

## Tomorrow's Company Briefing on...

# The Role of Aid and Trade in Reducing Global Poverty

July 2009

*This briefing summarises the strengths and weaknesses of both aid and trade within a poverty reduction strategy. It shows that it is important to distinguish between different types of aid, as the efficacy of each is dependent on the context in which it is administered. An assessment of the success of trade led growth strategies in reducing poverty is made and the difficulties faced by developing nations in following such a strategy are explored.*

### An introduction to the aid vs. trade debate

The persistence of absolute poverty in our world, where around one billion people live on less than a dollar a day, has led to a long history of literature aiming to determine why so many remain in poverty and the best method of alleviating it. The said literature will be summarised here, as will the history of the use of aid and trade in development strategies and the role these may play in the future.

Aid has often been seen as a solution to a chronic lack of investment in developing countries and was championed for large parts of the twentieth century, although in recent years scepticism has grown regarding its effectiveness. Trade, meanwhile, has theoretical proponents stretching back to Adam Smith and Ricardo, and has been accredited with the success of a number of Asian nations. Indeed the debate has often been characterised as 'aid vs. trade' as a result of the more successful development of Asia after decolonisation, which focussed on trade, when compared to Africa, which received large amounts of development aid. In recent years, many have suggested that this 'either trade or aid' mentality is counterproductive, and that both can play a part in developing the poorest nations.

### Aid and Trade: Key facts

- Over \$1tn of aid has been given to developing nations in the last 60 years
- Proponents of aid state that it alleviates suffering and provides capital necessary for investment
- Opponents of aid say that it distorts incentives, prevents reforms and leads to 'Dutch Disease' (when an appreciating currency suppresses exports)
- The Commission for Africa estimates that we need to provide up to \$12bn a year to get developing countries on the road to becoming global trading partners<sup>1</sup>
- China has lifted 200m people out of poverty in the last 20 years, a result of 8% growth and a 35 fold increase in exports

<sup>1</sup> DfID report, 'Why Trade Matters', 2005

## **A brief history of Aid**

The first modern example of using foreign contributions to promote development is the Marshall Plan in post war Europe, when the USA gave a total of \$13bn to countries in Western Europe to pay for the continent's reconstruction. This aid, it must be acknowledged, was given in part as a result of tensions developing between the USSR and USA at the start of the Cold War, and was administered by the newly created IMF and IBRD (World Bank). However, it is widely believed to have helped Western Europe and Japan to reconstruct a number of its key industries, to build new housing and to create sustainable growth that lasted well into the 1950s.

With the perceived success of the Marshall Plan, this model was replicated in parts of the 'third world', much of which was being decolonised, where it was perceived that infrastructure was inadequate to achieve self-sustaining growth once independence was achieved. As such, during the 1960s and 1970s, foreign aid spending shifted from Western Europe and Japan to political allies in the Middle East and Asia and to poor countries in sub-Saharan Africa and south Asia.

Towards the latter part of the twentieth century, a greater emphasis was placed upon Official Development Assistance (ODA), with developed countries pledging in 1970 to give 0.7% of GNI in ODA. Only 5 countries have met this target, with the UK committed to meeting it by 2013.

Despite aid continuing to be used as a political tool in the 1980s and 1990s with the preponderance of conditionality, it continued to be cited as a key instrument in reducing global poverty, with popular campaigns such as Live Aid (1985) and Live 8 (2005) stressing its importance. However, a growing body of critics has emerged, led by William Easterly and, most recently, Dambisa Moyo.

## **How aid can reduce poverty**

The economic growth models of the post war years asserted that levels of savings, and therefore investment, were the key drivers of growth. As many developing countries had a large proportion of the population earning subsistence wages, the savings rate was particularly low and therefore it was believed by many that aid could provide the capital needed for investment during the early stages of growth. Chenery and Stout (1966) presented the two-gap model, in which the first gap is that between the savings rate and the amount of investment necessary to attain a certain rate of growth, while the second gap is that between imports and exports for a given level of productivity<sup>2</sup>.

This type of theory is still prevalent today, with Jeffrey Sachs asserting that the poorest countries are stuck in a 'poverty trap', a vicious cycle of underinvestment in physical and human capital and underdevelopment. Some countries, he purports, need a help up onto the first rung on the ladder of development, by investing in basic healthcare, education and infrastructure to break the cycle of deprivation.

