



Development Cooperation, Growth and Poverty Reduction: A Survey of the Evidence

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1. Introduction

Over the first decades of its existence, the modern system of development cooperation, which was established in the 1960s under the auspices of the Organization for Economic Cooperation and Development (OECD) Development Assistance Committee (DAC), was mainly concerned with achieving higher economic growth in developing countries. The intellectual underpinning came from the well-known two-gap model (Chenery and Strout 1966), which assigned to donors the role of providing external resources in order to overcome developing countries' savings and foreign exchange gaps. The structural adjustment programs that dominated the development discourse of the 1980s also aimed at putting recipient countries on a higher growth path by implementing macroeconomic and structural reforms.

Only in the 1990s did a consensus emerge that poverty reduction should be regarded as the ultimate objective of development cooperation. While this shift was associated with an increased use of instruments directly targeting the poor, such as cash transfers, it still left ample room for growth-promoting activities, because growth has been shown to lead to lower poverty in most instances. The literature on pro-poor growth (e.g., (Ravallion and Chen 2003)) added considerations of inequality to the agenda, either stating that the reduction of excessive inequality is a goal in itself or stressing that lower inequality raises the poverty-reducing potential of economic growth. Finally, with the adoption of the Millennium Development Goals (MDGs) in September 2000, helping improve non-monetary poverty indicators such as child and maternal mortality became a new priority among donors, prompting a significant shift in aid allocations from production sectors and physical infrastructure to social infrastructure.

The present paper provides an overview of the empirical evidence regarding the impact of international development cooperation on economic growth, (monetary and non-monetary) poverty and inequality in order to assess whether donors have directly or indirectly contributed to achieving internationally agreed poverty reduction targets.

This might also give an indication of what to expect from development cooperation when it comes to moving towards the very ambitious Sustainable Development Goal (SDG) of completely eliminating absolute poverty.

2. Aid and Growth

This section first looks at the relationship between development cooperation and economic growth in recipient countries, which is arguably the most controversially debated topic of the aid effectiveness literature. It then highlights donors' recent efforts to help recipients raise exports and inflows of foreign direct investment (FDI), which can be regarded as one particular mechanism through which foreign aid might spur recipient growth.

2.1. Direct Growth Effects

The vast existing empirical literature on the effectiveness of foreign aid in raising economic growth and development in recipient countries has so far yielded ambiguous results (e.g., (Qian 2015)). In an influential set of meta-analyses surveying the aid effectiveness literature, Doucouliagos and Paldam (2009) conclude that aid has failed to significantly improve economic growth. In contrast, reviewing a range of empirical aid-growth estimates published since 2008, Arndt et al. (2016) conclude that the large majority of studies have found positive impacts, particularly when effects are assessed over longer time periods. An important strand of the aid-growth literature argues that foreign aid can only be expected to be growth-enhancing under specific conditions. Most notably, Burnside and Dollar (2000) suggested—and confirmed empirically—that donors could contribute to economic growth in developing countries only if they focused their engagement on recipients with reasonable levels of governance. This finding shaped policies by the World Bank and other donors for quite some time, even though Easterly et al. (2004) showed early on that Burnside and Dollar's estimates are not robust in the presence of minor changes such as the use of an updated and enlarged dataset. Even studies that find a positive growth effect of foreign aid generally point to moderate magnitudes. Clemens et al. (2012), for example, estimate that raising economic growth by one percentage point per year in the average recipient country would require aid in the order of 10 percent of GDP.

The observation of results varying strongly across different studies can be due to a number of reasons. One key difficulty is that much of the existing literature examines aggregate foreign aid, which comprises a set of very heterogeneous components. While some components such as emergency assistance are not at all expected to

affect economic growth rates, others may do so through widely differing mechanisms (Qian 2015). Cash transfers to the poor, for instance, are likely to have immediate and direct income effects, whereas the process that eventually leads to income effects of projects supporting women empowerment is much more complex and time-consuming. The aggregation of aid also increases the difficulty of developing credible strategies for the identification of causal effects. It has been almost impossible to find an exogenous source of variation that fulfils the exclusion restriction, i.e., does not affect growth through channels other than aid.

The few studies that carefully address the endogeneity of aid have not been able to resolve the empirical ambiguity. Dreher and Langlotz (2020), for example, instrument foreign assistance with a shift-share instrument along the lines of Nunn and Qian (2014), interacting donor-government fractionalization and the probability of each recipient country to receive aid from a particular donor. Their results suggest that the effect of foreign aid on economic growth is insignificant. Galiani et al. (2017) apply an approach that resembles the quasi-experimental regression discontinuity design. They exploit the fact that some of the poor countries receiving aid from the World Bank's International Development Association (IDA) crossed the income threshold over the period under consideration and thus became ineligible for IDA grants. Their identifying assumption of this approach is that countries above and below the threshold only differ in that those above receive less aid. Consequently, the authors employ as an instrument for aid, whether a country is above or below the threshold. They find that foreign aid increases growth. Specifically, according to Galiani et al. (2017), "a one percentage point increase in the aid to GNI ratio from the sample mean is shown to raise annual real per capita growth in gross domestic product by approximately 0.35 percentage points", which is a sizeable but still moderate effect.

