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**An Aid-Institutions Paradox? A Review  
Essay on Aid Dependency and State  
Building in Sub-Saharan Africa**

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# **An Aid-Institutions Paradox? A Review Essay on Aid Dependency and State Building in Sub-Saharan Africa**

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**Todd Moss, Gunilla Pettersson, and Nicolas van de Walle<sup>1</sup>**

## **Abstract**

A number of proposals today support a substantial increase in foreign aid levels to sub-Saharan Africa even though this region already receives a historically unprecedented volume of aid. This essay reviews the evidence regarding the potentially negative effects of aid dependence on state institutions, a topic which has received relatively little attention. We note several pathways through which political institutions might be adversely affected and devote particular attention to fiscal and state revenue issues. In addition to reviewing the economic literature on the aid-revenue relationship, this essay brings in the long-standing political science literature on state-building to consider the potential impact of aid dependence on the relationship between state and citizen. We conclude that states which can raise a substantial proportion of their revenues from the international community are less accountable to their citizens and under less pressure to maintain popular legitimacy. They are therefore less likely to have the incentives to cultivate and invest in effective public institutions. As a result, substantial increases in aid inflows over a sustained period could have a harmful effect on institutional development in sub-Saharan Africa.

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“The importance of public revenue to the underdeveloped countries can hardly be exaggerated if they are to achieve their hopes of accelerated progress.”

*-Nicolas Kaldor, Foreign Affairs, January 1963.*

“I have made revenue collection a frontline institution because it is the one which can emancipate us from begging, from disturbing friends... if we can get about 22 percent of GDP we should not need to disturb anybody by asking for aid....instead of coming here to bother you, give me this, give me this, I shall come here to greet you, to trade with you.”

*-Yoweri Museveni, President of Uganda (which collects 11% of GDP in taxes and receives a further 11% of GDP in aid), Washington DC, September 21, 2005.*

## **1. Introduction**

After a crisis of legitimacy throughout the 1990s, aid is popular again in the policy community. Several new studies have suggested that at least a doubling of overseas development assistance (ODA) from 2000 levels is necessary as a precondition for meeting international development targets (Zedillo Panel 2001; Devarajan et al. 2002). The Commission for Africa (2005) chaired by British Prime Minister Tony Blair called for an immediate \$25 billion increase in aid to sub-Saharan Africa, with an additional \$25 billion to come by 2015. This would constitute roughly a tripling of aid to the continent. Further, the UN’s Millennium Project (2005) has estimated that global ODA will need to rise even further than the previous estimates, reaching at least \$195 billion by 2015 from current levels of some \$79 billion in 2004. These calls for more ODA are echoed in various parts of the United Nations system, the World Bank, many NGOs, recipient countries, and even some European governments.

Many of the low-income countries targeted for substantial increases in aid already receive historically unprecedented flows. For instance, ODA to sub-Saharan Africa was the equivalent of 11.7 percent of the continent’s GNI in 2003 (excluding Nigeria and South Africa).<sup>2</sup> Exactly half of the region’s 46 countries with data for 2003 received in excess of 10 percent of GNI in ODA, and 11 received more than 20 percent. Globally, there is a core set of roughly three dozen countries that have received a tenth of GNI or more in aid for at least the last two decades. This is a lengthy time period for receiving sizeable aid with few historical precedents. The large flows to Europe during the Marshall Plan lasted only a few years and never exceeded 3 percent of GDP of any receiving country (De Long and Eichengreen, 1991; O’Connell and Soludo, 2001). While substantial US support during the early Cold War to allies such as Korea and Taiwan tapered off within a decade, contemporary aid ratios in these three dozen countries has tended not to recede,

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<sup>2</sup> Including South Africa and Nigeria, two large economies that receive very little aid, brings this proportion down to 5.7 percent of GNI (WDI, 2005).

but to grow larger over three decades. Moreover, if the large increases in aid proposed actually materialize, aid ratios will rise substantially further and the number of countries crossing the 10 percent threshold will grow significantly (Moss and Subramanian, 2005).

Skepticism about the desirability of such aid increases has tended to emphasize economic and management issues. Some observers have expressed concerns about the capacity of low-income states to absorb large new flows in addition to the flows they already receive, and have pointed to the weak management capacities of governments, the dearth of good new projects and programs to fund, or the ambiguous association between aid and measurable development outcomes (White, 1998; Burnside and Dollar, 2000). Other observers have worried about the macro-economic impact of large aid increases; they have pointed to “Dutch disease” effects on small economies (see for example Heller, 2005, Rajan and Subramanian, 2005). Relatively less critical attention has been paid to the potential effects of large increases in aid on public institutions in low-income countries.

Yet institutional issues have recently returned to the foreground in debates on economic development. The critical importance of sound public institutions to the development process has become an article of faith, not only among political scientists (for example, Herbst, 1990, Haggard, 1990; Evans 1995), who could be supposed to have professional reasons to argue for the importance of institutions, but also has emerged more recently as a consensus among economists (for example, Rodrik, 2003; Ndulu and O’Connell, 1999; Acemoglu et al., 2004). Sachs’ (2005) view that good institutions are entirely a result of development, rather than their cause, is now a minority view.

Aid is thought to work best in environments with high quality public institutions, presumably as part of a capable ‘developmental’ state (among a large literature see Burnside and Dollar, 2000; World Bank, 1998). Increasingly, measures of institutions are an explicit factor for aid disbursement and allocation. Thus, ‘institutional development’ is frequently an independent variable thought to affect the efficiency of aid, and thus a legitimate factor in selecting aid recipients and determining allocation strategies. This suggests that aid should be “selectively” focused on countries that are thought to most effectively use resources to engage in poverty reduction. Such logic underlies IDA’s performance-based allocation process and the Millennium Challenge Account, a new US aid program that explicitly targets assistance to countries that are thought best able to use additional resources (Radelet, 2003).

