



Aid Effectiveness and Capacity Building: Implications for Economic Growth in Developing Countries

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Background and Context

- **Capacity building remains a major challenge for many developing countries**
 - ∅ **Technical assistance process involving transfer of knowledge from north to south (Berg, 1993)**
 - ∅ **Development aid remains highly uncoordinated and fragmented (Dethier, 2008)**
- § **Governments in developing countries have adopted a wide range of reforms often with the advice of multilateral institutions without adequate capacity to implement these programs (World Bank, 2005)**
- § **Solutions imposed unilaterally from donor agencies cannot address 'ownership' of country programs**

Background and Context — contd'

- **Capacity building is an “endogenous process”, strongly led from within a country, with donors playing only a supportive role (OECD, 2006)**
 - Ø **Involves much more than enhancing skills and knowledge**
 - Ø **Incentives, organizational effectiveness, and governance remain important**

Aid Effectiveness and Country Capacity building

- **While more attention is paid to how foreign aid affects economic growth, less attention is paid to the issue of negative consequences of country capacity**
- **Technical assistance has been largely donor driven, with little room for local agencies to choose and design projects and programs**
- **Knowledge sharing is virtually absent in aid agencies and countries**
- **In regard to ownership and participation, serious reforms are necessary to address the disparity in capacity between donors and recipient country**

Main Questions

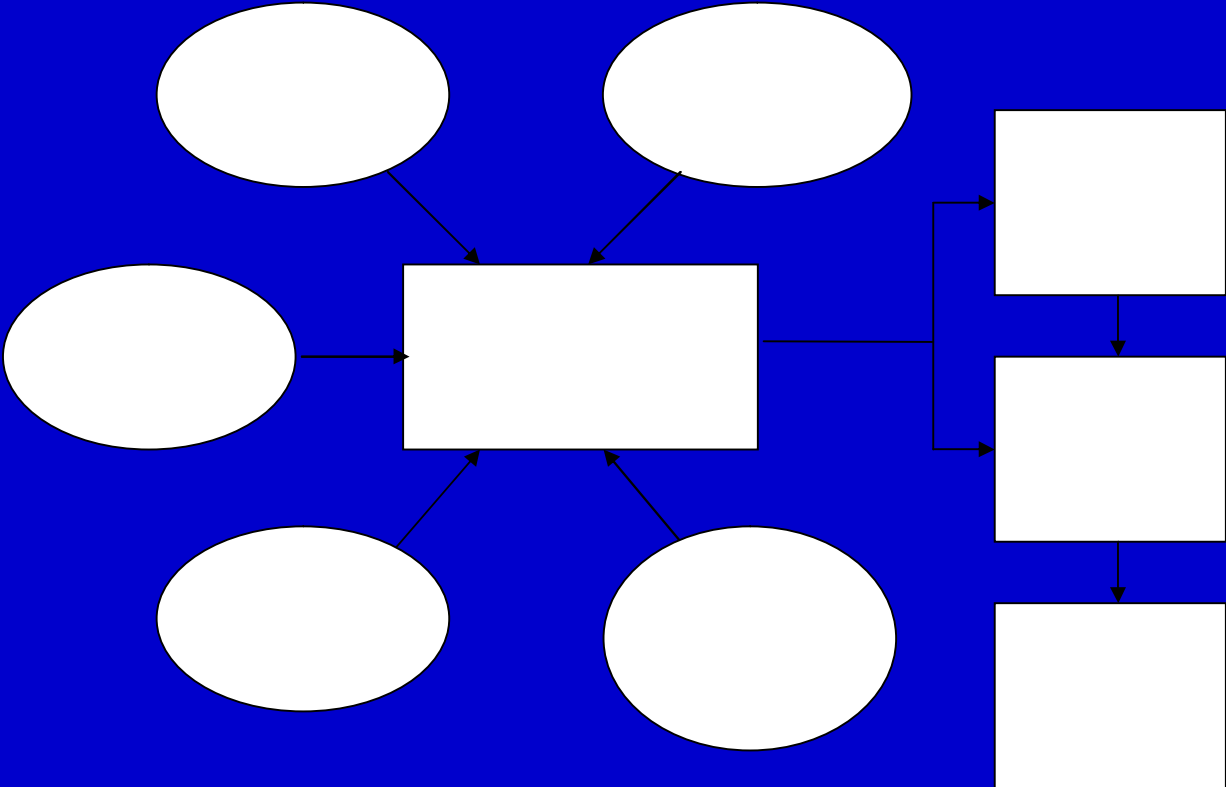
- **What is the optimal level of country capacity required to achieve economic growth targets?**
- **What sort of conceptual approaches allows us to understand the relationship between country capacity and economic growth?**
- **Under what conditions donor intervention improves or displaces country capacity?**

