**Essay: Aid and Debt Relief - Impact on Development?**

**READ THE ESSAY BELOW AND COMPLETE THE FOLLOWING TASKS…**

1. Highlight factors that support aid/debt relief in one colour and factors that reject aid/debt relief in another colour
2. With these points, create a table on to show the pros and cons of aid in economic development

Overseas aid is "Financial help given by richer countries to poorer ones to help their industrial and economic development". Overseas aid totalled $133.5 billion in 2011, "equivalent to 0.31 per cent of developed countries' combined national income". Aid has been declining recently, falling "by 4% in real terms in 2012, following a 2% fall in 2011". Debt Relief is "A partial or total remission of debts, especially those owed by developing countries to external creditors". Developing countries owed almost $5 trillion, leading to repayments in excess of $1.5 billion per day. Economic development is a process of structural change in the pattern of output, trade and employment as well as an evolution of living standards. According to Amartya Sen, it involves the creation of economic freedoms through the expansion of capabilities and the reduction of extreme poverty. Development is influenced, to a certain extent, by aid and debt relief among other factors.

Aid can be a barrier to development due to the presence of corruption. Aid projects are often criticised for perpetuating ruling elites. Countries, such as Liberia, Malawi, and Niger, despite receiving large amount of aid, continue to have very low HDI ratings as this money is lost due to corruption (measured by the corruption perception index) and low levels of democracy.

Aid economists, Dierk Herzer and Oliver Morrissey, explain that "aid has, on average, a negative long-run effect on output", meaning long-run aggregate supply decreases as a result of aid, lowering the country's productive potential". This they argue is not due to the "quality of economic policy" but rather "law and order, religious tensions and government size". These factors are important as: law and order protects private property, large governments suggest both high bureaucracy and corruption, and religious tensions results in militaristic governance and an allocation of aid to sustain war. However, Herzer does admit that "there are large differences across countries (in about a third of cases the effect is positive)" but is adamant that the extent to which aid hinders or facilitates development is dictated by those three factors.

Furthermore, aid organisations can influence the effectiveness of their projects by circumnavigating corrupt governments and directing aid directly to the people who need it. In practice, as a recent inquiry suggests, "The Department for International Development 'has little understanding of what is and is not working' in its anti-corruption efforts". DFID has been given "an 'amber-red' rating - the second lowest, indicating 'significant improvements' were required. The main issue was that DFID had not "'developed an approach equal to the challenge' and is not focusing enough on the poor". The report concluded that perhaps "the general principle that aid should first 'do no harm' had been breached".

However, pioneering economists, Banerjee and Duflo, offer a solution to this in the form of targeted bottom up projects. They argue "that so much of anti-poverty policy has failed over the years because of an inadequate understanding of poverty." After significant practical experimentation, they advocate bottom up projects, such as providing de-worming tablets so that children can concentrate and so go to school, rather than top down projects, such as education subsidies. This is because the latter involve government failure from ideology, asymmetric information, and inflexibility that reduces aid effectiveness as experienced by DFID.

Aid can also hinder economic development by fostering dependency and market distortion. Dambisa Moyo, in Dead Aid, highlights a "contrast between African countries that have rejected the aid route and prospered [particularly South Africa and Botswana] and others that have become aid-dependent and seen poverty increase. Moyo suggest that aid has "trapped developing nations in a vicious circle of aid dependency, corruption, market distortion, and further poverty, leaving them with nothing but the 'need' for more aid".

Despite receiving large amounts of aid, countries, such as Ethiopia, Rwanda, and Haiti, have seen stunted improvement in infrastructure and in health conditions (measured by infant mortality rate). Moyo suggests that the main issue is that aid "hinders the emergence of an essential entrepreneurial class". Instead of politically motivated long-term aid commitments, Moyo calls for a sharp focus on developing a private sector. With FDI making up 43.5% of capital flows into developing countries in 2010 compared to only 10.9% for aid, aid should focus on reforms to attract FDI not try to replace it.

Paul Collier also suggests that currently aid does not help reform. He reported that "the actual allocation of aid is radically different from the poverty efficient allocation. In the efficient allocation, for a given level of poverty, aid tapers-in with policy reform. In the actual allocation aid tapers-out with reform."

Aid does not seem to facilitate long-term structural change nor does it even seem to target development at all because aid is not allocated efficiently to the poorest countries. In the efficient model, "aid is targeted disproportionately on countries with severe poverty and adequate policies: a category of country in which 74% of the world's poor people live. In the actual allocation such countries receive a much lower share of aid (56%) than their share of the world's poor". However, if aid were more efficient it could lead to significant benefits to development. Currently, aid is "lifting around 30 million people per annum sustainably out of absolute poverty. With a poverty-efficient allocation this would increase to around 80 million people." Reduced poverty could even develop into improved savings. This would enable Sub-Saharan Africa to lower its savings gap. According to the Harrod-Domar model of growth, this should increase investment and thus economic growth. In turn, this could provide funds for further development.

**Debt relief**

Debt relief also poses a barrier to economic development due to potential for moral hazard to occur. Some argue that countries will take larger risks if debts they know their debts will be lessened. There is particular concern surrounding 'unjust debt'. This is "often 'dictator debt' – money lent by rich countries to poor countries ruled by strongmen, who commonly used it to finance military ventures or vast follies. It is [estimated at US$735bn](http://www.open.ac.uk/personalpages/j.hanlon/3WQ_illegitimate_debt.pdf) and makes up almost [one fifth of the total debt](http://www.theguardian.com/global-development/poverty-matters/2012/may/15/developing-world-of-debt) owed by the developing world." By providing debt relief, countries are encouraging these dictators to take more money away from the country as the debt will be cancelled in the future. This relief does nothing to address the structural issue.

