

The Absorptive Capacity Limit: The point where too much aid becomes bad aid

An absorptive capacity limit is the point at which too much aid suddenly becomes bad aid. There are limits to the amount of aid that a country can absorb or spend efficiently. As a consequence, allocating more financial assistance to a government could actually result in worse government performance than would otherwise have been the case, with potential tipping points where too much aid impacts effectiveness of all existing aid. At that point, development risk – the longer-term risk of not achieving development objectives – and fiduciary risk – the shorter-term risk of corruption and mismanagement – can both increase significantly.

More aid is likely to improve recipient government performance when total aid is relatively low. But as aid increases, the incremental improvement that the aid delivers reduces. Eventually, the incremental improvements become negative, reflecting declining performance rather than improved performance. If aid continues to increase to very high levels, then a tipping point may arrive, causing a major decline in government performance – worse than would have been the case if no aid had been given at all.

A key task for any donor is to allocate their aid efficiently – to allocate aid among and within countries in such a way so that performance of a recipient government is not compromised by having too much or too little financial assistance, or too much of the wrong type assistance.

Government performance can be defined in various ways. One is via the state sovereignty gap, or the rate at which a state's sovereignty gap is being closed. The sovereignty gap is a targeted proxy for government performance that focuses on state capacity to meet citizens' expectations. Other performance indicators can be used, including: i) Millennium/Sustainable Development Goals; ii) government effectiveness and perception measures (e.g. Worldwide Governance Indicators, Human Development Index, Democracy Index, Ease of Doing Business, Bertelsmann Stiftung's Transformation Index); iii) fiduciary performance scores and indexes (e.g. PEFA and Open Budget Index, Corruption Perception Index); and selected macroeconomic and social (e.g. in child mortality, economic growth, primary school completion and access to sanitation).

Absorptive capacity and government performance issues go hand-in-hand.

An efficient country aid program should be one that maximises improvement in government performance. There is value in providing decision makers with information on the efficiency of aid interventions from a total country aid program perspective,

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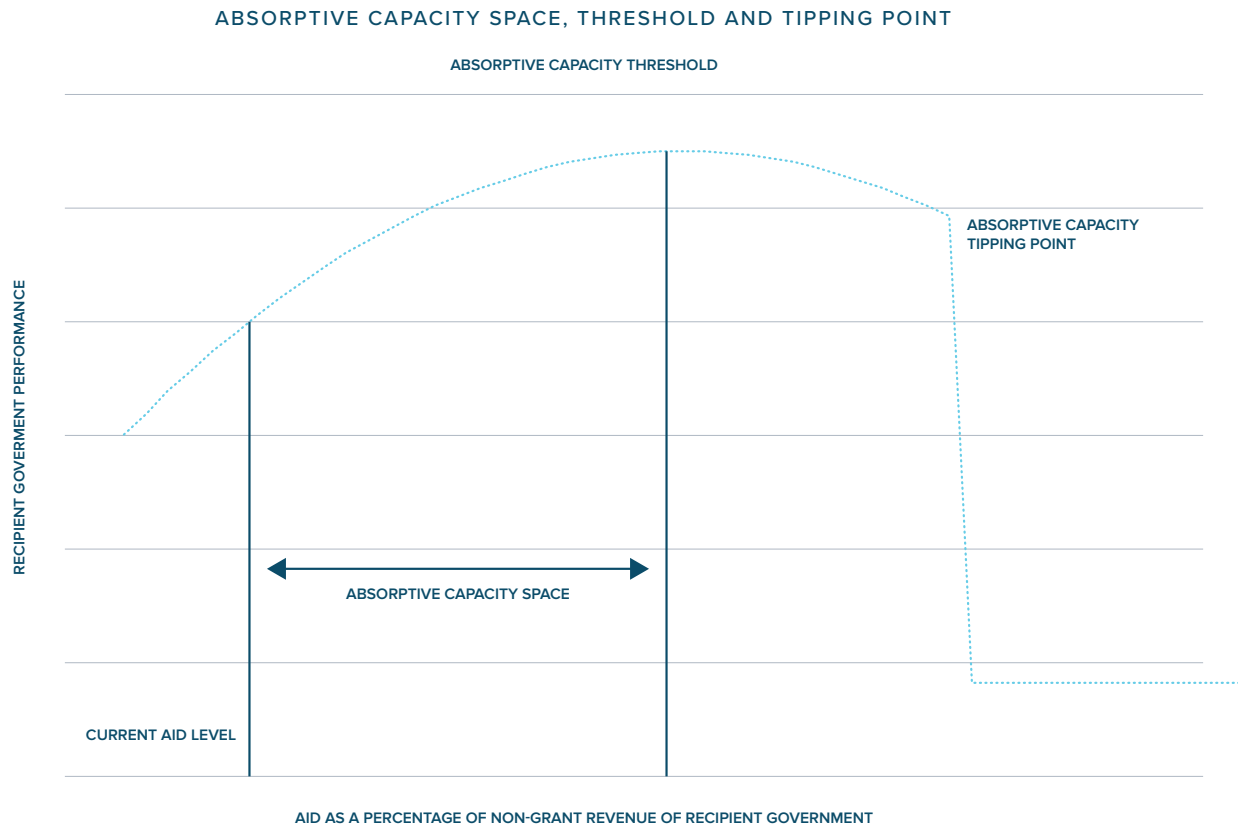
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in terms of government performance. Some donors use an aid allocation formula approach as a starting point for allocating resources among recipient countries based on some form of government performance criteria, though absorptive capacity limits are generally handled qualitatively. A formula approach can also be used to allocate resources within a country program, among sectors, for example. Approaches can involve some form of macroeconomic and/or sectoral analysis together with some type of institutional assessment to capture need and performance, and capacity to spend the additional resources efficiently. How much aid a government can efficiently use will depend on its capacity to absorb more aid. The same can be said of sectors within countries. It follows that an efficient allocation of aid is one that takes into account absorptive capacity constraints.

