

i Candidate instructions

ECON4915 - Development Economics

This is some important information about the written exam in ECON4915. Please read this carefully before you start answering the exam.

Date of exam: Tuesday, June 4, 2019

Time for exam: 14.30 - 17.30 (3 hours)

The problem set: The problem set consists of 1 problem.

Sketches: You may use sketches on this exam. You are to use the sketching sheets handed to you. You can use more than one sketching sheet. See instructions for filling out sketching sheets below. It is very important that you make sure to allocate time to fill in the headings (the code for the problem, candidate number, course code, date etc.) on the sheets that you will use to add to your answer. You will find the code under the problem text. You will NOT be given extra time to fill out the "general information" on the sketching.

Access: You will not have access to your exam right after submission. The reason is that the sketches with equations and graphs must be scanned in to your exam. You will get access to your exam within 2-3 days.

Resources allowed: No written or printed resources - or calculator - is allowed (except if you have been granted use of a dictionary from the Faculty of Social Sciences).

Grading: The grades given: A-F, with A as the best and E as the weakest passing grade. F is fail.

Grades are given: Thursday, June 20, 2019

1 Problem 1

Discuss the effect of development aid on the economies of poor countries. How can we identify the impacts of aid?

Fill in your answer here and/or on sketching paper

Introduction

In 2018, OECD's Development Assistance Committee gave 153 Billion USD Development Aid to the developing world. About 2.7% points less than in 2017, mostly because of in-donor-country-refugee costs. Development Aid is the monetary aid of developed countries to developing states which is supposed to support long-term development of the latter. This distinguishes it from Humanitarian Aid which is given as emergency response. Globally various actors engage in on different levels in giving Development Aid: Official Development Aid is given by governments, either directly to the receiving country's government or via a multinational organisation such as the United Nations and its suborgans (UNICEF, WFP, FAO, UNDP, etc.) or the World Bank. On average donor countries give about 0.41% (2015) of their GDP, still below the UN's goal of 0.7%. Further Non-Governmental Organisations (e.g. Oxfam) contribute aid to development projects and recently private foundations such as the Bill and Melinda Gates foundation start to play a more important role.

However, why is it globally widely accepted and internationally claimed that rich, industrialized countries should give development aid?

Researchers in Development Studies, namely Jeffrey Sachs, claim that poor economies are stucked in a development trap which they can only escape from with an exogenous *Big Push* helping them to achieve a positive GDP growth rate, followed by the possibility to industrialize.

This thought has been adopted since 2000 in the UN's projects the Millenium Development Goals (MDGs) and followed in 2015 by the Sustainable Development Goals (SDGs). Both gather for the first time internationally agreed on development objectives on the path to eradicate poverty.

Furthermore, aid is given altruistically motivated, simply to help poor nation's population to escape misere.

Here, one remarks that former colonial relationships seem to create a certain responsibility thought. On the other hand, aid is also, usually unofficially, tied to economic investment decisions favoring the donor country, for strategic reasons such as military actions or political influence (e.g. Vote-Buying in the UN's Security Council).

Empirical Evidence

However, if Development Aid really impacts the poor countries development process as internationally expected remains empirically not clearly confirmed.

If one looks at the relationship between the Amount of Aid received in % of GDP and the a nation's GDP growth rate, one will find a clear negative correlation. However, this result has to be interpreted with care: One should not conclude that Aid necessarily negatively impacts the GDP growth rate. It is rather a case of reverse causality. Countries which perform economically badly (for very different reasons) and thus have low GDP growth rates usually receive the most development aid.

Further, Mosley (1987) shed light on an interesting difference between development aid's impact on the economy's Micro and Macro level which he called the Micro-Macro-Paradox. Development Aid show a strong, positive impact on the Micro level, while this effect completely disappears on the aggregated (Macro) level and hence, seems to have no impact on a nation's GDP. Even though this seems to be paradox, it can be explained through several channels: Firstly, projects are often inadequately evaluated. Mostly, because the evaluation is conducted by the NGO carrying out the project and thus has a strong incentive to show positive results. Secondly, there are no common criteria to measure a project's success and hence, evaluation becomes subjective. Thirdly, development aid projects do not necessarily need to target the improvement of economically relevant indicators. The planting of trees to fight against desertification might impact the GDP only decades later. This brings the question up if the GDP Growth Rate actually is an accurate measurement of all development processes. Finally, even if a successful project (micro level) has a positive impact on aggregated level, it also can lead to crowding out of the receiving country's government investments in that specific sector towards less productive activities. Maybe a national government would have invested in medical infrastructures without foreign development aid, but due to the ongoing project it prefers to spend on the capital's government buildings.

These explanations show that it is rather difficult to find the causal impact of Development Aid on the poor economies development process. In order to be able to show this causality all given aid, conditional on controlling for important confounding variables needs to be randomly assigned to the country. Hence, the explanatory variable *Aid* cannot be correlated with the error term of the regression equation ($cov(Aid, e)=0$). As we try to estimate impacts on an aggregated level, a Randomized Control Trial (RCT) Approach is surely not helpful. The thought of truly randomly giving development Aid to countries seems ridiculous and impossible. However, economic research makes use of Instrumental Variables (IV) Regressions. Here, Development Aid is instrumented by another variable which i) can explain a great part of the Development Aid's impact (it is a relevant instrument) and ii) is exogenous with respect to the depending variable (here usually GDP Growth) and the error term. Such instruments have for example been, voting in the UN General Assembly, strength of ties with donor countries, lagged development aid, population size or landlockedness.

