing world poverty can be viewed as a collective good. In the latest wave of the World Values Survey, more than 50% of respondents in major donor countries, such as Germany, the Netherlands, and the US, viewed 'people living in poverty and need' as the most serious problem facing the world.[11]

As is well-known from the literature on the private provision of a collective good, in such situations a free-rider problem arises.[12] It is better for each individual leave the task of providing the good to other concerned individuals. With the number of potential donors running into hundreds of millions, the free-rider problem is so severe that one would hardly expect any contributions at all. Indeed, Kopczuk et al. (2005) argue that their calculations show that US aid policy is consistent with social preferences that place essentially no value on the welfare of the citizens of the poorest countries or an implicit assumption that all transfers are wasted. On the other hand, we do observe donations that are sizeable enough to sustain thousands of development NGOs, some of which are household names, and are large enough to influence rich-country governments and multilateral institutions. It thus seems likely that a

[11] http://www.worldvaluessurvey.org/WVSOnline.jsp, accessed May 19, 2014. The complete wording of the question is "Please indicate which of the following problems you consider the most serious one for the world as a whole?" 6.5-13% of respondents in these countries considered another development related issue, poor sanitation and infectious diseases, the most pressing. The results are similar in other traditional DAC countries like Australia, Spain, and Sweden. The exception is Japan, where more than 40% answered that environmental concerns were foremost on their minds.

[12] The idea originates with Olson (1971). The standard "technical" reference is Bergstrom et al. (1986).

significant part of private contributions to foreign aid can be explained by motivations that are not outcome-oriented.

As noted by Andreoni (2006), fundraisers know most people must be asked to donate. The “demand” for contributions brings forth the “supply.” This could be due to the social pressure implicit in the request, especially when someone comes knocking on your door or stands curbside soliciting passers-by. Declining to give in a face-to-face encounter feels a bit like saying “I’m a mean, non-caring person.” As most fund-raising drives are not based on personal interaction, a related inclination is probably even more important in explaining the “power of the ask,” namely, the desire to convince *yourself* that you are not such an individual. Giving to confirm to oneself that one is a person who cares about others has been labelled expressive giving by Hillman (2010). This notion is closely related to the concept of warm glow giving of Andreoni (1989). It is the act of contributing that matters to the donor with such motivations, not the outcomes produced.

Why are motivations for giving important? Because they have ramifications for the whole system. If individuals donate to NGOs solely to feel good about themselves, these organizations do not have to deliver results. This is likely to magnify the accountability problems that arise from the peculiar governance structures of NGOs, which per definition have no owners. Similarly, if citizens do not care about outcomes, governments are free to use their aid budgets in pursuit of other goals. Moreover, development in general or aid more narrowly is never the most important topic for voters when deciding which party or candidate to vote for. This observation further strengthens the supposition that the accountability constraint is unlikely to be binding for politicians in this dimension, and implies that special interests such as NGOs and aid bureaucrats, not voters, could be their real principals.

Before we proceed to discuss the roles of these other donor-side actors in more detail, note that assuming expressive behavior on the part of citizen-taxpayers is not a necessary condition for asserting that the latter are unlikely to be demanding results. This is important, for the empirical literature on charitable giving in general finds that government grants to NGOs reduce private donations by a factor between 0 and 100%. As the canonical model of the private provision of a pure public good predicts that crowding out will be complete whereas a model where gifts are only motivated by warm glow suggests there will be no crowding out, the evidence suggest that either people have mixed motives or the population consists of both pure altruists and individuals with an expressive rationale for giving.

However, even if a sizeable number of individual donors "in principle" are outcome-oriented when it comes to development issues, they are unlikely to be so in practice for the simple reason that they lack the information and knowledge required to judge results. The broken feedback loop in Figure 2 illustrates that the aid system does not have an automatic mechanism for the ostensible beneficiaries to report back to the original donors. Analyzing this chain to attribute responsibility for (lack of) results is extremely costly to single citizen-taxpayers. In addition, such information is a collective good and is therefore subject to a second order free-rider problem. Thus, even most outcome-oriented individuals are likely to end up basing their actions with respect to both the voluntary and the compulsory part of their contributions to foreign aid on the emotive appeal of "doing something" to reduce world poverty. Indeed, Nunnekamp and Öhler (2012) find that donations to US development NGOs do not seem to be driven by publicly available information about the efficiency with which these organizations allocate funds. Instead, a small crowding-in effect suggests private donors take public funding to be a signal of quality.[13] As I will now discuss, this is unlikely to be a fool-proof solution as neither politicians nor aid bureaucrats have strong incentives to focus on efficiency in aid allocation and delivery.

[13] Naturally, most estimates of crowding-out are based on organizations operating domestically. Studies of aid NGOs indicate this sector is different. Ribar and Wilhelm (2002) find little evidence of crowding-out, while Herzer and Nunnenkamp (2013) is another study finding crowding-in. Unless governments use matching grants to a larger extent in this sector the evidence thus favor warm glow models of private aid, perhaps augmented by official funding serving as a seal of approval.

2.2. Motivations for official aid

It follows from the supposition that expressive behavior is likely to be widespread among donor country voters when it comes to development assistance that their governments have considerable slack in delivering results. They could use this space to pursue their own agendas, or find it opportune to adopt the ones pushed by NGOs and official aid agencies. The roles played by the latter two are the subject of the following subsections. Here I focus on the aggregate picture of how official aid is distributed across recipients. Aid allocation is important for at least two reasons. The size of the flow might of course matter for the effects generated. For example, some researchers argue that there are decreasing returns to aid, others that more aid means more rent seeking. There are also studies indicating that donor motives matter for aid impact, with politically-driven transfers being less effective.[14] With the notorious lack of robustness of aid-growth regressions in mind and no clear theoretical rationale for these results, one should obviously not jump to conclusions. However, these results suggest that the fine print matters in the aid industry.

It is common to classify donor motives into three categories: recipient need and merit as well as donor interests. The latter is often subdivided into geopolitical and commercial interests. The big picture is that, relative to recipient need, self-interest is on average a more important factor for the bilateral donors than the multilateral institutions. This is due to the large bilaterals, as there is a group of small donor countries that act more like the multilaterals. Nevertheless, the income levels of the recipients influence the allocation decisions of even the most hard-nosed donor countries. The Samaritan's Dilemma suggests that this is not unequivocally a good thing.[15]

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[14] See for example Dreher et al. (2013), Headey (2008), and Kilby and Dreher (2010).

[15] The Samaritan's Dilemma is due to Buchanan (1975) and its application to aid to Pedersen (1996).

The Aid Donor's Dilemma is that what the donor does to alleviate need induces actions by the beneficiaries that counteract the intended effect and quite possibly prolong their dependence upon the donor. The donor might talk tough, but recipients know that actions speak louder than words: aid policy will be dynamically inconsistent as the donor will in the end respond to their needs even if they could have done more on their own account. For concreteness, consider competition for aid among recipient countries.[16] If a fixed aid budget is allocated on the basis of consumption levels, a recipient becoming richer will be given less as the donor redistributes toward the other, now relatively poorer, countries. In effect, the allocation mechanism taxes investment and other efforts raising recipients' own income. This story is consistent with Boone (1996) and Werker et al. (2009), who find that foreign transfers tend to crowd-out domestic savings and thus have little impact on investment.[17] As I discuss in section 3.2, it is also in line with the ineffectiveness of aid conditionality.