There are competing reasons to allocate aid, and efficiency and government performance are just two of many. The formula approach is not intended to provide the definitive allocation, just serve as a baseline to help focus discussion.

Figure 1 provides an illustration of absorptive capacity for a hypothetical recipient government. It shows that, as level of aid to this government increases, so too does government performance, but only up to the absorptive capacity threshold. This threshold is the optimal level of aid. Beyond this point, the performance of the government can no longer be improved. The reason for this fall is absorptive capacity. One proposed rule of thumb for optimal aid levels is around 20% of GDP¹². Sector or agency level rules of thumb have also been proposed, with absorptive capacity thresholds being the point at which agencies should generally not receive more funding, in the form of projects, than they do from appropriations from government³.

FIGURE 1 ABSORPTIVE CAPACITY SPACE, THRESHOLD AND TIPPING POINT



As aid levels increase past the absorptive capacity threshold, there may be a stage where an Absorptive Capacity Tipping Point is reached. This is the point that government performance suddenly deteriorates significantly – to levels that theoretically could even be worse than if no aid was given at all.

Absorptive capacity space is the difference between current aid levels and the absorptive capacity threshold. The absorptive capacity space is the additional aid a country can absorb without declines in government performance.

Absorptive capacity is not fixed – theoretically, it can be improved by successful reform. Absorptive capacity can change if the underlying drivers of absorptive capacity change. An increased capacity to absorb aid can occur for various reasons, such as increased public financial management competencies or less onerous aid delivery methods that impose lower transactions costs on recipient governments. In this case, the curve in Figure 1 shifts upward and to the right, meaning that larger amounts of aid can be absorbed by the recipient government in question, without declines in government performance, and that government performance is higher at all possible levels of aid.

A state's capacity to absorb budget support should theoretically be greater than its capacity to absorb project-based support.

This is on the basis that budget support does not fragment country accountability systems, whereas project-based support can. Further research in this area is warranted.

Perverse incentives emerge from aid dependency, which drive tipping points and deteriorating government performance.

The rent-seeking and governance theory of the “resource curse” says that because most of the national wealth originates with government, and not citizen taxes, it can be very profitable for the private sector to focus on rent-seeking from government (i.e. the

search for abnormal profits at the expense of others). Applied to aid, the story is that since a significant amount of wealth originates with donors and recipient governments, it can be profitable for the private and public sectors to focus on rent-seeking rather than productive investment and better governance. Perverse incentives also applies when consulting firms are hired by donors to work for governments. This is the “common pool problem,” where costs are borne by many but the benefits are enjoyed by a few, and where there is uncertainty over property rights. This is a typical problem faced by all governments. However, it is argued that in resource- and aid-dependent countries, the implications and forces are much more powerful. Moreover, in aid dependent countries, the country accountability systems break down – and get replaced with donor accountabilities. One example is when director generals can become more concerned about pleasing donors – in order to keep donor resourcing flowing – rather than they are with pleasing their minister – since the minister is no longer the primary provider of discretionary funding. Overall, the quality of governance arrangements can be adversely affected when there is aid dependency. Perverse incentives emerge for individuals to engage in corrupt activities and retard transparency and accountability standards and reform. This translates into a story that says that significant levels of aid increases inefficient rent-seeking, reduces governance standards, and increases corruption, which are all inefficient and bad for growth. Hence we can expect government and donor failures contributing to market failures.

Development Practice Note a future DPN describes the macroeconomic, microeconomic and institutional drivers of absorptive capacity and measurements. Development Practice Note a future DPN provides policy options on how to move from aid dependency to a safe and stable path of fiscal sustainability.

Note:

1. McGillivray, M and S. Feeney, (2008), “Aid and Growth in Fragile States”, UNU-WIDER Research Paper No. 2008/03, Helsinki, Finland Feeny, S. and M. McGillivray (2009), “Aid Allocation to Fragile States: Absorptive Capacity Constraints”, *Journal of International Development*, 21(5): 618–633, 2009. McGillivray, M, Carpenter, D, and Norup (2012), “Evaluation Study of Long-Term Development Co-operation between Laos and Sweden, SIDA Evaluation, Stockholm, Sweden.
2. Research has shown that for small island developing states (SIDS), the level of official development assistance at which its contribution to growth is highest is when aid is between 30 and 40 percent of recipient country GDP. All aid-receiving countries in the Pacific are SIDS. This level of aid is, however, an average optimal level of aid among SIDS. The optimal for some SIDS will be above 30 to 40 percent, while for others it will be below this range. As such it should be interpreted with some caution.
3. Laing, A, (2011), “Technical Working Paper - Timor-Leste: Ministry of Education Economic Efficiency Assessment, Ministry of Education/World Bank, Dili, Timor-Leste.