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Chapter: Foreign Aid and Quality of Government

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Abstract

This chapter reviews empirical literature on foreign aid and QoG. The chapter begins with a description of how scholarship on foreign aid and QoG developed in conjunction with prominent debates in the development community. The chapter discusses three major debates: whether or not QoG moderates foreign aid effectiveness, whether or not donors give aid selectively based on QoG, and whether or not foreign aid undermines or can help build QoG. With regard to aid effectiveness, the most recent literature suggests aid can be effective even under conditions of poor QoG. With regard to selectivity, the existing literature shows increasing selectivity for overall aid flows since the end of the Cold War and provides evidence of selectivity in terms of type of aid. The evidence that aid undermines QoG is not as strong as some of the initial studies in this literature claimed. The chapter concludes by suggesting ways forward for all three literatures.

Keywords: foreign aid, foreign aid delivery, foreign aid effectiveness, institutions, governance, quality of government, selectivity, conditionality

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1. Introduction

Under what conditions does foreign aid improve quality of government (QoG) in recipient countries? Does QoG enhance the effectiveness of foreign aid, and if so, should donors target their aid based on QoG? During the Cold War, aid agencies largely ignored questions of governance, anticorruption, and transparency in their decision-making. Since the mid-1990s, however, these concepts have become central to policymaking in the development sphere, yielding a multitude of aid projects and programs aimed at strengthening QoG in poor countries and an impulse toward selectivity on QoG characteristics in aid allocation. Empirical research both has laid the foundation for some of this real-world decision making and also has examined the extent to which donor actions match with their announced intentions.

This chapter begins with a historical account of how scholars and practitioners have interacted over time: donor efforts in promoting aid effectiveness or QoG in recipient countries have responded to the creation of systematic evidence, while scholars have identified research questions by looking at practical challenges faced by the development community.

Then we review empirical scholarship interested in uncovering the conditions under which aid improves growth and development. One prominent claim in the aid effectiveness literature is that aid leads to growth in countries with high QoG. More recent literature, however, has called into question the robustness of evidence for this claim. The initial finding nonetheless has motivated donor agencies to condition aid policy and delivery on QoG, spurring further research that aims to understand how QoG levels shape decision making about foreign aid. This research agenda has been productive for better understanding the behavior of aid agencies, and there are areas for further development. One concern raised by development practitioners and academics alike is that foreign aid flows might undermine QoG. We review this literature, noting the mixed evidence and the analytical challenges to reaching firm conclusions. We argue that this literature needs to move forward with collecting new measures of and data on the alleged mechanisms by which aid supports or hinders growth in QoG.

2. Quality of government, foreign aid effectiveness, and foreign aid decision-making

Historically, foreign aid has served a dual purpose of trying to achieve strategic goals desired by the wealthy countries of the world while also looking to support economic development in aid-receiving countries (Morgenthau 1962). The earliest theories of how foreign aid would spur economic development were largely mechanical, assuming that there was a financing gap created by low savings rates that foreign aid could fill, quickly propelling poor countries into a self-sustaining circle of economic growth (Easterly 2006). Given strategic motivations and a simple theory of foreign aid effectiveness, aid agencies during the Cold War largely ignored questions of governance, anticorruption, and transparency in their decision making.

In the 1980s, the structural adjustment era was characterized by the idea that foreign aid could be used to incentivize good economic policies, defined as policies that limited the role of the state in economic management (Williamson 1990; Mosley, Harrigan, and Toye 1991). Structural adjustment lending allowed borrowing countries to reduce fiscal imbalances, while conditions attached to the loans required the governments to dismantle state structures and implement market-oriented policies such as deregulation and privatization. The underlying logic was that market-friendly policies, macroeconomic stability, and openness to trade would enable a transition to development (World Bank 2005).

Yet by the early 1990s, this new theory of how foreign aid could be used to promote growth had been thoroughly challenged by the setbacks experienced by developing countries over the previous decade (Boone 1996; Easterly 2005). One dominant reaction was to insist that the failure had been one of implementation, not of policy design (World Bank 1989; Mosley, Harrigan, and Toye 1991; Killick, Gunatilaka, and Marr 1998; Dollar and Svensson 2000; Svensson 2003). These discussions raised the issue of the extent to which political elites in aid-receiving countries were interested in promoting economic growth or rather were simply seeking rents. Other scholars

pointed to donor failures to contextualize the reforms (Rodrik 2006) or the difficulties of donors actually enforcing the conditions contained in structural adjustment programs (Easterly 2005).

The shortcomings of structural adjustment and the end of the Cold War opened the door to increased attention to the on-the-ground politics in developing countries. As early as 1989, the World Bank described the underlying development problem in Africa as a “crisis of governance” (World Bank 1989). It began to dawn on practitioners that structural adjustment programs could not produce lasting effects when recipient QoG was poor. In 1990, the World Bank’s general counsel issued a legal memorandum to its Board of Directors that set out a framework for dealing with the issue of governance “as prelude to any future analysis of the manner in which the WB may take it on operationally” (Lateef 2016). This was a clear signal from the world’s leading development actor that QoG should be a part of the language of development (Weaver 2008; Winters and Kulkarni 2014). By 1997, the World Bank’s flagship publication, the *World Development Report*, reflected this major shift in thinking: that year, the report focused on the central role of the state in development and noted the need to reinvigorate public institutions that had been dismantled by structural reforms; the report also highlighted the importance of effective rules and restraints, competitive pressures from within the civil service and outside, and increased citizen’s voice and participation (World Bank 1997).