Most studies of aggregate aid allocation reveal a middle-income bias and a small-country bias; both types of recipients tend to receive more aid than their income levels warrant.[18] The standard interpretation is that this is due to geopolitics: middle-income countries tend to be more important strategically and it is argued that it is cheaper to buy the votes of less populous countries in international fora. During the Cold War, pledging allegiance to one of the main protagonists, the Soviet Union or the US, and supporting them regionally as well as internationally could bring substantial rewards. This seems to be the

[16] See for example Hagen (2006b), Pedersen (2001), and Svensson (2000b).

[17] The main conclusion of the former is that "[t]he marginal propensity to consume [aid] is insignificantly different from one," whereas "[i]n small countries, or countries where the aid/GNP ratio is extremely large (over 15 % of GNP) […] aid does lead to higher investment." (p. 293) Werker et al. (2009, p. 227) find "little measurable effect on growth," as "[a]id substitutes approximately one-for-one for domestic savings and brings little in the way of foreign investment."

[18] Notable studies of aid allocation include Alesina and Dollar (2000), Berthélemy (2006), and Hoeffler and Outram (2011).

main explanation for the drop in total aid in the 1990s (Boschini and Olofsgård 2007). The US has also invested heavily in the peace process in the Middle East over the years.[19] More recently, Afghanistan and Iraq have been major recipients due to the War on Terror. The French support for its former colonies and the Japanese greasing of its relations with various Asian neighbors with whom it has extensive economics ties are relatively stable features of the aid allocation process of DAC donors.

There are arguably cases in which self-interest aid is subject to dynamic inconsistency too. For example, it is hard to deny a strategic ally further aid on the grounds that it has not devoted sufficient resources to the physical and organizational infrastructure that will enable it to fend for itself. One possible explanation why some scholars find that transfers motivated by recipient need produce better results in terms of growth than self-interest aid might be due to the number of applicable recipients. There are many poor countries, and perhaps this limits the extent to which governments can test the patience of "good" donors. On the other hand, there are fewer countries that are truly important geo-strategically and this could give their governments greater leeway to pursue bad policies, as the main requirement for keeping the money flowing is that they provide military and diplomatic cooperation.

A third factor that potentially matters for aid allocation is "merit," i.e., the quality of policies and institutions. The World Bank and the regional development banks all use subjective measures of policies and institutions when allocating their funds. Among the bilaterals, rule-based distribution of aid is less common.[20] Indeed, Dollar and Levin (2006) show that the multilaterals are more selective than the bilaterals. As most theories of growth predict strong effects of policies (Easterly 2005a) and the dominant position in the literature is

[19] According to Alesina and Dollar (2000: 40), "Egypt and Israel receive much more aid than other countries with similar characteristics. Egypt receives 481 per cent more and the value for Israel is basically off the scale."

[20] The Millennium Challenge Corporation of the US is a notable exception as it tries to take the quality of governance into account when determining with which countries to enter into contracts.

that institutions are the main deep determinant of development (Acemoglu et al. 2005), this could explain aid ineffectiveness. Given that the bulk of aid is given bilaterally, it is perhaps not surprising that overall donors do not seem to punish corruption (Alesina and Weder 2002; Svensson 2000a) or make larger transfers to more democratic recipients (Svensson 1999). On the other hand, it has proven difficult to establish empirical support for the intuitive proposition that aid works better when policies are better.[21] In addition, Rajan and Subramanian (2008) fail to detect any differential effect of multilateral aid on growth. This might be due to the fact that the influence of the largest bilaterals, the US in particular, extends into the multilateral institutions. Developing countries voting with the US in the UN Security Council obtaining more and larger IMF loans with less stringent conditionality is but one consequence.[22]

If allocation criteria have changed for the better after the end of the Cold War we might expect greater aid effectiveness now. Dollar and Levin (2006) conclude that both types of donors have become more selective over time, a finding Claessens et al. (2009) confirm for the bilaterals. In contrast, Easterly and Williamson (2011) contest the existence of a trend toward greater selectivity. It is thus not clear whether foreign aid is now better targeted at countries having better policies and institutions more robust to rent seeking.[23] Moreover, most likely the nitty gritty details of aid policy implementation matters too. Thus, we need to look at what aid agencies do.

[21] Burnside and Dollar (2000) (in)famously made this claim. However, their results are extremely fragile, c.f. Roodman (2007). Of course, growth regressions in general lack robustness. It is also difficult to find good measures of policies, so this does not prove that policies do not matter either.

[22] See Dreher and Vreeland (2011), who also nicely summarize the literature on this topic.

[23] Furthermore, bear in mind that there are studies – some of which are reviewed in section 3 - arguing that recipient institutions and policies are changed by donor money. Interpreting interaction effects between aid and some proxy for institutions or policies is a risky business if the latter variables actually are functions of aid.

2.3. Incentives in official aid agencies

Easterly (2002) describes the aid industry as a “cartel of good intentions.” We have just seen that good intentions are hardly a complete description of the motivations of donors. Moreover, as Klein and Harford (2005) note, the history of this industry since the end of World War II is one of a steadily increasing number of players as official donors establish new aid agencies, bilateral as well as multilateral, public-private partnerships are formed, and the number of humanitarian and development NGOs multiplies. They also point out that there have been no exits to dent the competitive pressures created by the continuous entry of agencies. A more fruitful perspective is therefore to view aid agencies as intermediaries located between donors and recipients in the aid chain (Martens 2005). There has been a growing demand for intermediation in the post-war period due to higher incomes (making donors of Southern European countries like Spain and Portugal, the oil-rich economies of the Middle East, and China), the break-up of countries such as the Soviet Union, Czechoslovakia, and Yugoslavia (creating both more donors and more recipients), and decolonization (leading to many more recipient countries).

Adopting this analytical point of departure does not mean that Easterly’s (2002) list of symptoms is not an accurate description of the health of aid agencies, only that the diagnosis is incorrect. The problems identified stem from well-known problems of bureaucracy, which are amplified in the context of foreign aid by expressive behavior and the broken feedback loop. Like other public agencies, aid agencies suffer from having multiple principals, many goals that are not adequately prioritized, and outcomes that are not easily measurable. Organizational theory then prescribes weak incentives, the consequences of which we observe as an excessive focus on inputs or outputs instead of results, an apparent unwillingness to evaluate properly and learn, and the influence of both "fads and fashions" and media coverage on decision-making.[24]

The argument in short is that in an environment wherein a principal (here: the donor country government) wants an agent (e.g. a multilateral aid agency) to pursue one or more goals and the former cannot perfectly monitor the actions of the latter, a problem of attribution arises. If the agent is risk-averse, rewards should be less closely tied to performance the more "noise" there is in the link from effort to (measured) performance. Thus, incentives should be weaker for tasks where outcomes depend to a greater extent on factors beyond the agent's control, or, equivalently, the principal can measure performance less accurately.[25]

Consider the World Bank. It has for a long time expressed its mission in the slogan "a world free of poverty." This goal has recently been concretized as ending extreme poverty, specifically, that the percentage of people living on less than $1.25 a day should be no more than 3 percent globally by 2030 (World Bank 2013). For an aid agency, this target is refreshingly clear. However, the Bank has also adopted a second goal, which is much less precise: promoting "shared prosperity," which is specified as fostering growth in the incomes of the bottom 40 percent of the population in every country. It is obviously more difficult to hold the institution to account for something as vague as "fostering growth," and it has a lot of leeway in choosing how to go about this task. Moreover, countless other factors besides the World Bank's decisions influence whether these two objectives are achieved. Its shareholders are therefore well-advised not to provide too strong incentives for goal attainment.

