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Does Foreign Aid Make the Poor Poorer?

Philip Booth

The UK government has decided to increase rapidly its foreign aid budget to nearly £13 billion by 2015. This policy has been promoted by the Prime Minister as a moral obligation. Economists, *as economists*, may wish to hold fire on the moral debate, but they can shed light on whether government aid actually helps development. And surely, if government aid makes poor people worse off, the moral justification is flimsy.

In A-level economics, various 1960s models are used to make the case for aid. Those models suggest, for example, that aid can fill the 'savings gap' and help countries accumulate capital to raise growth. In the context of these models, the actual historical record of foreign aid is something of a puzzle.

Aid has not worked

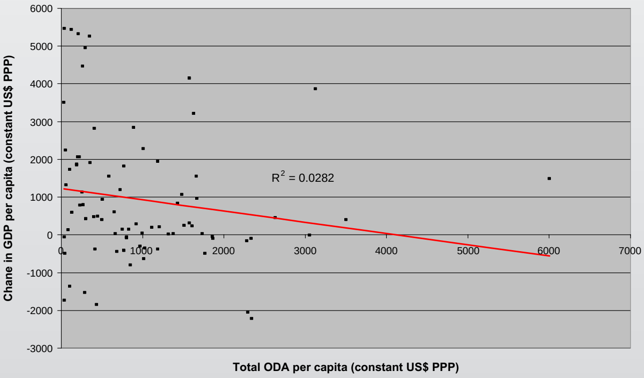
Many South and East Asian countries have increased national income very rapidly with negligible foreign aid. On the other hand, Africa has received nearly $600bn of aid and its economic growth rate has been very slow. Indeed, as Figure 1 shows, there is no relationship between overseas development aid (ODA) and economic growth and there is no analysis of the data that tends to find a positive relationship.

There is a solution to this puzzle, but the solution lies outside the field of technical micro- or macro-economics.

Good governance

It is very difficult for economic activity to develop if the basic principles of good governance do not exist. These principles include peace; the rule of law; the absence of corruption; freedom of contract; the enforcement of contracts through efficient court systems; sound money; and the ability to register legal title in businesses and property. For example, if a business is not legally recognised, it becomes impossible for it to expand – as the business will then come to the attention of the authorities; the business cannot make contracts with employees as they will not be enforceable; it cannot advertise or borrow money; and so on. If people are not sure that contracts can be enforced in the courts – because of either corruption or inefficiency – proper business activity may grind to a halt.

Figure 1: Aid and growth – 1975 to 2000[1]



Countries that have grown rapidly in recent years have been those that have nurtured improved conditions for business and put in place the basics for good governance. A study by the Fraser Institute showed that the world's top 24 countries ranked by the quality of their legal systems had an average GDP per capita of $25,716 at the end of the period (2000) and average economic growth of 2.5 per cent during the period studied (1980 to 2000). The bottom 21 countries had an average income of $3,094 per capita and average economic growth of 0.33 per cent. The criteria used to rank legal systems were effectively the good governance principles listed above.

Indeed, basic economic and political reforms in countries such as India and Vietnam have led growth to rise dramatically. And it is the poor who tend to benefit most when this happens – though this can depend on the sequencing of reforms. In India, for example, the eight poorest states all currently have economic growth rates above the average and the proportion of the population that describes itself as hungry has fallen by 90% since the 1991 reform programme (see *The Elephant that became a Tiger,* published by the Cato Institute, 2010 and available from www.cato.org). Belatedly, many African countries are now growing and the continent has some of the top reforming governments as well as a marked reduction in civil conflict. None of this has any relationship to the provision of foreign aid.

Unfortunately, the provision of aid can undermine good governance by providing more opportunities for preferment and corruption by the elites and it can exacerbate ethnic conflicts. The world's worst dictators have received over $100 billion in official development aid and so it is not surprising that one study suggests that 40% of all arms in Africa have been financed by foreign aid. Those same systems of poor governance often lead to huge amounts of aid being diverted so that little reaches the people for whom it is intended.

Adam Smith got there first

The simple lesson for budding economists is that we should not forget to study the political institutions within which economic activity takes place. And we need to look at what happens if the provision of foreign aid undermines the framework within which economic activity takes place. Or, as Adam Smith once put it in a lecture in 1755: 'Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice: all the rest being brought about by the natural course of things.'

