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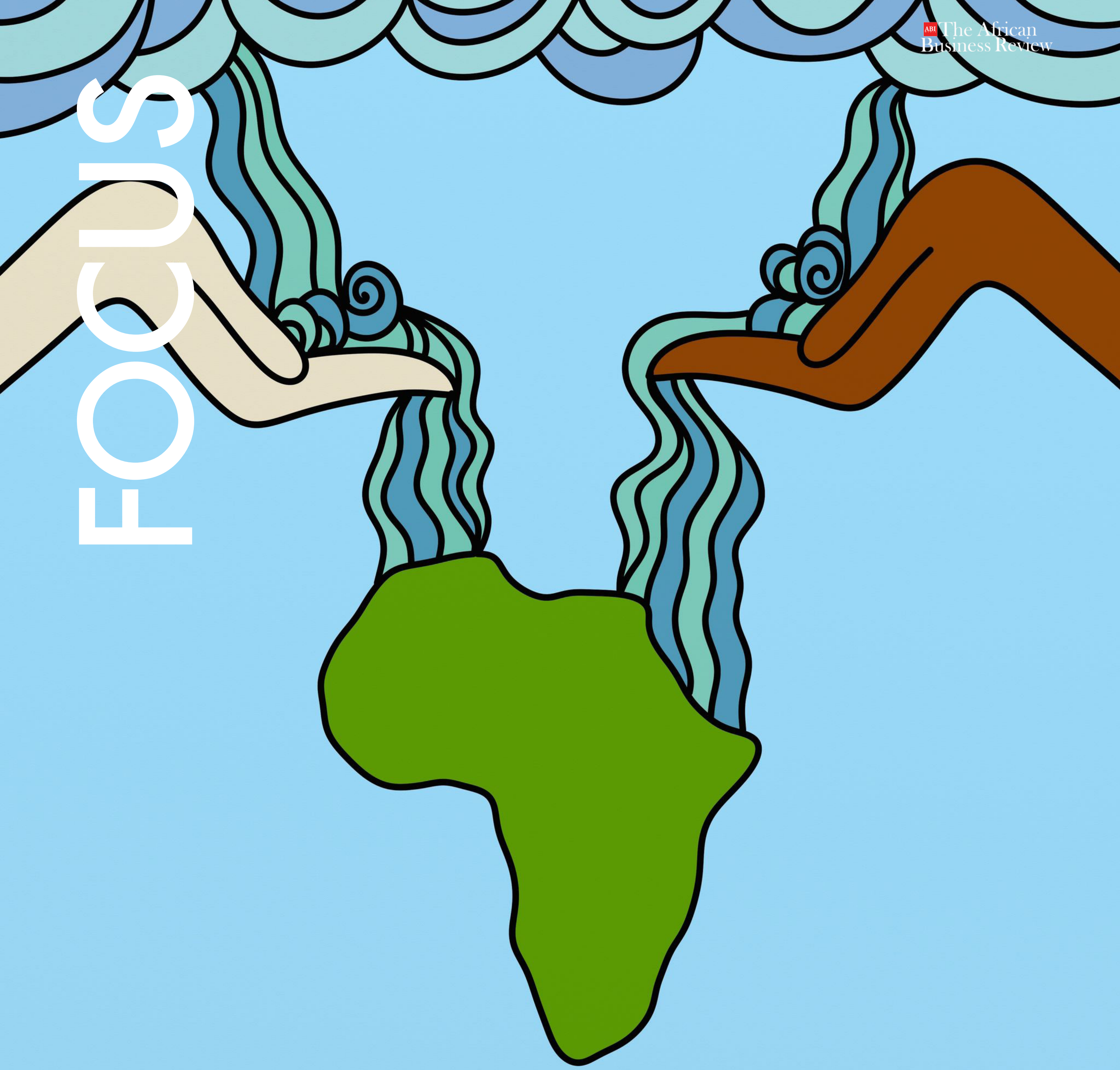

Does foreign aid make economic sense?

By Finn Tarp

Foreign aid is often seen as different from other forms of investment, and some argue that rather than having a positive effect it tends to distort economies and may potentially slow growth and development. In this article, the author argues that this is not the case and cites UNU-WIDER research, which shows that foreign aid has had a positive effect on growth on average in the long run. Furthermore aid has been crucial in supporting the broader development process through expanding life expectancy, cutting child malnutrition and maternal deaths, facilitating transitions to democracy and reducing overall poverty.