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[24] See Easterly (2001) on the role of fads and fashions in the aid industry. Eisensee and Stromberg (2007) demonstrate that US international disaster relief depends on whether the incident coincides with other newsworthy events, and that the influence of the media creates biases in the response to different types of disasters and the regions in which they occur.

[25] For applications of principal-agent theory to aid, see the contributions in Martens et al. (2002).

A further complication stems from the fact that the Bank has multiple shareholders, which most likely have conflicting objectives. Rich member countries want this institution to be prudent in its lending decisions so as to preserve its good standing with financial markets, as this will minimize the risk that they will have to put up more money. Sometimes they will want it to make exceptions to the rules for important allies. Poor member countries want cheap loans with few conditions. Furthermore, there are a multitude of other actors that would like to influence the Bank to their advantage - staff, private contractors, and NGOs, for example – even though they formally play no role. In a situation of common agency, the incentives provided by different actors can easily counteract each other, leaving the Bank with a lot of room to do things its way without being sanctioned.

Selecting intrinsically motivated agents could be a remedy against the ills of weak explicit incentives. It could also mean more cost effective aid as overall levels of remuneration can be lower when staff shares the goals they are contracted to attain. Casual empiricism suggests there are many such individuals in aid agencies. However, by the standard Olsonian argument, anyone genuinely supporting the goals of a particular aid agency has an incentive to be a free-rider (Francois 2000, 2003). It would be better to work in the private sector, receiving the complete package of monetary incentives your qualifications and experience warrant, and let others do the good deed of working for lower pay in an aid agency. Thus, even if the casual empiricism accurately reflects realities, it is more likely to be a sign of aid agency staff being characterized by expressive behavior. Once again, this matters as they are then not motivated to produce results for the beneficiaries, only to be themselves "doing something about it."

One thing aid agencies can do to be perceived as "doing something," is to spend their budgets. As is the case for other bureaucratic organizations, underspending often appears to be interpreted by political principals as an indication that there is a dearth of programs and projects worth funding. The standard reaction seems to be budget cuts, which are a serious threat to any ambitious bureaucratic czar. With no institutionalized mechanism connecting the two ends of the aid chain, he or she is under no pressure to demonstrate results either on home ground or foreign soil and has few tools with which to incentivize staff. An exhausted budget does at least keep immediate superiors happy and is often useful when lobbying for further allocations that will boost his power and prestige among his peers.

Given this situation, it is no wonder that critics have been searching for alternatives. One alternative that has had vocal advocates in recent decades is using NGOs. Due to their small size and charitable missions, these private aid agencies are said to be nimbler, more motivated to work in "difficult environments," and closer to the poor than the official mastodons. Is there any truth to these bold claims?

2.4. NGOs in donor countries

NGOs are sometimes said to belong to the "third sector," with the market and the public sector being the other two. As a residual entity, it is very heterogeneous, including foundations, trade unions and other large membership organizations as well as charitable agencies run by a single individual. The tasks they engage in also vary enormously, from local social work to international advocacy. One common denominator has already been mentioned: these organizations do not have any owners in the sense of residual claimants, as they are supposed to be not-for-profit.[26] This raises serious accountability issues, especially for organizations that do not have members either, which are rarely counteracted by regulation by peers or governments. The combination of weak governance and regulation with

[26] Thus, non-profits is another term commonly used for these organizations. A third is voluntary private organization. Each of these captures some, but not all, of the five characteristics that are used by the Comparative Nonprofit Sector Project at Johns Hopkins University: a third sector entity is a self-governing, voluntary, and private organization not distributing profits (Salamon et al. 2004). For simplicity, I mostly use the term NGOs.

tax exempt status in many countries (e.g. the US) could tempt entrepreneurs to establish NGOs to profit from overgenerous pay and fringe benefits instead of dividends.

Some researchers argue that NGOs have a competitive advantage over for-profit firms when some aspect of a transaction such as quality is not contractible.[27] Ex post, a not-for-profit entrepreneur has a weaker incentive to shirk on quality as remuneration in kind is less valuable than cash, increasing the price consumers are willing to pay ex ante. In addition, it is sometimes supposed that, if individuals support the mission of a charity, they are willing to work for a wage below their opportunity cost. However, the first argument presupposes that the non-distribution constraint binds to some extent and that consumers know it. Given the generally weak external oversight and numerous examples of fraudulent behavior this might be questionable. Moreover, even though it is in fact true that many individuals volunteer considerable amounts of time to NGOs, echoing the argument made for the staff of official agencies, anyone intrinsically motivated by the mission of an NGO has an incentive to free-ride. Thus, warm-glow utility from expressing a particular image of yourself by volunteering or working for a charitable organization is likely to be a more important motivating factor for staff members than pure altruism. In sum, neither "only individuals intrinsically motivated by altruism work in this sector" nor "NGO entrepreneurs are constrained from acting opportunistically by the organizational form" can be assumed without caveats.

In the market, competition usually has positive effects like spurring firms to become more efficient and innovative. The salutary facts are not as obvious in the case of NGOs. Their revenues from user fees or commercial activities usually constitute a minor share of the total. This tends to make them more attentive to the demands of their financiers than to their users. Emotionally charged advertising seems to play an important role in the market for private donations to NGOs in the aid industry, with pictures of poor children or victims of

[27] See for example Glaeser and Shleifer (2001) and Hansmann (1980).

wars and natural disasters featuring prominently in their mass-marketing. As is well-known, advertising is a waste of resources to the extent that it merely shifts revenues from one identical actor to another, as opposed to enlarging the market or benefitting more efficient actors disproportionally. While advertising probably raises total donations to some extent, there is little reason to believe that it leads to a reallocation of resources from bad to good NGOs if expressive giving is the dominant driver of contributions. Moreover, Nunnenkamp et al. (2013) show that even though public financiers perform some screening based on administrative overheads - in contrast to private donors - the effect of such costs on the probability of a development NGO exiting the market vanishes when the share of official funding becomes too high. Apparently, beyond some point the positive financial impact on survival cancels out the negative impact of stricter monitoring and evaluation, rendering public funding an imperfect screening mechanism in terms of NGO efficiency.

While donor country NGOs often advocate for larger aid budgets, this is unlikely to be a major activity for the operational ones, as more money in total is a collective good for all NGOs engaged in development work. Lobbying for public funds for their projects and programs and participating in contests for activities designed by official agencies are thus presumably much more important. According to Werker and Ahmed (2008), about half of open USAID contracts are awarded to private companies, mostly in infrastructure projects, whereas NGOs tend to obtain contracts in the social sectors, where quality is arguably less easily observable. Similarly, Huysentruyt (2011) finds that the two organizational types rarely compete head-to-head for tenders put out by the UK's Department for International Development (DFID). Moreover, the personnel costs stipulated in bids by non-profits were 60% below those of for-profits.

