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Editorial

Aid Policy and the Macroeconomic Management of Aid

TONY ADDISON
UNU-WIDER, Helsinki, Finland

and

FINN TARP *
UNU-WIDER, Helsinki, Finland
University of Copenhagen, Denmark

Summary. — This is an introduction to the UNU-WIDER special issue of *World Development* on aid policy and the macroeconomic management of aid. We provide an overview of the 10 studies, grouping them under three sub-themes: the aid–growth relationship; the supply-side of aid (including its level, volatility, and coordination of donors); and the macroeconomic framework around aid. The studies in the special issue demonstrate the centrality of research methodology, the importance of disaggregation, and the need to account for country-specific situations and problems. This introduction concludes that the sometimes "over heated" debate on aid needs redirecting toward more rigorous analysis, in which the advantages—and disadvantages—of using aid for development can be evaluated in a calmer manner.

Key words — foreign aid, development finance, aid effectiveness, aid coordination, macroeconomic policy

1. INTRODUCTION

The growth in private financial flows to developing countries, as well as the expansion in their revenues from natural resource extraction, is reducing their dependence on official development assistance (ODA). Developing countries can now benefit from considerably more foreign direct investment, portfolio capital flows, and remittance flows than they did in the past. The rise in commodity prices over the last decade has contributed to the growth in export earnings as well as foreign exchange reserves, making low-income countries (LICs) much less dependent on ODA to finance imports. Revenues from resource extraction are in many cases now providing considerable amounts of public revenue, and improvements in tax administration have bolstered the public finances more generally. Many LICs are now less dependent on ODA to finance their development budgets.

Some of this success can be attributed to aid itself, although by how much remains a point of vigorous debate. Our judgement is that aid-financed infrastructure has helped improve the incentive for domestic and foreign investment, thereby improving the supply-side of economies—export sectors in particular. Aid-financed human capital investments—via healthcare, education, safe water, and sanitation—have not only improved human development but also added to the long-run growth potential of LICs. The support of aid to institution-building has generally improved the quality of budgetary management as well the ability of tax institutions to mobilize more domestic revenue. Hence, the reduction in the overall dependence of developing countries on ODA is in part a function of aid itself.

Nevertheless, we should avoid complacency. Progress is difficult to make in the "fragile states," a sub-group of LICs whose governance problems and susceptibility to violent conflict makes it difficult for aid to gain traction (Addison, 2012). Strong criticisms of aid continue to be made, especially in the popular press and in the legislatures of donor countries. Moreover, donors must undoubtedly rethink their aid policy as LICs continue to graduate to middle-income status, implying both a change in the nature of their economic opportunities and policy problems. For this reason, we will no doubt see a reconfiguration of aid modalities over the coming decade, and the debate over the "post-2015 development agenda" is already part of this.

That reconfiguration of aid, and the design and implementation of effective aid, requires a deeper understanding of aid's impact and the overall funding and policy environment in which it operates. There are many dimensions to this understanding, and no single individual, nor any one organization, can claim to have all the answers. Aid is far too multi-dimensional and complex for that. For its part, UNU-WIDER has sought to make a meaningful contribution through an initiative on Research and Communication on

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Foreign Aid (ReCom), which has in recent years undertaken a comprehensive assessment of what works and what might work in aid.[1] ReCom has identified and sought to analyze and gather evidence on aid's many dimensions.

To take just three important dimensions, we developed more rigorous analysis of how aid impacts on economic growth, more insight into how the supply-side of aid is affected by changing macroeconomic conditions in donor and recipient economies (and the coordination problem between suppliers), and a better perspective on the macroeconomic management of aid flows (particularly their fiscal dimensions). This UNU-WIDER special issue explores these three topics, through 10 studies, eight of which originate under ReCom.[2] This introduction provides an overview of the studies, and draws out some of their key messages, especially for policy.

2. OVERVIEW OF THE SPECIAL ISSUE

The effectiveness of aid in assisting economic growth has long been an issue of prime importance to the policy debate, and a variety of views have emerged, both positive and negative, from successive waves of research (Temple, 2010). The first two papers in this special issue focus on the aid–growth relationship. Given the numerous determinants of growth itself, and the potential for endogeneity, it is unsurprising that econometric methodology has been of key concern. The choices made regarding econometric models, the use of data (and whether data points are excluded), as well as the estimation methods used and the assumptions made with regard to endogeneity, are all important in driving the varying results to be found in the literature regarding aid's relationship to growth (Clemens, Radelet, Bhavnani, & Bazzi, 2012; Dalgaard, Hansen, & Tarp, 2004; Juselius, Framroze-Møller, & Tarp, 2014).

