

# INSTITUTIONS AND FOREIGN AID

### 3 FOREIGN AID CHALLENGES

Currently, foreign aid does little to foster economic development

Western democracies give foreign aid to some pretty unsavory regimes

Much foreign aid is expropriated by corrupt leaders, never reaching the target population

A NEW YORK TIMES BESTSELLER

**JEFFREY D. SACHS**

# The End of Poverty

*Economic Possibilities for Our Time*

**FOREWORD BY BONO**

*"Book and man are brilliant, passionate, optimistic and impatient...Outstanding"*

—THE ECONOMIST



# DIAGNOSIS: POVERTY TRAPS

Poor countries cannot attract investment, due to lack of human capital and infrastructure

This “investment gap” makes poor countries losers in globalization, widening gap so the poor get even poorer

This makes it even harder for poor countries to attract investment

This vicious cycle is a poverty traps

# HOW AID IS SUPPOSED TO WORK?

Aid allows investment in infrastructure and human capital

Facilitating outside investment

Aid can lift poor countries out of the poverty trap vicious cycle and replace it with a virtuous cycle of investment and growth

Aid is meant as a short- to medium-term measure, not permanent subsistence



William Easterly

# The Elusive Quest for Growth

Economists' Adventures  
and Misadventures  
in the Tropics



# ARE THERE POVERTY TRAPS?

From 1950–2001 the growth rate of the bottom 20% of countries is indistinguishable from the growth rate of the top 80% of countries

Of 28 poorest 20% in 1950, 11 no longer among the poorest 20% in 1985

# DOES AID WORK?: EASTERLY'S VIEW

From 1950–2001, within 20% of poorest countries, aid recipients did not grow faster

In 1990's average African country received aid equal to 15% of GDP, yet growth plummeted

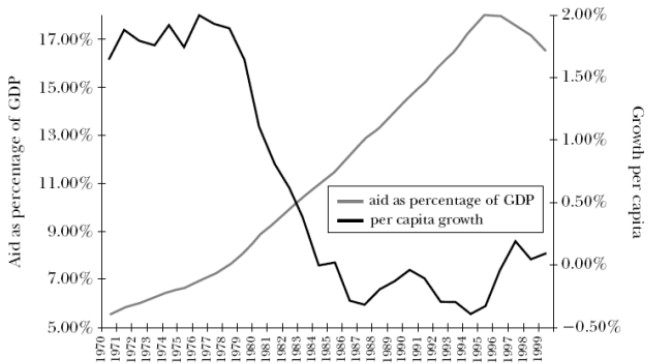
Of 88 aid recipients between 1965–1995, only 6 had more than dollar-for-dollar growth

- ▶ Hong Kong, China, Morocco, Tunisia, Sri Lanka, Malta



## Aid and Growth in Africa

(10-year moving averages)



## DOES AID WORK?: BEST EVIDENCE

Countries that just barely qualify for aid have higher growth than countries that just fail to qualify (Galiani et al., 2014)

- ▶ 1 percentage point increase in the aid-to-GNI raises per capita GDP growth by 0.35 percentage points

Aid flows from OPEC to poor Muslim countries due to oil shocks have mixed effects (Werker et al 2009)

- ▶ No effect on growth, positive effect on consumption, negative effect on savings

Dutch disease: aid inflows  $\Rightarrow$  currency appreciation  $\Rightarrow$  lower growth in exporting industries (Rajan and Subramanian, 2011)

Aid associated with decreased democracy, increased corruption, increased conflict

# EASTERLY'S OPTIMAL AID POLICY

Key is conditionality to create good incentives

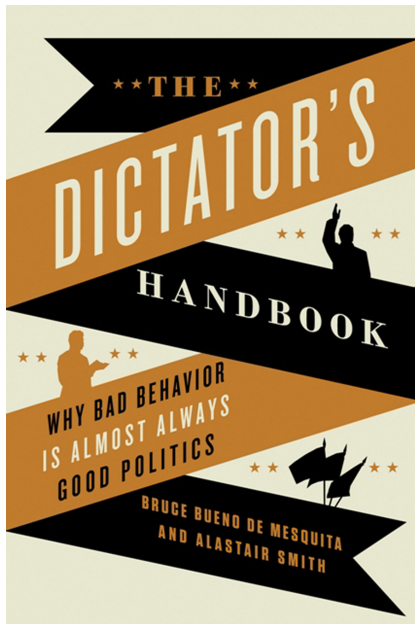
Non-corrupt governments who pursue rational economic policy

Aid organizations that rigorously measure and report outputs rather than inputs

# THE FOREIGN AID CHALLENGE

Donor governments are not following this advice

If a policy entrepreneur is interested in better aid policy,  
need to know why



# THE POLITICS OF AID POLICY

Think of foreign aid as an exchange of money for policy concessions

- ▶ Egyptian security cooperation with Israel
- ▶ Flyover rights during Iraq and Afghanistan wars
- ▶ Lower trade barriers

The pattern of economically inefficient aid may be politically optimal

- ▶ Aid is not intended to help the poor

# COSTS AND BENEFITS OF GIVING AID

**Costs:** Aid uses resources that a donor-country leader could have used for domestic purposes

**Benefits:** Aid purchases policy concessions which help the donor-country leader's domestic constituents

# AID WILL GO TO AUTOCRATS

Donor-country leader must give recipient-country leader enough aid to compensate for cost of policy concession

- ▶ Look for the cheapest recipient country

Democratic leaders depend on good policy to stay in office, so they are expensive to buy off

- ▶ Democratic countries are unattractive aid-for-policy targets

Because it is cheaper to buy off autocrats with aid than to buy off democrats, most aid will flow to autocracies



# THE POLITICAL REALITY OF FOREIGN AID

Most aid will be from democrats to autocrats

Only give aid to democrat when there isn't an autocrat who can provide similar concessions

Aid packages to democrats will be rare, but when given, will be large

- ▶ Democrats more expensive to buy off

# SOME FACTS FROM OECD AID DATA

Autocracies more likely to receive aid

Conditional on aid being given, democracies receive larger packages

Poverty, death rate, not correlated with receiving aid

More likely to give to trading partners (especially Scandinavians)

# POLITICS AND AID: BEST EVIDENCE

Rotating membership of non-permanent members of UN Security Council

Variation in importance of issues facing security council each year

Countries receive more foreign aid when they have a vote on security council in years when issues are important

Aid may be buying influence on security council

# THE PERVERSE WELFARE EFFECTS OF FOREIGN AID

Good for donor leader

- ▶ Policy concession helps domestic constituents

Good for recipient leader

- ▶ Resources can be expropriated and used to reward key supporters or stolen

Good for donor citizens

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Good for donor citizens

**Bad for recipient citizens!**

- ▶ Make policy concession and keep autocratic leader in office longer

# LESSONS FOR THE POLICY ENTREPRENEUR

Do not simply advocate for more aid or “better aid”

- ▶ Aid is “ineffective” because of political strategy, not because government doesn’t understand how to do aid

Strategies for an aid-policy entrepreneur

- ▶ Privatize/de-politicize the delivery of foreign aid
- ▶ Encourage multi-lateral over bi-lateral aid
- ▶ Identify and empower institutional actors with incentives for non-politicized aid
- ▶ Grass roots mobilization on efficacy, not level, of aid?

Aid may be doing more harm than good