

# FOREIGN AID

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EE 462 Development Macroeconomics

# 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?

# What is Foreign Aid? <sup>(ODA)</sup> Official Development Assistance

- **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

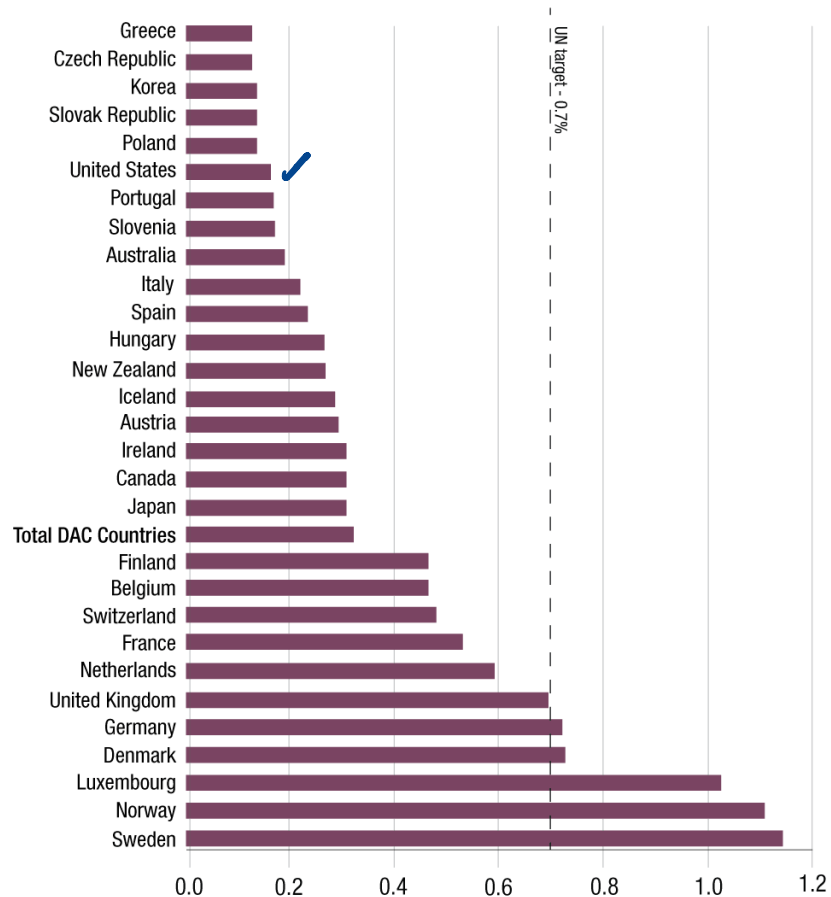
- **Bilateral aid:** Aid given directly from one country to another
  - Major bilateral donors: Government Agencies such as USAID, JICA, SIDA, CIDA, etc
  - Who is the world's largest donor?
- **Multi-lateral Aid:** Aid that pools together resources from many donors
  - Major multilateral institutions: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

ADB ↘

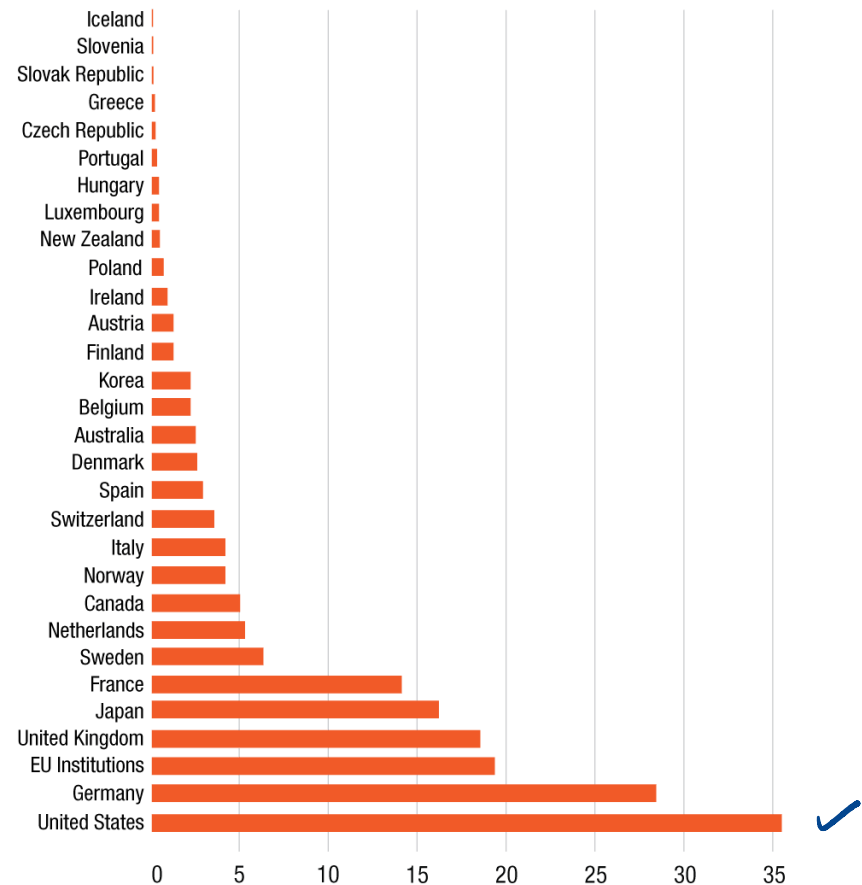
UNDP  
UNICEF  
UNHCR  
(EC)