What do we mean by Capacity Building?

A process involving human resource development, creation of new forms of organizations and institutions, building innovative networks, and integrating country ownership that improves the efficiency of learning activities

- Ø Efficiency depends on the economic and political systems, social infrastructure and institutions
- Ø Technical, organizational, institutional and policy learning

Conceptual Framework



The Model

- **Two sectors — Goods sector and a R&D sector**
- **Four factors of production — Capital, labor, human capital and capacity resources**
- **Technology is non-rival and so the entire level of technology is used in both sectors**
- **Generalized Cobb- Douglas technology with increasing returns for the R&D sector**
- **One donor and one recipient**

The Model — contd'

- § Savings rate is exogenous and constant
- § Population growth and human capital growth is also constant and exogenous
- § Equation of motion of capacity

$$\dot{CK}_t = H_t^\lambda CK_t^\phi Y_t$$

Steady-State Conditions

- § For the steady state capacity to maintain or grow over time, there exists a ϕ^* satisfying $(2-\gamma) > \phi$, such that if $\phi > \phi^*$, an economy's capacity declines affecting the steady-state rate of growth
- § For the existence of a steady-state solution, the critical values of ϕ and γ must satisfy the following condition

$$(1-\alpha) > \frac{\gamma^*}{(2-\phi^*)} > \frac{a(2-\phi^*-\gamma^*)+c}{c}$$

Policy Exercises

1. Increase in the rate of learning in an economy

- § Results in larger human capital stock**
- § Even if the share of human capital in the R&D sector remains unchanged, the increase in the stock leads to an increase in growth rate of technology**
- § Larger growth in human capital results in increasing the amounts of resources used in the goods producing sector leads to higher capital stock**

Consequence: Increase in long-run capacity, technology, capital stock and output

Policy Exercises — contd'

2. Doubling capacity resources when elasticity of output w.r.t. capacity is low

§ **Greater human and physical capital accumulation**

§ **Greater technology absorption, with resources being used efficiently in the goods producing sector**

Consequence: Significant increase in the long-run capacity, technology and output

Policy Exercises — contd'

3. Doubling Capacity resources when elasticity of output w.r.t to capacity is high

§ **Decline in human capital stock — individuals moving into donor funded projects**

§ **Decline in technology accumulation — donors can have multiple agenda without due consideration to the requirements of the recipient country**

Consequence: The economy never reaches a new steady state possibly due to diminishing returns to aid

Programmatic Implications for Donor Agencies

- § **Development aid should be conditional on a country's level of capacity — Estimate φ^* for each country**
- § **An S-model of aid effectiveness is appropriate — both country ownership and need should determine the level of development aid (Abegaz, 2005)**

Conclusions

- In the steady-state, growth rate of capacity is strongly dependent on the learning parameter, the elasticity of output w.r.t capacity resources, and how the resources are utilized by the recipient country with the help of donor funds
- Increasing learning capabilities improve human capital stock and unambiguously increase the rate of growth of output, technology and capital stock
- Donor's intervention is most desirable when elasticity of output w.r.t. country's capacity resources is low
- Donor's intervention crowds out recipient country of projects and programs when the elasticity of output w.r.t country's capacity is even moderately high