The end of the Cold War also meant that, with less strategic motivation for aid, aid budgets started to decline. This incentivized aid agencies to think more deeply about how to demonstrate that foreign aid could be effective. As a result of the studies that we describe in the next section, from the mid-1990s, the governance agenda grew significantly. No longer focused only on strengthening the state, development actors interested in QoG looked also at democratization, security, justice, strengthening civil society, and much more. Still riding the wave of euphoria that followed the fall of communism and recent democratization trends in Sub-Saharan Africa and Latin-America, international development actors contributed financing for elections, independent courts,

and representative parliaments, among other institutions, recognizing the centrality of politics in development.¹

Evidence on the link between QoG and foreign aid

One component of the intellectual trends undergirding policy changes in the development community during the 1990s was the increased interest in institutions in economics and political science. Advances by North (1990), Ostrom (1990), Tilly (1990), and Evans (1995) on the importance of institutions for growth and development influenced the debate on foreign aid effectiveness. In a seminal study originally circulated as a World Bank working paper in 1997 as background to the *Assessing Aid* report (World Bank 1998), Burnside and Dollar (2000) represents the seminal quantitative attempt at evaluating the role of sound macroeconomic policies for aid effectiveness. They measure sound macroeconomic policies based on the level of inflation, the size of the budget deficit, and the degree of trade openness. Looking at the period from 1973 to 1993, they find that foreign aid is effective at promoting growth *but only when policies are good* (i.e., when inflation and budget deficits are relatively low and when the country is relatively open to trade).² This finding seemed to confirm an emerging consensus about the centrality of good policy in the aid effectiveness debate. It also motivated central players in the aid area, like the World Bank, to recommend that donor governments and their aid agencies condition aid policy on the soundness of recipients' macroeconomic foundations (Pronk 2001). In the 1998 *Assessing Aid* report, the World Bank went as far as suggesting that "an increase of USD 10 billion in aid, favoring countries with sound management, would lift 25 million people per year out of poverty. By contrast, an across the board increase would lift only 7 million out of poverty" (World Bank 1998, 16).

¹ Although we do not review it here, there is a substantial body of work that examines the link between foreign aid and democratic change in recipient countries; see, for example, Finkel, Pérez-Liñán, and Seligson (2007), Wright (2009), Bermeo (2011), Kersting and Kilby (2014), and DiLorenzo (2018) and the review in Dijkstra (2018).

² In a subsequent working paper, Burnside and Dollar (2004) more directly focused on "institutional quality" as the key moderating variable, finding strong empirical support in their data for the idea that aid leads to economic growth in the presence of QoG (defined as the average of the six indicators that today are known as the Worldwide Governance Indicators).

The initial Burnside and Dollar (2000) finding of a conditional effect of aid on growth was widely cited in the practitioner community and used to justify the emerging focus on governance in the realm of aid-giving.³ To identify the causal effect of aid on growth, Burnside and Dollar (2000) – building on Boone (1996) – included a set of instrumental variables in a first-stage equation: population, arms imports, and indicators for Egypt, membership in the Franc zone, and Central American countries. They argue that these variables will predict variation in aid flows that is exogenous to economic growth, allowing them to capture the causal effects of aid.

Work that replicates Burnside and Dollar (2000) (e.g., Easterly, Levine, and Roodman 2004) has tended to use these same instruments. It is easy, however, to imagine violations of the exclusion restriction. Arms imports and the Central America indicator are meant to proxy for an aid-receiving country's strategic importance, something that should increase aid flows. Insofar as these measures proxy for armed conflict, however, it is easy to imagine that conflict affecting growth through a channel that does not involve foreign aid – a violation of the exclusion restriction (Wright and Winters 2010). These concerns have led some authors to eschew instrumental variables completely and argue that the best that we can do is attempt to model plausible time frames in which aid might have had an effect (Clemens et al. 2012).

From the perspective of causal identification, the literature needs more attempts to find exogenous variation in aid. Galiani et al. (2017) treat countries losing access to funding from the International Development Association (IDA), the World Bank's concessional lending wing, as exogenous to growth in a small window around an eligibility threshold. They estimate a significant relationship between aid and growth by studying differences in countries that have remained eligible for IDA financing and those that have lost eligibility. These authors do not, however, look at whether or not this effect is moderated by QoG. Carnegie and Marinov (2017) study the effects of aid flows associated with rotation in the European Union Council presidency on human rights and democracy

³ It also inspired scholarship to theorize beyond the conditioning effect of good policies. Kosack and Tobin (2006), for example, find that aid is effective at promoting human development in recipient countries that exhibit higher levels of human capital; the authors understand higher human capital as representing government preferences for spending on human development.

(but not on economic growth). Like Galiani et al. (2017), they identify a specific process that predicts aid increases and decreases and study the effects of those changes in aid. The literature on how QoG moderates aid effectiveness needs to engage with these creative attempts to identify exogenous variation in aid.

The original Burnside and Dollar (2000) spurred numerous studies that investigate the robustness of the finding. The subsequent evidence suggests that the conditional effect where foreign aid promotes growth only under good policies is not, in fact, robust to different data or model specifications (Hansen and Tarp 2000; Lensink and White 2000; Easterly, Levine, and Roodman 2004; Roodman 2007; Rajan and Subramanian 2008; Clemens et al. 2012).

Ultimately, however, the donor community took the original Burnside and Dollar (2000) finding to heart insofar as it supported the practice of conditionality in foreign aid giving, where tranced foreign aid is disbursed only as aid-receiving countries meet a set of pre-specified conditions. This form of aid rewards countries for taking strong measures to promote sound macroeconomic policies as identified by the donor (Gwin and Nelson 1997; Girod 2018).

