

# FOREIGN AID

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EE 462 Development Macroeconomics

Semester 1/2014

# Topics

- Economists' Views on Foreign Aid
- Donors and Recipients
- Aid, Growth, and Development
- Donor Relationships With Recipient Countries

# Issues Related to Foreign Aid

- What are motivations for foreign aid?
- What are the impacts of aid?
- Debates: What is the relationship between aid, growth, and development?
- Where, when, and how should aid be provided?

# Economist Views on Foreign Aid

- **Aid Optimists** - Jeffery Sachs and Joseph Stiglitz
  - Case success: Botswana, Korea, Taiwan, Mozambique, Uganda, Tanzania.
- **Aid Pessimists** – William Easterly
  - Case massive Foreign Aid Failure in Africa: Congo/Zaire, Haiti, Zambia, etc

# What is Foreign Aid?

- **Foreign aid** comprises of financial flows, technical assistance, commodities given by one country to another for development purposes, either as grants or subsidized loans.
- Official definition of foreign aid is given by **Development Assistance Committee (DAC)** of the OECD.
- Two criteria:
  - It must be designed to **promote development and welfare** as the main purpose.
  - It must be provided as either as a **grant or a subsidized loan**.
- The grants and subsidized loans that make up foreign aid are referred to as **concessional assistance**.

# Different Forms of Aid

- **Official Development Assistance (ODA)**
  - Aid provided by DAC donor government to low- and middle-income countries for development purposes.
- **Private Voluntary Assistance**
  - Grants from NGOs, religious groups, charities, foundations, and private companies
  - Examples: The Bill & Melinda Gates Foundation, World Vision, Oxfam, etc.
  - Much of the recent increase in foreign aid has come from private sources.

# DONORS AND RECIPIENTS

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# Who Gives Aid

- **Bilateral aid:** Aid given directly from one country to another
  - Major bilateral donors: Government Agencies such as USAID, JICA, SIDA, CIDA, etc
  - Who is the world's largest donor?
- **Multi-lateral Aid:** Aid that pools together resources from many donors
  - Major multilateral institutions: World Bank, IMF, UN, Regional Development Banks, the European Commission
  - World Bank: IBRD, *IDA*, IFC, ICSID
  - United Nation: UNDP, UNFPA, UNICEF, UNHCR

## The **Commitment to Development Index**: Ranking of quality of their Aid policies

- Ranking of quality of 22 richest countries' aid policies by CDI criteria
  1. Foreign aid quantity and quality
  2. Trade policies
  3. Foreign investment policies
  4. Migration policies
  5. Environmental policies
  6. Security - peace keeping operations
  7. Technology - support of Research & Development
- Ranking in 2010: Sweden #1, Denmark #2, USA #11

# Aid Recipients

- Over 150 Countries received aid in 2009.
- Afghanistan received the largest ODA **in absolute terms**.
- On a **per capita basis**, Mayotte, Tuvalu, and Palau received highest ODA per capita.
- What region receives the largest in absolute terms? What percentage of GDP?
  - Sub-Saharan Africa: ~44.5 million US\$ (4.9% of GNI and \$53 per person)
  - South Asia: ~14.5 million of US\$ (0.9% of GNI and \$9 per person)

# The Motivations for Aid

- Foreign policy objectives and political alliances
- Poverty reduction
- Country size - More aid is given to smaller countries.  
Why?
- Commercial or trade ties
- Enhancing Democracy (??)