A report by the UN in 2012, suggested the promising alternative of introducing "indexed loan repayments", tying interest rates to growth. This would enable risks to be balanced more fairly between creditors and debtors. It should also reduce the need for debt relief and provide interest rates conducive to consistent economic development.

Debt relief allows poor governance and economic policy to continue. It is myopic and fosters dependency. This short-run approach forgoes progress in economic policy, which could lead to lower interest rates when issuing debt in future.

However, debt relief can encourage improved policy through reform agendas. For example, as part of the HIPCI, the IMF required Comoros to maintain "macroeconomic stability", reform "telecommunications and energy", carry out "a national measles vaccination campaign for children to achieve 90 percent coverage nation-wide", and improve "debt management".

Furthermore, "The UN Development Programme (UNDP) is working on an initiative that would see rich countries write off debt owed to them by Small Island Developing States (Sids) in exchange for the money being spent on climate change adaptation". However, the agenda behind these top-down reforms may not always be appropriate and effective for the country but rather reflect the interests of the international body. For example, the IMF, under Strauss-Kahn, had a heavily free market focus.

The debt overhang hypothesis also states that debt relief can help improve the economic situation. "An excessive debt burden can provoke a series of actions by the government, creating a vicious circle that can be stopped only by reducing debt to a sustainable level (in a broad sense)." The debt service incurred may "severely crowd-out spending on development priorities" and "provoke sub-optimal fiscal and other government behavior (e.g. excessive domestic borrowing, excessive inflationary financing, excessive taxation of some sectors in the economy) and lessen incentives for economic reform". This may discourage domestic and foreign investment, damaging growth and development.

However, a Stanford research paper argues that "debt relief is unlikely to stimulate investment and growth in the nations being considered for debt relief under the highly indebted poor countries (HIPCs) initiative" as "the HIPCs do not suffer from debt overhang". The paper highlights "a lack of the basic infrastructure that forms the foundation for profitable economic activity—property rights, roads, schools, hospitals, and clean water" as the key constraints on development. These may be more effectively addressed by direct foreign aid rather than debt relief.

There are some developing economies that experience significant crowding-out due to debt servicing. For example, Armenia, Hungary, and Jamaica experience debt service as a percentage of exports of 30.9%, 84.6%, and 38.2% respectively. Similarly, the UK decision to cancel Sudan's debt was to free up "money that can then be spent tackling poverty and providing essential services such as schools and hospitals to their people". However, theory suggests that "fiscal response effects may not be so considerable in practice" as the degree to which "debt relief mobilizes resources for other uses, is only valid to the extent that, in the absence of debt relief, debt would have been (fully) serviced. If this is not the case, the resource effect of debt reduction will be less than expected."

In conclusion, debt relief and overseas aid have varying effects on development due to a number of country specific parameters. Some organisations, such as the Jubilee Debt Campaign, argue that "Failure to cancel unjust and unsustainable debts continues to increase poverty and inequality around the world." They explain that "Debt crises in the 1980s, 1990s and 2000s caused two or more 'lost decades of development'. In sub-Saharan Africa, the number of people living in extreme poverty (on less than $1.25 a day) increased from 205 million in 1981 to 330 million by 1993."

However, "the HIPC has "led to millions more people having access to healthcare and education". However, debt relief is not currently the solution to most countries' development issues. In the future, this may change with a new, post-crisis "boom in lending to developing countries", causing "External loans to low income countries" to increase "by 75 per cent between 2008 and 2012" and "Loans to sub-Saharan African governments more than doubled over the same period of time".

The report also suggests "government revenues are not rising to keep pace with repayments". UNCTAD Secretary-General Mukhisa Kituyi has attributed stagnation in advanced economies, causing reduced export growth and capital development in developing economies, to the worsening of "the debt-to-GDP ratio…for the first time in more than a decade, to an average of about 22 per cent". Joseph Stiglitz also argues that "The growing complexity of the market makes it harder for developing nations to free themselves of debt, increasing inequality worldwide". Although "Such restructurings are necessary for the market economy to work", "while we have a system to deal with private bankruptcy, we have no system for sovereign debt restructuring".

This highlights the need for improved institutions globally and particularly in developing economies. Similarly, the M-PESA project has revealed "the need for a low-cost transactional platform that enables low-income customers to meet a range of payment needs". Regarding aid, I agree with Angus Deaton that the "central dilemma" is that when "the conditions for development are present, aid is not required. When they do not exist, aid is not useful and probably damaging". However, this does not mean developed countries do nothing to help developing ones. Deaton sights pushing "drug companies to tackle diseases that threaten poorer countries", supporting "the free flow of information about inventions and new management techniques", relaxing "trade barriers", providing "poor countries with expert advice at the bargaining table", and easing "immigration restraints" as options.

One particularly exciting opportunity is the implementation of "service-performance guarantees (SPGs)", which "are a type of insurance against a variety of risks". For example, an SPG could be a "guarantee that the business would be compensated for lost output if power supplies failed. (As the chart below shows, faulty supplies wreak economic havoc in many SSA countries: 9 of the 15 worst-performing countries are in SSA.)"