1. With thanks to Julian Morris for compiling the figure.

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The History and Politics of Government Spending and Debt

Dr. Stephen Davies

The National Debt is something most people never think about. Like a great mountain range, it looms in the background of national life, something that is hardly noticed because it is so much taken for granted. At times however it becomes an object of deep concern and controversy, and arguments about the debt have a central place in political debate. We are clearly in such a period now. Looking at the history of British state debt and the economics and politics of public finance enables us to better understand the position we are now in. What becomes apparent is that, while in some ways the present situation has many precursors, in other ways it is novel and that novelty means that any British government is going to face very difficult political and economic choices.

The origins and early history of public debt

State debt that was tradable and secured against future revenues was invented in Europe by Italian city-states. It was further developed as a means of public finance by the Dutch in the early seventeenth century. However it was the British state that perfected this as a way of funding government. The National Debt was founded in the late seventeenth century with the creation of the Bank of England, a corporation of London merchants with the role of managing and financing government borrowing through the sale of tradable securities. Initially these loans were secured against the income from specific taxes. In 1750 the then Prime Minister, Henry Pelham, consolidated all of the various funds so that the debt was now a charge on tax revenues in general. He also made the debt effectively perpetual, so that as securities expired the debt was not always repaid but usually rolled over through the issuance of fresh debt. The national debt was intensely controversial in the eighteenth century. Critics made three points: that the rapidly escalating debt was an unacceptable burden on the productive economy; that by making public spending seem less painful it encouraged wasteful forms of spending, above all wars; and that the existence of a large traded debt created a parasitic class of bondholders with an interest in both wars and the political fortunes of the party that controlled the government.

The National Debt and public spending today.

Currently the accumulated National debt officially stands at around £965 billion, about 60% of GDP. Even with the planned fiscal consolidation put in place by the coalition it is forecast to rise to £1.1 trillion by 2011 – 75% of GDP. In addition to the explicit debt there are unfunded liabilities (legally binding undertakings by government to make certain payments in the future such as pensions and PFI obligations) that amount in total to £1.36 trillion or 92% of GDP. The current total of debt and quasi-debt is £2.46 trillion, 146% of GDP. This excludes the possible costs of bank bailouts and state pensions over which there is a degree of discretion.

This substantial debt is being added to at a rate unprecedented in peacetime. The current deficit (the amount the government has to borrow each year to cover the gap between its revenue and its spending) stands at around 10% of GDP. No less than 43% of the total official debt has been run up in the last three years! The Coalition aims to eliminate the deficit by the end of this Parliament but reaching this target depends on assumptions about growth that are unlikely to be met. Quite simply, adding to the debt at this rate is unsustainable.

Haven't we been here before?

In simple number terms the level of accumulated debt we now have is not unprecedented and is even low by historical standards. Figure 1 shows the size of the National Debt as a proportion of GDP from 1692 to today. Figure 2 shows the history of public debt in the twentieth century. In the eighteenth

Figure 1[1]

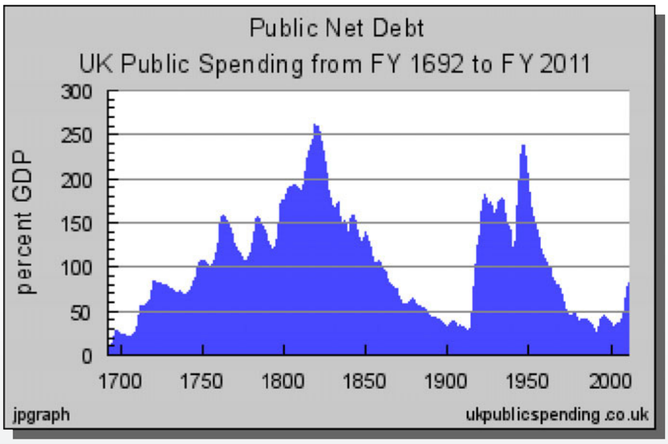
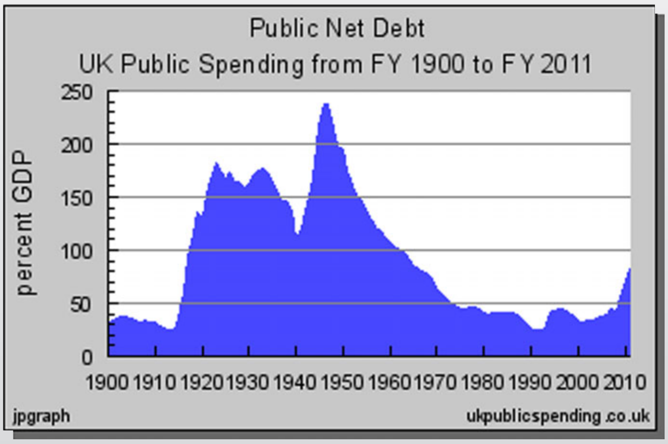