Many developing countries have enjoyed impressive economic growth in the last few decades. *The Economist* reported in 2011 that six of the 10 fastest growing economies of the 21st century so far are in Africa. This is a fact. It is also a fact that continued economic growth will be crucial in Africa post-2015. Has foreign aid had something to do with the economic turn-around, and can international cooperation help support growth in the future? The simple answer is, yes indeed. At the same time, academic and policy debates about whether aid spurs or hinders economic growth rage on; and we often see views expressed in the popular literature that argue that aid does not work; is a futile endeavor; and should rather be ended. These positions are however typically not based on the best evidence available. Arguably, it is time to move the discussion about foreign aid, growth and development beyond ideology and preconceived ideas, and focus on what hard data and sound evidence can tell us.

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The evolution of the aid-growth debate

The academic literature on the aid-growth relationship can usefully be divided into four generations, reflecting changes in both economic methodology and paradigms of development. *First*, in the early years (roughly until around 1980) development was typically seen as a stable and linear relationship between investment and growth; and many studies assumed that aid had a positive effect on growth. Aid was simply plugged in to help close gaps in savings and/or foreign exchange, and thus facilitated growth enhancing investment. The general consensus was also that while aid does indeed tend to increase investment and savings, it does so by less than the total amount given, suggesting, perhaps unsurprisingly, that some aid is consumed rather than invested.

A *second* generation of studies was born in 1987 when Paul Mosley and his co-authors identified the so-called micro-macro paradox. This work raised justified doubts about the underlying growth model, suggesting both that expecting all capital investment to translate into economic output, and expecting all aid to be used as investment, were overly bold assumptions. Other doubts about previous research on the macroeconomic effect of aid were also raised. In particular it was pointed out that in order to be accurate, studies needed to take into account that countries receive aid precisely because they are poor, and their economies are performing badly (i.e., the so-called endogeneity problem). Concerns were also raised that aid seemed in some cases to be misused by dictatorial regimes; and finally the impact of aid did not seem to show up in macro-economic cross-country studies.

These doubts about the assumptions at the core of previous research, as well as the new availability of panel data, which allowed researches to look into the impact of aid both across and within countries over time, motivated the new approach of the *third* generation from the early 1990s. The attentive reader will probably remember the famous 1994 heading: "Aid Down the Rathole", which *The Economist* used when the study of a London School of Economics professor, Peter Boone, was reviewed. His work did not stand unchallenged for long. World Bank economists Craig Burnside and David Dollar argued already in 1997 that aid works, but only sometimes, and that for aid to have an effect the right conditions, namely good fiscal, monetary and trade policy, had to be in place. Thus, the third generation ended up being cautiously optimistic about aid's impact, even if there was disagreement about the circumstances under which aid works and has this positive impact. Big efforts were also made internationally to promote more aid-giving at the 2002 United Nations International Conference on Financing for Development, also known as the Monterey conference.

This optimism is not reflected in the *fourth* generation that became influential around 2005. The then Chief Economist of the IMF in 2008 published a paper where he and his co-author argued that at the macro level it is difficult to identify 'any systematic effect of aid and growth'. This seemed to be a resurrection of the micro-macro paradox first identified by Mosley, and the non-existence of impact was used widely in the public debate to motivate aid criticism. When looking for reasons it was, for example, argued that aid is associated with Dutch Disease whereby the exchange rate tends to appreciate with foreign currency inflows and undermine exports. Other arguments put forward include political economy dynamics (keeping poor governments in place), and that aid inflows can weaken governance by encouraging corruption and rent-seeking activities in general. The problem with many of these explanations is in practice that while they may convey interesting theory and stories, few have actually tried to test them systematically with available data. So, conflicting conclusions continue to abound.

Analytical challenges

It is interesting that so widely different conclusions have been drawn in the aid–growth debate, given that studies are in many cases based on the same publically available data. One major analytical difficulty is the question of causation. Aid is given to countries that are poor and have difficulties. When they grow and do better donors tend to give less aid. So, it may look to the uninformed eye as if less aid is a good thing. It is of course a good thing to do better, but this by no means implies that aid did not support the growth to begin with. This analytical challenge is clearly not unique to the aid-growth debate and must be taken properly into account in any meaningful analysis.

Moreover, one often hears that since econometric models do not find a statistically significant effect of aid on growth then such a relationship does not exist. Yet, absence of evidence is by no means equivalent to evidence of absence. The fact that the relationship does not always seem to be statistically significant may have many causes, including problems with the length of time the dataset covers or the care with which the econometric analysis is done. In particular, it is critical to disentangle the mechanisms through which aid may effect growth, and vice versa. Can this be done? Yes – and recent research by UNU-WIDER has done so.