These findings are consistent with the view that NGOs pursue missions providing intrinsic motivation to their staff and/or are constrained from behaving opportunistically by their non-profit status. As is well-known, official donor agencies seem to have subscribed to this view as they have channeled more and more aid dollars through these agents (see e.g. Figure 1 in Werker and Ahmed 2008). A further impetus to subcontracting aid activities to NGOs has come from the supposition that they are less bureaucratic and more attuned to local needs in recipient countries than bilateral agencies. In addition, since they are private agencies, donor country governments have found them useful in cases where they for various reasons prefer avoiding their own counterparts in recipient countries.

Data on the role played by NGOs in development assistance is rather limited. This not only applies to their own funds, but also to the amount of official aid they receive, be it for programs and projects of their own design or as subcontractors. However, the studies that do exist provide little indication that they go where official agencies cannot or will not go. Based on a survey of large international NGOs that do not have an exclusively humanitarian orientation, Koch et al. (2009) conclude that they replicate the location pattern of their official patrons and, moreover, tend to cluster geographically. Econometric analyses of more detailed data from Germany (Nunnenkamp and Öhler 2011), Sweden (Dreher et al. 2010), and Switzerland (Nunnenkamp et al. 2009) confirm this picture of congruence in cross-country allocations for NGOs and official agencies, and reluctance on the part of the former to engage in "difficult environments." Furthermore, the more dependent German and Swiss NGOs are on public co-financing, the stronger these tendencies are (Dreher et al. 2012a; Dreher et al. 2012b). Hence, there is little basis for viewing development NGOs as a distinct type of aid agency.[28]

Official donors seem to have taken this point. They are increasingly demanding that Northern NGOs have Southern partners in their projects. They have also tried to "build" civil

[28] The only minor exception is that poverty measures seem to be more important than GDP per capita in explaining NGO allocations. Furthermore, the authors of the studies cited caution that they cannot test whether NGOs are better at targeting poor and vulnerable groups within recipient countries.

society in recipient countries by supporting local NGOs directly. As we will see in the next section, these efforts have been successful in raising the number of such organizations. It is rather more doubtful whether they have managed to lay the foundations for third sectors that are rooted in the concerns of important domestic groups and financially sustainable once the impetus from foreign aid goes away.

3. Recipient countries

3.1. Aid as a sovereign rent

Aid can be viewed as a sovereign rent (Collier 2006). This is apt whether it is received for altruistic or strategic reasons; there is some feature of the recipient state that makes it attractive to the donor. This could be poverty, natural resources, cultural ties, a strategic geographical location, or a crucial vote in an international body. Some of these assets, such as being a former colony of France, are durable and thus could generate a near-permanent flow. Other rent-producing assets are non-durable, of known (being a non-permanent member of the UN Security Council) or unknown duration (being eligible for IDA funding).

In the same way as a natural resource has to be extracted to enjoy the rent today and the size of the rent fluctuates with world market prices, aid rents vary with external circumstances and require some kind of action on the part of the recipient government. Mali is a French colony, but it competes for French aid with other ex-colonies of France, and how much is at stake depends on the French view of the importance of such transfers for its overall foreign policy. As we have seen, some sovereign rent-producing assets (e.g. poverty and good governance) are manipulable, inducing inflows in an indirect manner. The point I want to make now is that maybe recipient diplomacy is an underrated part of the aid relationship.

Economic diplomacy could be viewed as international lobbying. Moreover, it consumes resources and is thus a close analogue to standard rent seeking. Consider the example of former President Kikwete of Tanzania (Kamata 2012, p. 298):

The general disquiet is that the president travels a lot and spends little time at home. Related to this is the money spent on these trips, which many among the public consider to be a misuse of meagre public resources. […] President Kikwete had spent about 120 days and TShs 2.4 billion (about US$ 2 million) on trips abroad between December 2005 and May 2010. Besides the President, other state functionaries, such as ministers, travel abroad for the same reasons.

This story fits with what I heard on the radio in Dar es Salaam one autumn morning in 1999. The news anchor announced that Kikwete's predecessor, Benjamin Mkapa, had gone on a tour of Europe and the US to prospect for more investment and aid. He also listed the names of the most important individuals accompanying Mkapa. According to my breakfast table companion, this was all the best and brightest permanent secretaries, those who held foreign degrees. My first thought was that this was crazy. Why were they not at home figuring out the best policies for their country to develop? Over the years, I have come to think that even though there might be long-run costs in terms of poor policies, it is perhaps in Tanzania's short run interests to maximize the foreign resource flow by having the few who in more than one way speak the donors' language travel abroad to lobby. Financial flows are more easily harvested than the returns to long-term investments at home. Unfortunately, this probably makes aid a distraction from the search for prosperity, which ultimately must start at home.

Obviously, not all types of aid are equally attractive to recipients. For example, aid tied to purchases of goods and services from the donor country is less easily appropriated by agents in the recipient country. Similarly, aid earmarked for specific projects, programs, and sectors is in general less valuable than transfers that are not "tagged" in this way, such as general budget support. However, even targeted aid could be fungible. The recipient could reduce its own allocation for that purpose and spend those funds on something else. Hence, the fungible portion of the aid flow may be subject to rent seeking in much the same way as general transfers and other types of public revenues. Determining the degree of fungibility is not straightforward as it depends on the characteristics of the donor, the recipient, and the activity, and is in essence a counter-factual exercise.[29] Still, it cautions us against both formalistic distinctions between aid types as well as assertions that any aid dollar is up for grabs, which seems to be the most popular assumption in the literature to which we turn now.

3.2. Corruption, rent seeking, and policy rents

The basic idea of most papers on aid and rent seeking is that the direct positive effect of aid, often taken to be a higher level of some productive public good in the recipient country, is counteracted by a negative indirect effect due to resources being used by individuals or groups to try to appropriate a share of the transfer for their own private benefit.[30] Whether GDP (growth) is larger with aid than without is thus not clear a priori. Further complicating the picture is the fact aid may lead to a reduction in taxation, raising the opportunity cost of rent seeking. The result is a highly non-linear relationship, which cannot in general be

29 See the theoretical analysis and discussion in Hagen (2006a). Feyzioglu et al. (1998) find that the degree of fungibility varies across sectors.

30 See e.g. Hodler (2007) and Economides, Kalyvitis, and Philippopoulos (2008). Most authors assume use some form of the classic contest function introduced by Tullock (1980) applies. There is a small literature surveyed by Mayer and Mourmouras (2008) where the focus is on effects of grants and loans from international financial institutions when vested interests play a major role in recipients. While the approach is useful in many ways, its strong assumptions - that interest groups cannot appropriate any part of the transfer from the multilateral and that the latter can buy reforms - put it beyond the scope of this chapter.

expected to be monotonic. Thus, what these models suggest is the possibility of aid having negative effects over some range, most plausibly at high levels, and that the probability of such a perverse outcome is higher where institutions are weak.

While many types of rent seeking such as lobbying for favorable policies or government contracts are hard to measure, proxies for corruption exist.[31] Svensson (2000a) argues that presumably rent seekers equalise the marginal costs and benefits of different forms of appropriation. If so, the effect of aid on corruption would at least qualitatively inform us about its relationship with rent seeking in general. Whether that is true or not, the topic is of independent interest. Both anecdotes of dictators stuffing bank accounts in tax havens with aid funds and more systematic case studies demonstrating how very large sums are diverted from aid-financed programs indicate that corrupt behavior might be a serious obstacle to aid effectiveness.[32] However, econometric studies paint an ambiguous picture. Whereas Alesina and Weder (2002) tentatively conclude that aid leads to more corruption, Tavares (2003) finds that in his cross-section it is the other way around. The answer of Svensson (2000a) to the question of whether aid corrupts is "it depends," as in his data the relationship is positive (negative) above (below) a critical value of ethnic fractionalization. The conflicting results do not seem to be due to a failure to control for the possibility of reverse causality; as already noted, neither Alesina and Weder (2002) nor Svensson (2000a) detect any tendency for donors to give less to more corrupt regimes.