2.2. Impact on Foreign Trade

Trade is one specific area in which donors have pledged to commit additional resources, especially since the aid-for-trade initiative was launched at the Hong Kong Ministerial Meeting of the World Trade Organisation in 2005. The reason this area has received particular attention is that trade and trade liberalisation can make a substantial contribution to economic growth and poverty reduction (e.g., (Winters et al. 2004)). However, a range of factors may prevent low-income countries in particular from taking advantage of trade opportunities. Among the obstacles are trade restrictions adopted by industrialised countries and the developing

countries themselves as well as structural weaknesses on the supply side such as low levels of human capital and an insufficiently developed infrastructure.

By tackling such supply-side bottlenecks, aid for trade holds the potential to foster exports from developing countries. This is not to deny, however, that the donors may provide foreign aid mainly to support their own exports to aid-recipient countries (e.g., (Hoeffler and Outram 2011; Nowak-Lehmann et al. 2009)). Hühne et al. (2014) integrate the recipient and donor perspectives in a nested gravity model where they test for differences in the effects of aid for trade on the trade flows in opposite directions. According to their empirical estimations, aid for trade promotes trade in both directions, with moderate quantitative impacts: A doubling of aid for trade means that exports from recipient to donor countries increase by about five percent, while imports by recipients from donors increase by about three percent. Hence, the results do not support the skeptical view that donors grant aid for trade primarily to promote their own export interests.

The results obtained by Hühne et al. (2014) point to “important limitations in the effectiveness of aid for trade. Strikingly, the significantly positive effects on recipient exports do not hold for the low-income group of recipient countries. Aid for trade rather [appears to promote] the exports of middle-income countries, most of which are probably less dependent on aid to overcome supply constraints.” Likewise, as Hühne et al. (2014) show, aid for trade turns out to be “more effective in promoting the exports of countries in East Asia and Latin America than the exports of countries in Sub-Saharan Africa, even though the need for support appears to be most pressing in large parts of Sub-Saharan Africa”.

Several studies (e.g., (Calì and te Velde 2011; Helble et al. 2012; Hühne et al. 2014) show that the impact on trade is positive for all three component parts of aid for trade, namely aid for ‘economic infrastructure’, aid for ‘productive capacity’, and assistance in ‘trade policy and regulations’. As one might expect, the third and most directly trade-related component of aid for trade exhibits the strongest trade-enhancing effect. For policy makers, it could thus pay off to put a stronger emphasis on support in the area of trade policy and regulations. This subcategory is so far fairly small and includes, for example, assistance in trade negotiations and technical support for meeting sanitary standards, which could turn out to be particularly beneficial for poor countries with weak administrative capacities.

2.3. Impact on Foreign Direct Investment

FDI has the potential to transfer technology, provide well paid employment opportunities, and promote economic growth and reduce poverty in developing

countries, but it has remained strongly concentrated in a few large and relatively advanced emerging economies (e.g., (Nunnenkamp and Thiele 2013)). Hence, the challenge of spreading the potential benefits of FDI across developing countries as envisioned in the Monterrey Consensus of the United Nations persists.

There are several channels through which foreign aid might foster FDI in developing countries. Aid can, for example, be expected to increase the productivity of private investment if it improves complementary factors such as economic and social infrastructure (Selaya and Sunesen 2012) or the regulatory environment. The small existing empirical literature on the relationship between aggregate aid and FDI is inconclusive. According to the pioneering cross-country study by Harms and Lutz (2006), the effect of aggregate foreign aid on foreign direct and portfolio investment was not significantly different from zero in the 1990s. Donaubaauer et al. (2020) report a significantly positive impact of aid on FDI for lower-middle-income countries, but an insignificant one for low-income countries. Asiedu et al. (2009) find even negative effects of aid on FDI in low-income recipient countries. Kimura and Todo (2010) use bilateral data in a gravity-type setting to investigate the relationship between aid and FDI. Estimating gravity equations for the top five donor countries (France, Germany, Japan, the United Kingdom, and the United States) in the period 1990–2002, they find that foreign aid, in general, does not have any significant effect on FDI. The only exception is a positive impact of Japanese aid on Japanese investment in recipient countries, which the authors call a “vanguard effect”.