Despite the failures of structural adjustment conditionality in the 1980s, there is some evidence that donors who seek to promote development have become more vigilant about implementing conditionality since the 1990s (Dunning 2004; Bearce and Tirone 2010; Dietrich and Wright 2015). Ultimately, however, the efficacy of aid as a tool for promoting good policy and QoG depends not only on donors and their development orientation but also on the interests of recipient governments (Mosley, Harrigan, and Toye 1991; Collier et al. 1997; Killick, Gunatilaka, and Marr 1998). Policy conditionality only works if foreign aid succeeds in realigning domestic incentives in favor of reform. Empirical evidence suggests that donor's ability to realign government incentives depends on conditions in the recipient country. For example, in a study about recipient compliance with World Bank conditionality, Girod and Tobin (2016) find that governments that are more dependent on donor assistance to stay in power are more likely to comply with the World Bank's conditions than those who are less dependent and have more non-aid revenue at their disposal.

Aid selectivity

Many scholars and aid industry practitioners alike remain sceptical of the possibilities of policy conditionality (Collier et al. 1997). An alternative to using policy conditionality is allocating aid to countries that *already* have a good QoG record, having demonstrated effort in the context of institutional reform and development. Collier and Dollar (2002), for example, posit that outcome-oriented donors should condition their aid flows on the policies of aid recipients. This type of conditioning of aid flows on existing characteristics of aid-receiving countries is known as selectivity.

Beyond good policy, scholars and practitioners have expanded the criteria for selectivity to include broader measures of QoG that proxy government effort and capacity to reform, including corruption, rule of law, regulatory quality, and government effectiveness, as well as political rights, liberties, and institutions. For example, the World Bank's "Country Policy and Institutional Assessment" index rates developing countries on indicators along four dimensions including macroeconomic and structural policies, as well as social policies, and public sector management and institutions.

What does the evidence say about the extent to which donors implement selectivity? Consistent with Collier and Dollar (2002), early works that examine foreign aid allocation patterns during the Cold War do not find evidence for donor selectivity with regard to policy or institutions. Neither bilateral nor multilateral donors, on average, systematically reduce aid flows when corruption in aid recipient countries is high (Svensson 2000; Alesina and Weder 2002; Neumayer 2003).

On the other hand, when scholars expand the temporal domain or focus only on the post-Cold War period, the empirical evidence shows increasing evidence of selectivity. A series of papers show that, starting in the 1990s, donors begin, on average, to systematically reward sound macroeconomic policy or a good governance environment with more aid (Berthélemy and Tichit

2004; Dollar and Levin 2006; Bandyopadhyay and Wall 2007; Claessens, Cassimon, and Van Campenhout 2009; Knack, Rogers, and Heckelman 2012; Annen and Knack 2018).

The literature reveals, however, important cross-donor differences in selectivity with some donors being more responsive to policy or QoG when making aid allocation decisions (Schudel 2008; Isopi and Mattesini 2008; Easterly and Pfutze 2008; Clist 2011). Recently, Annen and Knack (2019) find that the proportion of policy-selective aid in the global aid budget varies over time, with substantial increases between 1990 and 2001 from zero to 60 percent, followed by a steep decline to only 20 percent in 2014.

In one prominent example, this performance-based view of foreign aid allocation is embodied in the United States' Millennium Challenge Account (MCA) program. Created in 2004, the MCA closely aligns foreign aid funding decisions with a country's performance on governance dimensions: only countries that meet specific policy and QoG criteria receive the generous aid packages that the institution can offer (Mawdsley 2007; Girod, Krasner, and Stoner-Weiss 2009; Goldsmith 2011). These criteria included quantitative, publicly accessible indicators from a variety of different sources that include corruption control, government effectiveness, rule of law, and/or macroeconomic indicators such as inflation or fiscal policy. According to the MCA, high scores on these indicators signal that a country has assumed responsibility for promoting change and development. While the MCA principle of picking winners may reduce the risk that foreign aid goes to waste, it also excludes many of the world's poorest countries – which do not have a record of good policy or high QoG – from funding.

While the notion of selectivity has traditionally revolved around overall aid allocation to countries with better policies and governance, recent scholarly advances have investigated selectivity for other aspects of donor decision-making. Explicitly recognizing the heterogeneity of aid delivery tools, Radelet (2004) advocates that “aid should be delivered to countries with better governance very differently than to countries with poor governance” (12). In line with this thinking, recent

evidence suggests that donors look to recipient QoG when making decisions about the sectors to which they will allocate foreign aid sectors and the modalities through which they will do so.

As argued by Svensson (2000), recipient QoG is linked to the risk of aid capture through agency problems and bureaucratic inefficiencies. Some evidence shows that donors reduce the risk of aid capture in low QoG environments by decreasing the amount of aid over which the government has control, such as programmable or budget aid (Winters 2010; Clist, Isopi, and Morrissey 2012; Winters and Martinez 2015). Others find that concerns about aid capture lead donor governments to alter their aid delivery tactics: when the risk of aid capture is high, as is the case in low QoG environments, donor governments, on average, decrease the share of government-to-government aid, while increasing the share of aid channeled through bypass actors (Dietrich 2013; Bermeo 2018). These bypass actors include international organizations, non-governmental organizations, and private sector contractors. A recent study by Eichenauer and Reinsberg (2017) finds evidence that the selectivity logic explains why bilateral aid donors sometimes channel resources through multilateral organizations for implementation (what the authors call “multi-bi aid”): when the quality of recipient governance is low, donors increase the amount of multi-bi aid, while decreasing the share of government-to-government aid.

