Is Global Poverty Better Reduced Through Free Trade or International Aid?

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Abstract

Aid versus free trade remains an intensely debated topic in the fight against global poverty. Aid proponents argue that it can reduce poverty in poor countries by funding development projects, infrastructure, education, healthcare, and social programs. On the other hand, aid critics believe that it perpetuates the cycle of poverty by creating aid dependency, increasing corruption, and disincentivizing sustainable economic development. Free trade proponents argue that it can help developing countries reduce poverty by increasing employment, technology transfer, and competitiveness. However, critics argue that trade disproportionally benefits richer countries and does not increase income in poor countries due to their lack of an economic structure capable to benefit from trade. This paper suggests that elements from both aid and trade are necessary for reducing global poverty, supporting the "aid for trade" initiative: stimulating global fair trade while allocating foreign aid to poor countries to create the capacities for facilitating successful trade.

1 Introduction

Historically, aid and trade have represented the two main principles in the fight against global poverty. Proponents of aid believe that it represents the only way to end poverty because global trade creates systemic disadvantages for the poorer countries and leads to their exploitation by wealthier countries. Therefore, they advocate for significantly much more aid to be given to developing countries to meet their development needs and fight poverty. Critics of aid argue that it leads to dependency which in turn delays the development of poor countries and keeps them in poverty. They believe that participating in global free trade is the best instrument for poor countries to increase their revenues and fight poverty. For many decades aid and trade were considered as two antagonistic approaches for ending global poverty. However, both aid and trade alone have failed to prevent the gap between rich and poor countries. This has led

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to a growing recognition that aid and trade should be used in a complementary approach in order to successfully eradicate poverty. As such, the Aid-for-Trade initiative was launched by the World Trade Organization (WTO) in 2005. The initiative is defined as the use of foreign aid to help poor countries trade successfully by improving their trading infrastructure and capabilities. The rationale of the "Aid-for-Trade" initiative is that while nations prioritize trade as a development strategy, donors too should scale up resources to enhance development and improve people's living conditions. This paper reviews the empirical evidence about the role of foreign aid and free trade in reducing poverty and recommends Aid-for-Trade as a significant pro-poor growth and development strategy. The paper is organized as follows: Section 1 explores whether foreign aid reduces poverty; Section 2 reviews the role of trade in helping poor countries achieve economic growth; Section 3 provides a brief background of the Aid-for-Trade initiative and reviews its impact on poverty.

2 Does Aid Alone Work in Reducing Poverty?

The notion that foreign aid can eradicate poverty has been a prevailing economic theory since the 1950s. As a result, in the last 50 years, the total amount of foreign aid allocated is about $2.3 trillion, with about 1$ trillion of that being given to Africa. Although aid agencies and governments alike have seen financial donations as the best solution to eradicate poverty, it is difficult to verify that large amounts of foreign aid have a positive impact on economic growth. [Ali] Econometric research has shown that aid inflows into a country do not lead to economic growth, regardless of the type of foreign aid, policy, or geographical environments. [Raja] Furthermore, the overwhelming majority of people who have escaped poverty in the last forty years were aided by economic growth in Asian countries, specifically in China, which have received little in the way of aid. On the other hand, over a quarter of sub-Saharan African nations are poorer now than they were in 1960. [Col] Foreign aid provided to these countries has accomplished little of its intended purposes.

Why does this happen? Borrowing a phrase from The Spectator [Ace], "extractive institutions," within recipient countries, keep the money from flowing to its intended destinations. As a stunning fact, only 20 percent of foreign aid reaches the intended recipients in poor countries. [OECa] Cronyism, economic nepotism, and outright corruption run rampant in many countries in Africa and the Middle East. Instead of facilitating the flow of foreign aid to schools or health clinics, often the elites embezzle the money for themselves while imposing economic impediments which systematically block poor people from receiving education, basic amenities, and health care. The conclusion of many researchers is that the failure of aid is due to bad governance and elite capture in recipient countries , but there is also mention of the incentives of all parties and information asymmetries between donor and recipient. [Sra], [Eas], [Wil], [Mah] Furthermore, the donors' motives are often not focused specifically on poverty reduction, but rather on various other goals, ranging from meeting humanitarian or emergency needs, securing strategic political and economic interest, showing solidarity, fight the war on terror, promoting human rights, and strengthening historical ties. [Mah] Additionally, as Rajan et al [Rajb] have shown, aid flows to a country result in its currency overvaluation which impacts exports performance and increases vulnerability to global economic downturns.