Figure 2



century there was a series of spikes in the total debt which correspond to major wars. By 1715 the debt had already risen to 60% of GDP and it peaked at 237% in 1815. In each case the debt run up during the war was significantly reduced in its aftermath. This typically took about twice as long as the time taken to run up the debt, so five years of debt-funded war would take about ten years to pay down. In the century between 1815 and 1914 the debt was steadily reduced, partly because of economic growth but mainly because Britain was not involved in a major continental war and governments, particularly Liberal, held down government spending and reduced taxation. By 1914 the National Debt had been reduced to 25% of GDP.

In the twentieth century the dominant feature in the national debt until recently were the two World Wars, as figure two shows clearly. By 1919 the debt stood at 135% of GDP and it reached 180% in 1923. Although it was significantly reduced in the inter-war years it was still over 100% in 1940 and it went on to just surpass the 1815 peak, reaching 238% of GDP in 1947. After World War II, governments of both parties reduced the debt until it once again reached a low of 25% in 1992. In the last twenty years it has fluctuated in the 30 to 40% of GDP range but began to climb sharply after 2003 (i.e. before the onset of the financial crisis). If the present trend were to continue then the all time high of 1947 would be reached in just over a decade.

Does this matter?

Should we be bothered by this trend if the total debt has been much higher than this before? In short, yes. Firstly, we should be concerned about the cost of debt servicing if interest rates on government debt rise because of general increases in world interest rates or higher perceived default risk, or if growth and tax receipts do not keep up with rises in other government spending. Once the total debt has gone above the kind of level it is at now, even small increases in interest rates translate into big increases in interest payments, while the increase in yield drives up all long-term interest rates and so slows down investment and economic growth – which makes the problem even worse. Once this increase in costs goes above a certain level, it can become politically and economically unsustainable.

Why, though, might this happen this time if it did not happen, as is often suggested, on earlier occasions when we had high levels of borrowing? Firstly, we should note that it *did* happen before – the UK was forced to rely upon a dollar loan from the US in 1947–48 (which was given for geo-political not economic reasons) and was driven to massive public spending cuts by rising yields in 1922–23.

Secondly, the cause of the debt accumulation now is different from previous episodes. Every time that the public finances have been under such strain in the past has been the immediate aftermath of a major war. The current deficit is unprecedented in peacetime. War expenditures are comparatively simple to cut back – you spend less on war material and soldiers' wages and relocate resources to the peacetime sector. The current deficit is caused by a decline in revenue combined with high levels of social spending, which is much more difficult to reverse politically. Furthermore, taxes are already at levels at which a further increase in taxes is much less feasible than in earlier centuries.

Moreover the problems of public finance that we now face, while exacerbated enormously by the crisis, pre-date it. No UK government has ever been able to raise more than around 38% of national income in tax revenue for any sustained period in peacetime, even when taxes are set at a level that theoretically should bring in more. It would seem that 38% is the maximum that the British public is prepared to pay in taxes – if they go any higher, people will change their behaviour so as to reduce their tax liabilities. This means that 40% of GDP is the absolute maximum level of public spending that is sustainable. Currently public spending is running at 50% of GDP and it was already at 43% before the crisis. This high level of spending is not of a kind that will naturally come to an end at some point – indeed, it is worse than that. The government has taken on unfunded obligations in the field of pensions, health and so on which, given the UK's population profile, effectively add to what is sometimes called the 'implicit debt' mountain.