What remains less well understood is how donor governments differentiate among the different possible bypass channels. Are there specific QoG concerns that lead donors to prefer NGOs instead of multilateral organizations? When do donors prefer to use private sector contractors over NGOs? Future research should continue to disaggregate bypass channels to better understand the effect of QoG on the choice among the various non-state delivery channels.

Recent studies also have revealed that aid donors differ in the extent to which they engage in aid channel selectivity. Comparing the predictive power of recipient QoG (measured as an average of five of the six Worldwide Governance Indicators) across individual donor regressions, Bermeo (2018) finds that, on average, donors condition foreign aid delivery on the quality of governance in the recipient country. Dietrich (2016) shows that not all donors do so to the same degree. She explains

that differences in the use of bypass aid across donor governments result, in part, from differences in governance orientations across donors, as donors hold contrasting conceptions about the role of the state in public sector governance. These contrasting views, in turn, influence their propensity to work with or around the recipient public sector. These findings receive robust empirical support at the level of cross-country spending as well as in data from individual aid agency decision-makers. In the context of multilateral aid, Dietrich, Reinsberg, and Steinwand (2019) find that differences in views about the appropriate role of the state in public sector governance systematically influence funding decisions across different types of World Bank trust funds. The existence of donor heterogeneity in aid delivery may help explain conflicting results in the literature that studies aid flows more broadly and cautions us from generalizing findings found in studies of a single donor.

Finally, the literature on public opinion and foreign aid also indicates that donor publics are selective and condition their support for foreign aid on the quality of governance in the recipient country. Both Bauhr, Charron, and Nasiritousi (2013) and Bauhr and Charron (2018) find that perceived corruption in recipient countries reduces support for foreign aid. Examining selectivity at the level of foreign aid channels, Dietrich (2019) finds that information about low levels of QoG in recipient countries increase support for aid through bypass channels.

3. The effects of foreign aid on quality of government

As donors became increasingly interested in the possibility that foreign aid effectiveness depended on QoG in aid-receiving countries and the possibility that they might therefore make better use of scarce aid dollars by conditioning their allocation of aid on QoG, the academic community and some practitioners simultaneously began to raise concerns that one of the very reasons for poor QoG in aid-receiving countries might be the presence of aid itself. Some authors went so far as to claim the existence of an “aid curse” akin the “natural resource curse” (Djankov, Montalvo, and Reynal-Querol 2008), while more recent entries argue that the concern that aid hinders the development of QoG have been overblown (Jones and Tarp 2016; Dijkstra 2018). In this

section of the chapter, we describe the theoretical reasons why aid might either help or hurt QoG and the indeterminate state of the existing literature, and then we suggest some ways that the literature might move forward.

Should aid improve or worsen QoG?

Although the literature on aid and QoG – particularly in the earliest entries (e.g., Knack 2001; Bräutigam and Knack 2004) – has focused on the apparent negative consequences of aid on QoG, there are a number of theoretical reasons to believe that aid should improve QoG. We have outlined seven in the top half of Table 1.

First, as described in the previous section, donors might condition their aid giving on governance quality. While aid selectivity is motivated, on the one hand, by a desire to send aid to environments where it is likely to be used well, it also, on the other hand, serves as a form of conditionality. Insofar as recipient governments know that that donors provide more aid to countries with higher levels of QoG, governments now have an incentive to improve QoG in order to attract foreign development assistance (Mosley, Hudson, and Verschoor 2004). Such a mechanism is contingent on recipient governments believing that their allotments of aid will increase if they undertake governance reforms.

Second, donors have frequently included QoG-related conditionality in their aid programs, requiring the meeting of QoG-related policy and institutional targets in order to release tranches of aid. The threat of losing out on promised resources should bring aid-receiving countries to improve their QoG. As mentioned above, however, the evidence suggests that poverty-averse donors frequently have been unwilling to enforce conditionality (Svensson 2003) and that the reforms linked to conditionality are typically achieved only in countries where they would have been achieved even in the absence of foreign aid (Killick, Gunatilaka, and Marr 1998). Recent work has suggested that donors have incentives to tailor conditions in such a way that they appear to imply meaningful

institutional change and yet stop short of actually reforming functions and capacities (Buntaine, Parks, and Buch 2017; see also Bräutigam and Knack 2004; Pritchett, Woolcock, and Andrews 2013).

Mechanisms Connecting Aid to Improved QoG

- (1) Ex ante conditionality (i.e., selectivity)
- (2) Traditional conditionality
- (3) Investment in processes and human capital (i.e., technical assistance)
- (4) Best practice examples in investment projects
- (5) Financing higher salaries for bureaucrats
- (6) Increasing human capital in society
- (7) Survival of reform-oriented government

Mechanisms Connecting Aid to Worsened QoG

- (1) Reduced development of infrastructure for taxation
- (2) Less monitoring and fewer demands for accountability
- (3) Less civil society development
- (4) Debilitating transaction costs
- (5) Decreased human capital in government
- (6) Increased use of patronage in public employment
- (7) Increased rent-seeking behavior among elites
- (8) Increased conflict among elites
- (9) Survival of poor-governance governments

Table 1. Theorized Links Between Aid and QoG.

