

Pillars of Prosperity

The Political Economics of Development Clusters

Chapter 6: Development Assistance

Tim Besley Torsten Persson

STICERD and Department of Economics
London School of Economics

Institute for International Economic Studies
Stockholm University

September 26, 2011

Outline

- 1 Motivation
- 2 The Core Model with Aid
 - Cash Aid
 - Other Forms of Aid

The story so far

- Developed comprehensive core model and some underpinnings.
- with determinants of investments in different aspects of state and in political violence – resulting typologies of investment and violence states summarized in Anna Karenina matrix.
- Implications for development policy – theme of **Chapter 6**
 - ▶ how can we think about the effects of different types of foreign intervention, in different types of states, taking into account effects on policy plus investments in state capacity and violence?

Motivation

- Foreign aid flows
 - ▶ in post-war period, foreign aid seen as main vehicle for improving the situation of poor and violence-stricken countries with badly functioning states
 - ▶ rising in real terms to local peak around end of cold war then falling but increasing again – 2009 value of ODA (USD 123 billion) is highest figure ever recorded
 - ▶ less impressive trends as share of donor countries' GDP, or per capita in receiving countries
 - ▶ largest receiving regions: Sub-Saharan Africa (33%), Middle East/North Africa (21%), South/Central Asia (15%)
 - ▶ many different types: budgetary support, project aid, technical assistance, post-conflict assistance, military aid...

Aid and other outcomes – Figures 6.1-2

- Aid and income
 - ▶ (obviously) negatively correlated
- Aid and violence
 - ▶ positively correlated – could reflect correlation with income but results in **chapter 5** suggest possible link from aid to violence
- Aid and state capacity
 - ▶ negatively correlated with both fiscal and legal capacity
 - ▶ could reflect omitted income, but theory suggests a likely negative link from aid to state capacity

Fiscal Capacity and Aid

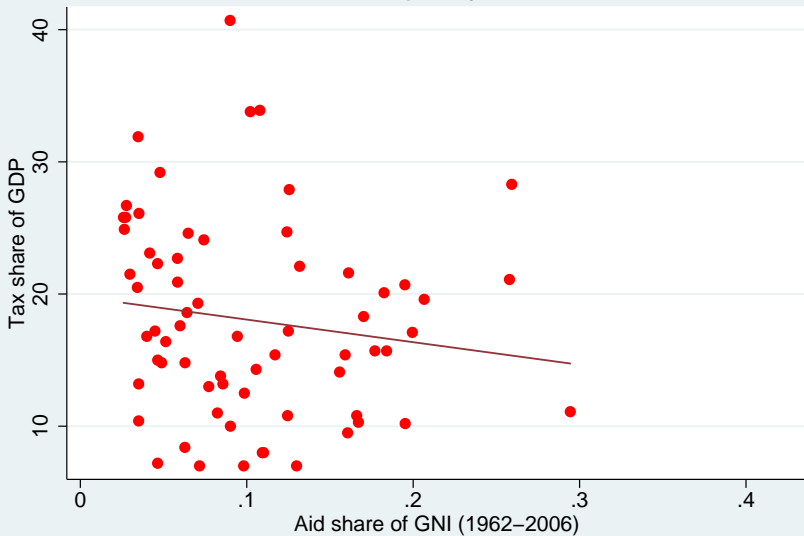


Figure 6.1 Tax share in GDP versus aid share in GDP

Legal Capacity and Aid



Figure 6.2 Property rights protection versus aid share in GDP

Different views on aid

- Aid is controversial
 - ▶ unclear which forms of aid effective in which environments
- Three stylized views of aid
 - 1 optimistic (traditional) view (Chenery/Sachs) – “aid helps”
main problem is lack of resources and aid flows necessary to build public institutions and accumulation of capital
 - 2 pessimistic view (Bauer/Easterly) – “aid harms”
pernicious effect on development and state building
 - 3 revisionist view (Collier/Rodrik) – “it all depends”
institutional environment decisive for effectiveness and conditionality should be sought to reach it

Outline

- 1 Motivation
- 2 The Core Model with Aid
 - Cash Aid
 - Other Forms of Aid

Main Forms of Development Assistance

- 1 Development Support: direct provision of public goods or infrastructure organized directly by donors and NGOs
- 2 Budgetary support: cash aid, either unconditional or conditional.
- 3 Technical assistance: improving government performance, identifying better projects.
- 4 Military support: outright military intervention, training, or supply of weapons.
- 5 Post-conflict assistance: peace-keeping, reconstruction of infrastructure.

