Foreign Aid: "Give a Man a Fish" or….

Lance Taylor

Lao Tzu's adage is a concise description of contradictory aspects of foreign aid. "Give a man a fish and you feed him for a day" means that aid can be a dole. But its true purpose is presumably to "teach a man (or a national economy) to fish and … feed him for a lifetime". A rule of thumb for successful "fishing" is that the economy sustains two percent annual per capita output growth. Employment creation should keep pace with rising population. This combination can make a big dent in poverty by increasing average income by 22% over 10 years and by 49% over 20.

Beyond Lao Tzu's distinction, foreign aid has many complicated effects on national economies. Ideas about how it should be implemented have changed notably over time. But it certainly has helped launch two percent or faster per capita growth performances, in diverse policy environments. Limited availability of hard currency is often the crucial bottleneck in a developing economy, holding down both supply and demand. If effective demand can increase because foreign exchange is available to pay for the associated imports, it can stimulate private sector investment and innovation. At the same time, the imports can bring in essential goods and technologies to raise productive capacity. Here are examples:

The first, most successful aid efforts were, of course, the post-WWII Marshall Plan in Europe and the parallel reconstruction program in Japan. They emphasized breaking forex bottlenecks via coordinated public and private interventions as opposed to a more recent obsession with market liberalization discussed below.

In the 1960s and 1970s, illiberal and bureaucratically planned South Korea utilized capital inflows and American-guaranteed market access to create a formidable industrial base, beginning with textiles and going on to the world's biggest integrated steel plant. Korea's international economic situation was a consequence of Cold War politics, but its planners took full advantage of the opportunities they had available.

In the 1980s, Chile sidestepped the rest of Latin America's "lost decade" because it received ample foreign assistance from international aid agencies favoring its neo-liberal policy stance. Increasingly sophisticated raw material exports supported economic expansion.

Several economies in sub-Saharan Africa now have respectable growth rates with support from Nordic and other donors who provided steady aid flows over decades for their own geopolitical reasons.

A downside risk of ample foreign assistance is that it can kick off an import-led boom with no expansion of productive capacity. One example is the Ivory Coast, the World Bank's poster child of the 1970s which thereafter became a disaster. At the sectoral level, there have been many examples of food aid crowding out domestic agriculture.

More generally, economists talk about a "Dutch disease" with big drops in domestic productive activity in the wake of a foreign exchange bonanza. (The phrase was coined by the *Economist* magazine in 1977 in reference to deindustrialization after natural gas discoveries in the Netherlands in the 1960s; Russia's natural resource windfall over the past few years is the leading current example.) The disease may return with contemporary foreign aid efforts.

Assuming that these pitfalls can be avoided, two percent growth overall has other implications. It requires even higher growth rates of labor productivity in leading sectors. Agriculture dominates poor economies and its productivity growth is crucial, as in sub-Saharan Africa. Despite its adverse effects on income distribution, the aid-fueled Green Revolution provided clear increases in both land and labor productivity. When there is real income growth, the agricultural sector's shares in GDP and employment inevitably decline so it cannot maintain a leading role indefinitely.

At higher income levels, the lead sector(s) must offer increasing returns and opportunities for robust output growth in response to demand. As the United Nations (2006) and a raft of historical studies demonstrate, a clear pattern of structural change emerges from the data for economies (mostly in East and South Asia today) which sustain rapid growth. As in Korea, industry almost always serves as the engine for productivity growth, though not job creation.

For a sector or the entire economy to generate employment, its per capita growth rate of demand has to exceed its productivity growth. Net job creation usually takes place in services. As already noted, more foreign resources can help raise productivity in industry, so real incomes can rise, and ease the demand constraint economy-wide, so people can be employed. Ultimately, exports and private capital can provide hard currency, as in Asia now, but aid can help get the growth process started.