In "Assessing Foreign Aid's Long-run Contribution to Growth and Development," by Channing Arndt, Sam Jones, and Finn Tarp, the authors extend the earlier analysis of Arndt, Jones, and Tarp (2010) by adding seven additional years of data and by investigating the effect of aid on additional final outcomes (poverty, inequality, structural change) and intermediate outcomes (investment, consumption, tax) and social outcomes (education, health) (Arndt *et al.*, this issue). Following Arndt *et al.* (2010) aid is instrumented for from a model of its supply-side determinants at the donor–recipient level. The results of the study by Arndt *et al.* in this special issue show that aid, in addition to simulating growth, has also promoted structural transformation, improved social indicators, and reduced poverty in the long run (but has no significant effect on inequality). There is evidence that the positive effect of aid on growth is transmitted via investments in physical and human capital (through funding improved provision of infrastructure as well as healthcare and education).

This is a broader assessment of the effectiveness of aid than that presented in the cross-country econometric aid literature so far. Although expectations for aid in the early years of development were too high, the cumulative impact of aid over time has not been insubstantial, and aid has certainly not been detrimental in the way asserted by critics such as Moyo (2009). With structural transformation now moving to the center of debates around the "post-2015 development agenda," aid could play a stronger role in the achievement of inclusive growth in addition to its focus over the last decade on human development.

One recent time-series contribution to the aid–growth literature, Nowak-Lehmann, Dreher, Herzer, Klasen, and Martínez-Zarzoso (2012) (henceforth "NDHKM") finds that aid has an insignificant or minute significant negative impact on per capita income in recipient countries. In "Aid and Income: Another Time-Series Perspective," Matthijs Lof, Tseday Jemaneh Mekasha, and Finn Tarp empirically re-examine the work of NDHKM, specifically focusing on their choices for data transformation and estimation strategy. Lof *et al.* (this issue) apply VAR models instead of the single-equation model used by NDHKM. Lof *et al.* find that NDHKM in taking a log-transformation of variables with negative values, non-randomly dropped observations, and thereby wrongly claim to uncover a lack of effect of aid on growth. The authors apply a Panel VAR model to the dataset of NDHKM. This empirical strategy explicitly allows for endogeneity and finds a positive long-term effect of aid on income, in contrast to NDHKM, and using the same dataset. Econometric methodology therefore remains critical to the aid–growth debate, and the evidence now emerging suggests a significant (although at times modest) contribution of aid to growth.

The next five studies in this special issue focus on the supply-side of aid; its response to fluctuations in economic conditions in both donors and recipients (Dabla-Norris *et al.*; Jones); its volatility and the impact of this on recipients (Hudson), and the presence of coordination (or not) between donors (Bigsten and Tengstam; Bourguignon and Platteau).

The post-2009 financial crisis in the group of high-income countries has put pressure on aid budgets in many if not most aid donors (Addison, Arndt, & Tarp, 2011; OECD, 2011). It remains to be seen whether the recent financial crisis has lasting effects on the bilateral programs of aid donors as well as their contributions to multilateral aid organizations, and whether the more pessimistic forecasts do come to pass. The evidence to date is inconclusive as to the relationship between aid and the business cycle in donor economies (Mold, Olcer, & Prizzon, 2008). Whatever the eventual outcome, the crisis has renewed interest in what determines the supply of aid, both in the short run as well as the long run, and two studies in this special issue add to our knowledge.

In "Aid Supplies Over Time: Addressing Heterogeneity, Trends and Dynamics," Sam Jones (this issue) focuses on how economic conditions in donor countries as well as other factors influence the supply of aid. Jones notes that bilateral aid broadly follows long-run trends determined by fixed and slow-moving factors such as historical linkages (past colonial history, in particular). Jones also finds considerable heterogeneity across donor countries and over time. For example, Norway has tended to consistently increase its aid budget, and Norway's aid is relatively stable, whereas Italy and others have switched between periods of cutting and increasing their aid budgets. This reflects the impact of fiscal restraint, which Jones finds to be a short-run determinant of aid supply. There is also a "bandwagon effect," whereby donors increase or reduce their aid at the same time. This is especially evident among large aid donors. Jones cautions us to avoid extrapolating from past trends and behavior in attempting to forecast future aid flows.

Of course developing countries also face macroeconomic shocks which are generally much more severe than those of developed countries. It is therefore of policy interest to establish whether aid flows also respond to those shocks, in addition to the impact on aid flows of the business cycle in the donor countries themselves. Both these challenges are taken up in "Business Cycle Fluctuations, Large Macroeconomic Shocks and Development Aid," by Era Dabla-Norris, Camelia Minoiu, and Luis-Felipe Zanna who empirically analyze the link between bilateral aid flows and negative macroeconomic