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Research and communication of foreign aid (ReCom)

The ReCom research programme led by the UN University World Institute for Development Economics Research (UNU-WIDER) has five themes covering the most important facets of development today; social sectors, gender equality, governance and fragility, environment and climate change, and importantly questions of growth and employment. The aid-growth question was taken as the point of departure to start uncovering what works and what could work in foreign aid. UNU-WIDER brought together some of the best researchers in this area, and asked them to review, assess and add their new insights to the debate. A series of studies (based on all available analytical approaches) has by now been published in leading academic journals, and what do they show:

- An inflow of aid at the level of 10 per cent of GDP spurs a more than 1 percentage point increase in annual per capita growth rate on average. Thus foreign aid has facilitated economic growth at the aggregate level over the long term (i.e. the period 1970-2007).
- Views that posit a non-existent or negative impact of development aid on growth have typically been based on miss-specified models and errors in data interpretation.
- When foreign aid is evaluated as an investment, it has had a annual internal rate of return of 7.3% since the mid-1970s.

Thus, the overall ReCom conclusion is that aid has had a very respectable effect on growth. This effect is in fact equivalent to what economists would generally expect based on current growth theory. So, there is no micro-macro paradox to be explained. In sum, aid has worked in promoting growth, and has worked well. At the same time, no informed individual will of course argue that foreign aid has worked with equal effectiveness everywhere and that failures have not been experienced, as has been the case with private investments. And development, which foreign aid is designed to support, is risky business.

The issue in financing development is therefore not "Trade-not-aid" as sometimes argued. It is "Trade-and-Aid". Aid and trade are not substitutes, they are complements. Resources (including aid) can be misused and have no or little effect. And aid is at the end of the day too small to do the job on its own.

Beyond growth - Has aid supported poverty reduction?

Growth cannot and should not be the only measure of performance in foreign aid, as the discussion about the Millennium Development Goals (MDGs) illustrate. It is therefore encouraging that UNU-WIDER's up-to-date ReCom research has shown that development assistance also has a positive effect on a number of intermediate factors which are seen as drivers of growth and development. Investment in physical capital and health are two clearly identifiable channels through which aid promotes growth; increased aid spending in these areas is likely to spur development in recipient countries.

Education is another important area. More specifically UNU-WIDER research finds that an average annual inflow of US$25 aid per capita over the period of 1970-2007 reduced poverty by around 6.5 percentage points, raised investment by 1.5 percentage points in GDP, augmented average schooling by 0.4 years, boosted life expectancy by 1.3 years, and reduced infant mortality by 7 in every 1,000 births. So aid increases growth and helps promote social development.

Final remarks

Is growth important for development? Yes, it is. As the economic pie grows there is more to share all around, and this "more" can then be used for furthering development to provide the possibility for dignified lives for the many, rather than just the few. After decades of foreign assistance we now know enough to assess properly whether aid works or not through rigorous analysis of the existing data. Clearly there are individual situations where aid has not worked as desired, but this should not be used to attack the premise and principles behind the entirety of foreign aid. Rather, it should encourage researchers, practitioners and policy makers to redouble their efforts to better understand the reasons why aid has not worked in some contexts, and learn as well from the situations where it has indeed worked well.

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In this context it is critically important to keep in mind that aid is a public resource which can be put to do things private business money typically will not do. The issue in financing development is therefore not "Trade-not-aid" as sometimes argued. It is "Trade-and-Aid". Aid and trade are not substitutes, they are complements. Resources (including aid) can be misused and have no or little effect. And aid is at the end of the day too small to do the job on its own. So, the lesson for policy-makers is: Use aid, but use it wisely together with appropriate supporting policies and investments. Then development will follow.

About the Author:

Finn Tarp is Professor of Development Economics at the University of Copenhagen Director of UN University-WIDER, Helsinki, Finland. He has some 35 years of experience in academic and applied development economics research and teaching. His field experience covers numerous countries across Africa and the developing world more generally, including longer term assignments in Swaziland (two years), Mozambique (eight years) and Vietnam (three years).

Professor Tarp is a leading international expert on issues of development strategy and foreign aid, with an interest in poverty, income distribution and growth, micro- and macroeconomic policy and modeling, agricultural sector policy and planning, household and enterprise development, and economic adjustment and reform.

In addition to his university positions, Tarp has held senior posts and advisory positions within government and with donor organizations, and he is member of a large number of international committees and advisory bodies. They include the European Union Development Network (EUDN) and the African Economic Research Consortium (AERC).