THE THEORY AND PRACTICE OF FOREIGN AID

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Analyzing foreign aid

What would be the topic of our discussion today? It would be analyzing foreign aid and that analysis will have a few segments. The first segment would be normative analysis. What is the rationale for foreign aid? That is the question. And the answer to that question is basically normative analysis. But we will also do a positive analysis of foreign aid. Instead of asking why foreign aid should be given (or not given) to some country, the question of positive analysis is: What is the real reason why some countries are involved in giving foreign aid? Then we will analyze the mechanism of foreign aid; what is going on when foreign aid is given to some country. And then we will focus on the results of the foreign aid. We will focus on empirical analysis of foreign aid and the explanation of these results – why foreign aid, at the end of the day, fails to achieve all these things that were ostensibly its aims.

Normative analysis: Poverty traps

As to the normative analysis of foreign aid, the main rationale for foreign aid is something known as a poverty trap. What is a poverty trap? A poverty trap is a mechanism of a vicious circle that, according to those who support poverty trap as the rationale for foreign aid, goes as such: Because countries are poor and because the majority of income of the population goes to consumption, savings are low. Because savings are low, the investments are also low. Low saving rates specify low investment rates, and because investment rate is low, growth rate is low, which means that there is poverty again. So, poverty at the beginning via low savings, via low investments, and via low or zero growth leads to poverty. That is the mechanism of the poverty trap.

Poverty traps and a two-gap growth model

The mechanism was first described back in 1943 in the seminal article of Rosenstein-Rodan. He took Southeast Europe as a case of the poverty trap. The mechanism of the poverty trap is reinforced as a theoretical explanation in work of Rostow (for example, *Anti-communist Manifesto* back in the 1960s) but also in a recent Jeffrey Sachs contribution from 2005. Similar to the model of poverty traps is the so-called two-gap growth model. Basically, the two-gap growth model is just a variation of the poverty trap model saying that low savings (that's one gap) and low hard currency (another gap) prevent dynamic growth in developing countries.

Assumptions in the poverty trap theory

Taking all these into account, there must be a breaking-away from the poverty trap; there must be closing of the gaps. Foreign aid is seen as the only way to break the poverty trap. But there is one assumption: the imperfection of international capital markets. So, because the capital market does not work properly, or according to some theoreticians does not work at all, there must be foreign aid to break the poverty trap. The whole mechanism is very simple – could be appealing. But there is this issue of sustainability. According to the poverty trap theory, once a country leaves the poverty trap, growth is sustainable. That is what Walt Rostow labeled as "take-off": once the country is in the air, the future is bright.

Do poverty traps really exist?

The problem with poverty traps is: do they exist at all? The recent contribution of Kraay and Raddatz (2007) demonstrated that poverty traps do not exist in Africa. So there is a clear empirical refutation of a poverty trap. For poverty traps to exist, subsistence levels across countries must be different – and subsistence level is the same because human beings are the same in all countries. Subsistence level in Angola is exactly the same as subsistence level in Congo, or Nigeria, or Ethiopia. There is no reason to make any difference among people in these countries. But according to the theory, for poverty traps to exist, there must be different subsistence levels.

So what if poverty traps do not exist?

But some people are not convinced. They say, "So what? Poverty traps do not exist, so what? Increased investments are good." Well, if we compare it to medicine, one would say, "I don't understand how this medicine works, but so what? Let's have that medicine applied. The more of the medicine, the better." Solving a problem without understanding causes of that problem is a shortcut to creating bigger problems than you're solving. And the crucial problem with increased investments is actually how investment projects are selected, how investors are committed to these projects, and how the efficiency of these investments can be achieved.

Supply-side analysis of foreign aid

There are two basic types of positive analysis of foreign aid. One is supply side – why countries who are donors are giving foreign aid. The recent contribution of Alesina and Dollar in 2000 demonstrated very clearly that foreign aid is driven from the supply side by political considerations, not economic considerations. Many countries have various political commitments to their former colonies. For example, France gives 57 percent of its foreign aid to former French colonies. In some cases political consideration is linked to the support recipient countries are giving to the donor countries. In the contribution of

Kuziemko and Werker in 2006, it was demonstrated that membership in the United Nations Security Council goes with an increase of U.S. aid of 59 percent. So aid from the United States goes up if the country is a member of the Security Council. Of course there is always quid pro quo. So the countries getting aid from America will vote in the Security Council according to what is perceived as American interest.

The demand side of foreign aid

It was demonstrated that donors are not very responsive to public policies of the recipient country, be it good or bad. For example, Alesina and Weder in 2002 demonstrated that there is absolutely no link between the level of corruption and aid. The fact that one country is more corrupt than the other does not mean that it will receive less aid. On the demand side, there is a recent contribution of Tornell and Lane demonstrating the so-called voracity effect: the more aid you get, the more aid you need. Later we will talk about the mechanism of voracity effect. But let’s now focus to the mechanism of foreign aid.