In many respects, this new approach is at odds with the more traditional argument that one of the primary purposes of aid (if not its most important) should be to build effective indigenous public institutions. By this formulation, institutional development is thought to be a dependent variable, affected by targeted aid. In contrast to the ‘selectivity’ philosophy, this older doctrine has been to channel aid instead to places with the greatest need for improved public institutions with the idea that aid itself will help to improve the institutional environment. This approach underlies growing donor efforts at so-called ‘capacity building’ and the ‘big push’ on aid first popular in the 1950s and 1960s and now advocated by the UN and others (Easterly, 2005). The Commission for Africa report

wavers back and forth between these two views of aid and institutions. It recognizes the importance of good institutions to making aid effective, in part because it argues that improved institutions will allow absorption of the much larger aid flows it advocates. But it also believes that these large increases can serve to leverage a much greater commitment on the part of African governments to improving the domestic institutions important to growth and poverty reduction.

Does aid necessarily help to develop public institutions and state capacity, or can there be an *aid-institutions paradox*? In this essay, we review an emerging literature that explores the potential effects of large amounts of aid on institutional development, including some of the most basic functions of the state such as the ability to collect revenues. Given the current debates regarding large new infusions of additional aid, an analysis of the institutional effects of aid is particularly timely. Because Africa presents the greatest challenges to development, and is the region most aid dependent, we especially look at the aid-institutions relationship in that region. Many political scientists now argue that public institutions in the region are poorly suited to promote economic development because of neo-patrimonial tendencies (Callaghy, 1988; Sandbrook, 1992; Chabal and Daloz, 1999; van de Walle, 2001). In the poorly integrated and fragmented states of the region, political leaders have relied on systematic clientelism and the private appropriation of state resources for political ends. As a result, government resources have not been utilized primarily to promote economic development, as political elites have acted in a predatory fashion to maintain themselves in power. There are other reasons for which the economies of sub-Saharan Africa have failed to gain economic development, but it is now widely conceded that these political dynamics have constituted a significant brake on growth. As a result, it is thus possible that inflows of external resources like aid could be a disincentive to state transformation. Does aid encourage the transition from patrimonialism and predation to rational developmental states?

It is far from impossible that certain types of aid could undermine long-term institutional development, despite donors' sincere intentions. Such a paradox is, of course, not new to the development literature. The so called 'resource curse' has long posited that unearned income undermines incentives to build local institutions and perhaps a social contract with the population (see Ross, 1999 for an excellent review; Karl, 1997; Birdsall and Subramanian, 2004). Natural resources represent an unearned rent accruing to governments; it is argued that this rent can have a negative and anti-developmental effect on the economy, public institutions, and even on the government's relationship with the citizenry. We will argue that aid can have many of the same dysfunctional effects as natural resources; that is, there can be an 'aid curse' as well that might create perverse incentives and lead to anti-developmental outcomes.

To analyze these issues, this review essay seeks to integrate two disciplinary literatures that have too long ignored each other. On the whole, political scientists have been remarkably oblivious to the political dynamics created by foreign aid, particularly in low-income countries where it is today the leading sector of economic activity and might thus be thought to have a significant impact on the local political economy. For their part,

economists have mostly ignored a long tradition in the political science literature which establishes a historical link between the state's revenues and its political and institutional attributes. The following section lays out the context for these questions, and explains why they are particularly relevant for today's debates about aid and development. Section 3 reviews the well-known macro-economic effects of large volumes of aid, and focuses on the institutional implications of these effects. Section 4 explores the potential negative effects of large aid flows on institution building through its effect on local bureaucratic and policy-making dynamics. Section 5 then examines the literature on state revenues and its relationship to foreign aid. The historical linkages between state revenue collection and state-building are considered in Section 6. A theme that emerges in the second half of the essay is the low quality of the available data on state revenues, particularly for Africa. At present, data deficiencies unfortunately prevent the formal empirical testing of many of the hypotheses developed in the essay. Nonetheless, the possibility of the existence of an "aid-institutions paradox" is significant, and Section 7 discusses the policy implications of our findings before concluding.

## **2. Aid and the development debates**

Aid clearly can be useful and has certainly contributed to economic development and improvements in quality of life variables in many countries. Evidence for successful aid is particularly strong in targeted programs with defined objectives (see Levine 2004 for examples in global public health). But, at the same time, and especially at very high levels over a sustained period, aid could also have distorting effects on some of the very outcomes donors hope to encourage through aid, such as policy ownership, fiscal sustainability, institutional development, and, ultimately, autonomous long-term economic growth.

One way to consider this problem is to think of aid as a subsidy. As such, aid is supposed to provide temporary financial assistance in order to encourage certain long-term behaviors: revenue collection, investment in physical and human capital, and the establishment of the institutions of a developmental state. There are clearly some cases where aid-as-subsidy has played this role, for example in South Korea or Botswana, where foreign assistance supported local efforts to do these things and the country gradually was weaned off aid. At the same time, there are many, indeed dozens, of other cases where aid is neither temporary, nor seeming to assist countries in fulfilling these roles. Instead, it could be argued that the subsidy has in fact discouraged revenue collection, distorted expenditure decision-making, and undermined the incentives to build state capacity. In these cases, aid could be viewed as not only a crutch delaying institutional development, but as potentially undercutting those efforts.

This possibility of harmful aid dynamics seems particularly acute in sub-Saharan Africa, where some countries have now entered into their third and fourth decades of receiving substantial volumes of aid. Much of this aid has also included explicit capacity building technical assistance from donors. The World Bank alone provided Africa with 70 civil service reform projects between 1987 and 1997, for instance (Levy and Kpundeh, 2005, p.



v), while a recent internal Bank evaluation estimates that over a quarter of all Bank credits to the region is explicitly devoted to capacity building (OED 2005, p. 9). Technical assistance to central banks seems to have been successful in building institutional capacity, but such examples appear more the exception than the rule. Many experts argue that state capacity has improved little during this period, and point to specific cases of clear decline (see van de Walle 2001; 2005).