Third, donors have provided significant amounts of technical assistance to poor countries over time, aiming to finance trainings and consultancies that lead to improved governance processes and the presence of more human capital in government. Technical assistance aims to directly improve state capacity by funding the provision of knowledge, tools, and education. On the one hand, stories of technical assistance programs failing to effect meaningful change are widespread (Bräutigam 2000), and as just described, states are known for engaging in “isomorphic mimicry” where – in response to donor demands – they create institutions that look like they will perform a function that they actually do not or cannot perform (Pritchett, Woolcock, and Andrews 2013). On the other hand, several studies of technical assistance have found positive impacts of technical assistance on democratization and QoG (Ear 2007; Gibson, Hoffman, and Jablonski 2015; Jones and Tarp 2016; Wright, Dietrich, and Ariotti 2018).

Fourth, even if not specifically aiming at transferring processes or human capital, the presence of foreign aid investment projects may provide best practice examples of good governance, and this information may diffuse back to the aid-receiving government. If, however, incentives for meaningful institutional change are not in place, then knowledge is unlikely to transfer in this way, as the critics of technical assistance would imply more generally. For example, government officials who are content with the existing state of QoG because they benefit from the rents that are a part of it will not seek out reform-related knowledge (Persson, Rothstein, and Teorell 2013).

Fifth, foreign aid may increase salaries among government officials and thereby reduce QoG problems related to corruption or shirking (Bräutigam and Knack 2004). Higher wages have been shown to reduce corruption in some contexts (Di Tella and Schargrodsky 2003), and insofar as foreign aid funds public sector wages paid to capable workers, aid might catalyze improved QoG.

Sixth, if foreign aid achieves its long-term objectives related to improving education and bringing about economic growth (which also improves education), then levels of human capital in society will increase, giving the government a more capable workforce (Askarov and Doucouliagos 2013; Dijkstra 2018). Assuming that incentives are in place for the government to hire capable workers and for those workers to then provide expected services, foreign aid might thereby indirectly finance improved QoG.

Finally, literature has shown that foreign aid promotes government stability and survival (Morrison 2009; Licht 2010; Ahmed 2012). If a government is reform-oriented, foreign aid inflows may give that government the breathing room that it needs to undertake reforms and improve QoG.

While many in the aid industry spend their time designing reform-oriented aid projects and seeking strategic openings for reform in aid-receiving countries, the literature also has provided a number of reasons as to why aid actually might undermine QoG. These alleged negative impacts of aid have been viewed as “unintended effects” (Dijkstra 2018). We describe nine logics for how aid might lead to diminished QoG – or at least diminished growth in QoG – in the bottom half of Table 1.

First, foreign aid flows undercut the need for governments to tax their citizens. In early modern Europe, monarchs in need of revenue created bureaucracies to monitor economic activity and collect taxes from citizens; the need to staff such bureaucracies also encouraged state investment in human capital development (Tilly 1985; Bräutigam 2008). In contemporary low-income countries, foreign aid has supplanted tax revenues and so has hindered state development and possibly human capital development and therefore the development of QoG.

Second, insofar as taxation stimulates monitoring of the government and demands for appropriate government behavior by tax-paying citizens, the absence of taxation makes it less likely that citizens will demand accountability from an aid-receiving government (Bräutigam and Knack 2004; Dijkstra 2018). Without societal demands for accountability, levels of QoG are likely to be lower. Eubank (2012) provides a particularly compelling depiction of such dynamics in a comparison of aid-receiving Somalia to the quasi-state of Somaliland, which has not received aid from the international community and therefore has had to engage in revenue bargaining with local citizens.

Third and relatedly, a lack of mobilization among citizens to hold government accountable implies that civil society more generally is less developed (i.e., that the organizations that try to account for taxpayer dollars in wealthy countries do not exist in poor countries). If this is true, then even a citizenry that wants to monitor or threaten sanctions against a government may lack the capacity for collective mobilization that would allow it to do so.

Fourth, the presence of development industry actors – and particular multiple foreign aid actors – in a poor country may impose debilitating transaction costs on a government that lacks QoG. As donors demand meetings and reports from government officials, those officials may develop skills that are useful for that delimited sphere of action and not useful for provision of overall QoG to the populace (Bräutigam and Knack 2004; Acharya, Lima, and Moore 2006; Knack and Rahman 2007). On the other hand, as described above, interacting with donors in these terms may lead to knowledge and skills transfer that is useful in the long-term for governance.

Fifth, if donors hire highly capable individuals to work for their country offices or in non-governmental or quasi-governmental parallel implementing units that they establish for specific projects, these individuals will not be available to take positions in government or will be distracted from fulfilling their duties (Knack and Rahman 2007). This is particularly problematic because donors typically are able to pay larger salaries than aid-receiving governments. While bureaucrats or would-be bureaucrats may acquire skills through working with donors, the continued career opportunities working with foreign donors makes it unlikely that these skilled individuals will return to work in government, thereby limiting the extent to which they can contribute to improving QoG.

Sixth, while the presence of foreign aid may increase government salaries, as described above, governments can also use foreign aid flows to grow the ranks of government, creating meaningless positions that serve only to provide patronage to favored constituencies (Ahmed 2012). To the extent that foreign aid leads to government bloat, we expect QoG to suffer, as well-meaning and capable staff become less incentivized to do their jobs and citizens have increased difficulty in discovering the right pathways for addressing their concerns through government.

Seventh and relatedly, foreign aid flows can incentivize rent-seeking behaviors among elites (Svensson 2000). Rather than investing in productive activities, elites may seek to gain access to the rents generated by foreign aid. By maneuvering to put themselves in charge of government programs, these rent-seeking elites can undermine QoG by making government more responsive to their individual interests than to societal interests.