Inefficiency of aid in direct funding of investment projects

One mechanism of foreign aid is direct funding of investment projects in a recipient country. Not so bad, one would say. But there are a few very important issues. Is marginal productivity of these investments – in other words, is the efficiency of these investments – bigger or equal to the investments funded by private capital? Of course that efficiency is smaller because there are no market criteria for investment project selection. There is no demanded rate of return on these projects, so there is no market selection. And because of that productivity goes down and efficiency goes down.

Furthermore, to whom are these investors accountable? Their accountability is not to the recipient country’s constituency. It is much more to the constituency of the donor country, and that constituency does not care about economic efficiency in the recipient country. French voters just don’t care about marginal productivity of investments in Chad or Sierra Leone.

Foreign aid as budgetary support

Another interesting mechanism for foreign aid is called budgetary support. Why should one country provide budgetary support to the other country? The rationale behind that goes this way: the budgetary support to a country will reduce tax burden while maintaining budgetary balance. That reduced tax burden will increase private investments because there will be more incentives for private investors.

However, that rationale depends on the model of behavior of the recipient government, as it was demonstrated by Boone in the 1996 contribution. There are three models of behavior. One is elitist government. Elitist government means that budgetary support goes to the public expenditure and public expenditure goes to the elite of the society. Of course, the government usually considers itself as the elite, which means that rich people in that society will get richer.

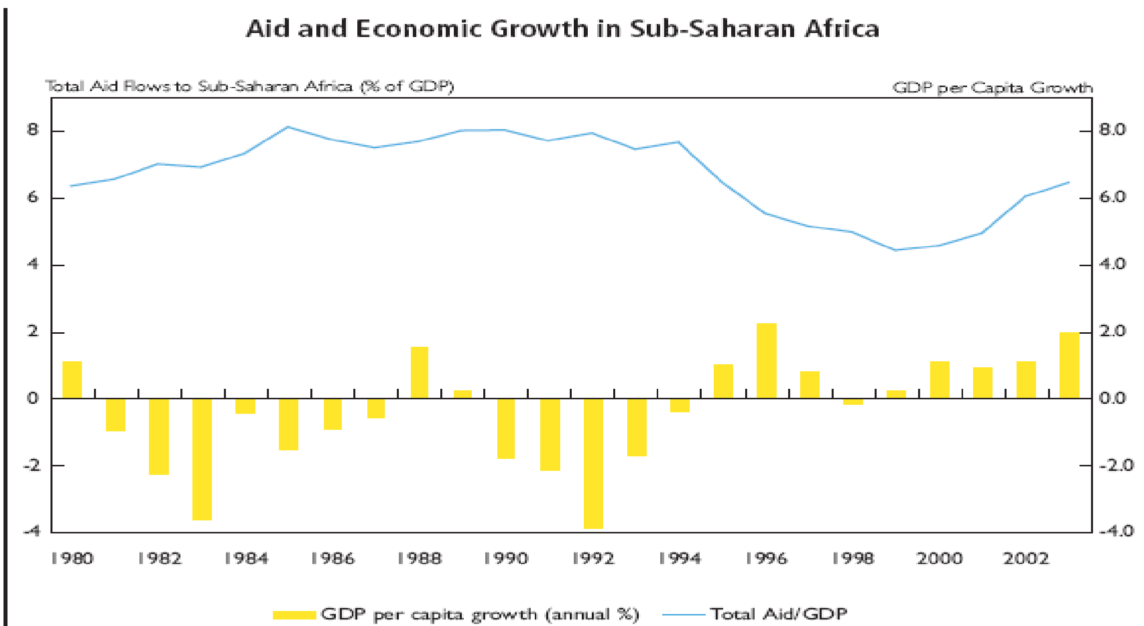
Different models of government behavior

There is a possibility for egalitarian government [the second model of behavior], which means that budgetary support will increase public expenditure and it will be distributed more equally. Finally, there is an option of government oriented towards free market, which means that the public consumption will stay the same, budgetary support will actually reduce the tax burden, and that will increase private investment incentives. It was demonstrated that the first two models are much closer to reality. So, budgetary support leads towards increased public expenditure with the same or bigger tax burden and no increase in private investments. Again, budgetary supports mean more spending and less investment.

Basic empirical results and the simple chart of aid flow to Sub-Saharan Africa and the growth rates of countries of Sub-Saharan Africa demonstrate significant correlation.

Empirical results

The bigger aid, the smaller growth rate. Obviously something goes wrong.



Sources: World Bank, *World Development Indicators Online*, available at www.worldbank.org/data; Organisation for Economic Co-operation and Development, *International Development Statistics*, available at http://www.oecd.org/dataoecd/50/17/5037721.htm

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