# AID, GROWTH, AND DEVELOPMENT

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# The Effect of Aid on Growth and Development

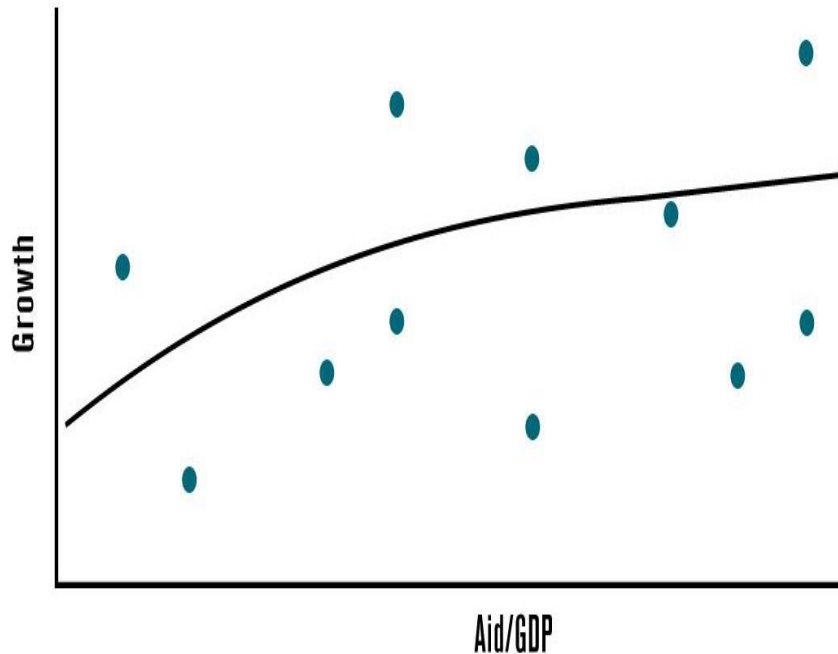
Generally, there are 4 broad objectives of aid:

1. To **stimulate economic growth** through building infrastructure, supporting sectors such as agriculture, technology, new ideas
2. To **promote other development objectives**, such as strengthening education, health, political systems
3. To **support subsistence consumption of food and other commodities** in case of emergencies and natural disaster
4. To **help stabilize an economy** following natural or man-made shocks.

# Three Views of Aid - The AID debate

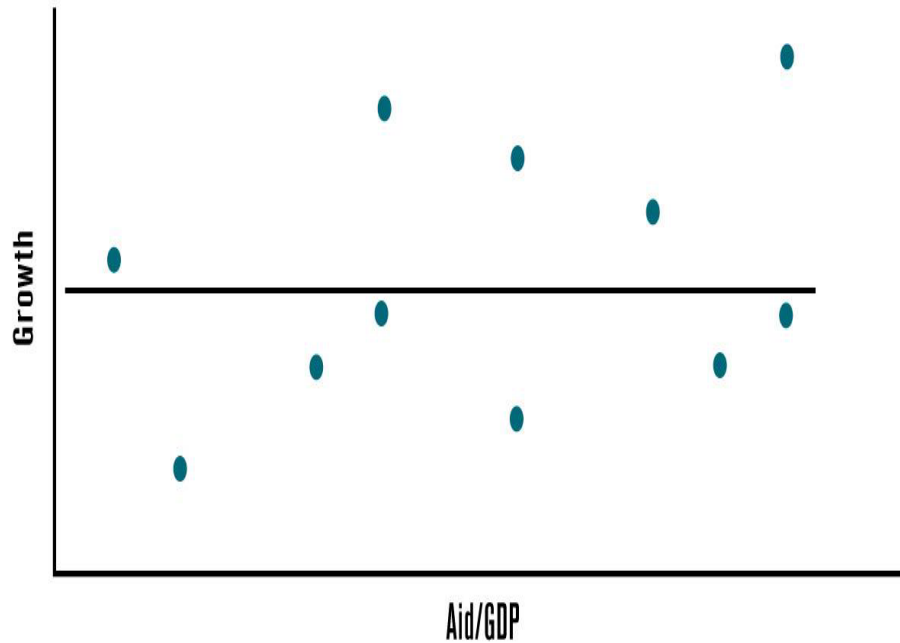
- **View 1: On average Aid has a **positive impact** on economic development, but not always**
  - Examples: Eradicating river blindness, Malaria, HIV/AIDs, etc
- **View 2: Aid has **little or no effect**, and may actually **undermine growth** and development.**
  - Example: The effect of Food Aid may lower domestic food prices and displace local production.
- **View 3. The effect is **conditional** depending on good policies, institutions and good Governance.**
  - Example: Aid to Botswana

View 1: Aid has a **positive impact on growth with diminishing returns** after controlling for the impact of other variables.