Eighth, at an extreme, this rent-seeking behavior might devolve into conflict. If foreign aid flows increase the value of being in control of the state, elite political actors within or outside of the regime will be incentivized to take control of the regime, perhaps through violent means (Grossman 1992; Nielsen et al. 2011). Intrastate conflict makes it more difficult to build QoG.

Finally, in contrast to the idea that aid might foment conflict and as described above, existing evidence suggests that aid may prolong government stability (Morrison 2009; Licht 2010; Ahmed

2012). Above we suggested that this could mean that aid facilitates institution building by keeping a reform-oriented government in power; however, it is equally plausible that aid – to the extent it prolongs government survival – may keep an anti-reform government in power, thereby preventing the development of QoG in a low-QoG country.

What does the evidence about aid's effects on QoG say?

As described above, some of the most prominent entries in the literature addressing aid's effects on QoG paint a rather negative portrait. In his seminal article, Knack (2001) finds "evidence that higher aid levels erode the quality of governance" (defined as the sum of three measures from the International Country Risk Guide dataset) while Djankov, Montalvo, and Reynal-Querol (2008) conclude that "aid has a negative impact on institutions" (defined as the measure of checks and balances included in the Database of Political Institutions) and indeed "is a bigger curse than oil." More recent literature, however, has been more positive. Jones and Tarp (2016) find a "small positive net effect of total aid on political institutions ... driven primarily by ... stable inflows of 'governance aid'." The authors use a composite measure of QoG, drawing on data about democracy, veto players, executive constraints, political terror, and judicial independence. Charron (2011) finds that multilateral aid is associated with *lower* corruption levels (as measured by the International Country Risk Guide) since 1997, while bilateral aid and corruption bear no relationship. Brazys (2016) finds that aid generally has a positive relationship with governance, entering negative territory only at very high levels of aid; the results vary somewhat depending on whether the outcome is from the International Country Risk Guide or the Worldwide Governance Indicators.

Looking at 22 studies published between 1999 (the working paper version of Knack (2001)) and 2012 in a meta-analysis, Askarov and Doucouliagos (2013) find that the overall results in the literature are almost evenly split. Across 620 statistical estimates of the relationship between aid and QoG in their study, slightly more than half are positive and slightly less than half are negative,

and in each case, about half of those are statistically significant. That is, 25 percent of the 620 estimates suggest a positive and significant effect of aid on QoG, and 25 percent of them suggest a negative and significant effect. When reducing the sample to 385 estimates from 13 studies that attempt to address endogeneity in some way, these proportions remain essentially unchanged: 26.5 percent of the estimates in that subsample are positive and significant, and 23.4 percent of them are negative and significant.

Regressing these different statistical estimates on the characteristics of the models that produced them, Askarov and Doucouliagos (2013) find that models that account for endogeneity produce more positive coefficient estimates and that models that study technical assistance produce more positive coefficient estimates (in line with the findings of Jones and Tarp (2016)). They also find that larger standard errors predict more negative estimates, which they interpret as providing evidence that the “literature is affected by publication selection bias, with a preference for reporting adverse aid-on-governance effects” (Askarov and Doucouliagos 2013, 622). In other words, studies finding null or positive effects of aid on QoG may not have seen the light of day relative to those that estimate negative impacts. Producing an average estimated effect from the underlying analyses in the meta-analysis, they find a positive relationship between aid and governance that is statistically distinguishable from zero for analyses that rely on data from the pre-1991 period. This analysis, however, uses only five percent of the statistical estimates included in the meta-data. For the average estimated effect based on the 95 percent of analyses in the meta-data that include post-1991 data, the average estimated effect is small, negative, and not distinguishable from zero. That is, the ultimate evidence seems to say that the average result in the literature is null, suggesting that aid neither improves nor undermines QoG.

In a non-quantitative systematic review, Dijkstra (2018) reaches a somewhat different conclusion about the earlier time period. She argues that studies employing data that goes up until 1995 or 2000 “show that aid, in particular aid proliferation and fragmentation, leads to a *lowering* of

the quality of bureaucratic governance” (Dijkstra 2018, 230; emphasis added). On the other hand, her conclusions are in line with Askarov and Doucouliagos (2013) for the more recent period, as she says that those “studies ... conclude that there are no significant effects” (Dijkstra 2018, 230). Looking separately at studies where corruption is the outcome variable, she similarly concludes that “there is little proof that aid flows systematically lead to an increase in corruption” (Dijkstra 2018, 231).

Assessing the state of the evidence

Like identifying a causal relationship between aid and growth, identifying a causal relationship between aid and QoG is a challenging enterprise. As described above in the discussion of aid selectivity, we have good reasons to expect a reverse causal relationship in which QoG predicts aid flows. Given the slow-moving nature of QoG, the strategy of lagging aid flows to predict QoG is unlikely to address this source of endogeneity. In addition, it is easy to come up with plausible stories about potential background covariates that might affect both aid flows and QoG. For instance, involvement in interstate conflict might both bring about changing aid flows and changing levels of QoG.

Of the 22 studies included in Askarov and Doucouliagos’s (2013) meta-analysis, 13 attempt to address endogeneity through either an instrumental variables strategy or generalized method of moments (GMM) estimation. Knack (2001) uses “[e]xogenous instruments for aid [that] are nearly identical to those used by Burnside and Dollar (2000)” (319). Specifically, Knack instruments for average aid/GNP or average aid/government expenditures over the period 1982-1995 using infant mortality in 1980, population in 1980, GDP per capita in 1980, and indicators for whether the country was in the Franc Zone or located in Central America, and then estimates the effect of instrumented aid on the change in QoG over 1982-1995. The two-stage least squares (2SLS) estimates are twice the magnitude of the negative coefficients estimated in an OLS model. These same instruments are

used in Djankov, Montalvo, and Reynal-Querol (2008), whereas Bräutigam and Knack (2004) use infant mortality, population, GDP per capita, and a set of colonial power indicators. Both of those studies estimate a negative relationship between aid and QoG. Ear (2007), on the other hand, relies only on infant mortality as an instrument for aid flows and finds that aid is either not related to QoG or else may have positive effects in some cases.

