The Foreign Aid Paradox

by Roger G. Noll

The obligations of wealthy nations to poor nations are much in the news. Bill Gates, Bono, Madonna, Angelina Jolie and other celebrities publicly advocate aid to developing nations, while several economists have written best sellers about underdevelopment. However, they disagree about whether rich nations and international organizations can implement effective aid at a scale and complexity that could achieve the MDGs.

Reasons for Optimism

The case for the MDGs has four components. Foremost is the abject poverty of nearly half the world’s population. Development agencies define poverty as an income of less than $1.25 per person per day (about $3,000 annually for a family of four). By this standard, nearly 3 billion people are poor. The U.S. poverty line for a family of four is an annual income of $20,000. By this standard, 9 percent of the world is poor.

The second argument for the MDGs is that recent history proves that poor nations can develop rapidly. In 1950, Hong Kong, Singapore, South Korea and Taiwan had roughly the same per capita income as Africa, yet their incomes now are comparable to rich nations. Brazil, China, India and Indonesia – complex countries that three decades ago suffered stagnation – now enjoy rapid growth. In Africa, the world’s poorest region, Botswana, Namibia and Mauritius are growing rapidly.

The third basis for the MDGs is new consensus about whether rich nations and international organizations can implement effective aid at a scale and complexity that could achieve the MDGs.

The fourth argument for the MDGs is that some inexpensive actions could yield big benefits. Effectively treating malaria costs about a dollar, and diarrhea treatments cost about 32 cents. Both diseases claim millions of lives annually and reduce the productivity of millions more. The third argument for the MDGs is new consensus about barriers to growth and policies to overcome them. Two decades ago the standard prescription for continued on inside...
economic progress was state-led development, based on central ownership of key industries, and minimal involvement with the international economy. Many developing nations placed no importance on macroeconomic policy, amassed huge budget deficits, and experienced runaway inflation. Today, most developing nations pursue reasonable fiscal and monetary policies, and they are open to trade and have privatized most state-run enterprises, often to foreign ownership.

Can Aid Reduce Poverty?

Cutting poverty in half faces serious obstacles, and the record of foreign aid in increasing economic growth is spotty. Yet some projects in poor countries are unqualified successes, including increased enrollment in primary school and the eradication of smallpox and near-eradication of Guinea worm, the Green Revolution, which essentially eliminated malnutrition in India, microcredit (especially for women), which overcomes the poor’s lack of loan collateral by relying on social pressure within families and villages to assure repayment, and telecommunications and villages to assure repayment; social pressure within families and near-eradication of Guinea worm, the eradication of smallpox, the result of improved education, health, infrastructure, legal institutions, etc. If a nation succeeds in one or two dimensions, the welfare of some may improve, but sustained growth is unlikely. For example, in the last four decades, life expectancy in poor countries, despite the AIDS epidemic, rose from 40 to 68 years. Infant mortality fell from 135 per 1000 births to 30. Primary school enrollment is almost universal. Even in sub-Saharan Africa, secondary school enrollment has risen from 2 percent to more than 35 percent since 1960. Despite this progress, economic growth has been minimal. Of the 62 countries that the World Bank classifies as poor, 25 had lower per capita income in 2000 than in 1960. The number of people classified as in “extreme poverty” (income below $1 per day) fell substantially only in East Asia – for the rest of the world, the number rose. These data show that progress in only some dimensions do not lead to sustained growth.

Further factors undermine the effectiveness of development policies and foreign aid. Donor policies that undermine growth include generous aid, centralization of aid within government, and political discussions in aid allocation. Rich nations often push to trade but practice protectionism against poor nations, especially in agriculture. For example, the United States severely limits sugar imports from Latin America to benefit American sugar beet growers, even inhibiting imports of Brazilian cane-based ethanol, which is far cheaper and more energy efficient than domestic ethanol. The recent Doha Round of trade negotiations broke down, because rich countries would not substantially reduce subsidies and other trade barriers for agricultural products.

Donors also send nations for supporting their international policies. Historically, for aligning with them during the Cold War and, currently, for supporting anti-terrorism. Aid increases the durability of recipient governments by increasing their budgets. Conspicuously, geographically motivated aid to governments that pursue bad domestic policies can reduce the recipient’s growth prospects. Rich nations have largely market-driven economies, but they base aid on detailed multicountry plans. William Easterly (2005) argues that the MDGs are really central planning: grandiose goals and a comprehensive multyear plan that is not derived from an economic assessment of capabilities and feasible alternatives. Incomplete information and ascendance of technical expertise make plans useless for the poor in poor countries even if there were a good idea, but experience shows that planning does not work in the best of circumstances. A subtle consequence of planning is that aid programs encourage centralization of recipient governments. Almost all aid goes to national governments in poor countries, but donors also focus on states. Thus, the paradox of development is that we now know how poor people are really rich but not how to overcome political barriers to growth. Extreme poverty could be cut in half in a decade, but probably not without political change by donors and recipients. Donors should condition aid on governance but should not expect that aid can create good institutions. Donors need patience. Because good institutions crucial for increasing number of nations are likely to use aid effectively.

Recommended Reading

The following recent books, written by economists for a general audience, provide detailed analyses of conditions in poor countries and the accomplishments and problems of foreign aid. Collectively, these books provide deeper analyses and many more facts about the issues addressed in this brief.