Our (cost-benefit) approach

- Perspective

- ▶ suppose a foreign government or multilateral organization makes a transfer of resources to a developing country – this money has shadow cost $\hat{\lambda} \geq 1$
- ▶ how will the transfer affect the behavior of the receiving government and the welfare of the citizens?
- ▶ look at equilibrium responses of
 - ★ policy choices: g, r^I, r^O
 - ★ state capacity investments: π, τ
 - ★ investments in violence: L^I, L^O

Cash aid in core model

- Model as higher period-2 non-tax income
- new timing is:
 - 1 We begin with initial stocks of state capacities $\{\tau_1, \pi_1\}$ and an incumbent group I_1 . Nature determines α_1 and R .
 - 2 The development assistance agency now considers whether to offer ΔR to be paid in period 2.
 - 3 I_1 chooses a set of period-1 policies $\{t_1, r_1^I, r_1^O, p_1^I, p_1^O, g_1\}$ and determines (through investments) the period-2 stocks of fiscal and legal capacity $\{\tau_2, \pi_2\}$. I_1 and O_1 simultaneously invest in violence levels L^I and L^O .
 - 4 I_1 remains in power with probability $1 - \gamma(L^O, L^I, \xi)$, and nature determines α_2 .
 - 5 I_2 chooses period-2 policy $\{t_2, r_2^I, r_2^O, p_2^I, p_2^O, g_2\}$.

Aid effects in peaceful states

- We have a benchmark result

Proposition 6.1

In a common interest state with linear demand for public goods, cash aid is worthwhile if and only if $\phi\alpha_H + (1 - \phi)\alpha_L > \hat{\lambda}$.

- return to public goods needs to be high enough
- If Cohesiveness fails

Proposition 6.2

In a weak or redistributive state with linear demand for public goods, cash aid is worthwhile if and only if $\phi\alpha_H + (1 - \phi) > \hat{\lambda}$.

- i.e., the criterion for worthwhile aid is stronger in non common-interest states

The Bauer paradox

*“A government unable to identify ... projects or collect taxes is unable to be able to use aid productively”
(Bauer, 1975, page 400).*

- “being unable to identify projects”
 - ▶ this is like having low α_H and/or low ϕ
- “being unable to collect taxes”
 - ▶ having less cohesive political institutions (low θ) hampers ability to collect taxes (low endogenous fiscal capacity, τ)
- these are the governments where Proposition 6.2 applies

Crowding out of state capacity?

- Alternative preferences for public goods
 - ▶ suppose α_s non-stochastic but utility concave, and we have only investment in fiscal capacity (one of extensions in Chapter 2)
 - ▶ optimal fiscal-capacity investment in common-interest state is denoted by $\hat{\tau}_2$ and determined by:

$$\alpha V_g (R + \Delta R + \hat{\tau}_2 \omega) - 1 = \frac{\mathcal{F}_\tau (\hat{\tau}_2 - \tau_1)}{\omega}$$

now, fiscal capacity does depend on the extent of aid $\frac{\partial \hat{\tau}_2}{\partial \Delta R} < 0$

- New form of Cohesiveness condition

$$\alpha V_g (R + \Delta R + \hat{\tau}_2 \omega) \geq 2 (1 - \theta)$$

Crowding out of public goods?

