RESEARCH BRIEF

Does aid promote development?

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KEY FINDINGS

- **Aid has had positive effect on growth and poverty reduction on average in the long term.**
- **There is no evidence of aid systematically increasing inflation or reducing the amount of credit available to private industry.**
- **In general aid that is channeled to human capital appears to be effective at stimulating growth.**
- **An average long term annual inflow of US$25 aid per capita over the period of 1970-2007:**
  - **reduced poverty by around 6.5 percentage points**
  - **raised investment by 1.5 percentage points in GDP**
  - **augmented average schooling by 0.4 years**
  - **boosted life expectancy by 1.3 years**
  - **reduced infant mortality by 7 in every 1000 births**

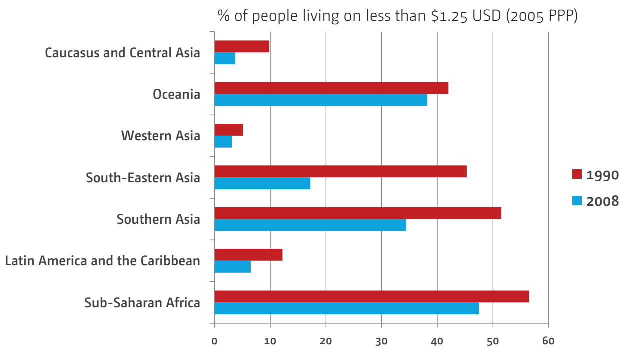
The question of whether aid is effective at promoting growth and development has been hotly contested for years. However, research increasingly shows that over long-term aid disbursements have had positive effects on the economy of recipient countries. But growth is not the only aim of aid. As donors continue to channel funds towards the Millennium Development Goals (MDGs)—which target, among other things, improvements in poverty reduction, primary education and health—it is important to understand how these relate to aid and its broader objectives.

Aid, growth, and other objectives

Aid is often seen as different from other forms of investment, and some argue that rather than having a positive effect on growth, aid tends to distort economies and may potentially slow development. This is not the case. There is no evidence of aid systematically increasing inflation or reducing the amount of credit available to private industry. Also the concerns about the potential negative impact of aid on domestic revenue mobilization are often exaggerated.

The effect that aid has on growth is not direct, but is rather the consequence of the effect it has on intermediate factors of development. UNU-WIDER research finds that an average annual inflow of US$25 aid per capita over the period of 1970-2007 reduced poverty by around 6.5 percentage points, raised investment by 1.5 percentage points in GDP, augmented average schooling by 0.4 years, boosted life expectancy by 1.3 years, and reduced infant mortality by 7 in every 1,000 births.

FIGURE 1: POVERTY REDUCTION SINCE 1990



Under these circumstances the effect of aid could also be expected to produce an increase in the rate of economic growth of around 0.5 percentage points. This implies a reasonable return on aid over the 37-year period. The most recent estimate of the annual internal rate of return is 7.3%.

Transmission channels

The evidence indicates that development assistance has a positive effect on growth, as well as on a number of intermediate factors which are drivers of growth and development. An important question then is which of these intermediate factors represent the key channels through which aid drives economic growth.

The evidence from UNU-WIDER research indicates that investment in physical capital and health are two clearly identifiable channels through which aid promotes growth; increased aid spending in these areas is likely to spur recipient countries. Education is another area which could lead to improvements in human capital; however the effect of education spending on growth remains to be identified statistically at the macro level. This may be related to several factors such as the available data, quality of education, and the time window under which the analysis has been conducted. This is not to say that education is not critically important.

All in all, a growing body of research is showing that, far from being detrimental, aid has positive effects on a number of desirable outcomes. UNU-WIDER research supports this assessment and enhances further our understanding of the mechanisms by which aid can have these effects.

This Research brief is based on WIDER Working Paper 2011/44 'Aid Effectiveness: Opening the Black Box' by Channing Arndt, Sam Jones, and Finn Tarp.