# HELPING HAND?

**Does foreign aid work? The empirical evidence suggests most foreign aid is ineffective. Furthermore, aid tends to increase inequality within countries rather than helping the poor, says CHRISTIAN BJØRNSKOV**

Despite widespread growth and unprecedented prosperity, almost a billion people live in absolute poverty. An entire industry has developed with the sole purpose of helping these people.

Yet, many commentators and politicians claim that still not enough is done. The United Nations has, for example, a stated goal that all rich countries ought to provide at least 0.7 per cent of their national income as foreign aid to poor countries.

In fact, richer countries have provided foreign aid to poor countries all over the world since the 1940s. Scandinavia is the region that has given the most relative to its size, although the United Kingdom was one of the pioneers of aid.

The very first foreign aid was provided to British overseas colonies in 1929 as a result of the Colonial Development Act, and the UK has recently reached the official UN goal. In 2013, the coalition government spent £11.4 billion on foreign aid, of which almost 40 per cent was given to African countries.

The rich countries in total spent more than £80 billion in 2013, one third of which went to Africa, which has, together with Asia, received almost £1 trillion in foreign aid since 1950.

If aid did what official agencies and politicians claim it does, one would perhaps expect Africa and Asia to both be economically thriving and fairly rich by now.

### A patchy growth record

Yet, although some countries in Asia and Africa have done well in recent years – Ghana and Vietnam are often mentioned as models to copy – others are substantially poorer today than they once were.

Despite progress in the last decade, Zambian citizens today have only about 80 per cent of the purchasing power they had in the late 1960s. In countries such as the Comoros and the Democratic Republic of Congo, real incomes have been falling for decades.

While the typical African country has received about 5 per cent of their national income as foreign aid, Zambia on average has received double that level. Indeed, in several countries aid has financed almost half of all public consumption.

This raises the question of whether it is foreign aid that promotes development where it happens, or is it something else?

In fact, most independent research suggests that foreign aid has no positive consequences in the long run and that it may come with unintended and unwanted side effects.

**ZAMBIAN CITIZENS TODAY HAVE ONLY ABOUT 80 PER CENT OF THE PURCHASING POWER THEY HAD IN THE LATE 1960S**

### Economic planning and economic development

In the aftermath of World War II, hopes ran high that the many European colonies, which were becoming independent in those years, would develop rapidly.

Official statistics coming out of the Soviet Union not only suggested that rapid economic development was possible, but also seemed to imply that communist command economies outperformed the free world.

Many believed that development could best be achieved by commanding massive investments in government-run industrialisation and that the more gradual and unplanned way that had led to Europe growing rich was too slow.

What the Soviet model and the growth theory of the day suggested as necessary were capital investments well in excess of those which could be financed by the relatively limited domestic savings in poor countries.

In addition, the Marshall aid received by Western Europe after the war provided an example of how substantial aid from richer countries could seemingly speed up modern development and sustain new democracies.

It was forgotten that the Marshall aid was intended to help European reconstruction after the massive destruction of World War II. In other words, its aim was to re-establish what had already been working before the war in a reasonably good institutional environment. The intentions of modern foreign aid are fundamentally different from those of the Marshall aid: it is mostly supposed to help poor countries develop and construct what had never been there. During the 1960s, many social scientists also started to realise that the theoretical foundations of aid were wrong and that the Soviet example was most likely a fiction. The British-Hungarian economist Peter Bauer famously described aid as transfers from poor people in rich countries to rich people in poor countries.

### Clutching at straws

Despite the debunking of the original case for foreign aid, in the mind of the public and in political discourse, aid came to be seen as entirely indispensable for the development of poor countries until studies in the late 1980s began to shed more light on the subject.

Paul Mosley famously summarised the first findings as describing a micro-macro paradox: while about half of all aid projects work, aid does not seem to help entire countries.

Hristos Doucouliagos and Martin Paldam, who have surveyed the entire literature on the effects of foreign aid that has been published since 1970, conclude that most analyses show no effects from aid.

