

Aid as a Catalyst for Economic Transformation: A Wider Vision for the Future of Aid

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Deeply rooted in the Christianity tradition, aid is widely considered as a form of charity. It is based on the belief that the rich should have the moral obligation to help the poor. The World Council of Churches took the lead in proposing in 1958 an international target for aid.¹

Such an altruistic conception of aid has merits in its own right. It has motivated people to provide the basic health care, nutrition and education to the poor who are struggling against the fate of abject poverty. However, it runs the risk of breeding financial and intellectual dependence of the poor upon the rich. If the ultimate goal of aid is to help the poor to stand on their own feet, then an alternative vision of aid is needed – aid as an investment in a process of economic and social transformation. A major part of aid efforts have been designed along these lines for several decades in fact. But what are the frontier issues now of the “aid as investment” approach?² What vision should we have for the future of aid, going beyond

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¹ Development Assistance Committee, “History of the 0.7% ODA Target,” *DAC Journal* Vol. 3, No. 4, 2002, pp. III-9–III-11, accessed 18 October 2011, www.oecd.org/dataoecd/16/38/45539274.pdf.

² Myriam Dahman Saidi and Christina Wolf, “Recalibrating Development Co-Operation: How can African Countries Benefit from Emerging Countries,” OECD Developing Centre Working Paper No. 302, July 2011, accessed

the altruistic approach to encompass a wider set of transformative actions, and beyond the definition of ODA established by the OECD Development Assistance Committee some 40 years ago? Here I put forward some of the elements.

Aid as a Bridge of Public-Private Partnership

Infrastructure is an essential precondition for economic transformation. Yet, African countries are facing a daunting infrastructure deficit. According to the World Bank report, transforming African infrastructure will require an additional \$31 billion a year.³ In a period of resource constraints within developed countries, what role can aid play in innovative financial instruments to narrow this vast infrastructure gap?

The conventional wisdom holds that aid should be delinked from private capital because commercial loans would water down the altruistic-nature of development assistance. However, such an orthodox view may rule out the possibility of public-private partnership where official development assistance can leverage private funds to support large-scale infrastructure projects. Fortunately, pilot innovation is underway: European Commission has started an expert group to study the potential benefits of establishing an *EU Platform for External Cooperation and Development*, aimed at

18 October 2011, www.oecd.org/dataoecd/44/44/48450803.pdf.

³ World Bank, *Africa's Infrastructure: A Time for Transformation*, Washington, D.C.: The World Bank Group, 2010.

optimising mechanisms for blending grants and loans.⁴ Of course, infrastructure alone cannot lay Africa's roads to prosperity. But to build up Africa's own dynamics of development, cross-continental infrastructure can help African people to move up the ladder of development.

Aid as a Vanguard of Foreign Direct Investment

Apart from innovative co-financing mechanisms, aid can also have a vanguard effect of facilitating FDI into less developed countries (LDCs). Although there is no guarantee that FDI alone can promote inclusive economic growth, it offers recipient countries an opportunity to lay the foundation for self-reliant economic development rather than financial dependence on external assistance.

In a level-playing ground in the global financial market, less developed countries are not on equal footing to compete for risk-averse private capital. In such circumstances, donor governments can play a positive role in channelling private capital into LDCs. While researchers have found that foreign aid in general does not have any significant effect on FDI,⁵ Japanese and South Korean⁶ development assistance in East Asian

⁴ Africa and Europe in Partnership, "New expert group on 'EU Platform for External Cooperation and Development'," 8 November 2011, accessed 10 November 2011, <http://www.africa-eu-partnership.org/node/2331>.

⁵ Kimura, Hidemi and Yasukuki Todo, "Is Foreign Aid a Vanguard of Foreign Direct Investment? A Gravity-Equation Approach," *World Development* Vol. 38, No. 4, 2010, pp. 482–497.

⁶ Hongshik Lee and Bokyeong Park, "Does Korea Follow Japan in Foreign Aid? Relationships between Aid and Foreign Investment," *Japan and the World Economy* Volume 23, Issue 1, January 2011, pp. 19-27.

countries has shed light on the vanguard role that foreign aid can play. The Japanese government has sought to use aid to facilitate FDI because aid can “transmit tacit information on the business environment of the recipient country and reduce country risk with the provision of a quasi government guarantee.”⁷ Some may question the above practice on the ground that government should not intervene to help its own companies gain an unfair advantage over other foreign firms. It is true that unconstrained government subsidies may distort market competition. But governments can help to redress the problem of imperfect information in the case of market failure.

