International Growth Centre

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Who benefits from aid-for-trade?

Both donors and recipients can benefit from aid, yet aid-for-trade seems to benefit the exports of middle-income countries most, rather than the developing economies for which it was designed

Susan Strange, the pioneer of modern international political economy, repeatedly asked her essential Latin question: "Cui Bono?" Translated as, "Who benefits?" the question embodies the view that all arrangements are to someone's benefit – something which, rather than ignore, we should scrutinise and question.

When it comes to aid-for-trade, this question seems fundamental. Aid-for-Trade emerged eight years ago from the WTO in Hong Kong, based on the recognition that further trade liberalisation would have limited effect if developing countries have supply and capacity constraints which were preventing them from trading more. The idea was simple: focus the foreign aid a developing country receives on improving its ability to trade more. Poor infrastructure not only made it difficult to export or import, but it also imposed higher costs on firms, making it unprofitable for many. Reducing those costs not only made trade easier, it also made it profitable where it hadn't been previously. Developing countries would then trade more.

Yet, in such an arrangement, who is it that actually benefits? Are developing countries who receive aid the ones benefitting, or are the real beneficiaries the exporters in the donor country? There are possible mechanisms either way. As mentioned above, one mechanism would be that, by reducing the cost of trade through infrastructure improvements, the aid-receiving country would see a boost in their exports. Yet, at the same time, reduced trade costs work in both directions and make it easier for the aid-donor to export more to the aid-recipient country. Many who are cynical of aid-donors' intentions, believing that aid is not given altruistically, but rather because it benefits the donor country, argue that this could be the intended effect: aid-recipient countries see an influx of imports from donor countries, which stifle their local economies via possible 'Dutch Disease' type effects in the aid-recipient. That is, the erosion of international competitiveness due a real exchange rate appreciation – effectively making their exports more expensive abroad.

Tied-aid

Yet, tied-aid – aid which requires that supplies are bought form the donor country – has actually been declining since the 1990s, casting doubt on such clear cut self-interest motives. However, there are other ways in which giving aid could boost a donors' exports, rather than the recipient's. "Good Will" and "Habit Formation" effects could do this. Here, giving aid could impart good will to the recipient country which changes that country's preferences in favour of the donors' exports. Similarly, habit formation does much the same by establishing patterns and habits for buying from the donor country.

Self-interest of donors

Although there are a lot of possible mechanisms out there, the challenge is to figure out empirically who actually benefits. So far, most studies on this have considered only aggregate trade flows and they look at trade in just one direction, which leaves out a lot. In our recent research paper on this, we hypothesised that aid-for-trade could be as much in the self-interest of donors as it is in promoting aid-recipient's exports. We tested our hypotheses by considering the effect from all donors on the exports and imports of recipient countries to all donor countries, giving a much richer view of the matter – and some telling conclusions.

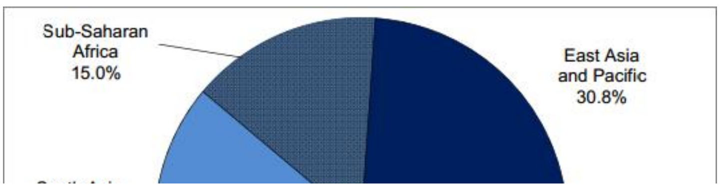
What we found was that aid-for-trade worked to boost aid-recipient's exports to the donors, as well as the donor's exports to recipient countries. Both benefitted. However, the effect on recipients' exports to donors tended to be stronger than the effect on donor's exports to aid-recipients. In quantitative terms, a doubling of aid-for-trade would imply that recipient exports to donors increase by about 5%, and recipient imports from donors increase by about 3%. There is little evidence, then, for the argument that aid-for-trade is purely for the benefit of donor countries' export interests.

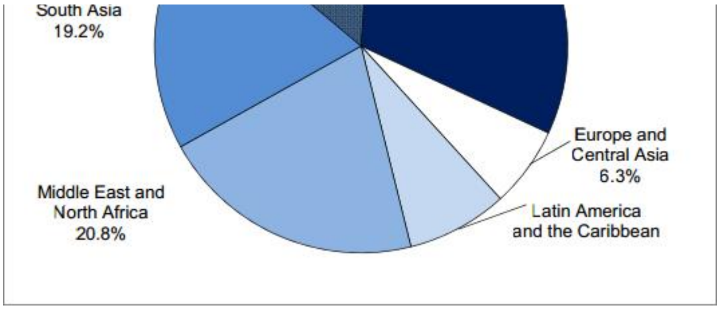
Aid doesn't help

However, our research also revealed something else: that aid-for-trade does little to help the poorest countries. The significantly positive effects on recipient countries' exports did not hold for the low-income group among aid-recipients. The important lesson here is that there are limitations in the effectiveness of aid-for-trade in overcoming supply constraints in the poorest countries – exactly where it is needed most. Rather, aid-for-trade promotes exports of middle-income countries, most of which are probably less dependent on aid to overcome hurdles to participation in world trade.

Similarly, aid-for-trade is more effective in promoting the exports of East Asia and Latin America than the exports of sub-Saharan Africa – even though the need for aid-for-trade seems to be most pressing in large parts of sub-Saharan Africa. This particular region received also a smaller share of aid-for-trade compared with other regions (see below).

Regional Distribution of Aid for Trade (1990-2010)



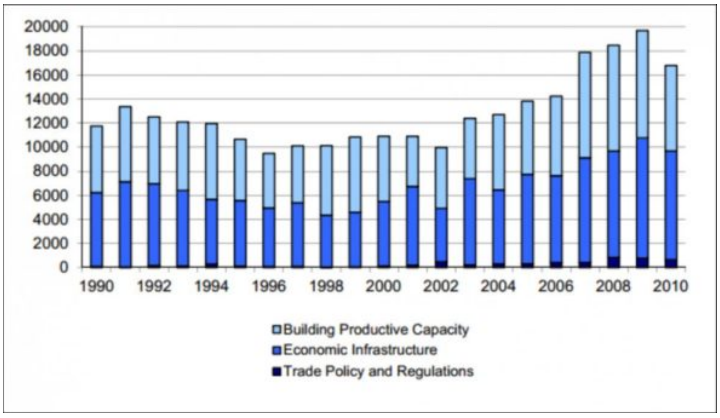


There is, then, definitely room to improve the effectiveness of using aid in boost recipients' ability to trade, and we can offer some tentative policy implications in this regard.

Policy implications

First, the effectiveness of aid-for-trade could be boosted by shifting its focus from projects in infrastructure and production towards working on trade policy and regulations. Not only is this sector a small percentage of aid-for-trade, but we found that when aid-for-trade was focused on this area, the impact on recipients' exports was particularly strong: a doubling of aid-for-trade in this area would be associated with a 10% increase in the recipient country's exports.

Major categories of aid for trade (1990-2010) in US$ million, current prices)



Secondly, donors should consider the skewed distribution of aid-for-trade in favour of Asia and at the expense of Sub-Saharan Africa. That said, it will be insufficient simply to reallocate aid-for-trade towards the regional areas which need it more. Rather, refined country-specific criteria would be required to identify where need coincides with local preconditions for an effective use of aid-for-trade.

We began by asking who benefits from aid-for-trade. Perhaps the more important question now is, "Who doesn't?" It's clear that the poorest countries aren't the winners. More should be done to address this.