# ODA from OECD

ODA grant equivalent as percent of GNI (2020)



ODA grant equivalent - USD billion (2020)



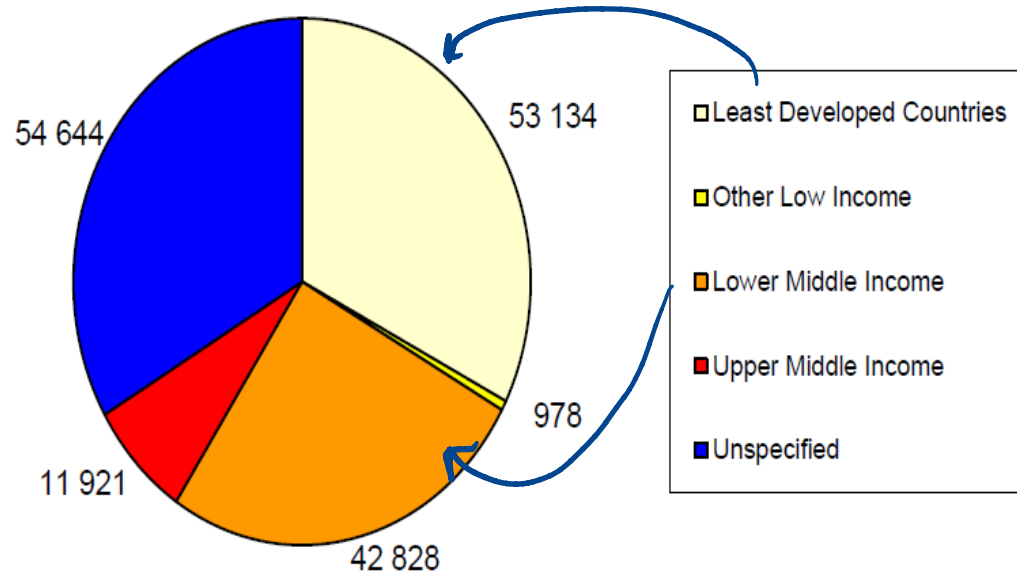
# Aid Recipients

- Which country received the largest ODA?
  - In 2019, Syria received the largest ODA **in absolute terms**.
  - In 2009, it was Afghanistan.
- 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) ]

# Aid Recipients

## 1.1.1. Top 10 ODA receipts by recipient *USD million, net disbursements in 2019*

1	Syrian Arab Republic	10 129	6%
2	Ethiopia	4 677	3%
3	Bangladesh	4 382	3%
4	Afghanistan	4 140	3%
5	Yemen	3 759	2%
6	Nigeria	3 277	2%
7	Kenya	3 173	2%
8	Democratic Republic of the Congc	2 810	2%
9	Jordan	2 690	2%
10	India	2 551	2%
	Other recipients	121 918	75%
	<b>Total</b>	<b>163 504</b>	<b>100%</b>