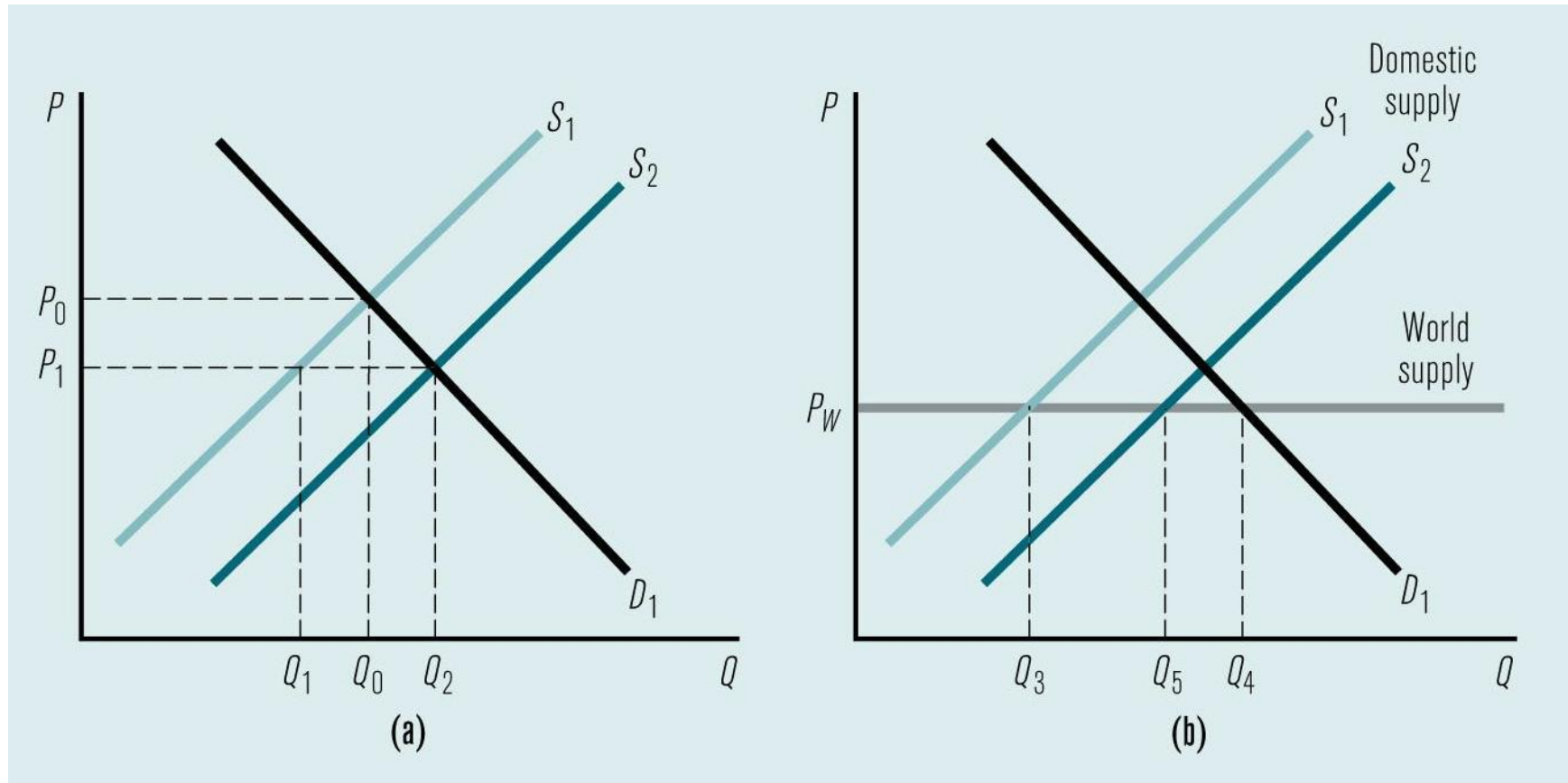
- Adding to the total amount of saving:  $\rightarrow \uparrow \text{Investment} \ \& \ \uparrow K$   
 $\rightarrow \uparrow \text{GDP growth}$
- Building knowledge and transferring new ideas.
- Promoting health, education, and the environment.
- Providing humanitarian relief; and supporting economic and political stability.