Previous British governments that have had to restore order to the public finances have done so in the aftermath of a major war. This is the first time in the UK that such an exercise has had to be undertaken when no war has taken place and it is long-standing non-military spending programmes that have to be cut back. What this requires is a serious public debate about exactly what it is we as a country want government to do, given the limits of the resources available and what we are collectively prepared to pay. Further burdens cannot be added to an ever-increasing debt mountain to be borne by the future generations.

1. Figures are reproduced by from Christopher Chantrill with permission http://www.ukpublicspending.co.uk/debt_brief.php

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A Critique of 'Steady State Economics'

Kristian Niemietz

Here is a brief account of human history:

'For the vast majority of human history, the size of the economy was small compared to the size of the biosphere. But over the last hundred years or so, this balance has changed remarkably due to the increase in the number of people in the world and the growth in each person's consumption of goods and services. [. . .] Due to economic growth, humanity now uses eleven times as much energy, and eight times the weight of material resources every year as it did only a century ago. The global economy is now so large that it is undermining the natural systems on which it depends. The result is a wide range of global environmental problems: climate change, biodiversity loss, stratospheric ozone depletion, deforestation, soil degradation, and the collapse of fisheries. The list goes on'

(O'Neill *et al*., 2010, pp. 23–26).

Here is another account of the same phenomenon:

'From 2 million or 200,000 or 20,000 or 2,000 years ago until the 18th century there was slow growth in population, almost no increase in health or decrease in mortality, [. . .] increase in wealth for a few, and mixed effects on the environment. Since then there has been rapid growth in population due to spectacular decreases in the death rate, rapid growth in resources, widespread increases in wealth, and an unprecedently clean and beautiful living environment in many parts of the world [. . .] In the 19th century the planet Earth could sustain only one billion people. [. . .] Now, 5 billion people are living longer and more healthily than ever before, on average. The increase in the world's population represents our victory over death'

(Simon, 1994, pp. 22–23).

Unlikely as it may seem, both authors are really describing the same planet, representing two diametrically opposed sets of assumptions. The first view, 'Malthusianism' or 'Steady State Economics' (SSE), holds that the planet's biosphere is highly fragile and can only cope with a low level of human economic activity. If the latter exceeds its 'planetary boundaries', it overstretches the biosphere's carrying capacity, and thus depletes the world's ecological capital: according to the SSE view, the lifestyle we have grown accustomed to is akin to the lifestyle of a prodigal heir, who squanders the family wealth in a mindless consumption frenzy. The only way to prevent disaster is to downsize the world economy to a level which the planet can absorb. Since this is deemed impossible in a capitalist economy, an economic system in which the state tightly controls all economic activity is advocated.

The second position, 'rational optimism' or 'sceptical environmentalism', rejects the SSE assumption that people are just passive consumers of the resources they stumble across. Rather, people are seen as potential problem-solvers, who can overcome resource constraints given the appropriate institutional setup: a system of secure property rights and the free formation of market prices.

Suppose demand for resource X was growing at a much faster rate than supply. A Steady State Economist would typically extrapolate this trend into the future, calculate the date we will 'run out of X', and describe the consequences in a melodramatic fashion. A sceptical environmentalist would argue that if this trend continues, the price of X will increase. This entices X-suppliers to look for ways of tapping into hitherto inaccessible X-deposits, and X-consumers to look for ways of making more with less X. Entrepreneurs, meanwhile, are enticed to look for ways of substituting X.

Whichever approach one finds intuitively more convincing, the empirical track record of the optimist position is vastly superior. Over the past 200 years, all kinds of resources have been predicted to run out and all kinds of ecological disasters have been predicted – next to none has ever materialised.

On the macro level, the long-term trend since the Industrial Revolution has been for the world to gradually become more populous and more prosperous. If the global ecosystem was in danger of bursting under the weight of our economic activity, it would have burst long ago. Instead, all kinds of social, health and environmental indicators have improved.

So what explains the continued fascination with doom-and-gloom theories? Most modern-day Malthusians make no attempt to hide their loathing of mass consumerism (e.g. New Economics Foundation, 2009). So there may be a predisposition, on their side, to ascribe negative consequences to a process which they are opposed to anyway. This highlights, once more, the danger of using economic analysis in order to seek confirmation for one's preconceived intuitions.

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