## **The trouble with aid**

In recent years, some commentators have been increasingly critical of the results delivered by aid, painting it as a \$1tn project that has failed miserably. Critics often point to the difference in fortunes of Africa and Asia. The former has received huge sums in aid but has got poorer by some measures since the 1970s<sup>3</sup>, whilst the latter has achieved high levels of growth in the last two decades, largely without assistance. A number of

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<sup>2</sup> William Easterly, 'The White Man's Burden', page 8

<sup>3</sup> [http://www.huffingtonpost.com/dambisa-moyo/aid-ironies-a-response-to\\_b\\_207772.html](http://www.huffingtonpost.com/dambisa-moyo/aid-ironies-a-response-to_b_207772.html)

arguments have been advanced for why aid has failed to reverse the cycle of poverty in Africa.

Perhaps the most cited argument is that aid has created a dependency culture within Africa, by distorting the incentives of political leaders and preventing much needed reforms and deregulation. There are well documented cases of aid funding the interests of corrupt leaders, either directly or indirectly, with Paul Collier finding in 2007 that 11% of bilateral aid indirectly and inadvertently goes on military spending<sup>4</sup>. Aid often causes an increase in government consumption without leading to wealth creation and can remain in the hands of the societal elite, without trickling down to where it is most needed.

'Dutch Disease', whereby a large inflow of aid causes the developing country's currency to appreciate has been blamed for suppressing export-led growth. This can cause an increasing trade deficit which is serviced by either borrowing or by the receipt of more aid.

William Easterly is particularly critical of the top-down approach to aid donation, with projects too often being driven by supply rather than demand. These types of donors, whom he calls 'planners', are both far more prevalent in the aid industry and far less successful than those who focus on what services are demanded and 'search' for solutions on the ground.

Proponents of aid sometimes take a similar line of argument to Easterly, arguing that the reason so much aid has led to so little development is because of the culture of conditionality throughout the 1980s and 1990s. 'Bad aid', it is argued, is the type that tries to induce policy reform: it has been shown by a number of studies<sup>5</sup> to have failed in this goal. Stiglitz has been particularly scathing of the IMF in its use of conditionality and Structural Adjustment Policies (SAPs) in the 1990s in its pursuit of ideological and political goals. Aid is often given to countries for political reasons, rather than on a basis of need or on an ability to use it efficiently and so is often inefficiently distributed.

### Different types of aid and when they are most effective

The most recent work regarding the efficacy of aid has begun to acknowledge that it is counterproductive to talk of aid in blanket terms; Dambisa Moyo is careful to point out that she is not criticizing humanitarian assistance or small project-led aid, but rather what she terms 'systemic aid', that which is given annually, often as budget support, by governments and international institutions. Indeed, it is very rare to hear criticism of humanitarian aid that is pledged in the wake of human disasters to alleviate suffering; criticism of demand-led projects, often carried out by NGOs is similarly muted.

Academics have recently focused work on looking at which types of aid are most effective in which scenarios. Devarajan, Dollar and Holmgren find that whilst aid is ineffective in inducing reform, it can be more efficiently allocated if donors consider what stage of the reform process the receiving country is in<sup>6</sup>. Budget assistance should be administered

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### Different Types of Aid

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- Humanitarian
  - Budget Support
  - Loans (low interest)
  - Technical Assistance
  - NGO projects
  - Programme/Project
  - Multilateral/Bilateral
  - Untied/Tied
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<sup>4</sup> Paul Collier, *The Bottom Billion*

<sup>5</sup> Including Burnside and Dollar (2000), 'Aid, Policies and Growth' and Collier and Dollar (2002), 'Aid Allocation and Poverty Reduction'.

<sup>6</sup> Devarajan, Dollar and Holmgren (2001), 'Aid and reform in Africa: Lessons from 10 case studies'

incrementally as policy improves; conditionality is only appropriate during the reform stage as beforehand it will be ignored and once governance is improved it can blur accountability and ownership of policy; technical assistance is useful at any stage of the reform stage, but must be driven by demand.

Paul Collier builds on this work in his book, 'The Bottom Billion', in which he argues that aid should be tailored to combat whichever of a number of different poverty traps a country may be caught in. For example, in post conflict situations, to improve incentives, aid should be administered gradually as the country becomes more stable and policy improves; to combat bad governance aid should only be used ex-post and not ex-ante, once policy is improving, not before reform has started; and to combat Dutch disease, aid should be focussed on improving infrastructure and providing technical assistance that will make a country more competitive in the long run. Aid delivered to countries caught in the 'natural resources trap', however, is largely impotent.