Both the theoretical literature on aid and rent seeking and empirical studies of aid and corruption are short on specifics when it comes to these appropriative activities. One might

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[31] A bribe is a transfer, which, viewed in isolation, does not entail social costs. Still, because these transactions are illicit, it is reasonable to argue that resources are wasted in structuring, concealing, and enforcing them, as well as in contesting the positions to which the bribes accrue.

[32] For example, Reinikka and Svensson (2004) uncovered that only 13% of a donor-financed grant per student reached primary schools in Uganda in the 1990s. The median was zero.

argue that measures of policy rents could also be used as proxies for rent seeking, but I do not find this argument persuasive. Rent seeking is only one possible source of inefficient policies. Governments also distort policies because of ideology or for patronage. Moreover, foreign aid could induce policy reforms if properly chosen conditionalities are enforced, but also delay them by soothing the aggregate consequences of distortions.[33] In fact, the mere expectation that donors differentially reward some policies might make governments choose inappropriate policies (Hagen 2013). Empirical studies seem to bear out the "prediction" that the effects of aid on policies are quite heterogeneous.[34]

To the layman this may seem surprising. Demanding policy changes and institutional reforms in exchange for aid have been one of the most controversial aspects of aid in recent decades. In the popular discourse, it is often portrayed as mighty donors (usually the IMF and the World Bank) arm-twisting poor country governments into doing things they would rather not do. Frequently the charge has been that recipients are forced to accept a standard package from the aid industry (the so-called Washington Consensus). However, the empirical literature demonstrates that the relationship is not quite as lopsided as the most ardent critics would have it.[35] Compliance is rarely 100%. One reason is that there are no institutions for enforcing aid contracts. If they are to be abided by, they must thus be self-enforcing. However, as argued above, aid agencies are under pressure to move money. Halting the flow is unlikely to be a desirable option in the absence of major corruption scandals or a breakdown of diplomatic relations. Threats of doing so are therefore likely to be dynamically inconsistent.

[33] See e.g. Rodrik (1989) and Casella and Eichengreen (1996).

[34] For example, Heckelman and Knack (2008) find that aid slows market-oriented reforms reform in some areas, but not in others; in sub-Saharan Africa, but not in other regions; and that the effect is much stronger in the 1980s than in the 1990s. Drazen and Easterly (2001) show that whether crises induce reforms depend on the policy instrument, as donors respond positively to extreme values of some policies and negatively to others.

[35] See e.g. Dollar and Svensson (1998), Easterly (2005b), and Ivanova et al. (2003) for econometric evidence.

Moreover, recipients have many ways in which to counteract the intentions behind the conditions even when they nominally comply. They have long since learned to take advantage of this situation, prompting conclusions like

All of the case studies agree that economic policy is primarily driven by domestic politics, not by outside agents. [...] In the pre-reform phase in which the government is not committed to reform, conditional loans have generally been a farce in which the government agrees to measures it does not believe in as a way to get funding, fail to carry them out, and then receives the funding from donors anyway. (Devarajan et al. 2001, pp. 34-35)

Even though there has been a move from conditionality to selectivity at the rhetorical level, the former has not completely vanished and the latter has thus yet to become the industry standard. Hence, understanding aid (in)effectiveness still requires us to study the political economy of aid within recipients. While the concept of rent seeking often conjures up images of firms lobbying or bribing public officials to obtain favors, in the current context there are also plenty of examples of aid having turned the non-profit sector in recipient countries into an arena for personal gain.

3.3. Rent seeking entrepreneurs in the NGO sector

As noted in relation to donor country NGOs, non-profits are a very heterogeneous group. It is thus not surprising that the NGO landscape also varies a lot across countries. Some of the largest NGOs in the world originate in developing countries, e.g. BRAC from Bangladesh, home of microfinance. There is also a long tradition in many countries of collective action at the local level, for example in the form of mutual aid or joint management of village commons. However, while data limitations limit the conclusions that can be drawn, there is evidence suggesting that in many countries receiving aid the outside money has had a significant impact on the number and types of formal not-for-profit organizations. More specifically, there has been a significant increase in the number of NGOs, many of which are only nominally not-for-profit. In the words of Chabal and Daloz (1999, p. 23):

The use of NGO resources can today serve the strategic interests of the classical entrepreneurial Big Man just as well as state coffers did in the past. Leaving aside those cases where NGOs are used purely for commercial purposes, it is as well to recognize now that there is today an international 'aid market' which Africans know how to play with great skill. Indeed, there is very little doubt that NGOs spend an excessive proportion of their budget on furnishing their members with sophisticated and expensive equipment (from computers to four-wheel-drive vehicles), leaving too little for the development projects which justify the work of the NGO in the first place.

Similar observations have fostered disparaging characterizations such as "personal" or "briefcase" NGO, i.e., organizations established for personal gain and/or having little activity beyond producing mission statements and funding proposals. One country where we do have insights into such behaviors is Uganda. Religious welfare organizations have a long tradition there, and are important players in the health sector. However, these are not defined as NGOs by Ugandan law. This means that the set of NGOs in the legal sense is particularly well-suited to studying the effects of foreign aid. A survey sponsored by the World Bank a decade ago provides detailed information on them that reveal interesting patterns.[36]

[36] The effort has resulted in a number of papers on which I draw in the following: Barr and Fafchamps (2006), Barr et al. (2005), Fafchamps and Owens (2009), and Burger and Owens (2010).

Many Ugandan NGOs appear to exist mainly on paper. In the capital, Kampala, the surveyors were only able track down 25 per cent of registered organizations, in the countryside less than 50 per cent. 93 per cent of the organizations investigated claimed to have financial accounts, but only 199 out of 295 could produce statements of revenues and expenditures. Of these, only 62 had revenues approximately equal to expenditures, as a non-profit should. Part of the reason could be that three large organizations accounted for half of total revenues and three-fourths of manpower (including volunteers). This gives the impression of a sector populated by a few successful organizations and a tail of smaller ones established in the hope of benefitting from the influx of foreign money, but ultimately failing in their endeavor. The fact that at the time of the survey there were nine times as many registered NGOs as private firms in Uganda only serves to reinforce this impression.

When it comes to funding, in 2001 the average organization received almost 50 per cent of its funds from foreign aid agencies (including international NGOs), whereas the weighted sectoral average was 80 per cent. This is a common pattern in many recipient countries as donors operate according to the Peter Principle; to those who have shall be given. Concentrating funding on organizations that have already proven themselves of course saves on screening and monitoring costs, but also serves as an entry barrier. This is consistent with the large number of inactive organizations.

97 per cent of the organizations report that they were involved in "raising awareness," the majority of them with respect to HIV/AIDS. 60 per cent claim to be involved in "advocacy and lobbying." Most organizations do not define themselves as suppliers of a specific service, preferring instead to define themselves in terms of target groups or a vague general activity such as "community development." The researchers dryly note that this flexibility with respect to activity might be an advantage in terms of attracting funding, but is probably not to conducive to achieving gains from specialization. Somewhat surprisingly,

client-community assessments were still rather high in general. However, as was noted for donor country NGOs, the Ugandan organizations tend to cluster, resulting in some duplication of effort, and do not seem to reach the poorest segments of society.

