CIPE

Development Institute

LESSON PLAN

The Theory and Practice of Foreign Aid

Prerequisite: CIPE Development Institute presentation by Dr. Boris Begović

I. Message

For the past several decades, the conventional wisdom has been that the plight of developing countries was due to a lack of resources, technology, education, and infrastructure. Hence, foreign aid was hoped to fill such gaps and bring about faster development. Yet despite massive aid flows (both in terms of grants and soft loans), empirical findings on the link between economic growth/development and foreign aid demonstrate that there is no statistically significant and robust relation between the two. The rationale behind foreign aid involves increasing investments in low-savings countries and budgetary support meant to decrease tax burden in the country (for a given level of public consumption). In theory, conditionality frequently attached to aid from International Financial Institutions is supposed to incent good governance and more accountability. In practice, however, the incentives for granting aid by donors often do not align with such goals. Instead, political and strategic considerations of the donor countries remain paramount in granting foreign aid, and for the IFIs continuation of their own lending operations often becomes a goal in itself.

II. Objectives

1. Conduct normative analysis of foreign aid answering the question: What is the rationale for foreign aid?
2. Conduct positive analysis of foreign aid answering the question: What are the real reasons why some donor countries grant foreign aid?
3. Understand the major types of foreign aid.
4. Discuss the relationship between aid and economic growth.

III. Discussion questions

1. What is the main rational for foreign aid?
2. What are poverty traps?
3. What are some other motives of the donors for giving foreign aid?
4. What are the major kinds of foreign aid?
5. Is foreign aid an efficient form of investment? Why or why not?

6. Are budgetary supports effective? Why or why not?

IV. Reading list

Required readings:

- Alesina, Alberto and David Dollar, "Who Gives Foreign Aid to Whom and Why?" *Journal of Economic Growth*, Vol. 5, 2000 (33-63).
- Boone, Peter D. "Politics and the Effectiveness of Foreign Aid." *European Economic Review*, Vol. 40, 1996 (289-329), http://cep.lse.ac.uk/pubs/download/dp0272.pdf
- Easterly, William "Was Development Assistance a Mistake?" *American Economic Review*, Vol. 97, Papers and Proceedings, 2007, (328-332), http://www.nyu.edu/fas/institute/dri/Easterly/File/Was_Development_Assistance_a_Mistake.pdf
- Sachs, Jeffrey D. *The End of Poverty: Economic Possibilities for Our Time*, The Penguin Press: New York, 2005, http://www.columbia.edu/cu/news/media/05/349_the_end_of_poverty/

Optional readings:

- Alesina, Alberto and Beatrice Weder, "Do Corrupt Governments Receive Less Foreign Aid?" *American Economic Review*, Vol. 92, 2002 (1126-1137), http://team.univ-paris1.fr/teamperso/page/files/Alesina%20aide%201.pdf
- Kraay, Aart and Claudio Raddatz, "Poverty traps, aid, and growth." *Journal of Development Economics*, 82(2), 2007(315-347), http://www.csae.ox.ac.uk/conferences/2006-EOI-RPI/papers/csae/KraayRaddatz.pdf
- Kuziemko, Ilyana, and Eric Werker. "How much is a Seat on the Security Council Worth? Foreign Aid and Bribery at the United Nations." *Journal of Political Economy*, Vol. 114;5, 2006 (905-930), http://www.hbs.edu/research/pdf/06-029.pdf
- Rajan, Raghuram G. and Arvind Subramanian, "Aid and Growth: What Does the Cross-County Evidence Really Show?" *IMF Working Paper WP/05/127*, 2005, http://www.imf.org/external/pubs/ft/wp/2005/wp05127.pdf
- Rajan, Raghuram G. and Arvind Subramanian, "What Undermines Aid's Impact in Growth?" *IMF Working Paper WP/05/126*, 2005, http://www.imf.org/external/pubs/ft/wp/2005/wp05126.pdf
- Rosenstein-Rodan, Paul N. „Problems of Industrialization of Eastern and Southeastern Europe." *Economic Journal*, Vol. 33 No. 210, 1943 (202-211).
- Rostow, Walt W. *The Stages of Economic Growth: A non-communist manifesto,* Cambridge: Cambridge University Press, 1960.
- Aaron Tornell, Philip R. Lane, "The Voracity Effect," *The American Economic Review*, Vol. 89, No. 1, March 1999 (22-46).

V. Lesson plan

Speaker's background

- President of the Center for Liberal-Democratic Studies (CLDS) and Professor of economics at the University of Belgrade, Serbias

Normative analysis of foreign aid

- Poverty traps as the main rationale for foreign aid
  - Rationale: low savings and investment in developing countries lead to low economic growth rate and perpetuate poverty
- Two-gap growth model
  - Rationale: low savings (first gap) and low hard currency reserves (second gap) prevent dynamic growth in developing countries
- Foreign aid seen as the only way to break poverty traps and fill the two gaps

Flaws in the rationale for foreign aid

- Unclear whether poverty traps exist at all
  - Trying to solve problems without fully understanding the underlying causes and side effects of foreign aid
- Little efficiency criteria applied to aid investments
  - No good criteria for how aid projects are selected and how the efficiency of these projects can be achieved

Positive analysis of foreign aid

- Supply-side analysis: Why donor countries are giving foreign aid?
  - Mostly political, not economic considerations
  - Donors are not very responsive to public policies in recipient countries
- Demand-side analysis: Why recipient countries need more foreign aid?
  - Voracity effect → the more aid you get, the more aid you need

The mechanisms of foreign aid and their shortcomings

- Direct funding of investment projects
  - Marginal productivity (efficiency) lower than in private investment
  - No market criteria for investment project selection
  - Little accountability of investors
- Budgetary supports
  - Depend on the model of behavior of the recipient government
  - Most governments are concerned with redistribution of foreign aid (often enriching themselves and their cronies), not using it for investment
  - Leads to increased public expenditure with the same or bigger tax burden and no increase in private investment

Empirical results in Africa

- The bigger aid, the smaller economic growth rate

<u>VI. Test questions</u>

1. **What is the difference between normative and positive analysis of foreign aid?**
    a. Normative analysis talks about universally accepted norms for giving foreign aid, positive analysis looks into the benefits of foreign aid

b. Normative analysis deals with the rationale for foreign aid, positive analysis looks into why in practice donor countries give aid
c. Both normative and positive analysis calculate how much foreign aid is given to developing countries, but use different methodologies

2. **The key rationale for foreign aid includes all except**
    a. Insufficient savings and investment in developing countries
    b. Insufficient reserves of hard currencies in developing countries
    c. The lack of natural resources in some developing countries

3. **Poverty traps are**
    a. Certain extremely poor areas of Sub-Saharan Africa
    b. Low savings, low investment, low growth paradigms used as reasons for giving foreign aid
    c. Mechanisms through which corrupt regimes in many developing countries squander foreign aid

4. **Why is private investment more efficient than foreign aid investment?**
    a. Private investors use market criteria used for selecting projects
    b. Private investments have a clear demanded rate of return
    c. Private investors are accountable for the efficiency of their projects
    d. All of the above

5. **Why budgetary supports do not work as intended?**
    a. Recipient governments do not know how to properly make use of aid
    b. Developing country governments have little incentives to use foreign aid for investment and growth
    c. The amounts given by donors in the form of budgetary supports are too small to make a difference

6. **True or false: over the years foreign aid has greatly increased economic growth in Africa. Discuss**