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# Briefing on New Study from the Center for Global Development: Clemens et al.'s *Counting Chickens When They Hatch: The Short-Term Effect of AID on Growth*

**BACKGROUND:**

The effectiveness of foreign aid has been vigorously debated for decades by academics and policymakers working in the development field. This decade is no exception. Numerous regression studies have been conducted, challenged, and reformulated, some of them finding aid to be an effective tool for promoting economic growth, some finding a zero or, paradoxically, even a negative association with economic growth performance, and still others finding little effectiveness, except for aid going to countries with the right kinds of institutions and policies.[1] Reaching a consensus on whether aid has been effective in promoting economic growth, and under what conditions, has proved elusive.

**THE STUDY AND ITS FINDINGS:**

Now, in a major step forward, Michael A.Clemens, Steven Radelet and Rikhil Bhavnani of the Center for Global Development have published a study that yields strong evidence that foreign assistance can be highly effective in raising the recipient's rate of economic growth in the short run, and can do even when institutions and policies of the recipient are far from perfect. For Clemens *et al*., the main fallacy of previous research on the aid-growth relationship has been its flawed focus on the effectiveness of *total* assistance in raising a recipient country's rate of economic growth regardless of the composition of that assistance. To escape this flaw the authors therefore disaggregate aid flows into three categories: (1) aid that can plausibly be expected to have an impact in the short run, (2) aid that can be plausibly be expected to have an effect in the longer run (ten years), and (3) humanitarian aid. Doing so, they convincingly establish that there is a positive and causal relationship between short-impact aid and economic growth, albeit with diminishing returns, over a four year period. The findings of this four year panel regression study seem not easily disputed and unlikely to be challenged seriously for some time to come.

**MEASUREMENT:**

The study by Clemens *et al*. disaggregates aid flows into growth-relevant categories for a large number of countries by using newly available data from the OECD's Creditor Reporting System (CRS) which reports aid commitments disaggregated by 233 distinct purposes for all donors and recipients annually since 1973.[2] Clemens *et al.* first assign each of the 233 codes into one of three mutually exclusive categories: (1) Short-impact aid defined as aid disbursements to raise GDP per capita within roughly four years to a permanently higher level (includes budget support or program aid, aid given as an investment for infrastructure including roads, communications, energy, banking, agriculture and industry); (2) Long-impact aid defined as intervention that might permanently raise GDP per capita but is unlikely to show the impact within a four year period (e.g. aid disbursed for social sector investment including education, health, population control and water) and (3) Humanitarian aid involving emergency assistance and food aid, given its primary purpose of keeping people alive and mitigating their suffering during hard times in which GDP is likely to be declining, cannot be expected to show any economic growth impact. Using the OECD's "prefix coding system" the authors further refined their three categories into four 'prefix codes' depending on the type or purpose of the credit.[3] The authors aggregate the data by recipient country so that each recipient country in each year has an observation for the total amount of each of the types of aid – short term growth impact, long-term growth impact, and growth neutral impact aid. The

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key variable in the four year economic growth rate equation turns out to be the amount of short impact assistance from all aid providers to a country, not the total amount of all kinds of assistance.

**EMPIRICAL RESULTS**

The study finds a strong, positive and causal relationship between short-impact aid and economic growth with diminishing returns over a four-year period. The impact is large - an estimated two-to-three times larger than that found in studies using the aggregate level of foreign aid. A $1 increase in short-impact aid raises output (and income) by $8 in present value in the typical country. On average, short-impact aid raises the four year growth rate regardless of a country's level of income, social indicators (e.g. life expectancy), strength of institutions, or quality of policies. But in countries with stronger institutions and with longer life expectancies, the average impact on growth is somewhat larger. The study shows that the economic growth and short-impact aid relationship is not linear, but has diminishing returns. This may be because of absorptive capacity issues in some countries, which long-impact aid seeks to address. But the authors find little or no positive relationship between either "long-impact" aid or humanitarian aid, and economic growth over a four year period. Rather than look for evidence of impact over a longer time span, for either type of aid (although, as they point out, some authors have found evidence of it) they argue convincingly that the kind of growth regression analysis with four year panel data they are using is an inappropriate tool to measure effects of those other kinds of aid. There is a significant negative relationship between economic growth and debt servicing.

**SO HOW MIGHT THIS AFFECT THE MIX OF DIFFERENT TYPES OF AID?**

Should international organizations and bilateral donor agencies like USAID focus more on providing short-impact assistance since this is what is likely to help improve recipient countries boost their economic growth rates, at least in a given four year period? Regression analysis can go only so far in answering this question. The authors say clearly that they cannot and do not want to estimate the relative effectiveness of the different kinds of assistance. They point out the difficulties of distinguishing long run impact (e.g. over a ten year period) from other factors which are likely to have changed greatly over a long span of time, affecting the growth rate. They admit that some of the growth-boosting impact of long impact aid may be captured by their analysis as part of the estimated growth impact of the short impact variety. In disaggregating aid flows, they also show what large portions of aid flows (about 45%) are unlikely to affect growth in a given four year period. If a major objective of foreign assistance, however, is to have some kind of positive economic growth effect in the short period, it would seem that assistance to some countries should include more aid flows that can be expected to have some kind of positive impact in the short-run, *e.g.* balance of payment support, investment in infrastructure, and support for productive sectors such as agriculture and industry, than is currently the case. What counts is total short-impact aid, of course, so more than one donor's aid mix is relevant. The authors have shown that such short-impact aid does not have to be restricted to a handful of recipient countries with the strongest institutions or best policies in order for it to have a strong positive effect on economic growth.

**HOW TO ACCESS THIS REPORT**

For more information on *Counting Chickens When They Hatch: The Short-Term Effect of Aid on Growth*, please click on: http://www.cgdev.org/Publications/?PubID=130

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[1] Clemens *et al* list numerous previous studies in their voluminous bibliography.

[2] However, the data only allowed them to do panel regressions with data from the 1990s decade.

[3] The prefix coding system splits each code into four specific categories: (1) investment projects, (2) other resource provision, including commodities and supplies, (3) technical cooperation, and (4) program/aid cash. By making use of the prefix codes, Clements et al. refine their initial categories. For example, they classify as long impact all aid for technical cooperation, regardless of its stated purpose, (e.g. TA for the Ministry of Economic Growth or TA for teacher training). They classify as short-impact, all program aid/cash assistance flows, regardless of their stated purpose.