Apart from the debate on aid effectiveness, the relationship between foreign aid and foreign direct investment (FDI) effects is also important, because FDI inflows to developing countries are shown to increase employment and reduce poverty reduction in host countries. [Ane] Selaya and Sunesen [Sel] examined how aid impacts foreign direct investments (FDI) in developing countries, and concluded that foreign aid that directly targets physical capital drives down FDI, further affecting the potential for economic growth and poverty reduction. Overall, the question about the effectiveness of aid remains an unresolved and contentious issue that occupies development economics discourse. [Sal] There are no clear data or consensus about the effectiveness of aid in poverty reduction. Furthermore, several papers that report significant positive effects of aid face heavy methodological criticism. Some scholars feel that the perception of aid failure in reducing poverty is the result of aid funds that have been too low to make a real impact on reducing poverty, advocating for significantly more foreign aid for poor countries. [Sac] On the other hand, other researchers believe that government aid is inefficient and has been harmful to impoverished nations by causing dependency, stimulating corruption, and overvaluing their currencies. [Moy] The well-known Zambian economist and staunch aid critic Dambisa Moyo, famously writes: "If the West wants to be moralistic about Africa´s lack of development, trade is the issue it ought to address, not aid." [Moy]

3 Does Trade Alone Lead to Poverty Reduction?

Trade is the most imperative source of wealth generation and economic growth. [Sac] The argument underlying international trade is based on the theory of comparative advantage, the idea that nations can carry on mutually beneficial trade by specializing in their strengths and importing products other nations specialize in producing. [Smi] Therefore, according to this theory, participation of the free global trade would enable all countries to expand their domestic market, access relevant technologies and know-how that which enhance domestic productivity and international competition, create more employment opportunities, increase income, and achieve sustainable economic growth. The experiences of newly industrialized economies in Asia, from the 1960s through the 1990s to date, are often used to demonstrate that low-income countries – with the right preconditions and determinants – can apply the emerging technological developments to enhance industrial development and manufacturing, and ultimately grow their economy and reduce poverty. However, the least developed countries, especially in Africa, have not profited from globalization and are left far behind.

Slow growth and the persistence of poverty in these countries have given rise to a body of literature emphasizing that poor countries have not been able to benefit from trade to the extent that rich countries have. [Fara] For instance, the increased participation of developing countries in the global trade has not been associated with a corresponding increase in income. [UN_a] Furthermore, the share of LDCs in world exports decreased from 3% in the 1960s to only about 0.5% in 2005 [Hol] despite them having preferential market access to the developed economies of European Union and United States.

Because the benefits of trade are not evenly distributed among countries, the gap between rich and poor countries has continued to increase, suggesting that trade fosters inequity. Why does this happen? Trade favors export-related growth, which incentivizes non-industrialized poor countries to export natural resources. The Prebisch-Singer hypothesis says that primary exports tend to exhibit declining terms of trade (TOT), meaning that the price of exports falls relative to imports and the nation has less and less capacity to import products. [Fos] As a result, export-oriented economies in the least developing countries are more vulnerable to global economic and natural shocks due to their dependency on commodity exports and insufficient export diversification. For example, in the wake of the financial crisis of 2008, least developed countries' TOT deteriorated around the world. [UN_b] Most developing countries rely on exporting natural resources and primary goods. As a result, they have the least bargaining power in the global trade system. Without diversifying away from natural resource exports, they often face the economic malady known as the Dutch Disease, where the overreliance on natural resources harms the broader economy. Unfortunately, these countries are often prevented from diversifying their economies by market forces [Van], which it has been likened to an economic straitjacket that creates a vicious cycle of natural resource dependence, poverty, ethnic strife, and conflicts, as seen in Africa and the Middle East. Overall, the main reason for developing countries remaining behind in the global trade is that they have supply-side capacity limitations and trade-related infrastructure gaps. Due to various constraints such as inadequate transport and manufacturing infrastructure, lack of capital, outdated technology, and unavailability of skilled labor, the productive capacity of developing countries is unable to keep pace with the demands of increasing trade, preventing them from fully benefiting from trade and reduce poverty. [Hal]