In sum, foreign aid has had a significant impact on the size and composition of the NGO sector in Uganda. One potential downside is that the inflow of financing might have drained the private sector of entrepreneurial talent. Such talent is in short supply in any country and they could be of particular importance for countries at low income levels, which need to ignite a growth process.

The theoretical model of Aldashev et al. (2014) illuminates another problem compounding the first. The non-distribution constraint precludes NGOs from having owners rewarded by profits. But even assuming that it holds – a big “if” in many developing countries where regulation of the charitable sector is both underdeveloped and weakly enforced – it does not by itself stop insiders from benefitting themselves through overly generous wages, plentiful perks, or lavish offices. A windfall of foreign aid could then not only attract entrepreneurs wishing to spend this windfall on additional services to the population, but also opportunists wanting to maximize their consumption. Thus, as the sector grows, the motivational composition deteriorates too over some range as long as monitoring stays imperfect.[37] This naturally has adverse consequences for the level of sectorial output.

A third problem with having a donor-driven NGO sector is that donor preferences have often proved to be fickle. One year education might be in vogue, the next community development. As seen in the Ugandan case, this tends to favor organizations that are adept at adapting to donor demands, not necessarily those that are good at delivering services in a

[37] Moreover, donors to a large extent started using NGOs because they were dissatisfied with government bureaucracies. The resulting downsizing has probably provided an opportunity for some of the former bureaucrats to become NGO entrepreneurs, a fact that the model of Aldashev et al. (2014) does not address. Individuals do not change motivation when changing sectors, so, if they were corrupt in public service, they are likely to be less than honest in the NGO sector too (though they might face different constraints on behavior).

particular field. At the very least, they are precluded from accumulating gains from specialization and learning-by-doing. Since donors seems to be doing most of the monitoring, the fact that aid agencies often are at least as concerned with spending their budget as they are with outputs or outcomes most likely reinforces this behavior.

A final problem is that when, donors call the shots, it is their priorities, which do not necessarily coincide with those of the recipient country population, that are decisive. An extreme example of this is how donor funding for HIV/AIDS has come to dominate the NGO scene in Malawi (Morfit 2011). This disease is a serious problem in Malawi, but it is certainly not the only problem this poor, aid-dependent society has. In countries like Uganda and Malawi, the label "civil society" hardly seems appropriate for the NGO sector as its activities are directed by foreigners. This naturally brings us to the issue of the relationship between the domestic institutions of aid recipients and foreign aid more generally.

3.4. Aid and the quality of governance in recipients

The empirical literature on the effects of aid on growth is quite sparse when it comes to the issue of whether effects are contingent on the quality of recipient countries' institutions. From a theoretical point of view one would expect such an interaction effect, e.g., because of lower corruption. This is what the model of aid and rent seeking by Hodler (2007) implies, for example.[38] In addition, the equivalent interaction variable is in general found to be significant with respect to the economic performance of resource-rich countries.

Rajan and Subramanian (2007) do find that aid reduces the relative growth rates of governance-sensitive industries in recipient countries. Moreover, Svensson (1999) shows that

[38] In Dalgaard and Olsson (2008), the opposite actually applies when the efforts of the government in protecting the rent is less effective than the efforts of rent-seekers. However, they stress that they consider this a special case. In Economides et al. (2008) and Svensson (2000a), aid is a common property resource, i.e., rent-seekers have access to the total transfer made to the recipient government.

aid has a positive impact on growth in democracies only. He argues that this is due to institutionalized checks and balances preventing democratic governments from channeling funds to non-productive uses. But even if rent seeking is likely to thrive when governance is poor, one cannot simply assume that it is perfectly (negatively) correlated with institutional quality. Bräutigam and Knack (2004), Busse and Gröning (2009), Economides et al. (2008), and Knack (2001) all investigate the effect of aid on a composite index created by summing indices on bureaucratic quality, corruption, and rule of law, finding that it is negative. Still, when Knack (2001) looks at the sub-indices separately, he discovers that in contrast to the other two indicators corruption is not significantly related to aid.[39]

These results suggest that there is more going on than easy money inducing corrupt behavior or creating policy rents in the context of weak institutions. Aid may change the quality of governance in recipient countries. This is in fact the purpose of so-called technical assistance. However, while this heavily criticized form of aid has rarely been successful in raising institutional quality in recipient countries, it seems unlikely that it has been responsible for lowering it. A prime candidate for being the cause of such an effect is the transactions costs of aid. As is well-known, the average aid recipient has to relate to a double-digit number of official aid agencies and perhaps hundreds of foreign NGOs (World Bank 2008). In combination, these are responsible for a very large number of aid activities, which are usually uncoordinated. In addition, extensive monitoring, reporting, and accounting activities accompany aid projects and programs.

The result is that donors often overburden the recipient bureaucracy with uncoordinated requests for meetings, demands for inputs into project planning, and onerous reporting requirements. They might also lure the best bureaucrats into their own country

[39] There also seems to be some heterogeneity across time as Askarov and Doucouliagos (2013) conclude that aid had a positive effect on governance during the Cold War, but no effect in recent years.

offices and project organizations by paying well in excess of civil service pay scales in recipient countries.[40] Even those who stay have their attention diverted by aid activities, as they can collect per diem by attending donor-funded meetings and workshops (see e.g. Smith 2003). Furthermore, donors sometimes circumvent planning processes and oversight mechanisms by cooperating directly with spending ministries and regional authorities instead of coordinating bodies such as ministries of finance or planning. Naturally, these 'transaction costs' are increasing in the number of donors as well as the number of activities they fund. In fact, Djankov et al. (2009) demonstrate that donor fragmentation significantly reduces the growth-impact of aid. And while there seems to be some improvement in donor practices in the wake of the Paris Declaration, these problems persist.

The quality of governance matters for economic development as it is a determinant of both the level and efficiency of investment. In a broader perspective, the effects of aid on political institutions have been the subject of a long-standing controversy. Djankov et al. (2008) find that aid is worse than oil in the sense of having a stronger negative impact on the level of democracy, thus furnishing critics with econometric support. On the other hand, the meta-study of Askarov and Doucouliagos (2013) suggests a more cautionary conclusion. While the overall effects are non-positive, aid seems to have fostered democracy in European transition countries. In addition, Kersting and Kilby (2014) argue that foreign transfers can influence the political regime of the recipient country in diverse ways, so careful attention to timing is necessary to tease out the total impact. They conclude that aid works as a positive incentive to democratization, a finding that is supported by the work of Brück and Xu (2012).

A detrimental effect of aid is consistent with the theoretical model of Acemoglu et al. (2004), showing how a kleptocrat can stay in power by skillfully buying off any take-over

[40] Knack and Rahman (2007) present a theoretical model of donor poaching of recipient government staff and find that the data is consistent with this story in the sense that aid undermines bureaucratic quality more, the more donors there are.

threats by the opposition using resource rents or aid. However, additional resources are likely to benefit any incumbent leader regardless of regime, at least to the extent that the strings attached are loose. A more general problem transcending the issue of the political regime is therefore that aid makes governments accountable to donors instead of citizens.[41] Of course, if NGOs are captive subcontractors for foreign aid agencies, this accountability problem is aggravated. It is also likely to make it more attractive to be in control over the aid rents that pass through the government.