Despite the efforts to obtain causal estimates with an instrumentation strategy, the particular instruments employed in the literature – like those found in the literatures on aid effectiveness and selectivity reviewed above – raise concerns about whether the exclusion restriction is satisfied or not. Development variables like infant mortality and initial level of development might plausibly affect changing QoG by affecting human capital or by affecting patterns of foreign investment in the country (and not just by affecting the magnitude of aid flows). The indicators for a country's strategic importance might predict both levels of foreign aid and other forms of strategic support provided by wealthy countries to keep a ruling government in power.

Similar concerns can be raised about alternative instruments that have been employed in the literature. Svensson (2000) instruments for aid with past levels of corruption and population. Tavares (2003) instruments for aid with bilateral distance and indicators for a shared land border, shared majority religion, and shared official language. Charron (2011) instruments for aid with indicators for the colonial origins of the aid-receiving country, the region in which the country is located, and past corruption. Asongu and Nwachukwu (2016) instrument for aid with a set of indicator variables categorizing countries by their income level, legal origin, and majority religion. Jones and Tarp (2016) use two sets of instruments that include colonial history variables either separately or alongside life expectancy and population. In all cases, it is possible to think of violations of the exclusion restriction and question the extent to which the authors are successfully manipulating the data into an “as-if random” situation.

A number of studies also include GMM estimates that aim to address simultaneity bias by using past-period changes in aid as instruments for present-period changes in aid. In Djankov, Montalvo, and Reynal-Querol (2008), the GMM models estimate a negative relationship between the change in aid dependence and the change in QoG (operationalized as a measure of checks and balances from the Database of Political Institutions) that is very similar to the relationship estimated using instrumental variables methods (and larger than that estimated using OLS). Brazys (2016) and Jones and Tarp (2016) provide GMM estimates of a positive relationship between aid and institutions that are very similar to the OLS estimates that they produce.

It is surprising that similar strategies for dealing with endogeneity nonetheless lead to different conclusions across different studies. One explanation for this – favored by Dijkstra (2018) – is that donors have become more conscientious over time and have improved the ways in which their aid flows are organized and have taken steps to mitigate potential negative consequences of aid. This then would lead to different conclusions for studies that look at one time period or another. Charron (2011) looks for variation in the relationship between aid and corruption before and after the development community embraced the anti-corruption agenda in the mid-1990s; as one would anticipate if donors have changed their behavior, he finds that aid is associated with reduced corruption in the more recent period. Jones and Tarp (2016) summarize their evidence as indicating that “a positive relation between Aid/GDP and political institutions appears more robust since the mid-1990s” (274). These findings are in line with those of Dunning (2004) and Dietrich and Wright (2015) who show that aid flows are more likely to predict democratization in the post-Cold War era. Asongu and Nwachukwu (2016), on the other hand, study the post-Cold War period in Africa and continue to find negative effects of aid on QoG.

Discriminating across types of aid

Foreign aid is not monolithic, but rather comes in different forms and is given for different reasons. As described above, some donors appear to prefer different forms of aid in different QoG contexts. In the literature looking at the effects of aid, a number of authors have broken down foreign aid by type as well. In doing so, they generally have been more likely to identify a *positive* association between (some types of) aid and QoG.

Charron (2011) not only looks for variation in the time period when aid might reduce corruption but also for variation in the type of aid that would reduce corruption. In line with expectations that multilateral donors more fully (or at least more quickly) embraced the anti-corruption agenda, he finds that multilateral aid is associated with reduced corruption beginning in the mid-1990s. Okada and Samreth (2012) similarly find evidence that foreign aid from multilateral donors – although also from France and Japan – predicts less corruption (as measured in the Worldwide Governance Indicators). Dadasov (2017) compared aid from European countries to aid from the European Union, and once again finds that aid from the multilateral donor has a positive association with QoG (as measured by an average of four of the Worldwide Governance Indicators).

Looking at the terms on which aid is given, Selaya and Thiele (2012) find that grants harm QoG (measured as bureaucratic quality according to the International Country Risk Guide), while loans have no effect, and they find that budget support in the form of grants is particularly deleterious. In their study finding that aid helps build QoG, Jones and Tarp (2016) find the largest associations for aid aimed explicitly at improving QoG (i.e., governance aid or technical assistance). In their data, economic aid and other forms of aid produce positive associations with QoG, but they are not statistically significant.

Future research

For the literature going forward, we recommend that more attempts be made to study specific mechanisms through which aid might either improve or worsen QoG. For example, the comparison between the Selaya and Thiele (2012) finding that budget support correlates with reduced QoG and the Jones and Tarp (2016) finding that governance aid correlates with improved QoG may point toward the usefulness of thinking through which of the mechanisms described in Table 1 above can be supported by patterns in the data in order to reconcile contrasting findings in the literature. The Jones and Tarp (2016) study should support beliefs that technical assistance can work, transferring better governance processes to aid-receiving countries and improving the skill levels of government bureaucrats. The Selaya and Thiele (2012) finding, on the other hand, may be indicative of how aid can drive rent-seeking or conflict among elites or else help low-QoG governments to stay in power. It would be harder to think of their finding as supporting a transactions costs mechanism (since budget support is designed to reduce transaction costs). And while budget support may inhibit the development of accountability because of reduced taxation, it is not necessarily clear why it would do so to a greater extent than other forms of aid.