## View 2: Aid has a **little or no impact on growth** and may have a negative impact.



- Aid could be a waste if it's misused or it's not spent "*efficiently*". How?
- The impact of aid is less than expected as it reaches its *absorptive capacity*.
- Aid weakening incentives for private sector activity.
- Aid *crowding out* tax revenue\*
- *Aid dependency*\*

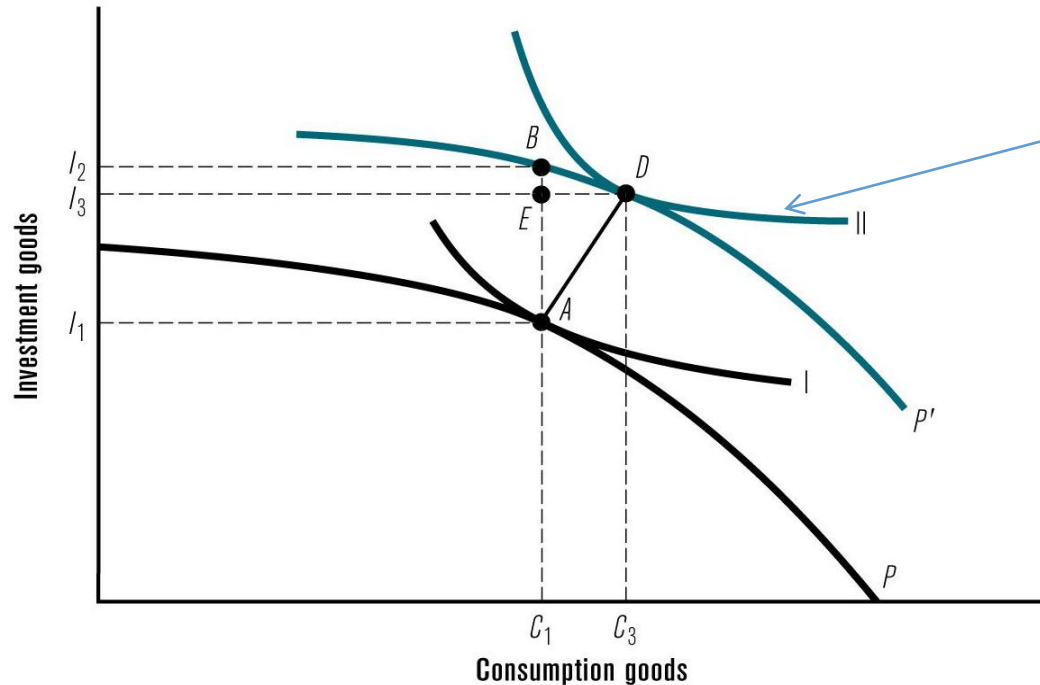
# Food Aid, Prices, and Production



(a) Food aid and production in the absence of imports  $\rightarrow$  Lower food price but displace local production

(b) Food aid and production with imports  $\rightarrow$  no change in food production and consumption

