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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.

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 $150–200 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 $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, 85 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, Ghana and Mauritius are growing rapidly.

The third basis for the MDGs is that some inexpensive actions could yield big benefits. Effectively treating malaria costs about a dollar, and diarrhea treatments cost about 12 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

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About The Author

Roger Noll is Professor Emiterus of Economics at Stanford University. In addition, he is a Senior Fellow at the Stanford Institute for Economic Policy Research (SIEPR).

Noll's research interests are broad, encompassing public policies geared toward business, telecommunications, political analysis of the judicial system, technology policy and economics of sports. He has written and authored numerous papers and books and is on many boards including the AEA and the California Council on Science and Technology. Noll received his Ph.D. from Harvard and his B.S. California Institute of Technology.

economic progress was state-led development, based on central planning, extensive public 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-owned enterprises, often to foreigners.

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-credit (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 privatization (aid was used to prepare firms for sale), which caused an explosion of wireless telephones in poor nations. These examples show that well-designed programs deliver significant benefits. Unfortunately, successful projects do not generalize easily. Researchers find no relationship between total aid and economic growth. Aid significantly increases growth only in countries with atypically good institutions.

Why Aid Has Not Caused Growth

Economics research identifies three fundamental reasons – one economic and two political – for the failure of aid to cause growth.

The economic reason is *complementarities*. Sustained economic growth requires progress in several dimensions – 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 48 to 68 years. Infant mortality fell from 131 per 1000 births to 36. Primary school enrollment is almost universal. Even in sub-Saharan Africa, secondary school enrollment has risen from 2 percent to more than 30 percent since 1960. Despite this progress, economic growth has been minimal. Of the 62 nations that the World Bank classifies as poor, 25 had lower per capita income in 2000 than in 1980. 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 areas does not lead to sustained growth.

Political factors undermine the effectiveness of development policies and foreign aid. Donor policies that undermine growth include protectionism, centralization of aid administration and political distortions in aid allocation.

Rich nations preach free 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 reward 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. Consequently, geopolitically motivated aid to governments that pursue bad domestic policies can reduce the recipients' growth prospects.

Rich nations have largely market-driven economies, but they base aid on detailed multiyear economic plans. William Easterly (2006) argues that the MDGs are really central planning: grandiose goals and a comprehensive multiyear plan that is not derived from an economic assessment of capabilities and feasible alternatives. Incomplete information and scarcity of technical expertise make planning unlikely to work 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 make accountability to donors easier. But many projects are most efficiently implemented by local governments, or even non-governmental entities. For these

programs decentralization helps 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 projects require that teachers and clinicians are trained 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 16 conditions that countries must satisfy to qualify for aid. The World Bank likewise tries to induce countries to improve governance.

But this approach fails, due to the difference between adopting good governance voluntarily versus promising reform because billions of dollars are at stake. Research on governance finds that, despite reform conditions, aid does not cause good governance. Botswana, Africa's poster child for good governance with a per capita income of more than $9,000, is successful because its post-independence leaders wanted good governance. The subsequent discovery of the world's richest diamond deposit then financed good development policies, causing Botswana to experience 30 years of rapid growth. By contrast, rich tin deposits in Bolivia, diamond deposits in Sierra Leone, and oil deposits in Iraq and Nigeria did not lead to development.

The causes of some bad governments are deep. Poor nations typically are arbitrary creations of colonial powers that contain several groups that are traditional enemies. Governments usually reflect a temporary victory that allows domination by one group. Leaders then use power to benefit kinsmen. If governments pursue good economic policies, the resulting growth raises the benefit of revolution for excluded groups, causing violence and instability.

Conditions on aid seek to cure these divisions through external pressure. As documented by Easterly (2002, 2006), history provides no examples of successful accommodations among warring groups, when externally imposed. These problems are solved only where groups reach accommodation themselves or redraw national boundaries.

What to Do?

Thus, the paradox of development is that we know how poor countries become richer, 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 governance. Instead, donors need patience. Because governance is improving, an increasing number of nations are likely to use aid effectively.

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 government, 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.

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 analysis and many more facts about the issues addressed in this brief.

Robert Calderisi, *The Trouble with Africa: Why Foreign Aid Isn't Working,* Palgrave Macmillan, 2006.

William Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics,* MIT Press, 2002.

William Easterly, *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good,* Penguin, 2006.

Angus Maddison, *The World Economy: A Millennial Perspective,* OECD, 2001.

Jeffrey D. Sachs, *The End of Poverty: Economic Possibilities for Our Time,* Penguin, 2005.

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