# 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 (??)

# Economist Views on Foreign Aid

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

# 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.

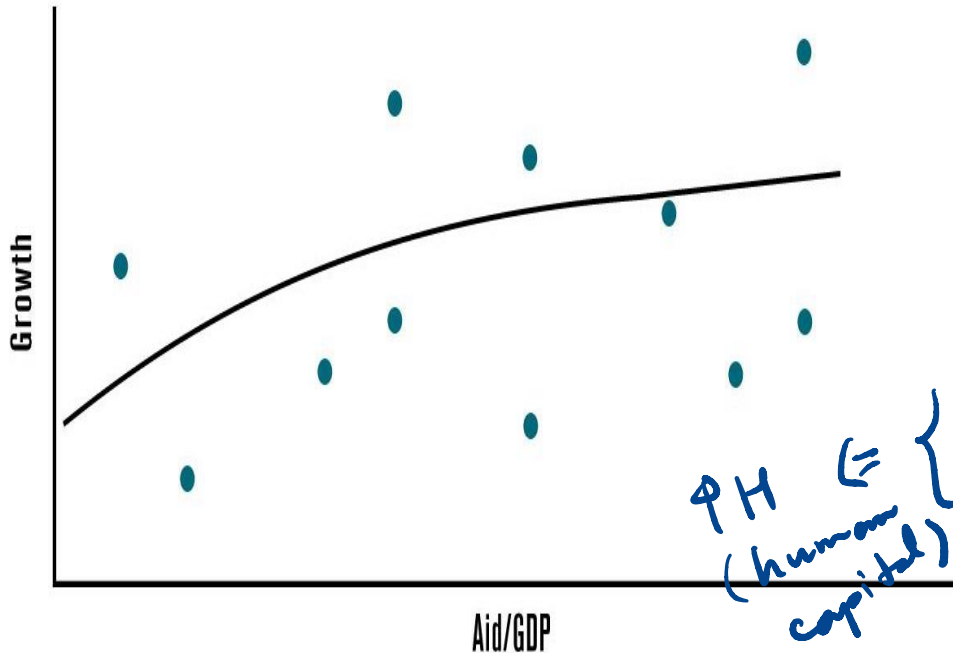
*social dimensions*

*food aid  
"Covax"*

# 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

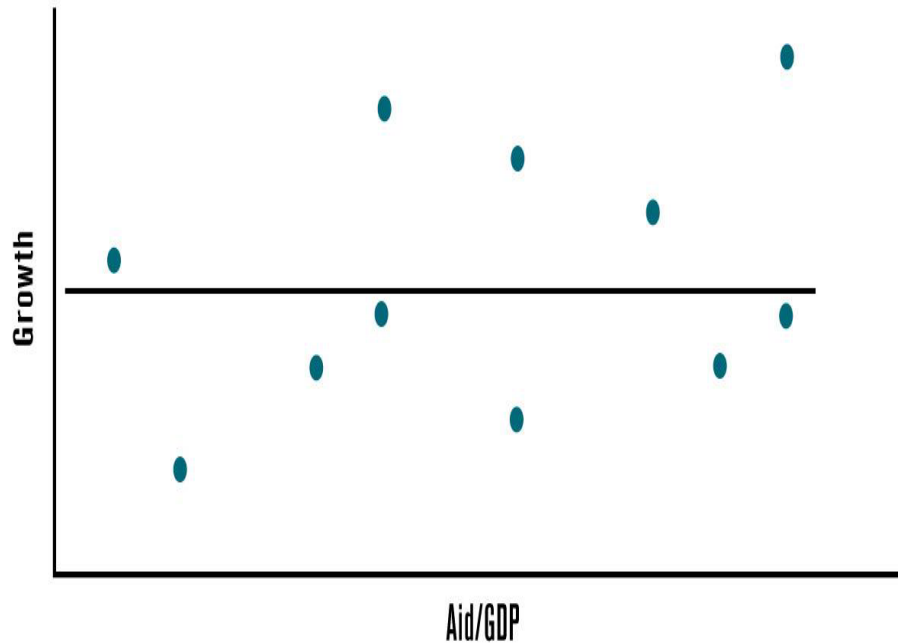
View 1: Aid has a **positive impact on growth with diminishing returns** after controlling for the impact of other variables.