Donors also should ignore geopolitical motives that waste aid on bad governments and should aid entities other than central governments. Rather than giving education grants to central governments, donors could channel aid through local governments, schools or parents, and rather than funding central governments to combat disease, donors could assist medical clinics based on the number of patients that they treat and students who seek training as medical professionals. In short, rich nations should practice decentralized, incentive-based systems for delivering services in poor countries like they practice at home.
economic progress took place in low-growth development based on central control and social ownership of key industries, and minimal involvement with the international economy. Many developing nations placed no importance on macroeconomic policies, amassed huge budget deficits, and experienced runaway inflation. Today, most developing nations pursue reasonable fiscal and monetary policies, and they are open to trade and have privatized most state-owned enterprises, often to foreign ownership.

Can Aid Reduce Poverty? Cutting poverty in half faces serious obstacles, and the record of foreign aid in increasing economic growth is spotty. Yet some projects in poor countries are unqualified successes, including attendance incentive programs, which dramatically increase school enrollment; the eradication of smallpox and near-eradication of Guinea worm; the Green Revolution, which essentially eliminated malnutrition in India; micro-lending programs, which dramatically reduced poverty; more efficient management of loan collateral by relying on information and scarcity of feasible alternatives. Incomplete assessment of capabilities and domestic policies can reduce the recipients’ growth prospects. Rich nations have largely market-driven economies, but they base aid on detailed multinational economic plans. William Easterly (2005) argues that the MDGs are really central planning, grandiose goals and a comprehensive multivector plan that is not driven from an economic assessment of capabilities and feasible alternatives. Incomplete information and secrecy of technical expertise make plans useful for workshops in poor countries even if it were a good idea, but experience shows that planning does not work in the best of circumstances. A subtle consequence of planning is that aid programs encourage centralization of recipient governments. Almost all aid goes to national governments to pay salaries to teachers and clinicians are paid and come to work. But in some countries these are patronage positions that require neither training nor coming to work. In these countries aid only increases the stability of bad government without helping the poor.

Donors deal with bad governance by imposing conditions on aid. For example, the U.S. Millennium Challenge Corporation has 15 conditions that countries must satisfy to qualify for aid. The World Bank likewise tries to induce countries to “reform” their constitutions. But this approach fails, due to the difference between adopting good governance voluntarily versus promising reform because of billions of dollars at stake. Research on governance finds that, despite reform conditions, aid does not cause good governance. Robert Cooper’s power of aid for good governance with a per capita income of more than $5,000, is successful because its governance is improved. If governments provide compelling benefits to intended beneficiaries impose accountability on those who implement projects. In the case of recipients, research shows that good governance facilitates growth. However, as measured by honest bureaucrats and an independent, non-corrupt judiciary, a stable democracy and well-defined, enforceable contract and property laws, most developing nations score low on good governance. Although health and education provide compelling examples of effective aid, they also offer governance horror stories. Successful education and health policies require that teachers and clinics at trained and come to work. But in some countries these are positions that require neither training nor coming to work. In these countries aid only increases the stability of bad government without helping the poor.

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The obligations of wealthy nations to poor nations are much in the news. Bill Gates, Bono, Madonna, Angelina Jolie and other celebrities publicly advocate aid to developing nations, while several economists have written best sellers about underdevelopment. The Millennium Development Goals (MDGs) of the United Nations commit members by 2015 to reduce by half world poverty and easily avoidable premature deaths. The U.N. seeks to achieve these goals through improving access to medical professionals, clean water, drugs, education, electric power, sanitation and transportation. Bottom-up estimates of the costs of efficient programs conclude that the MDGs can be achieved by roughly tripling foreign aid, from about $60 billion to $180–200 billion annually. The U.S. response, the Millennium Challenge, increases bilateral foreign aid by 50 percent over three years. Development economists give the MDGs a mixed reception. Economists broadly agree about the primary impediments to growth in poor countries and the effectiveness of foreign aid. However, they disagree about whether rich nations and international organizations can implement effective aid at a scale and complexity that could achieve the MDGs.

Reasons for Optimism

The case for the MDGs has four components. Foremost is the abject poverty of nearly half the world’s population. Development agencies define poverty as an income of less than $2 per person per day (about $500 annually for a family of four). By this standard, nearly 5 billion people are poor. The U.S. poverty line for a family of four is an annual income of $20,000. By this standard, 89 percent of the world is poor. The second argument for the MDGs is that recent history proves that poor nations can develop rapidly. In 1950, Hong Kong, Singapore, South Korea and Taiwan had roughly the same per capita income as Africa, yet their incomes now are comparable to rich nations. Brazil, China, India and Indonesia – complex countries that three decades ago suffered stagnation – now enjoy rapid growth. In Africa, the world’s poorest region, Botswana, income of $20,000. By this standard, 89 percent of the world is poor. The second argument for the MDGs is that recent history proves that poor nations can develop rapidly. In 1950, Hong Kong, Singapore, South Korea and Taiwan had roughly the same per capita income as Africa, yet their incomes now are comparable to rich nations. Brazil, China, India and Indonesia – complex countries that three decades ago suffered stagnation – now enjoy rapid growth. In Africa, the world’s poorest region, Botswana, 35% of the population suffers from malaria. The same year, annual treatment costs were about $15 per person. Effective treatment could reduce malaria incidence by 90 percent. The third argument for the MDGs is that some inexpensive actions could yield big benefits. Effectively treating malaria costs about a dollar, and diarrhoea treatments cost about 32 cents. Both diseases claim millions of lives annually and reduce the productivity of millions more. The third argument for the MDGs is that some inexpensive actions could yield big benefits. Effectively treating malaria costs about a dollar, and diarrhoea treatments cost about 32 cents. Both diseases claim millions of lives annually and reduce the productivity of millions more. The fourth argument for the MDGs is new consensus about barriers to growth and policies to overcome them. Two decades ago the standard prescription for continued on inside..