3.5. Contesting the positions controlling aid appropriation

Violence could be considered the most extreme form of rent seeking. In this case, the rent is the resources that can be commanded by capturing the state. The struggle for power is often modelled in terms of the probability of winning using some form of the Tullock contest function, sometimes adjusted with a parameter quantifying the advantage an incumbent has by commanding the repressive apparatus of the state. In such a setting, aid has several possible effects. First of all, it raises the size of the prize, which should lead to more intense competition for power. Secondly, aid channeled through the government could increase any incumbency advantage by allowing for higher military spending. In fact, as aid is fungible, even funds for projects outside the public sector could allow the incumbent to spend more to fight or repress the opposition.[42] Thirdly, if aid fosters growth, thereby raising incomes, the opportunity cost of fighting is increased. As argued in the introduction, the evidence for a growth effect of aid is not very strong. The latter channel can hence probably safely be ignored. We are then left with two effects that counteract one other: aid makes it more

[41] The classic reference is Moore (1998). Eubank (2012) uses the case of Somaliland, which is not internationally recognized and thus receives no aid, to demonstrate how the need for tax revenues can force unrepresentative governments into concessions in the form of more accountable political institutions.

[42] Collier and Hoeffler (2007) do indeed find that development aid is fungible into military spending.

attractive to be the sovereign, but also facilitates holding on to power through repression. Which of these prevail is an empirical question.[43]

De Ree and Nillesen (2009) find no significant effect of aid on the onset of civil conflicts in Sub-Saharan Africa, the most aid-dependent region, but a negative effect on their duration. Similarly, in the data set of Nielsen et al. (2011), negative aid shocks increase the probability of conflict. In contrast, Nunn and Qian (2012) find that US food aid raises the likelihood as well as duration of civil conflict. This is consistent with the model of Blouin and Pallage (2008). They show that when there is no clear incumbent or rebels control parts of the territory of a state, warring factions can finance their expenditures for arms and soldiers by "taxing" humanitarian aid organizations.

This further suggests that the geographical distribution of aid within a recipient country matters, as argued by Findley et al. (2011). Investigating Angola, Mozambique, and Sierra Leone, they find that aid activities attract conflict. Another mechanism is uncovered by Crost et al. (2014). They study a large scale intervention in the Philippines financed by the World Bank. Municipalities that were just eligible experienced an increase in conflict as rebels apparently wanted to prevent the program from being successful, fearing this would undermine their support in the population.

Of course, these results do not imply that aid does not lead to social waste when conflicts are quelled and prevented through large-scale expenditures on repression.[44] Moreover, even in countries not prone to (open) violent conflict, foreign transfers could allow rulers to stay in power longer. As I just argued, dictators might use such funds to finance "divide-and-rule" strategies, but democratic incumbents can also enhance their election

[43] As pointed out by Mehlum and Moene (2006), the issue is actually slightly more complex, for a larger incumbency advantage makes the prize more secure and thus more tempting. This could intensify the fighting.

[44] For an analysis of the effects of aid in a model with three possible states – peace, repression, and civil war – see Besley and Persson (2011).

probabilities with the help of plentiful patronage spending coming directly or indirectly from fungible aid. Indeed, Kono and Montinola (2009) find that aid helps both autocratic and democratic leaders survive, albeit in slightly different ways.

In turn, as even altruistic donors have an interest in who is allocating their funds in recipient countries, it is unsurprising to find that leadership effects impinge on donor strategies. As shown by Faye and Niehaus (2012), donors give significantly more (less) in election years to more (less) closely aligned governments. US governments of different ideological stripes are also more inclined to fund generously recipient counterparts of similar persuasions (Lskavyan 2014). It seems safe to conclude that the political economies of donors and recipients are inextricably intertwined.

4. Conclusion

Aid is a sovereign rent much like natural resource rents. As rent seeking is often blamed for the sub-par economic performance of resource rich countries, it is natural to check whether such unproductive activities can explain why foreign aid on average seems to have little impact on economic development. Theoretically, the comparative statics result is clear: more aid leads to more rent seeking. In recipient countries where governance is poor, this response can be strong enough to outweigh the direct positive effects of the transfer.

Empirically, the picture is less clear. For the two main forms of domestic rent seeking for which we have data, corruption and armed conflict, the jury is still out on the question of whether aid fosters them. This could be due to poor data, but also due to aid being endogenous. However, while some donor organizations condition their transfers on the quality of governance and policies, we have seen that it is not clear whether there is a trend towards greater selectivity on these grounds and the studies of corruption and conflict reviewed here do try to address the endogeneity issue. Moreover, there are other ways in which foreign assistance could have negative effects on economic performance, e.g., Dutch Disease, large transaction costs, and the entrenchment of unaccountable elites. The keyword seems to be heterogeneity, and we need more finely calibrated empirical studies that can pick up variations in aid effects across space and time.

This does not mean that the concept of rent seeking is not relevant to the topic of foreign aid. In a more general sense, there are numerous indications that plentiful aid distracts recipients' attention away from more important sources of progress. Furthermore, I see a number of ways in which more research can further our understanding. First of all, not all aid is equally susceptible to appropriation, but this has so far received scant attention in the literature. Secondly, the main qualification to the analogy between aid and resource rents is that the size and durability of the sovereign rent is to a much larger extent under the control of other agents in the former case. Analyzing dynamic models in which donors have a mix of altruistic and selfish interests, generating a mix of durable and transient rents, are likely to further our insights on aid impact.[45] Thirdly, in the literature on the Samaritan's Dilemma, recipients manipulate some variable of interest to the donor in order to receive more aid. However, anecdotal evidence suggests that aid-seeking also occurs directly through economic diplomacy. This close cousin of standard rent seeking has to my knowledge not been explored formally. Finally, international aid-seeking and domestic rent seeking could be combined in a hierarchical game.[46] A greater understanding of larger parts of the aid chain might allow for changes that make such transfers more immune to rent seeking at all levels. Unfortunately, given the fact that the ends of the chain are unconnected and that the starting point is donor-

[45] A natural starting point for such inquiries would be the general analysis of rents of different and uncertain durabilities by Aidt and Hillman (2008).

[46] Van Long (2013), reprinted in this volume, presents an excellent review of rent-seeking contests in general, including hierarchical ones.

taxpayers with expressive behavior, there is little reason to expect major improvements in overall aid effectiveness.