Foreign Aid  $\Rightarrow \uparrow S_f \Rightarrow S_T \uparrow$   
 $\Rightarrow I \uparrow$

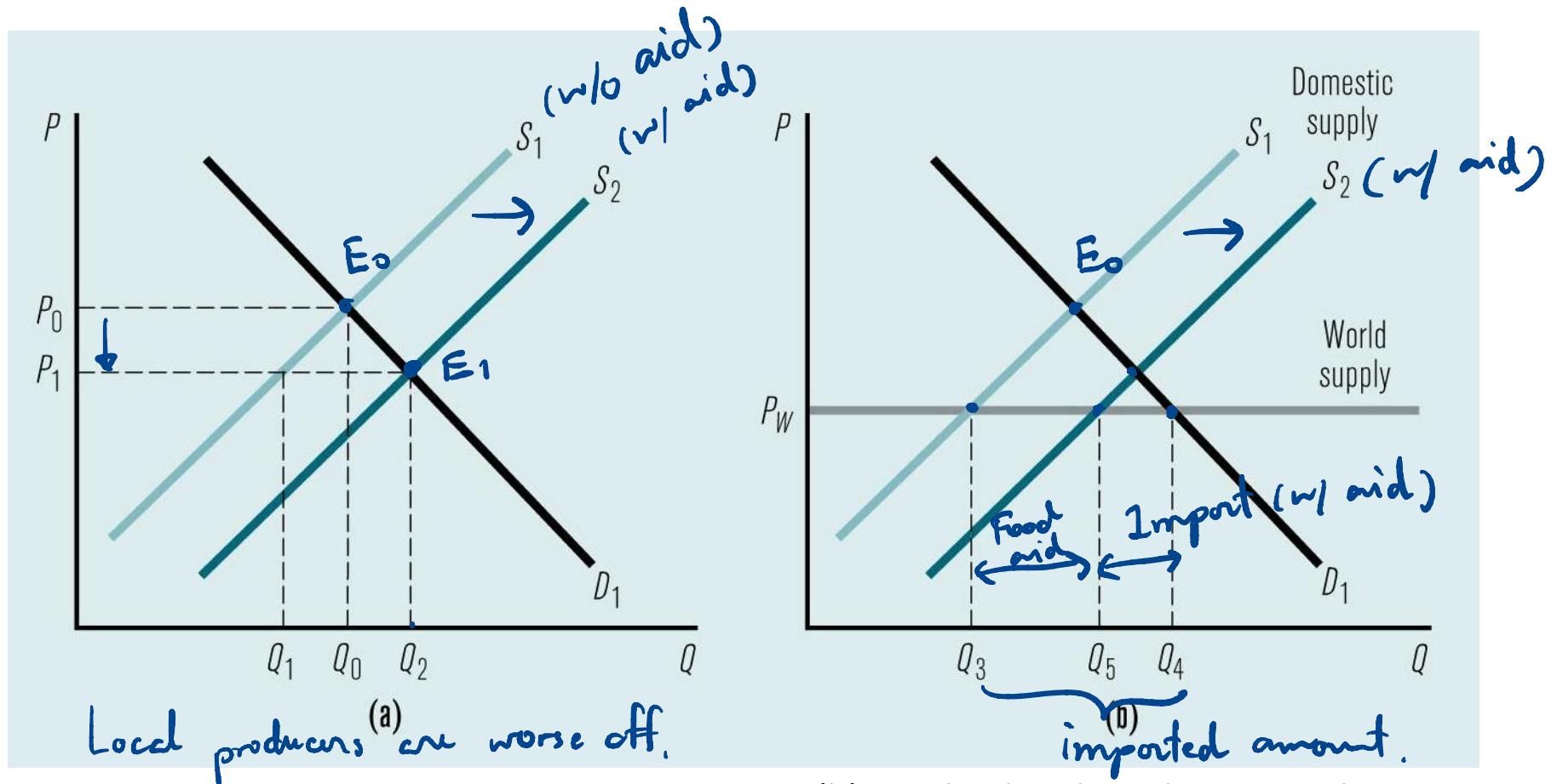
- Adding to the total amount of saving:  $\rightarrow \uparrow Investment$  &  $\uparrow K$   
 $\rightarrow \uparrow GDP$  growth
- Building knowledge and transferring new ideas. } shifts up production function
- Promoting health, education, and the environment.
- Providing humanitarian relief; and 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*\*