# Impact of Aid on Investment and Consumption



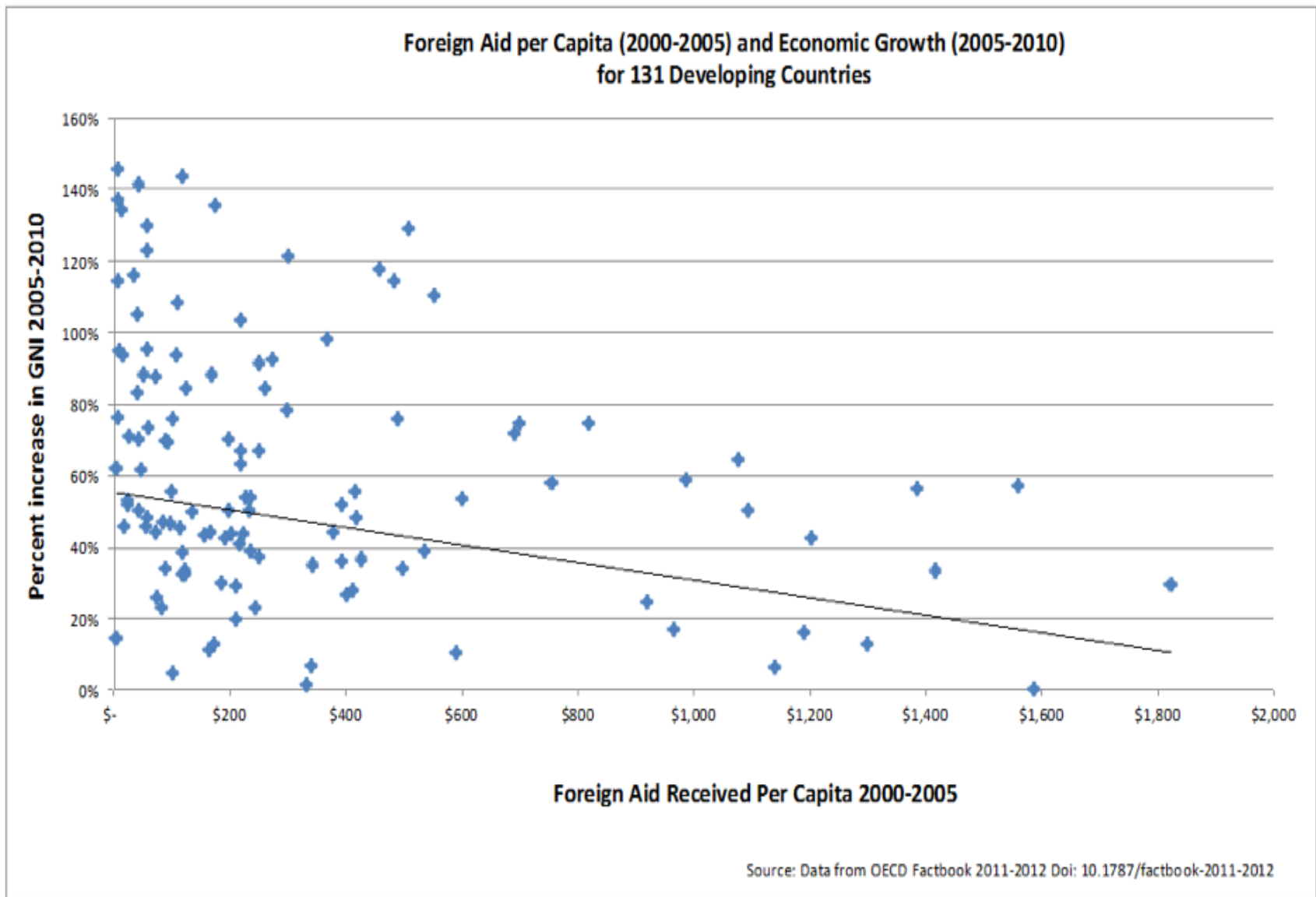
Foreign aid totaling AB turns into actual new investment of only AE because the country maximizes welfare at point D.

Aid could have a smaller-than-expected effect on investment:

- *Not all* aid is aimed at increasing investment and growth.
- The impact of aid could be *partially offset* by a reduction in either private saving or government saving.