In some cases, the lack of progress on capacity building can be attributed to political instability. After all, at any given time in the last three decades, over a dozen economies in the region have been subject to violent civil conflict (see for example Collier, 2005) and the emergence of warlord rule in the context of the collapse of the central state (Reno, 1998). Long periods of political stress, conflict and state collapse, continue to have a significant impact on state capacity, even after the return to political stability because of their long-term institutional effects, notably on the supply of trained manpower. Perhaps more striking is the slow pace of institution-building in relatively stable political systems. Indeed, a substantial literature has documented the pervasive weakness of the central state in sub-Saharan Africa, which often exercises weak if any effective sovereignty over much of its territory, and has less legitimacy than a variety of sub-national and private governance structures that compete with it for popular support (Herbst, 2000; Englebert, 2000; Jackson and Rotberg, 1982). It has become fashionable in the donor community to blame this surprisingly slow pace of state capacity building on the nature of African bureaucracies, which are argued to be patrimonial and corrupt, and thus not particularly interested in the provision of public goods essential to development (Levy and Kpundeh, 2005; OED, 2005). But even if one accepts this diagnostic, the question remains, why has the large volume of aid devoted to capacity building not had a bigger impact on improving these public institutions, and transforming them into, using the Weberian terminology, more 'rational-legal' bureaucracies?

### **3. Aid, fiscal policy, and macroeconomic outcomes**

A number of potential negative effects of large aid volumes on institutional development can be identified. Much of the focus from economists has been on macroeconomic imbalances caused by large volumes of aid. One central issue has been the possibility of large ODA inflows affecting the real exchange rate and undermining the competitiveness of the export sector—the so called 'Dutch disease' (most recently, see Rajan and Subramanian, 2005). Management of the real exchange rate is arguably rendered even more difficult by ODA volatility, which also is thought to have negative effects (see below). Dutch disease-type effects have been noted in a number of African aid recipients (see Younger, 1992 on Ghana; Adam and Bevan 2003). Experiences from Uganda (Atingi-Ego, 2005; Nkusu, 2004) and other countries suggest that an active central bank can manage these exchange rate appreciations and, for the most part, mitigate pernicious effects on competitiveness, but nonetheless, a number of country episodes suggests that in fact a large volume of aid can and does undermine competitiveness.

Another set of economic concerns emphasize the role of aid within the budget process itself, with most studies suggesting that foreign aid can undermine the ability of recipient governments to budget appropriately. Several have implicated the volatility of aid flows as the source of distortions. In a 37-country survey, Bulir and Lane (2002) found that aid is more volatile than domestic fiscal revenues and that this volatility lessens any potential positive benefits of aid on recipients. McGillivray and Morrissey (2000b) found the volatility of aid often leads to poor budgeting and underestimation of revenues, particularly since aid commitments tend to overestimate actual disbursements. Similarly, Heller and Gupta (2002) argue that the fiscal uncertainty of dependence on external assistance makes long-term planning extremely difficult.

Beyond volatility, there have also been some questions about perverse incentives of aid on the process of economic policymaking. Brautigam and Knack (2004), for example, found that high levels of aid serve as a “soft budget constraint”: the access to foreign resources convinces decision makers that budgets are flexible and encourages fiscal indiscipline. Two case studies looking at Ghana found that as donor financing increased, so did disparities between budgeted expenditures and actual spending, suggesting that the budget process was increasingly directed toward satisfying external donors rather than reflecting actual public spending preferences. Killick (2004) thus described Ghana’s “budgetary façade” and Pradhan (1996) similarly called the budget a “deceptive mirage”, in which aid was distorting both the budget process itself and the government’s ‘ownership’ of the country’s purported development agenda.

A number of observers have examined the impact of large volumes of aid on the mix of public expenditure and the overall spending levels. A number of papers suggest that aid results in excessive and unsustainable levels of government consumption, also leading potentially to macro-imbalances. Khan and Hoshino (1992) found aid to be generally treated as an increase in income leading to higher government consumption, but that some public investment is also financed by aid. In a broad literature review, McGillivray and Morrissey (2000a) found that aid tends to be associated with government spending increases in excess of the value of the aid, although there is no clear answer on the impact of aid on consumption versus investment. This was reinforced in McGillivray and Morrissey (2000b) where they concluded that aid leads to increases in expenditure not financed by the corresponding increase in revenue. More recently, Remmer (2004) also found that aid leads to overall increases in government spending.

How might these possible macro effects of aid negatively impact public institutions? The potential loss of competitiveness means lower exports and economic growth, fewer jobs, and increased dependence on external assistance. Resource volatility contributes to macro-economic instability, which complicates public policy making in vital areas such as budgeting and planning, and tilt public spending toward consumption rather than investment. These can exact a negative effect on the quality of the civil service, public services, and infrastructure, all indirectly undermining the ability of the state to transition from patrimonialism to a more ‘developmental’ path.

The rest of this paper addresses more direct and, we argue, more significant but less well-documented negative institutional effects of large volumes of aid. Much of the literature cited in this section describes dysfunctional economic outcomes but does not really explain them. To do so, we need to turn to institutional factors, which we begin to do in the next section.

#### **4. Donor practices and institutional change**

In addition to macroeconomic and fiscal effects, there are costs of aid related to the structures, practices, and procedures of the current international aid system. These include a longstanding and well-known list of common complaints about aid: volatility and uncertainty of ODA flows; fragmentation of donor efforts; project proliferation and duplication; conflicting or dominant donor agendas; competition for staff; and high administrative and oversight costs (Among many, see Cohen, 1992; Berg, 1993; Brautigam and Knack, 2004; Knack and Rahman, 2004; van de Walle, 2005). Birdsall (2004) lists many of these as the “seven deadly sins” of the aid business. Such practices are argued to have substantial costs for public administration. For instance, the proliferation of donors and projects constitute a substantial burden for the small number of qualified public officials, who spend much of their time attending to donor concerns and managing aid activities rather than promoting the development of the country—that is, when they do not exit altogether from the civil service to go work for better wages in donor and NGO organizations. Management of donor visits (“missions”) became such a problem in Tanzania, that the country was forced to declare a ‘mission holiday’, a four-month period when they take a break from visiting delegations to focus on budget preparation. Similarly, aid volatility and project proliferation complicate effective government control over budgets and development planning. Much, if not most, aid is not integrated into national budgets, thus posing real sustainability problems, and they are often implemented through parallel structures that cream the best staff from the civil service, and make government coordination of policy much more difficult.