- Effect of aid on public-goods provision depends on type of state
 - ▶ we have $\frac{dg_2}{d\Delta R} \in [0, 1]$

Proposition 6.3

Suppose that the government is investing only in fiscal capacity and that there is curvature in the demand for public goods. Then

- 1 *In a common-interest state, cash aid is worthwhile if and only if $\alpha V_g (R + \Delta R + \hat{\tau}_2 \omega) > \hat{\lambda}$.*
- 2 *In a redistributive or weak state, aid has no impact on the provision of public goods and state-capacity investments, so that cash aid is never worthwhile.*

Aid effects in the presence of violence

- Back to core model (linear demand for public goods)
 - ▶ consider θ low enough that Cohesiveness does not hold, and ϕ low enough that state is prone to political violence

Proposition 6.4

In a weak or redistributive state, which is prone to political violence, a small increase in cash aid is welfare improving if

$$\phi\alpha_H + (1 - \phi) - \omega(\pi_1) \frac{dL}{dZ} > \hat{\lambda}$$

where

$$\frac{dL}{dZ} = \begin{cases} \left[\lambda_1 \frac{dL^I}{dZ} + \nu \frac{dL^O}{dZ} \right] & \text{if } Z > Z^O(\theta; \nu, \xi) \\ \lambda_1 \frac{dL^I}{dZ} & \text{if } Z^O(\theta; \nu, \xi) \geq Z > Z^I(\theta, \lambda_1; \xi) \end{cases}$$

- Third term above shows impact of aid on equilibrium violence.

Impact on Stability

- But, by proposition 5.1 more violence affects stability:

Proposition 6.5

In a redistributive state, which is prone to political violence, cash aid can increase political stability and increase the investments in fiscal and legal capacity.

- when institutions are not cohesive, foreign aid allows incumbents to entrench themselves
e.g. case of a repressive government

Conditionality

- Prospective gains exist
 - ▶ Propositions 6.2 and 6.3 highlight possibility that conditioning aid to be spent on public goods could be valuable.
 - ▶ Propositions 6.3 and 6.4 open the door for conditionality to influence the investment decisions
 - ▶ but how can such conditionality be made credible?
- View conditionality as a contracting problem
 - ▶ to what extent can a donor specify an array of *verifiable* and *enforceable* decisions by recipient in exchange for ΔR ?

Other Forms of Aid

- Aid in other forms than budgetary support
 - ▶ technical assistance
 - ▶ assistance in building state capabilities
 - ▶ military aid
 - ▶ post-conflict assistance
- How represent in core model
 - ▶ can be approximated via other parameters

Technical assistance

- Examples
 - ▶ work by J-PAL (or various NGOs) to identify high-value public interventions, sometimes with Randomized Controlled Trials
 - ▶ can think about these in core model as attempts of raising α_s or ϕ

Proposition 6.6

Technical assistance that increases α_H or ϕ increases welfare and investment in state capacity. It also reduces the likelihood of political violence.

- interventions that help raise α_L may even help raise the probability of a common-interest state
- But important challenges remain
 - ▶ scaling-up from small monitored trials to system-wide levels
 - ▶ issues of predation and corruption (extensions in chapters 3 and 4)

Improving state capabilities

- Examples
 - ▶ assistance with tax administration and law enforcement
 - ▶ can think about these in core model as lowering the costs of state building $\mathcal{F}(\cdot)$ and $\mathcal{L}(\cdot)$

Proposition 6.7

Technical assistance that reduces the cost of investing in state capacity, $\mathcal{F}(\cdot)$ and $\mathcal{L}(\cdot)$, increases welfare and investment in state capacity. Such assistance will raise the likelihood of political violence, all else being equal.

- the violence effect arises as the redistributive pie grows and hence the value of holding office

Military assistance (to incumbent)

- Examples
 - ▶ provision of weapons, training, or intelligence
 - ▶ can think about these in core model as an increase in the relative productivity of incumbent's investments ξ

Proposition 6.8

Military assistance that increases ξ , augmenting the military capacity of government, increases the parameter range in which there is repression. This increases political stability and investments in fiscal and legal capacity

- higher stability may come at price of entrenched incumbent, with opposition frozen out of power, in redistributive “rentier” state

Post-conflict assistance

- Examples
 - ▶ peace-keeping, disarming rebels – like raising ν
 - ▶ settlements between fighting parties – like raising θ

Proposition 6.9

Post conflict assistance that raises ν or θ will lead to greater investments in state capacities and reduce the parameter range in which there is violence.

- but permanently changing θ requires durable reforms of political institutions, so we have to think about the incentive compatibility of such reform – indeed, the topic of **chapter 7**.