A clearer and more positive picture emerges when considering specific aid categories rather than the very heterogeneous aggregate aid figures. Selaya and Sunesen (2012) confirm their hypothesis that donor support for complementary factors such as human capital formation is associated with more FDI, whereas aid invested in physical capital comes at the expense of lower private investment. In substantive terms, the regression results suggest that one aid dollar invested in complementary factors draws in around two dollars of FDI in the long run. Donaubaauer et al. (2016) provide evidence that aid for physical infrastructure has promoted FDI over the period 1990–2010. Lee and Ries (2016) explore whether aid for trade has promoted greenfield investment by lowering operating costs. According to their estimates for the period 2003–2013, this has indeed been the case at least in the more advanced recipient countries. Examining the sector-specific transmission mechanisms in a structural gravity framework, Donaubaauer et al. (2020) find that aid for physical infrastructure, post-primary education, and governance as well as aid for trade remove investment barriers and thereby increase FDI stocks.

Accordingly, donors could become more effective in supporting FDI by putting a stronger focus on the aid categories that help improve the provision of inputs complementing private investment.

3. Aid, Poverty, and Inequality

Foreign aid could help mitigate poverty and inequality within recipient countries if two critical conditions were met. Donors would have to allocate aid in line with their rhetoric on pro-poor growth, by targeting the most disadvantaged population groups. At the same time, the authorities in the recipient countries would have to ensure that aid actually reaches the poor. Both conditions are likely to be violated to at least some extent. From the literature on aid allocation across recipient countries, it is well known that donors pursue a mix of motives, being motivated partly by developmental concerns and partly by commercial and political self-interest (e.g., (Hoeffler and Outram 2011)). Commercial donor interests may have as a consequence that foreign aid, e.g., in the area of physical infrastructure, is concentrated in industrial clusters rather than remote areas where the poorest people are living. Likewise, using aid as a means to buy political support by the local elite implies that it favors the rich and influential rather than the poor within a particular country. On the recipient side, aid may be used to provide goods and services that benefit the poor, but it has also been shown to induce rent-seeking and elite capture (e.g., (Reinikka and Svensson 2004; Andersen et al. 2020)).¹

3.1. Impact on Poverty

3.1.1. Monetary Poverty

The first MDG, which simply states that the share of people living in absolute income poverty should be cut by half between 1990 and 2015, has been reached globally if not in all developing countries. Whether aggregate foreign aid has contributed to the decline in poverty is hard to assess due to the same reasons discussed above for the case of economic growth. Still, the consensus is that, on average, foreign aid has been associated with falling monetary poverty. The soundest empirical studies so far, by Hirano and Otsubo (2014) and Arndt et al. (2015), confirm this view using per capita income of the poorest quintile and the poverty headcount (at \$1.25 and \$2 per

¹ This paragraph closely follows Box 3.5 in Stephan Klasen et al. (2018).

day) as poverty indicators, respectively. According to Arndt et al. (2015) estimates, a doubling of aid reduces poverty by around 15 percentage points.

Kaya et al. (2013) go beyond the aggregate perspective and look at the poverty impact of one specific category, aid for agriculture. Employing a fixed effects panel approach they estimate that a one percent increase in agricultural aid reduces the headcount poverty ratio by 0.2 percent in the aid recipient countries. The study also found that the growth elasticity of the headcount poverty ratio ranges from 1.7 to 3.5 across different specifications, which leads to the conclusion that agricultural aid is effective in poverty reduction directly and indirectly through growth. In a similar vein, Hirano and Otsubo (2014) show that social aid significantly and directly benefits the poorest quintile in society, while economic aid increases the incomes of the poor through growth.

3.1.2. Non-Monetary Poverty

While the objective of cutting monetary poverty by half may have attracted the strongest public attention, OECD Development Assistance Committee (DAC) donors appear to have put even more weight on achieving the non-monetary MDGs if one judges them by their aid allocation decisions: the average share of overall aid budgets devoted to supporting social infrastructure investments rose substantially from about 20 percent in the early 1990s to over one third throughout the 2000s.

The existing empirical evidence tends to show that aid targeted at the social sector has helped improve various MDG-related indicators. According to cross-country studies at the macro level, more aid for education has been associated with increased primary school enrollment, less repetition and higher completion rates (D'Aiglepiere and Wagner 2013; Dreher et al. 2008). Likewise, aid for health has been shown to lead to lower infant mortality (Bendavid 2014; Mishra and Newhouse 2009).

More recent studies for several Sub-Saharan African countries (De and Becker 2015; Odokonyero et al. 2018; Kotsadam et al. 2018), which are based on geocoded data at the sub-national level and thereby mitigate the methodological problems that arise in particular from the unobserved heterogeneity prevalent in cross-country settings, corroborate the previous findings.

For the case of Malawi, De and Becker (2015) estimate significant, positive effects of education aid on raising school enrolment, of health aid on decreasing disease severity and of water aid on decreasing diarrhea incidence based on a combined propensity-score matching and difference-in-differences approach. The estimated effects are modest but non-negligible: an average health project, for example, leads to close to one fewer work day lost due to illness, per person per year.