Whilst different types of aid may be effective in different situations, what has become clear is that whilst aid can be part of the solution, it is not a panacea and there are no 'magic bullets' in defeating poverty. The historical success of trade in reducing poverty has resulted in a shift of focus in development strategies, initially towards export-led growth strategies and, more recently, in favour of aid for social enterprise projects.

### **A brief history of international trade**

It is thought that trade has taken place throughout much of recorded human history and international trade has benefitted a number of peoples over the centuries, most notably the European powers, with Portugal, the Netherlands and Britain dominating trade routes in the 16<sup>th</sup>, 17<sup>th</sup> and 18<sup>th</sup> centuries respectively, with Spain also benefitting from its trade links throughout this period. These powers managed to accrue wealth and maintain a standard of living that was without precedent. The 19<sup>th</sup> century also saw advances in theoretical work to explain the benefits of free trade, with Ricardo and Adam Smith amongst its proponents.

Whilst theory had shown that protectionism was detrimental to the world at large, many countries sought to protect their industries from external competition, and free trade reached a nadir during the Great Depression of the 1930s. However, at the end of World War II, the role of protectionism in prolonging the depression was acknowledged and steps were taken to prevent such measures being taken again, with 44 countries signing the Bretton Woods Agreement in 1944. The General Agreement on Tariffs and Trade (GATT) was signed by 23 countries in 1947, with the number of signatories increasing up until the founding of the World Trade Organisation (WTO) in 1994 with the conclusion of the Uruguay Round of negotiations. Regional free trade blocs, such as the EU (formerly the EC and EEC) and the North American Free Trade Association (NAFTA) have led to economic prosperity of their members.

The use of trade in reducing poverty, therefore, is not a particularly new phenomenon. The growth of South Korea and Japan in the 1960s and 1970s can be attributed to increasing export revenue, and this growth significantly increased standards of living in both of these countries. Since the end of the Cold War, countries in the ex-soviet bloc have shown robust growth, particularly those benefitting from the free trade opportunities within the EU. China, India and Brazil are amongst a series of emerging economies posting unprecedented rates of growth as a result of export-led growth strategies. Indeed, as a result, 200m have been lifted out of poverty in the last 20 years in China alone<sup>7</sup>

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<sup>7</sup> DfID, 'Why Trade Matters' report, 2005 , page 4

## How trade can reduce poverty

According to Oxfam, 'history makes a mockery of the claim that trade cannot work for the poor'<sup>8</sup>, and it is now widely accepted that trade can be mutually beneficial for those who take part. These mutual benefits are explained most simply by Ricardo's theory of comparative advantage. By specialising in goods in which a country has a comparative advantage (i.e. goods that can be produced at a relatively lower opportunity cost), both trading partners can make gains from trade, even if one has an absolute advantage (producing at a lower overall cost) in producing all goods. In the past this model has been dismissed for being oversimplified in explaining the complicated nature of the modern international trading system, yet economists have shown that it still holds today<sup>9</sup> and that free trade can benefit all of its partners.

Whilst Ricardo's theory is still valid today, its theoretical grounding fails to fully explain all of the benefits available from trade, and the potential difficulties in achieving a fair trading system that can deliver these benefits. Further explanations of how trade can lead to growth and development in developing countries include the creation of greater economies of scale for firms with access to wider markets, an influx of Foreign Direct Investment (FDI), increased competition leading to enforced improvements in productivity and the transfer of knowledge, technology and improved production methods. This last point is particularly pertinent when considering wider human development as the sharing of technology, medicines and knowledge has not only allowed countries such as China to grow at an unprecedented rate, but has also led to vast improvements in global health and education.

## The difficulty of trade-led growth and development

The existence of a small but significant, and often vociferous, anti-globalisation movement is evidence that at least some in society do not believe that trade benefits all and it must be acknowledged that difficulties persist for developing countries in reaping the benefits from trade. Amartya Sen asserts that 'the great rewards of globalised trade have come to some but not others'<sup>10</sup>. Protectionism within developed nations, particularly in agricultural industries, is often the focus of protest, as are excessively rapid reforms insisted on by international institutions, the likes of which contributed towards the East Asian crisis in 1997.