These big shifts in economic structure can only be created by a combination of technocratic top-down policy and spontaneous innovation from the bottom up. State intervention can ease the process. Even in neo-liberal Chile, the government consistently supported expansion of agro-exports. But there are arguments to the contrary, highly influential today, but completely ignored at the time of the Marshall Plan or South Korea's growth spurt.

An ancient idea in economics – first clearly stated by the "Austrian" school from Vienna in the 1870s, and trumpeted for developing countries by Hernando de Soto (2000) and William Easterly (2006) – asserts that rapid growth can only emerge from private entrepreneurship under clear property rights protection. History belies the proposition.

There was pro-active developmentalist state intervention in the now-industrialized economies (Ha-Joon Chang, 2002) and in 20th century success cases (Alice Amsden, 2003). Consider the United States in the 19th century. Agricultural exports prevented a foreign exchange bottleneck. There were enormous public subsidies (with enormous corruption) to support investment in infrastructure and the highest tariffs in the world to protect industry. Entrepreneurs from Rockefeller to the Robber Barons abounded, paying scant heed to conventional property rights.

In less strident versions, the Austrian argument dominates much current discussion of aid and development policy, especially among major donors. The Washington consensus, now entering remission, strongly emphasized private sector initiatives and strict limits on the state role in the economy. Over the past two or three decades, many aid packages informed by the consensus did not generate linkages among demand growth, productivity, and employment. Per capita income levels did not rise, and foreign aid become, at best, a dole and, at worst, a cesspool for corruption.

Certainly, doles can have positive impacts at the micro level. A hand-out from abroad may cure smallpox or alleviate childhood malnutrition, but it is a hand-out notwithstanding. The United Nations (2006) and other studies show that in recent decades, many poor economies have seen marked improvements in primary education and health care, but have not been able to grow. Even if they succeed on their own terms, people-oriented technical fixes at the household level, as advocated by Jeffrey Sachs (2005), have not stimulated economy-wide expansion from below.

Looking toward the future, foreign assistance is bound to be available in limited quantities. Cost estimates for the Millennium Development Goals, a humanitarian aid program emphasizing technological tricks to bring quick results, range upward from $150 billion per year. Current aid flows, in principle, are in the order of $100 billion, including debt relief. In practice, the transfer is far less. The International Monetary Fund is not allowing governments to channel forgiven debt toward increased spending on poverty reduction because of its inherent phobia (not supported by any evidence) that a modest increase in fiscal outlays will kick off uncontrollable inflation.

Even if aid mounts, the IMF relents, and humanitarian goals are realized, the MDG effort can only be successful if it puts economies on paths of sustained growth. In the past, aid has sometimes set off growth; more often, it hasn't. There are many challenges to overcome:

At the micro level, just by itself, human capital augmentation will not support steady growth unless high productivity enterprises get started.

Entrepreneurship is essential to this end, and should be rewarded.

But that will not happen spontaneously in a liberalized market environment. The state has to play a strong supportive role. Many Washington consensus packages tied the hands of governments. In a contemporary catch phrase, their available "policy space" has to be permitted to expand.

Finally, foreign resources have to steered toward stimulating production. The aid flows being contemplated for the MDG are big enough to trigger frivolous import booms and Dutch disease. With good policy, such risks have been avoided in the past, and can be in the future.

Lance Taylor *is Arnhold Professor of International Cooperation and Development at the New School for Social Research.*

References

Amsden, Alice (2003). *The Rise of the Rest: Challenges to the West from Late-Industrializing Economies.* New York: Oxford University Press.

Chang, Ha-Joon (2002). *Kicking Away the Ladder: Development Strategy in Historical Perspective.* London: Anthem.

deSoto, Hernando (2000). *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else.* New York: Basic Books.

Easterly, William (2006). *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good.* New York: Penguin.

Sachs, Jeffrey (2005). *The End of Poverty: Economic Possibilities for Our Time.* New York; Penguin.

United Nations (2006). *World Economic and Social Survey 2006.* New York: Department of Economic and Social Affairs.