Furthermore, employing a difference-in-differences estimator, Odokonyero et al. (2018) find that aid allocated to Uganda's health sector had a fairly "strong effect on reducing the productivity burden of disease indicated by days of productivity lost due to illness but was less effective in reducing disease prevalence".

Kotsadam et al. (2018) match geographic aid data with available georeferenced survey data from five Nigerian Demographic and Health Surveys. Their difference-in-differences estimates suggest "that children born to mothers who live in locations close to one or more aid projects have a lower risk of dying before the age of 12 months". In substantive terms, aid is estimated to lower the infant mortality rate by about one percentage point, or more directly by 10 children per 1000 born, which is again a non-negligible effect. The mortality-reducing potential of foreign aid seems to be particularly strong for less privileged groups like children of Muslim women, and children living in rural areas.

3.2. *Impact on Inequality*²

As in the case of poverty, the expected impact of foreign aid on inequality depends on the extent to which funds are well-targeted and aid capture is avoided. The latter tends to be inequality-increasing as rents are typically captured by local elites endowed with a disproportionate share of a country's economic and political power (Angeles and Neanidis 2009).

Given these counteracting factors, the question of whether foreign aid has reduced within-country inequality is an empirical one. The evidence so far—all obtained using the Gini coefficient as the indicator of inequality—is limited and ambiguous. Herzer and Nunnenkamp (2012) find that foreign aid exerts an inequality-increasing effect on income distribution. According to Chong et al. (2009) as well as Arndt et al. (2015), there is no robust association between aid and inequality. Shafiullah (2011) as well as Hirano and Otsubo (2014) conclude that aid reduces income inequality.

The mixed results of these studies may partly be due to differences in country samples and time periods as well as differences in the panel data techniques employed. Yet, the most recent analysis by Hirano and Otsubo (2014) also points to a more substantive explanation. The authors detect a considerable heterogeneity of the estimated impacts across aid sectors. Specifically, aid given to the social sector, which increased disproportionately over the period covered by their study, is shown

² This subsection closely follows Box 3.5 in Stephan Klasen et al. (2018).

to have the strongest and most robust inequality-reducing effect. This is in accordance with the evidence of effective support for social infrastructure presented in the previous section. Yet, even for social sector aid the impact on inequality as measured by changes in the Gini coefficient is not significant in quantitative terms.

Overall, the part of foreign aid dedicated to the social sector appears to be effective in improving social indicators that matter for the poorest segments of the populations in recipient countries. This is even though the targeting of social sector aid towards primary services—while having improved—still leaves much to be desired. The share of educational aid budgets allocated to post-secondary education, for instance, is still roughly equal to the share primary education receives (Lanati and Thiele 2020). Further improvements in targeting may be seen as a realistic next step towards increasing the poverty- and inequality-reducing potential of foreign aid.

4. Concluding Remarks

The evidence presented in this paper suggests that development cooperation can help achieve growth and poverty reduction in partner countries, even though the effects are likely to be modest in many cases. Most confidence can be put into the finding that, in accordance with the MDGs, aid for social infrastructure has contributed to achieving non-monetary goals such as higher school enrollment and lower infant mortality. It remains to be seen whether donors will continue to play a positive role when it comes to reaching more ambitious SDGs such as ensuring quality education for all. The evolution of educational quality has so far clearly fallen short of the improvements realized in quantitative indicators (e.g., (Bold et al. 2017; The World Bank 2018)). For instance, many pupils leave primary school without being able to read simple sentences and solve basic mathematical problems (The World Bank 2018, p. 2). To help overcome the quality problems in social infrastructure and come closer to meeting the respective SDGs, donors need to shift their strategy. While building schools or health facilities was mainly a matter of providing resources, quality improvements will require much more nuanced interventions. These include technical support in curricula development as well as training programs for school teachers and health personnel. Governance reforms such as performance-enhancing incentives for teachers will also play an increasing role.

Foreign aid specifically targeted at facilitating integration into international trade and attracting FDI has also shown to be effective in most existing empirical studies, even though its positive effects tend to largely miss low-income countries. In contrast, it is inherently difficult to empirically identify income effects of foreign

aid at the macro level, which the long-standing and still unresolved debate about the aid–growth relationship illustrates in a forceful manner.

In any case, if the aim is to bring poverty close to zero in accordance with SDG1, the potential of measures that mainly work through “trickle down” growth is likely to be more limited than in the past. This is because many of today’s poor live in a fragile state and/or face multiple development obstacles such as belonging to a discriminated minority, lacking assets or having limited access to markets and public services. Any donor response to this kind of structural poverty has to be multi-dimensional, including support for building state capacity and targeted interventions such as land-tenure reforms and the establishment of road connections to remote areas.

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