Far from helping to develop effective state bureaucracies, certain aid practices can in fact serve to reinforce the patrimonial element within recipient governments at the expense of the legal-rational. Projects provide for the allocation of all sorts of discretionary goods to be politicized and patrimonialized, including expensive four-wheels drive cars, scholarships, decisions over where to place schools and roads, and so on. The common practice of paying cash ‘sitting fees’ for civil servants attending donor-funded workshops, where the daily rates can exceed regular monthly salaries, even turns training into a rent to be distributed. More broadly, when donor projects are poorly integrated into national budgetary processes, and not subject to much transparency or effective control, it is argued, they help sustain anti-developmental practices within the state apparatus. Because local officials are not included in policy planning, they often come to view aid projects as little more than a set of scarce private goods to be allocated. Aid dependence thus leads to a situation in which bureaucrats are often not rewarded for focusing on their core developmental functions but rather on getting money from donors. Technocrats, who are specialized in budget management and/or planning, say, are less rewarded than

bureaucrats who are adept at interacting with donor organizations and accessing their resources. If these two are not part of the same skill set, the wrong kind of individual expertise may be rewarded and over time, real developmental capacities may atrophy within the administration.

Particularly pernicious for state institutions in Africa has been the combination of high aid flows and economic crisis, both sustained over a long period of time. As development policy has come to be dominated by repeated fiscal crises and driven by short-term adjustment and debt management, the patrimonial attraction of aid resources has been accentuated. In countries where power means access to state privileges and rents, and political systems are sustained by complex clientelist relationships, aid and the scarce goods it provides become all the more desirable for the political management of economic crises (van de Walle, 2001). In short, states who find it difficult to meet civil service payrolls are more likely to politicize aid funded sitting fees, per diems and scholarships to study abroad. Indeed, they will endeavor to turn aid into a mechanism to increase government consumption rather than public investment.

It also seems reasonable to surmise that the larger the relative aid flows, the more these problems are likely to be exacerbated. In many countries of sub-Saharan Africa, aid flows are such that aid dynamics simply dominate local development efforts. Moss and Subramanian (2005) identify 22 low-income countries, 16 of which are in sub-Saharan Africa where ODA inflows are equivalent to at least half of total government expenditure. In twelve poor countries, of which ten are African, the ratio of ODA to government expenditure was 75 percent or more. Looking at a slightly earlier period, Brautigam and Knack (2004) find roughly similar numbers of aid intensity.

Because most of the concerns listed in this section are directly related to the way in which aid is delivered and administered, in theory at least, many of these are fixable through changes on the donor side. These shortfalls have long been identified and some efforts are underway to address them, such as donor pooling or using budget support instead of project aid (Eifert and Gelb, 2005). There are also several large institutional attempts to improve the efficiency of aid delivery, such as various programs by the OECD's Development Assistance Committee or the Paris High Level Forum on Aid Harmonization and Alignment. In practice, however, these inefficiencies exist because of very real political or bureaucratic constraints, and progress in reducing them has proven to be slow and uneven. In many ways, these problems seem to be actually getting worse; for instance, the number of distinct projects funded by donors has nearly tripled since 1995 (Roodman, forthcoming).

Perhaps most worrying, there appear to be few incentives for either donors or recipients to change their practices. As Brautigam and Knack (2004) argue, "political elites have little incentive to change a situation in which large amounts of aid provide exceptional resources for patronage and many fringe benefits" (2004, p. 263). Moreover, until very recently, the government's performance did not appear to affect whether or not it received aid, so there appeared to be little or no cost to misusing aid. Alesina and Weder (2002) actually find that high levels of corruption within recipient countries were

positively correlated with aid flows through out the 1990s. On the other hand, incentives to improve aid effectiveness appear less important within donor organizations than other concerns, related to bureaucratic incentives within aid agencies, and to the importance of commercial, foreign policy and ideological objectives on the part of donor governments (Easterly, 2003).

## **5. The aid-revenue relationship**

A third institutional effect of aid that has been posited in the literature concerns its impact on state revenues. This is an important issue since the ability of the state to collect revenues is critically linked to state capacity, while the central role of revenue collection in political development and state-building has long been accepted. Schumpeter was perhaps the first to argue that a country's tax system fundamentally reflects its political institutions (Schumpeter, 1918/1991). Reliance on citizens for raising public revenues, as opposed to unearned income via offshore extraction or external assistance, is considered an essential ingredient to establishing accountability between the state and society.

The contemporary literature suggests that taxation is a useful indicator of state capacity. Because revenues are necessary to fund the state's activities in a sustainable manner, the size and consistency of government revenues can tell us a lot about the level of capacity that exists within the state apparatus. This has long been argued in the aid literature. According to Kaldor (1963), the key determination of whether a state moves from aid dependency to economic self-sufficiency is the degree to which the state learns how to tax, thereby leading to a lessening of the need for aid. According to Bauer (1976), foreign aid displaces the processes of institutional maturation essential to development, including the capacity of the state to collect revenue. Azam et al. (1999) arrive at a similar conclusion, claiming that the ability of a state to remove itself from reliance on aid will depend on the degree to which the state engages in learning-by-doing in the public sector, a process that is greatly affected by the level of aid in relation to overall revenue and the initial institutional conditions.