Clemens (2011) evaluates several research articles on the impact of Development Aid on Development of poor economies which originally showed highly diverse results.

Firstly, he concludes that most of the instruments used have been weak/ irrelevant (such as e.g. population size) and/ or endogeneous as well. Secondly, he points out that the type of aid and the impact's time horizon has to be chosen with care. According to him, both factors would explain the different results in the original papers. Therefore he re-conducted all regressions, trying to implement a homogeneous set up:

Clemens works with a short panel data set to apply fixed effects estimators and thus is able to control for country specific, time-invariant factors. Further, he used a lagged the depending variable due to the assumption that development aid's impact will only arrive a few years later. Finally, he only used *Early Impact Aid*, excluding humanitarian aid and aid which's impact only would have occurred in the long term. In this set up all regressions show highly similar results: Clemens came to the conclusion that Development Aid has a very modest, positive impact in a country's development. However, he also emphasizes that there could be still a possibility of *Granger Causality* and that this result, by no means, states that Development Aid is the main driver for a positive economic development.

Therefore, it is absolutely crucial to take a closer look at different conditions of receiving countries and different ways of donating Development Aid.

Donation Conditions and Procedures

Today, the process of giving Development Aid does not imply a simple transaction between governments.

Mostly, due to a rather obvious problem: the fungibility of aid. Donor countries usually fear, correctly or not, that the financial support given will be used for purposes which do not align with their own political objectives.

This has been addressed in several ways.

With the MDGs/ SDGs a new era of project and program aid started. Today's Development Aid is mostly channeled to be invested in a specific sector (Health Care, Education, Infrastructure such as Sanitation and Electricity Provision etc.) or even specific projects in a process which is monitored by internationally operating organisations.

Further, donor governments still tend to set up so called tied aid contracts which include next to the financial support also the purchase of technical assistance or other capital goods from the donor country. Ensuring Foreign Direct Investments for own national in the receiving country surely leads to a greater acceptance of donations in the donating country's population but does not necessarily help the receiving country's development.

Finally, donating governments as well as multinational organisations link aid contracts to the fulfilling of other economic or political indicators. This kind of *Conditional Aid* has firstly been used by the International Monetary Fund to promote Market Liberalization and Free Trade conditions in the post-cold-war period, only with a rather mixed success. Today, governments link aid rather to Good Governance Indicators such as low corruption rates, transparency, freedom of speech and most importantly, to Democracy.

Some research suggests that Foreign Aid can help to stabilize authoritarian regimes as a dictator receives an external source of financing and does not need to raise taxes, etc. for which he would be held accountable for.

Even though the donating government's objective is clear and on the one hand also seems quite justified, this aid conditionality is heavily debated and criticised internationally. Temple (2010) points out that Conditionality leads to the intervention of one state into another, sovereign state's decision making process. This bears the risk of Western Paternalism, especially regarding to democratization processes, but also with respect to a problematic lack of knowledge of the receiving country's actual needs.

The latter got more and more public attention due to recent publications such as the German documentary "Sweet Poison - Aid which leads to Poverty". Here, the producers show in which way so called White Elephant Development Projects are only short time solutions, but aggravate existing problems in the long run. One given example has been the building of a fish-factory at the Lake Victoria in a region suffering from power cuts, financed by Norway's NORAD.

On the other hand, sometimes it is undebatably crucial to take a developing country's political structures into account. It is empirically shown that Development Aid to governments of failed or fragile states can fuel conflicts in a detrimental way. Foreign Development Aid is, similarly to wealth from natural resource extraction, simply a valuable source of revenue at the government level which fosters Rent-Seeking-Activities of political or armed groups trying to gain power over these sources. In these cases, it is probably wiser to tie financial aid to conditions or specific projects.

The last paragraphs discussion shows that the Quality of Institutions in general plays a highly relevant role for the final, causal impact of Development Aid, if not even is the decisive factor whether Development Aid has none, a positive or probably a negative impact on future development of today's poor economies.

Concluding Remarks

Looking at the great, global picture, one can conclude that Development Aid most likely has a modest, positive causal impact on the world's poor economies' development.

However, if Development Aid truly can be the main driver for eradicating global poverty, as claimed by Sachs and others, remains highly questionable. Currently, reality seems to partly confirm Sachs' opponent Easterly's theories. As a self-declared "Aid-Pessimist", Easterly claims that Development Aid is not enough and working too slowly, if helping at all. Poor economies should rather improve standards towards market liberalization.

The Ladder-Theory seems partly to reconcile both views: Poor economies are likely to be stuck in a Poverty trap, unable to develop themselves. They cannot ascend a "Ladder of Development" because today's industrialized nations "cut off the first steps of this ladder" by forcing underdeveloped economies to participate in free trade markets build on the western nation's conditions.

Following this view, a true solution to eradicate poverty would be not only to "pile up a mountain of financial support under the ladder" but also to re-construct the first ladder-steps: Poor economies need to develop their infant industries protected by tariffs before opening up to world's market. Rwanda, only 25 years after the genocide, is a shining example of a thriving economy due to protecting its textile industry from the global market. Similarly, economic trade unions such as ECOWAS can be expected to change rules of the international trade game.

It is time for the world's donor countries to realize that giving Development Aid without simultaneously phasing-in own economic sacrifices linked to international trade policies, will not bring the expected

positive development boost in aid receiving countries.

Besvart.

Knytte håndtegninger til denne oppgaven?

Bruk følgende kode:

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