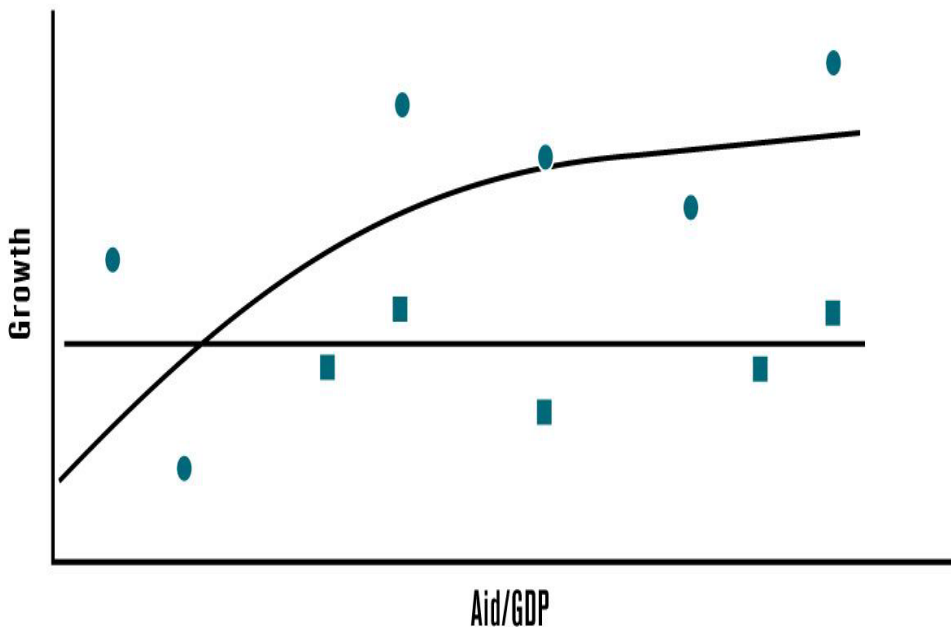
# AID Dependency

- Recipients become dependent on aid when aid flows are relatively large for long periods of time.
  - Larger the amount of aid, the **greater is the risk of a sudden reduction in aid**.
  - Large aid flows give donors **substantial leverage over the recipient** – willing to introduce whatever conditions required by the donors
    - Weaken public accountability and impede the development of civil society
  - Process of gradual aid reduction over time become more difficult.



<http://www.forbes.com/sites/realspin/2012/09/25/4-6-trillion-later-foreign-aid-remains-an-economic-somnolent/>

## View 3: Aid has a **positive impact on growth in some circumstances** but no impact in others.



Three “conditional” explanations:

- Characteristics of the recipient country
- Type of aid:
  - Emergency and humanitarian aid
  - Aid on health, education, democracy
  - Aid that directly affects growth (e.g. roads, electricity, agricultural support, etc.)
- Donor practices

# DONOR RELATIONSHIP WITH RECIPIENT COUNTRIES

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# Donor Relationship with Recipient Countries

- **The Principal Agent Problem:** Aid givers delegate *agents* which may not promote wishes of the donors especially in the presence of corruption. *Who are the agents?*
  - Taxpayers and elected officials (in donor countries)
  - Elected officials and aid agencies
  - Aid agencies and aid agencies employees, contractors, consultants
- **Conditionality:** specific policies or packages of policies that donors requires recipient countries to adopt in order to get aid.
  - Could be controversial!
  - Examples: liberalizing fertilizer prices before providing agricultural loans, privatizing of public utilities

# Toward Aid Effectiveness

- **Country selectivity**
  - Give aid to more democratic with good governance & least corruption
- Promote **participatory approach** - How?
  - Reduce problems in the principal-agent relationship.
- **Harmonize and coordinate** better
  - Ex. Several hundred aid missions are in Tanzania and Ethiopia
- **Result-based management**
  - Allocate to projects that show results, modify existing programs, and learn from experience (what worked, what didn't).