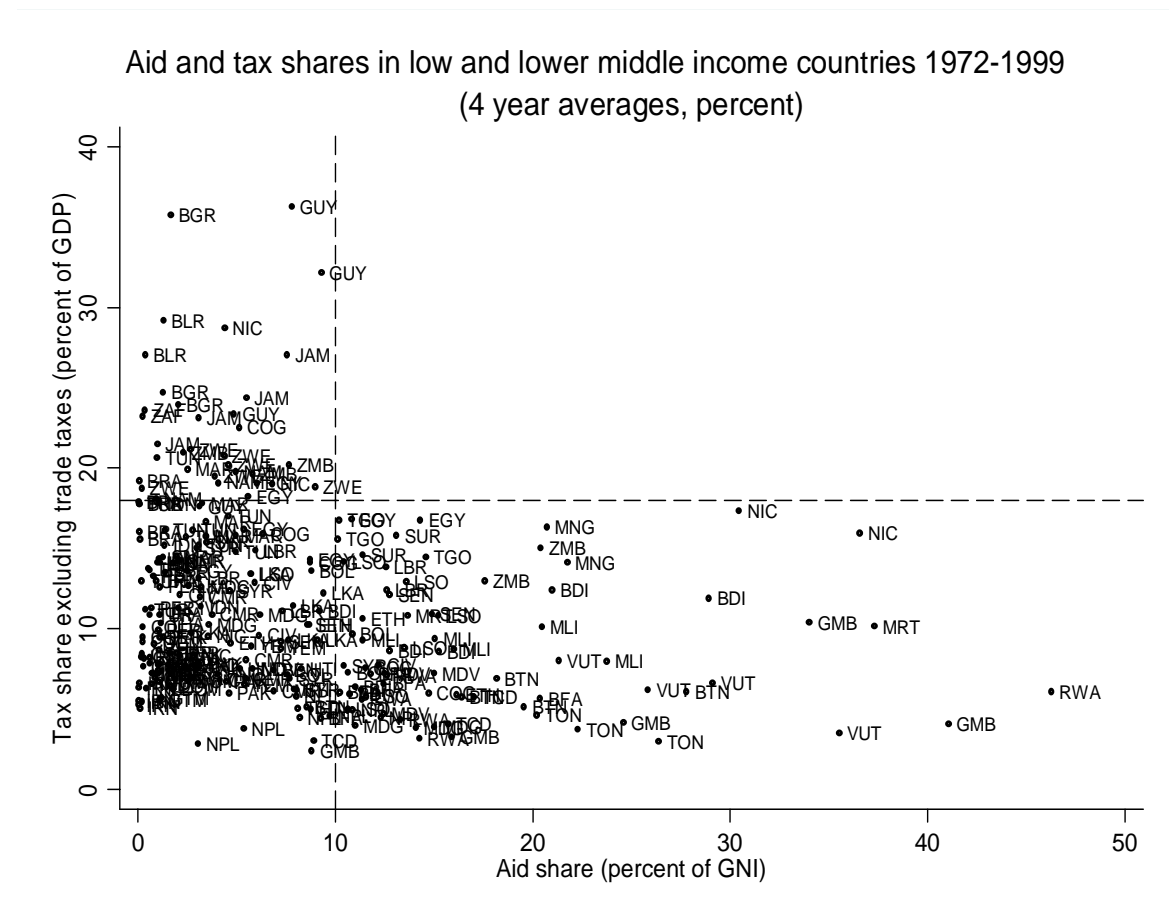
Early empirical tax effort studies focused on a small set of variables considered the main determinants of tax effort, most commonly measured as tax revenue as a share of GDP (Lotz and Morris, 1967; Celliah, 1971, Celliah et al. 1975; Tanzi, 1981). The tax effort literature typically considers the level of development and the economic structure as primary determinants of tax shares: GDP per capita, the degree of openness of the economy, the agricultural and/or industrial share of GDP, and in some cases population growth (Tanzi, 1992; Leuthold 1991; Stotsky and WoldeMariam, 1997; Ghura 1998).

In the tax effort literature, foreign aid is generally expected to reduce tax shares since aid provides an alternative, non-earned source of revenue for governments in addition to tax revenue (Ghura, 1998; Remmer, 2004; Brautigam and Knack, 2004). Consequently, a government that receives significant amounts of aid is thought to have less incentive to tax and improve its tax administration. That is, foreign aid may be used as a substitute for domestic revenue mobilization whilst allowing the same level of expenditure (Heller,

1975; Kimbrough, 1986). Not only may aid inflows lead to lower tax effort, but they may also slow down the development of domestic institutions such as the tax administration in recipient countries (Brautigam and Knack, 2004).

A negative relationship between tax revenue and aid is certainly suggested by Figure 1 that shows the four-year averages of tax revenue (excluding trade taxes) as a share of GDP against the four-year averages of aid as a share of GNI for 55 low and lower middle income countries for 1972-1999, using the standard IMF data on government finances. The point of this figure is merely to show the simple correlation between tax collection and aid receipts. There are many cases of low aid and low tax (those toward the bottom left). There are also a moderate number of high aid and low tax (bottom right) and low aid-high tax countries (upper left). However, there are no incidences at all of high aid (>10% of GNI) and high tax (>18% of GDP). These thresholds are of course arbitrary and the figure does not imply any causation, but it does indicate that based on historical experience, high levels of both do not occur at the same time.

**Figure 1**



Sources: GFS (2004); WDI (2005) and authors' calculations.

What is the econometric evidence on behalf of this relationship? It is actually more ambiguous than one might think. Leuthold (1991) examines the effect of the standard

variables, controlling for the economic structure and the level of development, and aid on tax revenue using panel data. All the standard variables are statistically significant and have the anticipated signs, whereas foreign aid has the expected negative sign but is not significant. Using data from Stotsky and WoldeMariam (1997), Brautigam (2000, p. 48) found that 71 percent of the African countries with aid/GDP above 10 percent in 1995 had lower than expected tax effort. Ghura (1998) examined the determinants of tax revenue for 39 sub-Saharan African countries between 1985 and 1996 and found foreign aid to have a significant, negative impact on tax shares. Teera and Hudson (2004) use data for 116 developed and developing countries for 1975-1998, but find aid to be insignificant. A panel study of 120 middle- and low-income countries over the period 1970-1999 by Remmer (2004) finds that aid dependency reduces tax revenue mobilization. The dependent variable is the change in tax revenue as a share of GDP, and the explanatory variables include the standard variables and three different measures of aid dependency (aid/GNI, aid/government expenditures, and aid/imports). All three aid dependency measures are negatively related to tax shares although only aid as a share of imports is significant. When reducing the sample to the period 1980-1999, both the aid share in imports and the aid share in government expenditures have a significant negative impact on tax effort.