Further difficulties exist for developing nations including a dangerous dependency on primary products, which are prone to fluctuating prices, and the danger posed by developed world competition. Stiglitz, on the topic of Infant industry protection has stated that 'countries often need time to develop in order to compete with foreign companies... they may have to protect their nascent industries temporarily'<sup>11</sup>. Paul Collier also asserts that many of the poorest countries (primarily in Africa) have, in effect, 'missed the boat' of trade led growth as low wage economies in Asia are now benefitting from 'economies of agglomeration', that is the benefits to a company of relocating to a low-wage area where similar firms already produce<sup>12</sup>.

The setting up of the World Trade Organisation (WTO) in 1994 promised to alleviate some of the problems faced by developing countries in accessing the benefits from trade in foreign markets, although negotiations in the 'Doha Development Round' have consistently stalled since beginning in 2001. Some point to a lack of transparency within the WTO, with the 'Quad' (USA, Canada, EU and Japan) seeking to use their influence to protect their

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<sup>8</sup> Oxfam, *Rigged Rules and Double Standards*, page 8

<sup>9</sup> See Paul Krugman's robust defence of the theory, <http://web.mit.edu/krugman/www/ricardo.htm>

<sup>10</sup> Oxfam, *Rigged Rules and Double Standards*, page 5

<sup>11</sup> Stiglitz, *Making Globalization Work* page 70

<sup>12</sup> For a more detailed explanation see Paul Collier, *The Bottom Billion* pages 82-85

vested interests<sup>13</sup>. As it stands, the Quad still has huge trade barriers in place to protect its fishing and agricultural industries, industries that employ around 75% of people in the developing world; 'fruit and nuts imported into the US can have a tax of 200% slapped on them, and for meat brought into the EU this can be as much as 300%'<sup>14</sup>.

However, gains have been made in recent years, with some reform of Western agricultural subsidies, the Multi-Fibre Arrangement, which increased market access for textile exporters and the granting of 'Special and Differentiated' (S & D) treatment, which is meant to acknowledge the vulnerability of poor nations to rapid reforms. Further, since 2001, the EU has adopted a stance of 'Everything But Arms' (EBA), under which all imports to the EU from the Least Developed Countries are duty free and quota free, with the exception of armaments.

### **Aid and Trade: the future of poverty reduction strategies**

There is a growing belief that a holistic approach is needed to tackle the persistence of global poverty, one that will include some types of aid to provide basic infrastructure to impoverished communities and an open trade policy to produce long run trade led sustainable growth. Trade has proved successful in promoting growth in many developing countries, but it needs to be accompanied by social reforms and investment in infrastructure, health and education to stimulate development: 'trade may be the single most potent tool in the fight against poverty, but it won't work in isolation'<sup>15</sup>. Whilst there is still disagreement as to the role of Moyo's 'systemic aid' (which she says should be turned off within 5 years), there is a growing consensus that aid should be demand-driven and directed from the bottom upwards. This has led to a shift away from large scale projects and 'Big Plans' towards small scale projects tailored to the needs of local communities. Indeed in the last decade we have seen a large increase in the volume of aid directed towards these projects, in particular Microfinance Initiatives (MFIs), which harness the profit motive of small-scale enterprises, empowering people to work their way out of poverty.



### **Further Reading**

Joseph Stiglitz, 'Globalisation and its Discontents'

Paul Collier, 'The Bottom Billion'

Jeffrey Sachs, 'The End of Poverty: Economic Possibilities of our Time'

<sup>13</sup> Payne, 'The Global Politics of Unequal Development', page 197

<sup>14</sup> DfID, 'Why Trade Matters' report 2005, page 21

<sup>15</sup> DfID, 'Why Trade Matters' report 2005, page 29

Dambisa Moyo, 'Dead Aid: Why Aid is Not Working and How There is a Better Way for Africa'

William Easterly, 'The White Man's Burden'

DfID, 'Why Trade Matters', 2005

<http://www.dfid.gov.uk/Media-Room/News-Stories/2005-to-do/Why-trade-really-matters-in-the-fight-against-poverty/>

Joseph Stiglitz, 'Making Globalisation Work'

Oxfam, 'Rigged Rules and Double Standards'

<http://publications.oxfam.org.uk/oxfam/display.asp?isbn=0855985259>

Anthony Payne, 'The Global Politics of Unequal Development'

Ha-Joon Chang, 'Bad Samaritans'

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This document was written in July 2009, by Rossa O'Keefe-O'Donovan.

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