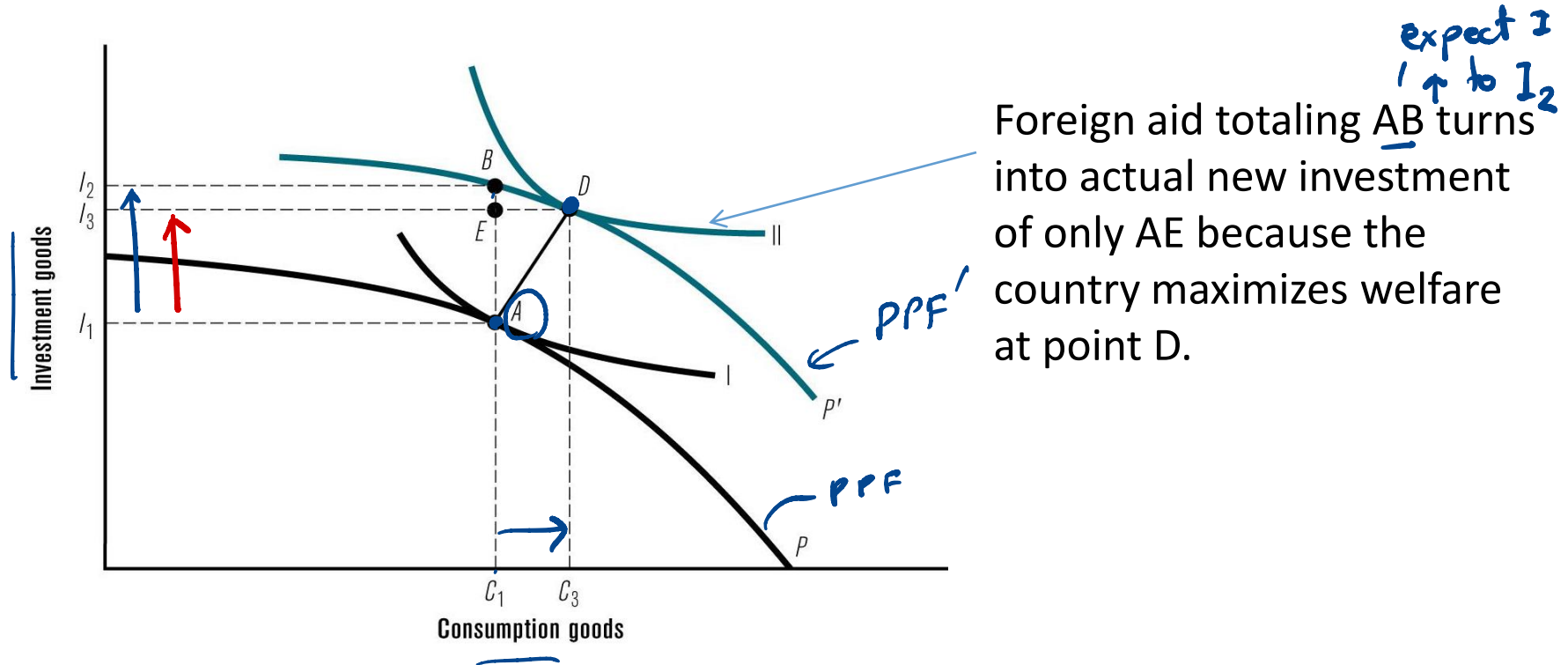
# Food Aid, Prices, and Production



(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 *Recipients are better off.*