One of the most recent studies focusing on the revenue response to foreign aid inflows separates total net aid into grants and loans to test if the impact of grants on domestic revenue is different from that of (concessional) loans (Gupta et al. 2004). This study suggests that some governments may consider grants to be a free substitute for tax revenue. By contrast, loans must be repaid, which provides incentives for governments to at least maintain tax revenues at current levels if not to increase them (Brautigam, 2000). Gupta et al. use the standard variables controlling for the economic structure and level of development in a panel of 107 developing countries over the period 1970-2002, but augment the model by adding grants and loans separately and a corruption variable (the International Country Risk Guide (ICRG) corruption index), to test their separate impact on the aid-revenue relationship. In their baseline regression the overall effect of total aid (grants and loans) on domestic revenue is negative and significant. When total aid is split into grants and loans, grants have a significant, negative effect on revenue while loans have a significant, positive impact. In their extended model, corruption is found to reduce revenue. To further test the negative effect of corruption on revenues, Gupta et al. rank countries according to their score on the ICRG corruption index and test the impact of grants versus loans on revenues in a sample consisting of the relatively corrupt countries. Their results suggest that countries with weaker institutions are likely to suffer a larger negative impact of grants on revenue than countries with better institutions.

In addition to the cross-sectional time-series studies there are several country case studies for which the results are more mixed. A negative relationship between aid and domestic revenue mobilization was found in Pakistan (Franco-Rodriguez et al., 1998), Zambia (Fagernas and Roberts, 2004a) and Cote d'Ivoire (McGillivray and Outtara, 2003). By contrast, a positive relationship between aid and revenue collection was found in

Indonesia (Pack and Pack, 1990), Ghana (Osei et al, 2003), and Uganda and Malawi (Fagernas and Roberts, 2004b, 2004c).

Generally, thus, the literature finds a negative relationship between aid and revenue collection, but this is not a conclusive result. For all of the studies, there are considerable concerns about the quality of the data and also the sensitivity of the results to specification changes, which make firm causal conclusions about the aid-revenue relationship impossible. Nevertheless, the typical explanatory channels are the replacement of tax with aid in the short term and the disincentives and moral hazard faced by aid-dependent governments to build tax administration and institutional capacity over the long-term.

To further test the hypothesis that there is a negative causal relationship between high levels of aid and domestic tax effort, we would need reliable revenue data for a broad range of countries over an extended time period. Ideally, we would also have disaggregated revenue data to be able to strip out the possible differential effects of aid on trade taxes versus direct taxation and other forms of revenue collection. This would allow us to isolate the revenues which require more state capacity to collect. Unfortunately, much of this data does not exist, especially for the set of countries that have been highly aid-dependent (indeed, the lack of data itself suggests capacity gaps). In addition to data shortages, much of the existing fiscal data is of extremely poor quality, particularly among low-income countries. This limits our ability to empirically analyze the hypothesis with any degree of confidence and of course also raises caution about drawing firm conclusions from any of the data-driven assessments.<sup>3</sup>

To summarize this section: a clear bivariate relationship appears to exist between high levels of aid and low levels of taxation. Poor data quality do not, however, allow us complete confidence that this relationship is not confounded by other factors that high aid-dependent countries have in common, such as low levels of economic activity and industrialization, that are also associated with poor revenue extraction. In addition, it is very hard to establish the exact nature of the link between state capacity and levels of state revenue. Intuitively, revenue generation is so central to state survival that one would think that states would not voluntarily abstain from collecting revenues it was able to collect. However, it is not completely possible to reject the alternative hypothesis that states choose not to seek revenues they have the capacity to collect because they are able to receive the equivalent revenues from foreign aid. To gain insights into this issue, it is perhaps useful to turn to an older political science literature on state building, which explores the impact of revenue collection on regime type.

## **6. Aid, Accountability, and the Political Regime**

A political regime can be defined as the set of institutions which determine the nature of political power, and which structures the relationship between the government and the

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<sup>3</sup> Including the data used in Figure 1. Some of the studies cited above appear to have benefited from access to privileged data from within the IMF that is presumably of higher quality but is not publicly available.



citizenry. A third and perhaps most critical set of negative institutional effects of aid can be identified as those that influence the political regime in a way that discourages the establishment of rational developmental states. The hypothesis here is that large sustained aid flows fundamentally alter the relationship between government elites and local citizens. Any kind of external financial flow changes the incentives faced by recipient government officials and their citizens, regardless of the precise nature of donor practices. That is, aid flows themselves, separate from particular inefficiencies in the aid system, can affect the evolution of state-society relations. If donors are providing the majority of public finance and governments are primarily accountable to those external agencies, then it may simply not be possible to also expect a credible social contract to develop between the state and its citizens. Using the current terminology, aid may undercut the very principles the aid industry intends to promote: ownership, accountability, and participation.

Large aid flows can result in a reduction in governmental accountability because governing elites no longer need to ensure the support of their publics and the assent of their legislatures when they do not need to raise revenues from the local economy, as long as they keep the donors happy and willing to provide alternative sources of funding. Although governments typically complain about conditions, it is still easier to manage donor demands than the slow and politically difficult task of building or improving domestic revenue collection. A reliance on aid as a substitute for local resources means the flow of revenues to the state is not affected by government efficiency, so there will be a tendency for governments to underinvest in developmental capacity. This *moral hazard* effect of aid dependence is borne out empirically, as high aid is associated with decreased quality of governance (for example, Brautigam and Knack, 2004; Knack, 2000). Heller and Gupta (2002) also argue that aid creates moral hazard because it reduces the incentive to adopt good policies and reform inefficient institutions, and thus weakens the government's developmental performance and encourages rent-seeking.

The link between the loss of accountability and aid is particularly striking in Africa since the region combines sharp economic decline with a relatively high level of political stability, at least if the latter is defined as the ability of office holders to remain in power. Thus, since 1980, the average African leader has remained in power just under 12 years, more than three times longer than democratically elected leaders in the prosperous democracies of the West (van de Walle, 2001). The absence of accountability is then not a manner of speech, but a practical reality: it is literally true that African governments avoid accountability for their performance.