4 Why Aid-for-Trade?

The desire to eradicate poverty and hunger is at the heart of the international agenda for sustainable development (Agenda 2030). [Sel] The goal also features in the development of financial institutions' strategic objectives. For instance, the World Bank's twin target is to reduce extreme poverty and boost shared prosperity worldwide. While historical data show that neither foreign aid nor free trade alone have not succeeded in ending poverty in developing countries, scholars gradually arrived at the conclusion that they should not exclude each-other, because they each offer particular advantages that can be combined to create a mixed approach that could be successful in reducing poverty in developing countries. Specifically, when foreign aid flows are focused on improving the capabilities of developing countries to adequately participate in global trade, aid can play an important role in effectively reducing poverty. Therefore, in 2005, during the Hong Kong Ministerial Conference, the World Trade Organization collaborated with the Organization of Economic Corporation and Development (OECD) to launch the Aid-for-Trade initiative, a project that seeks to increase the foreign aid amounts that target trade-related activities to maximize trade benefits. [Nil] At its core, the initiative considers aid as a catalyst for harnessing the benefits of trade as an instrument for growth and poverty alleviation. The objective is to help countries reduce trade costs, build infrastructure, develop fair administrative rules and procedures, and enhance productivity. [Lam] Some of the relevant assumptions underpinning the Aid-for-Trade initiative include: (1) trade is a powerful engine for enhancing economic development. However, developing countries have not benefited equitably from globalization. Secondly (2), border restrictions (e.g., tariffs and infrastructure and administrative procedures) have fallen over the years, enhancing integration in the world economy as nations build productive and competitive capacities. Thirdly (3), the initiative assumes that LDCs and some low-income nations lack the capacity (in terms of institutions, procedures, policies, information, and infrastructure) to integrate and compete in global markets. In short, Aid-for-Trade proponents implicitly acknowledge that trade liberalization cannot benefit poor countries and people without sufficient supply-side investment and complimentary policies. Furthermore, Aid-for-Trade recommends adjustment measures to compensate nations whose preferences have been eroded by trade liberalization (mainly free trade agreements). Regarding the international aid policy, Aid-for-Trade recommends relocating Official Development Assistance (ODA) priorities to more relevant economic sectors. [Gnaa] The initiative also advocates for the rebalance of social and economic aid purposes. It is a potential mechanism for compensating ODA's adverse effects on countries' competitiveness. Aid-for-Trade is a strategy of harmonizing various aid components into a single framework. Aid-for-Trade is supplied through existing country-based allocation mechanisms from bilateral and multilateral donors and agencies.

These abundant empirical findings are further supported by the results of the 111 case stories reported by the public and private sector from Aid-for-Trade beneficiary countries to the OECD/WTO in 2015. [OECc] The results showed that Aid-for-Trade has led to export market diversification; increase in the overall employment, as well in women's employment; increase in foreign and domestic investments; increase in per capita income; poverty reduction; import market diversification; and increase in remittances. Importantly, Gnangnon [Gnac] analyzed the export structure data from 121 countries (of which 41 are LDCs), that received Aid-for-Trade between 2002–2015. The analysis showed that Aid-for-Trade flows promoted diversification of the structure of export products in the recipient countries from natural resources and primary products to low, medium, high-skilled, and technology-intensive manufactured