# Impact of Aid on Investment and Consumption

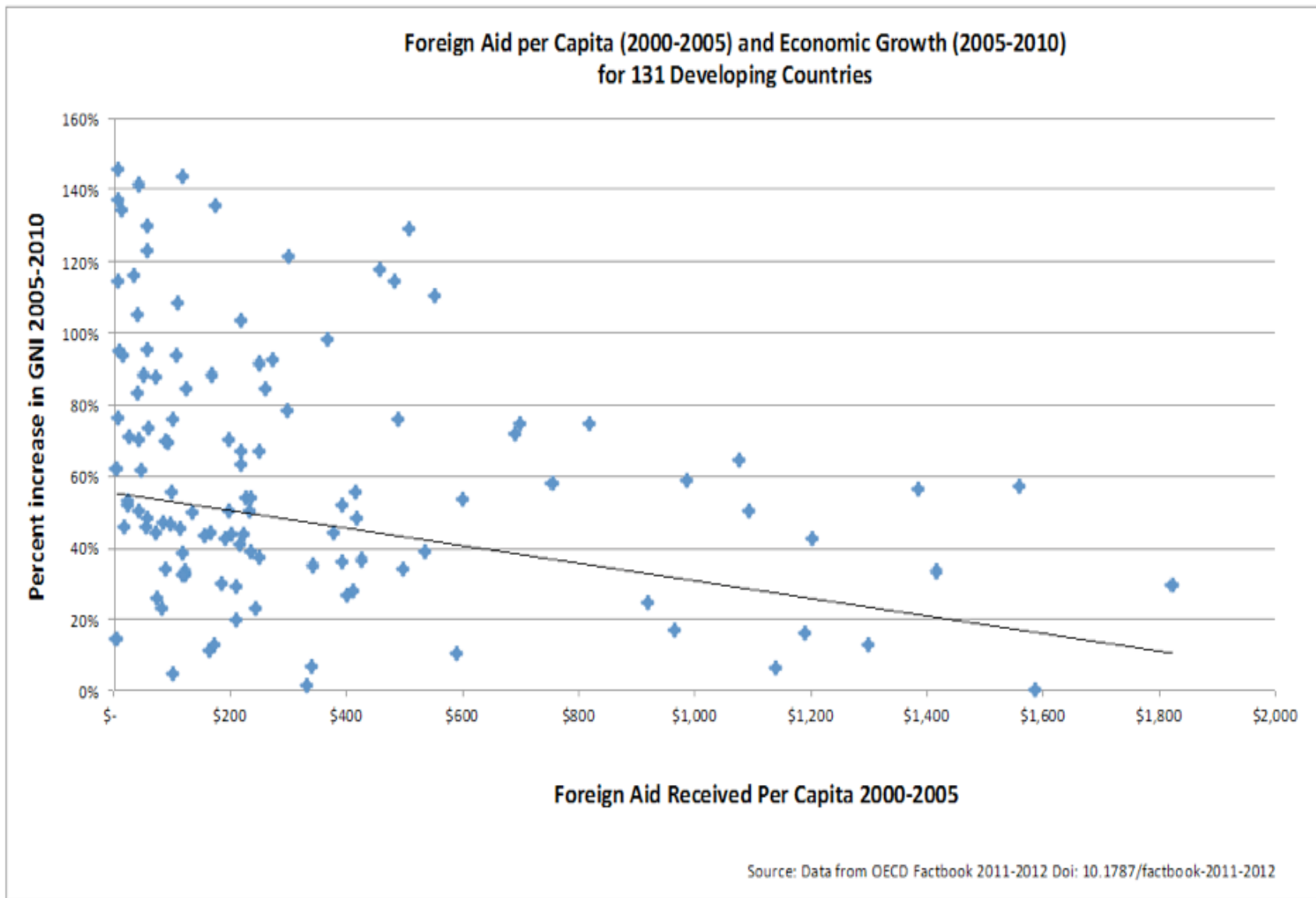


Aid could have a smaller-than-expected effect on investment:

- *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.

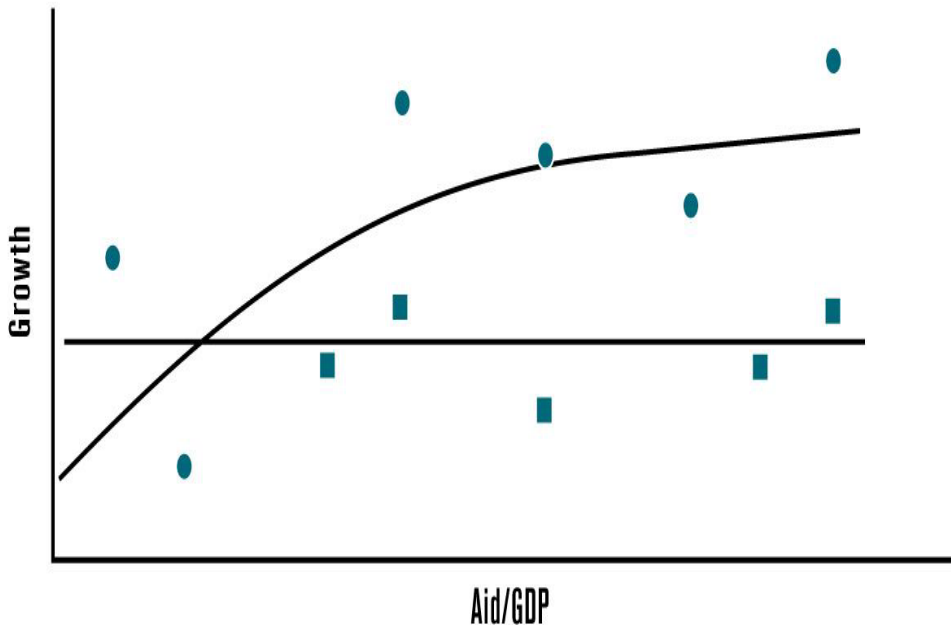
# AID Dependency

- 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.** *(compared to GDP)*
  - 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

*Principals*

- **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).