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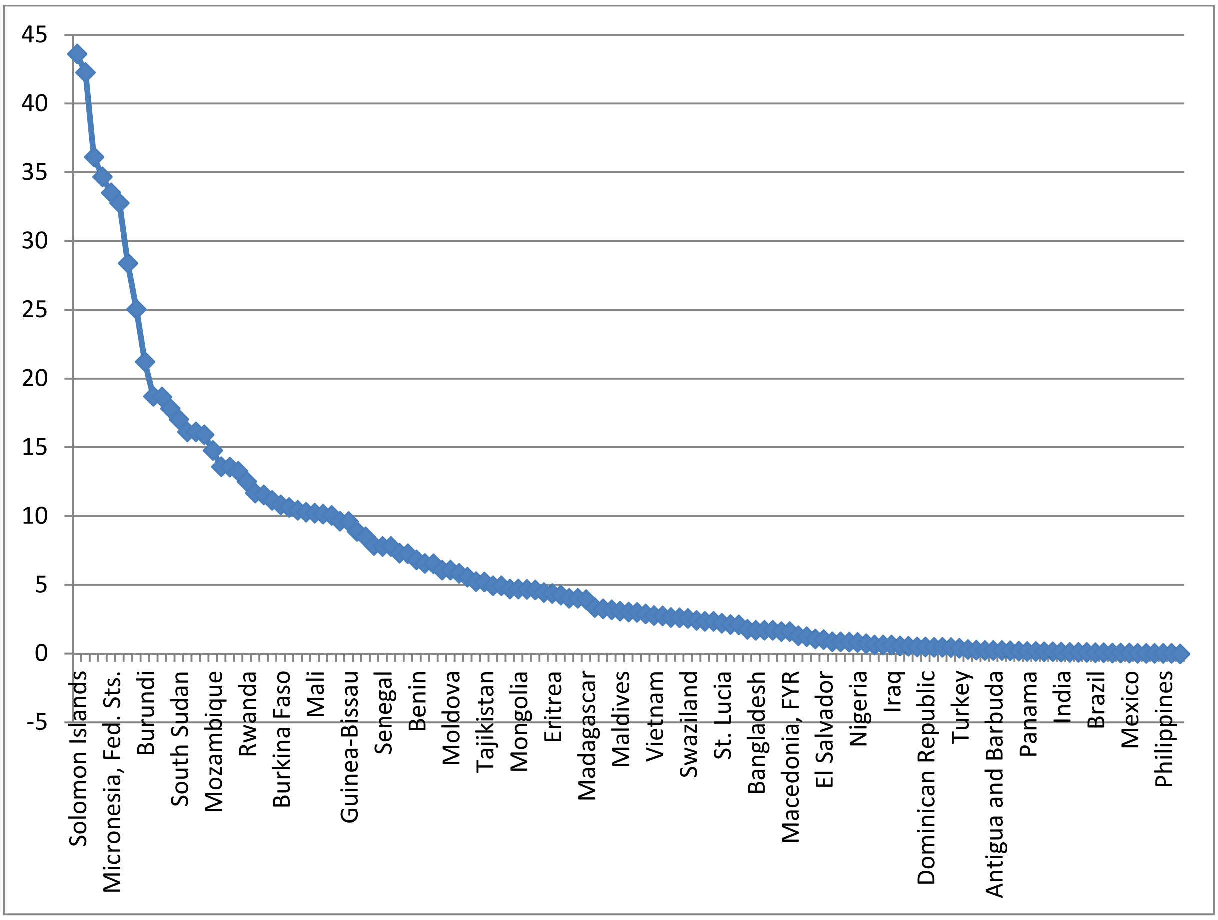
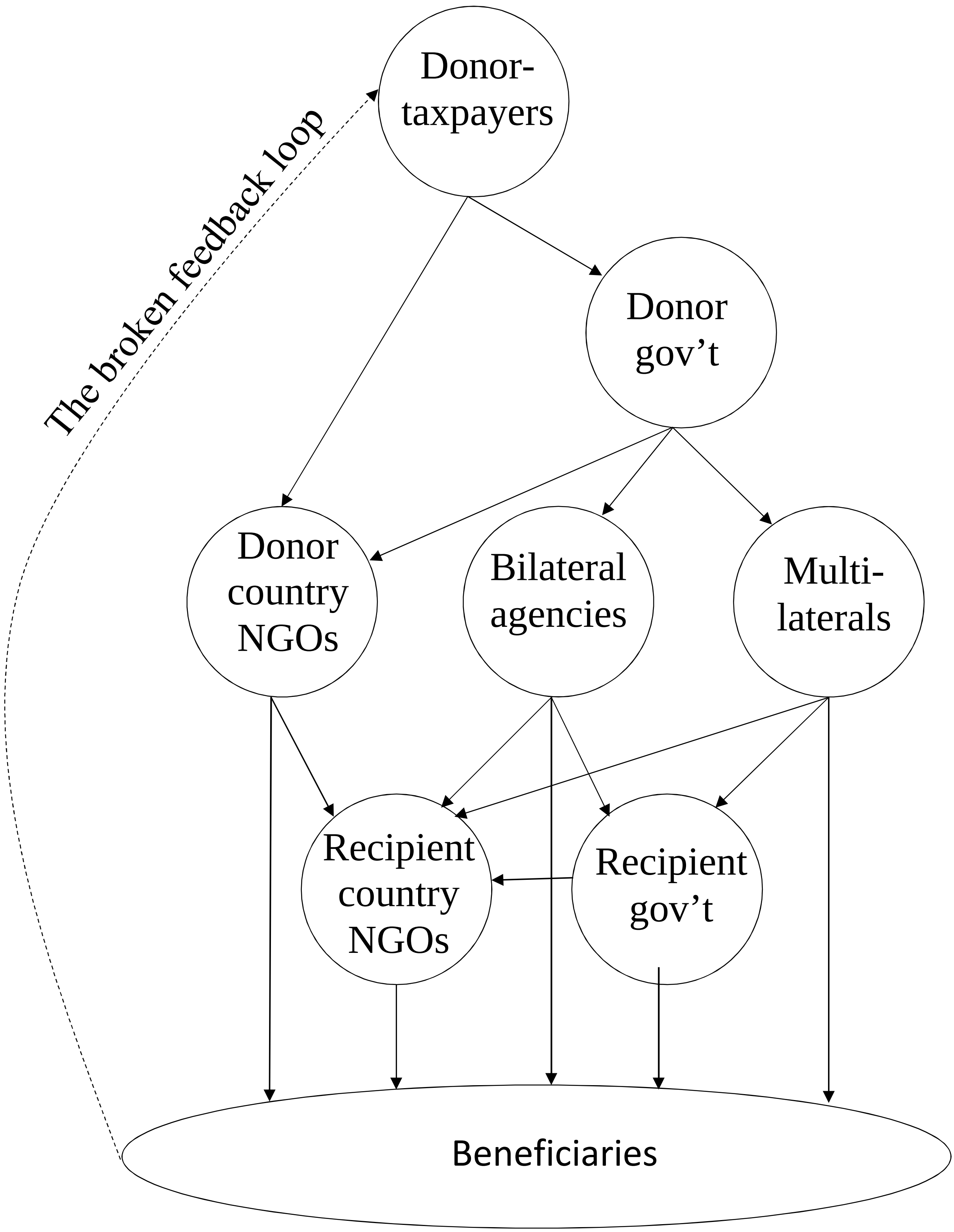
Table 1: Top Ten Recipients of Net Official Development Assistance (ODA), 2012

Country	ODA/GNI (%)	Country	ODA per capita (current USD)
Solomon Islands	43.6	Tuvalu	2484
Tuvalu	42.3	Marshall Islands	1446
Liberia	36.1	Micronesia, Fed. Sts.	1113
Marshall Islands	34.7	Tonga	746
Micronesia, Fed. Sts.	33.5	Palau	723
Afghanistan	32.8	Kiribati	642
Malawi	28.4	Samoa	639
Kiribati	25.0	Solomon Islands	555
Burundi	21.2	Cabo Verde	498
Sao Tome and Principe	18.7	West Bank and Gaza	495
Memo		Memo	
Low income	8.0	Low income	49
Least developed	6.2	Least developed	49
Middle income	0.2	Middle income	11

Figure 1: Countries ranked by ODA/GNI ratio, 2012

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