Aid as a foothold for Linking into Global Value Chains

Trade is usually applauded as a mutual-benefit path to economic success. Yet trade liberalization can do more harm than good if trading partners do not gain a foothold on the global value chain. To find a way out of this dilemma, developing countries need a viable development strategy to upgrade their industrial structures. An integral part of such a strategy is to learn from others. This learning process can build up comparative advantages that fit with a country’s development stages. For instance, China’s success in the past three decades suggests that development is “a process of learning, selective adaptation, and industrial upgrading.”⁸ Aid

⁷ Hidemi Kimura and Yasukuki Todo, “Is Foreign Aid a Vanguard of Foreign Direct Investment?,” p. 493.

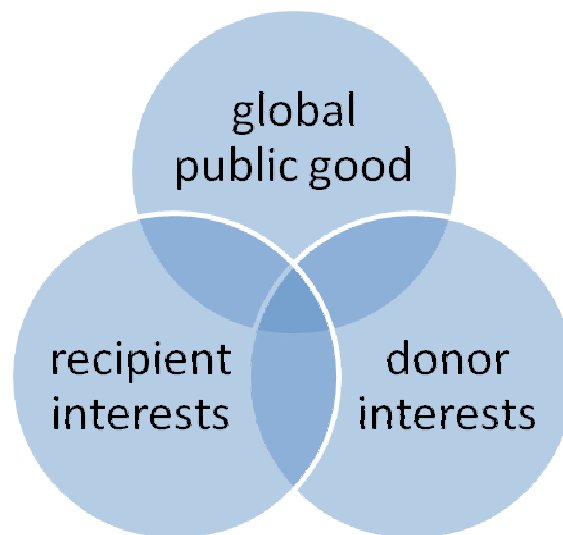
⁸ Justin Yifu Lin and Yan Wang, “China’s Integration with the World: Development as a Process of Learning and

could enhance this learning process by sharing technical and managerial knowledge. As the saying goes, also in Chinese, “give a man a fish and you feed him for a day, and teach a man to fish and you feed him for a lifetime.” Aid is not merely a transfer of resources, but also a learning process.

In a nutshell, aid can act as a catalyst for economic transformation if it fulfils its potentials as a bridge for public-private partnership, a vanguard of foreign direct investment and a foothold for linking into global value chains.

However, the synergies between aid, trade and investment are underdeveloped and the linkages are often misplaced in the current aid effectiveness debate, even in the context of “aid for trade” approaches. The conventional wisdom is that official development assistance (ODA) should be delinked from commercial interests in order to ensure its purely altruistic nature. Undoubtedly, undue linkages between aid and trade can thwart the development purpose. Tied aid is a case in point. If aid is used as a subsidy for trade promotion, it may not only retard the process of industrial upgrading in donor countries but also incur huge costs at the sacrifice of development opportunities for recipient countries. Such negative effects of aid-trade-investment packages should be avoided. But

this does not mean that any attempt to link aid with trade and investment is self-defeating. Those who oppose such linkage often assume that aid that serves donors' self-interest would undermine the development efforts in recipient countries. However, such a dichotomous view rules out the possibility that there is room for mutual benefits. Aid as a catalyst for economic transformation opens up a new space where aid can enhance the recipients' potential and donors' own interest. The following diagram illustrates that how donor interests and recipient interests can go hand in hand.



Towards a Diverse and Complementary Development Partnership

Economic transformation is the key to the success of self-reliant development. Aid can play a pivotal role in enhancing this transformative process through innovative co-financing instruments, facilitating foreign direct investment, and generating learning processes.

This is my vision for the future of aid. Such a perspective does not necessarily supplant other views of aid. Instead, in order to make economic growth serve the purpose of development, other aid programmes that focus on social investment and social welfare are indispensable. That's why I firmly believe that development partnerships should be grounded on the principle of diversity and complementarity.⁹

The Paris Declaration and the Accra Agenda for Action have opened up a new space for development partnerships to achieve better aid effectiveness. Yet such a vision would become an unfinished cause if donors follow a narrow guideline of aid effectiveness. The development ownership of recipient countries would become a mirage if there are no wider options available. That's why I hope my vision for the future of aid can complement other viable paths to better development outcomes.

⁹ National Graduate Institute for Policy Studies (GRIPS) Development Forum, *Diversity and Complementarity in Development Aid: East Asian Lessons for African Growth*, February 2008.