Drawing on interview evidence from Bolivia and Peru, Cornell (2014) describes pathways by which technical assistance might fail to lead to government reforms: if government bureaucrats lack experience, have short time horizons, or do not want to be associated with programs begun under a different political administration. The description of “isomorphic mimicry” found in Pritchett, Woolcock, and Andrews (2013) might also point toward how we can understand cases where aid-motivated reforms appear to happen but do not actually make a difference. In addition to disaggregating aid, we anticipate that this may also necessitate moving away from studying pre-existing indices of QoG and thinking about new ways to measure the size of government, the quality of bureaucrats within the government, the extent to which government positions are awarded as patronage, rent-seeking behavior among elites, and so on. The most theoretically advanced articles

in the literature (e.g., Svensson 2000; Knack and Rahman 2007) have tended to continue to rely on the general ICRG measure of QoG or its bureaucratic quality component, rather than presenting data that truly hones in on the mechanism.

With regard to the “fiscal contract” mechanisms presented in Table 1, a recent set of country-specific studies that look to see how the presence of foreign aid impacts government legitimacy provides insight into the extent to which aid substituting for taxation might reduce citizen interest in interacting with or holding the government accountable. These studies have generally found little evidence that foreign aid undermines government legitimacy or reduces citizen interaction with their governments (Sacks 2012; Dietrich and Winters 2015; Baldwin and Winters 2018; Blair and Roessler 2018; Dietrich, Mahmud, and Winters 2018). This work on how aid may make citizens think differently about their government as compared to how citizens in OECD countries think about theirs continues and may hold important clues for the ways in which aid can most effectively promote QoG.

Beyond the fiscal contract channels, researchers should think about other ways to collect micro-level data for the other mechanisms linking aid to QoG. Do parts of a government with greater foreign aid flows accomplish fewer things than other parts of the same government because of transaction costs? Do increases in aid lead to a thinning out of the government bureaucracy? Alternatively, do increases in aid lead to higher government salaries and the retention of higher-quality workers? Is there evidence of governments incorporating best practices observed in investment projects? Answering questions like these with more precise data is another way of helping the literature to move beyond contrasting macro-level associations.

Finally, we believe it worthwhile to evaluate the extent to which foreign aid that is conditioned on the QoG in recipient countries really makes for better development outcomes. The question of what has resulted from more aid selectivity in allocation and delivery is an important one. Yet it is not at all simple. As Annen and Knack (2019) remind us such a test requires us to

disentangle donor selection effects from recipient incentive effects. In their paper, the authors find that 10 percent increase in the global share of policy selective aid yields small but statistically significant improvements in policy or QoG, as measured by the GPIA index. We recommend further work in this direction, based on careful QoG measurement choices.

4. Conclusions

Up until the late 1990s, the international development industry did not advance an agenda that could be considered a QoG agenda. During the 1980s, the accepted international development paradigm was decidedly neoliberal: its central aim was to dismantle the state through structural adjustment reforms that would promote the free reign of market forces. The failure of structural adjustment to spur global economic growth, alongside global shifts in response to the end of the Cold War, however, had ramifications for how the international community saw the development process. The recognition that international actors needed to acknowledge the possibility of a central role in the development process for states – and for how those states were governed – yielded shifts in development thinking: the concept of QoG entered development programming across the donor community.

In this chapter, we have reviewed empirical research that laid the foundation for this shift in thinking. Empirical scholarship interested in uncovering the conditions under which aid effectively improves growth and development investigates the moderating role of QoG. Perhaps the most prominent finding in this body of work, Burnside and Dollar (2000), which argues that foreign leads to growth only in countries with high QoG, was a catalyst not only for further research on the role of QoG on aid effectiveness but also for encouraging international development actors to promote the nascent governance agendas. Subsequent studies, however, have called into question the robustness of the Burnside and Dollar (2000) result. The strand of the aid effectiveness literature that focuses on QoG – like the aid effectiveness literature more generally – needs to concentrate on finding instances

where exogenous variation in aid flows can be identified and more rigorous causal claims about the impact of aid can be made. Going forward, we recommend that interested scholars in the aid-governance link consider joining forces and coordinate experimental research in ways that help overcome external validity concerns associated with isolated, individual impact studies; with a view towards producing more reliable answers across different institutional contexts.

Given the growth in a doctrine that QoG moderates aid effectiveness, we assessed the evidence of whether the donor community's increasing commitment to QoG was reflected in their actions. The literature suggests that, in the post-Cold War context, there is relatively robust empirical evidence that donors condition aid policy and the forms of aid delivery on QoG. We believe that there is much still to be learned from this literature about how aid agencies make decisions and how they negotiate with aid-receiving governments. Variation in donor relations across low- and high-QoG countries should teach us both about how the development industry works and about the possibilities for successful promotion of development objectives through foreign aid.

Our review then examined the literature on the effects of foreign aid on QoG in aid-receiving countries. One concern raised by development practitioners and academics alike is that foreign aid flows might undermine QoG. The evidence base is mixed, although as with the selectivity literature there is some suggestion that problematic patterns found in Cold War data do not persist in the post-Cold War era. To move forward in this literature, we suggest that scholars devote more attention to testing the multiple mechanisms by which foreign aid is alleged to affect QoG and collecting the micro-level data necessary for testing those mechanisms.

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