A long-term decline in governmental accountability also appears to have a direct impact on the degree of democracy prevailing in the system. Qualitatively, Moore (1998) has argued that countries which rely on a greater proportion of 'unearned' income will tend to be less democratic and have less effective institutional mechanisms and accountability. Simply put, the actions of such governments typically indicate they do not have to worry as much about maintaining legitimacy because they do not collect revenues from their own population. Guyer (1992) and others have made exactly such an argument about Nigeria, while more recently the negative links between aid dependency and low levels of

democratic rule have been argued in a number of country case studies (see Hoffman and Gibson, 2005 on Tanzania; Hanlon, 1991 on Mozambique). In these dynamics, aid can be compared with a natural resource, such as oil, that provides unearned rents for the government. An earlier literature on 'rentier' states in the Middle East had indeed argued that oil resources have allowed governments to resist pressures to democratize (Anderson, 1987; Chaudhry, 1997).

Of course, it might be argued that aid comes with more strings attached than oil, and that donors can affect governmental behavior by setting conditions on their aid. However imperfectly, donors do not condone government corruption, incompetence or authoritarianism. Though inconsistently, donors have promoted democracy and better governance in Africa, at least since the end of the Cold War (van de Walle, 2001). Donors have also sought to explicitly promote accountability and participation, using intensified oversight of accounts and conditionality, such as the insistence on a poverty reduction strategy paper (PRSP) process, which subjects the national budget to multiple rounds of consultation with civil society groups. But the PRSPs and conditionality, and other donor processes (even if better enforced), cannot fundamentally replace government accountability towards its citizens in an equally legitimate way, no matter how well-intentioned or vigilant the donors.

A large flow of aid over a sustained period also can undermine popular participation. On the one hand, the assent of the population is less important to governments that receive large amounts of external support. They will devote less time and resources to explaining and defending policy decisions to their citizens, and will underfund the kinds of public institutions that encourage popular participation. On the other hand, the decline in ownership brought about by the externalization of decision-making necessarily results in departicipation. If citizens believe that their leaders respond to pressures from London, Paris or Washington, they will not devote as much time pressing demands on the local legislature and executive. More to the point, they may view the local legislature as the place to press for favors and patronage, rather than for policy outcomes, and this will once again tend to reinforce the patrimonial elements in the local political economy.

The African contemporary record is certainly compatible with such an interpretation. The region is characterized by strong presidential rule, as well as weak and pliant legislatures (van de Walle, 2001; Joseph, 2003; Barkan and Gibson, 2005), and frail civil society organizations. The absence of participatory checks on the executive branch of government in the region can tentatively at least in part be ascribed to the high volume of aid governments receive. Indeed, the relationship with the donors may well have served to reinforce tendencies which other structural factors were already creating. Many early observers had noted the low levels of participation in African political systems following independence (Kasfir, 1971; Collier, 1982), while the tendency of these countries to produce highly presidential political systems, with powerful executives and impotent legislatures has also long been related in the literature (Schatzberg, 2001; Bratton and van de Walle, 1997). The weakness of civil society in the region has also been described by numerous observers (Ndegwa, 1995; Harbeson et al., 1994).

To be sure, political systems with stronger traditions of both vertical and horizontal domestic accountability might have been affected differently by a large volume of aid. But in Africa's post-colonial regimes, these aid flows inevitably enhanced an evolution already under way. Poorly integrated political communities with substantial ethnic fragmentation, and a small (or non-existent) middle class to buttress democratic rule were more likely to fall prey to authoritarian rulers relying on clientelism to remain in power. A small number of countries, such as Botswana, avoided the worst of these pitfalls (Acemoglu et al, 2003; Lewis, 1993), in part thanks to unusual leadership. But for most the post-independence period was characterized by the emergence of regimes that enjoyed little popular legitimacy and needed a combination of systematic clientelism and various repressive political instruments to remain in power. These types of regimes were comforted in these tendencies by steady increases in aid that seemed automatic throughout the 1970s and 1980s. Governments could undertake profoundly anti-developmental actions and not threaten their relationship with the western donors. Thus, the move to authoritarian and military government in the 1960s did not reduce aid. The replacement of independent civil service commissions and merit-based promotions by politicized presidential control of the civil service was similarly condoned, not least because donors found it convenient to rely on a large number of foreign experts, to palliate weaknesses in the civil service (Berg, 1993). Disastrous nationalization of private firms owned by foreigners for the benefit of political cronies close to the president in countries as diverse as Nigeria and Zaire did not prevent aid to continue its upward trajectory (See Rood, 1976; Callaghy, 1984 on Zaire; Biersteker, 1987 on Nigeria).

A comparison with the historical experience in the West is instructive here. Much scholarly work has closely linked democratic development to the evolution of taxation (see Ross, 2004 for an excellent overview). Historians of the emergence of strong democratic states in the West emphasize the link between the progressive growth of democratic and accountable government, on the one hand, and the emergence of a state apparatus that had both the capacity and the legitimacy to extract an increasing amount of revenue from society, on the other. In an influential essay, North and Weingast (1989) showed that the emergence of Parliamentary sovereignty in Britain with the Glorious Revolution of 1688 dramatically increased the ability of the British government to raise taxes, and ensured the country's military and economic success in the 18<sup>th</sup> and 19<sup>th</sup> century.

Ardant (1975) showed that the European states that were able to finance and then win wars were the states that were able to build their extractive capacity, but also to gain the assent of their populations, often by extending political rights. In Tilly's famous aphorism, "the state made war and war made the state", the need to finance wars motivated states both to build their extractive capacity, but also to maintain their own legitimacy (Tilly, 1975, 1985). In short, taxation is important because it is essential to democratic governance, but also because it holds the key to state building and state survival. The comparison with the low income countries in Africa is instructive, since they did not have to fight international wars to ensure their survival (Herbst, 2000; Jackson and Rotberg, 1982).