Although a number of researchers find that aid is associated with faster growth, other people working with similar data and methods tend to find no effects. The studies that find positive effects tend to be conducted by researchers with close ties to or funding from donor organisations.

Applying more advanced methods and distinguishing between democracies and dictatorships make no real difference to the results. Doucouliagos and Paldam conclude that, overall, aid is entirely ineffective in creating growth but they also note that their findings do not imply that all aid is ineffective.

Some of the most recent work indeed tries to ascertain whether particular types of aid work. Doing so first requires some way of dividing aid into different categories. This proves to be difficult.

Michael Clemens and colleagues for example argue on theoretical grounds that some types of aid work in a way that makes its effects visible within five to ten years. They find evidence that this 'early-impact aid' generates growth whereas other types of aid do not affect growth in any visible way.

### What works, and what does not work?

In recent work I look at different categories of aid. The vast majority of foreign aid disbursed since 1970 can be divided into four groups: aid given with the aim of furthering economic development; aid with the purpose of furthering social development; reconstruction aid disbursed after wars and major natural disasters; and a residual category that includes small amounts of aid for other purposes.

As Figure 1 shows, the shape of foreign aid has changed over the years. In the early years, most aid was given for economic development in line with the idea that rapid industrialisation was the key to development.

In more recent years, a growing share of aid has been given for social purposes such as education, healthcare and environmental protection.

Economic aid now accounts for less than a third of all aid. In addition, about 15 per cent of all aid has been for reconstruction after wars, major civil unrest or natural disasters.

Examination of the evidence suggests that only reconstruction aid is effective. When a developing country has suffered a war, civil war or natural disaster, inflows of reconstruction aid help get countries quickly back on their feet.

Interestingly, this type of aid is similar to Marshall aid which is also thought to have been helpful to post-war Europe. The remaining 85 per cent of aid flows in the other categories seem to provide no benefits.

In previous studies, it seems as if it is this inconsequential 85 per cent of aid flows that have dominated the results and overshadowed the 15 per cent of aid that had some benefit.

**EXAMINATION OF THE EVIDENCE SUGGESTS THAT ONLY RECONSTRUCTION AID IS EFFECTIVE**

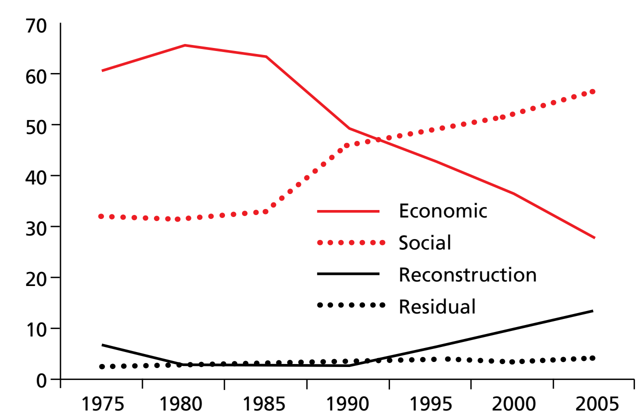


**Figure 1: Shares in total foreign aid of different types of aid 1975-2005**

### Does aid help the poor most?

We could, of course, ask whether it is only growth that matters. Might it be possible that foreign aid helps the poor whilst not affecting growth?

For example, it might change the distribution of incomes in poor countries? However, a new study by Dirk Herzer and Peter Nunnenkamp finds no evidence of such a positive effect.

Instead, when comparing 21 countries across a long period of time, they find that countries receiving more aid develop a more uneven distribution of income, consistent with Bauer's claim that aid mainly helps rich people in poor countries.

While more work on poverty reduction is evidently necessary, what little research has been done suggests that aid funding may tend to end up in the hands of the wrong people or at least sets in train forces that benefit richer people more than poorer people.

The depressing conclusion of more than 40 years of research is therefore that although some types of aid work under some types of conditions, it does not do what it was intended to do: help poor countries grow faster and lift people out of poverty.

At best, our financial aid to poor countries can help them overcome disasters in the same way as US aid helped Europe find its footing again after World War II.

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