In the 20<sup>th</sup> and 21<sup>st</sup> centuries, the basic functions of a developmental low-income state are to raise revenues and make effective expenditures in order to promote development. Successful developing countries—Korea, Taiwan, Botswana—have typically been solidly extractive states, with above average tax effort ratios. Not all of these states have enjoyed democratic governance during the early phases of their development, but almost invariably, their governments enjoyed substantial political legitimacy, and none were highly repressive. Of course, most of the low-income states of Africa typically have low tax effort ratios.

In recent years, donors have financed a sharp increase in social services provision in sub-Saharan Africa, notably in health and education. Historically, such increases in provision have been the hallmark of democratic governments, or at least of governments facing substantial participatory pressures. Thus, in the West, the rise of public education coincided in general terms with the introduction of the electoral franchise. Pressures from below encouraged governments who wanted to remain in power to provide more services to its citizens. In most African countries, however, the pressures have been external. In fact, a substantial proportion of the national development effort is not integrated into the national budget and does not concern the government. It is not uncommon for donors to fund over half of the country's public investment budget, while foreign NGOs with their local partners can be providing from a third to half of the social services available to African citizens in some countries (Semboja and Therkildsen, 1995). Indeed, somewhat ironically, African governments have found it politically convenient to blame the donors and NGOs for unpopular sectoral policies, poor social services and negative economic outcomes, as if these were not among their core responsibilities.

There are similar differences in the rise of civil society. In the West, an emerging middle class sought to build a counter-weight to the state and its organizations, and the result was a wide variety of membership organizations, unions and clubs with an independent basis of power, that with time were able to increase the accountability of the central state (Hall, 1995). In Africa, the absence of economic growth long undermined the development of an indigenous independent civil society. In recent years, there has been a flowering of small non-state actors and some of them were instrumental in the emergence of democratic movements that did topple some authoritarian governments in the early 1990s (Bratton and van de Walle, 1997; Harbeson et al., 1994). Yet, there remain very few membership organizations in the region, and many of the bigger NGOs that have emerged are mostly funded by the donors, typically to help undertake donor initiatives in the social sectors. Because these organizations receive funding from the donors, they are less likely to seek to build up their own memberships, or autonomy. Because they help donors implement projects that governments fail to undertake, they actually help governments escape accountability for their developmental failures.

As a result of these different dynamics, governments have escaped accountability and have been allowed to focus their resources on non-developmental expenditures that help them remain in office. Van de Walle (2001) shows that there have been substantial increases in the size of defense expenditures in the region for instance, and the number and size of public offices such as parliamentary bodies, ministerial cabinets, national

commissions, and provincial governments have steadily risen through two decades of economic crisis, even as the share of aid in the funding of development has sharply increased.

Paradoxically, as a result, in Africa, the extension of social services has often been accompanied by a decline of participation, low governance quality and an increase in clientelistic behavior. If we agree with Fox (1994) and others that the process of democratic consolidation in low-income states requires a transition from clientelism to citizenship, in which governments engage in participatory contractual exchange relationships with the population, then donors efforts may have paradoxically negative effects on citizen-government relations in the region.

## **7. Conclusions**

Our review of the literature suggests that there are reasons to believe that a large and sustained volume of aid can have negative effects on the development of good public institutions in low income countries. We have reviewed different bodies of literature that suggest that the current aid system may have undercut incentives for revenue collection and negatively affected public governance in Africa. In addition, we have examined a political science literature that finds both anti-development governance patterns across most of sub-Saharan Africa and strong historical evidence that revenue generation is central to the idea of accountability and the establishment of state institutions. Combined, they suggest that aid may undermine the development of effective state structures.

There are many gaps in the data needed to prove these tentative claims. Also, state revenues are an imperfect indicator for state capacity, since states are able to get revenues in many different ways, only some of which involve much extractive capacity. Nonetheless, the analysis does suggest that an aid-institutions paradox, whereby high levels of aid can have a negative effect on local institutions, is a potentially serious concern. Given the possibility for substantially more aid flowing to Africa in the near future, scope for such a harmful dynamic is likely to be exacerbated.

A quarter of a century ago, the World Bank issued its so-called Berg Report (World Bank, 1981), which called for a doubling of aid to address its many economic and social problems. It must be particularly distressing to the development community how many of those problems persist, despite the fact that increases in aid were considerably higher than those hoped. This fact alone should encourage skepticism about the current proposals that a sharp increase in aid volume will have the intended effects in the region. It is not at all clear that the current aid practices – with the negative effects on institutions described above – will or can be reformed. But, as we have argued, there are good reasons to believe that high levels of aid over a prolonged period is likely to have negative institutional effects, at the very least, if the current aid delivery modalities are not substantially reformed.

How much is too much aid? We have studiously avoided this difficult question until the end of the paper. The same Berg (1997, 2000) suggested that aid starts to have negative

effects on local institutions when aid flows reach 5 percent of GDP, which would mean that the overwhelming majority of states in the region are negatively affected. A more recent and thorough review of aid absorption (Clemens and Radelet, 2003) find the 'saturation point' (where additional aid would produce zero economic impact) highly dependent on local conditions, but ranging from 15-45 percent of GDP. Surely, the incentive dynamics raised by this easy come into play well before such an extreme level is reached.

Our analysis is in no way meant to disparage the desirability of general increases in aid flows, however, or suggest that additional aid could not necessarily be spent without producing the negative institutional effects. Our findings do not cover a range of activities that might be donor financed which could have positive institutional effects, such as debt relief, peacekeeping, and regional security arrangements. Similarly, we join other analysts who have advocated substantial increases in funding for regional and global public goods, such as agricultural research or anti-malaria research. All the available evidence on the likely impact of the eradication of endemic diseases in the region suggest current funding levels to be inadequate (Ferroni and Mody, 2002), and a substantially larger flow of resources would be unlikely to have the kinds of negative institutional effects described here.

In sum, it seems likely that the extra public dollars now being proposed for traditional development assistance might well be better spent for other types of assistance that would in the long run have a greater impact on the development of the region. However, an historical view of the complex evolution of state institutions suggests that not only are they critical to producing developmental outcomes, but that donors should be unambiguously aware that their assistance can have perverse effects on some of the very outcomes they hope to encourage.

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