Author	Findings
Velde te [Vel]	Aid-for-Trade improves both micro- and macro-economics of recipient countries
Fero et al [Fer]	A 10% increase in aid to transportation, information, communication and technology, energy, and banking services is associated with a 2.0%, 0.3%, 6.8% and 4.7% increase respectively in the exports of manufactured goods from the recipient countries
Helbe et al [Hel]	A 1% increase in aid for trade facilitation generates a 415 million USD (US dollar) increase in global trade
USAID 2010 [USA]	Each additional USD in Aid-for-Trade increases the value of developing country exports by 42 USD two years later
OECD/WTO [OECb]	One USD invested in Aid-for-Trade leads to an increase of nearly eight USD in exports from all developing countries and an increase of twenty USD in exports from the poorest countries. These effects are more pronounced for exports of parts and components
Hünhe et al [Hü]	Aid-for-Trade increases recipient exports to donors as well as recipient imports from donors with the former dominating the overall positive effects
Cali et al [Cala]	Aid for trade reduces trade costs: an increase of 1 million USD in Aid-for-Trade reduces in the costs of packing, loading and shipping by 6%
Busse et al [Bus]	Review of 99 developing countries for the period 2004- 2009 showed that Aid-for-Trade lowers trade costs
Gnangnon et al [Gnab]	A 1% increase in the Aid-for-Trade is associated with a 7.3% increase in export diversification and a 1.2% improvement in export quality
Martuscelli et al [Mar]	Aid-for-Trade increased income and thus reduces poverty,
De Melo et al [Mel]	Aid-for-Trade that targets building productive capacities in agriculture, road rehabilitation, and insurance programs raises the productivity and the income of the poor selling agricultural products

Table 1: Aid-for Trade results

export products. This is particularly important because export diversification is linked to increased economic resilience to external shocks.

As a recognition of this success, Aid-for-Trade now represents around one-third of ODA globally. [Hyna] Furthermore, the Aid-for-Trade has had a synergistic effect on both aid and trade, by increasing the amount of foreign aid donated as well as increasing trade flows. Importantly, the Aid-for-Trade initiative has achieved a closer and more effective partnership between donor and recipient countries as well as between the private and public sectors in developing countries. This wide-based co-operation is key for the sustainability of the aid-for-trade approach in improving poverty.

Given its acknowledged promising results, could Aid-for-Trade be considered the panacea for achieving sustained economic growth and ending poverty in developing countries?

Unfortunately, this is not yet the case. Various aspects of the Aid-for-Trade initiative have been criticized. [Hyna] First, the amount of aid and its distribution remains in the autonomy of the donor countries which allocate their assistance according to their goals and interests. As such, Stiglitz and Charlton [Stia] have proposed to create a multilateral institution to independently distribute the aid-for-trade. Second, scholars have warned of the risk that the increased allocation of donor funds for trade could come at the expense of aid for health or education, with negative impacts for the poor countries. [Stib] For this reason, it is argued that aid for trade should be additional to the foreign assistance. However, data contradict their criticism by showing that the share of funds allocated for Aid-for-Trade remains unchanged at about 33% of the overall ODA. [Hyna] Nevertheless, it is important that aid-related institutions remain vigilant for preventing diversion of aid fund from essential sectors to trade. Third, it remains unclear how the Aid-for-Trade initiative can help in very challenging situations - countries involved in violent conflicts, which perpetuate the cycle of poverty and violence. As a salient example, the tremendous amounts of different forms of foreign aid and Aid-for-Trade flows have failed to improve poverty in Afghanistan. One of the most important reasons for this failure is that more than 80% of aid given to Afghanistan was spent on short-term programs to improve the security in the country, with much less attention given to improving trade capacities and economic diversification. [Farb]

According to Cali [Calb] there are three main mechanisms for how trade impacts political stability and conflict: the opportunity cost mechanism (decreasing real incomes increase the relative value of engaging in violent activities), the rapacity effect (the incentive to fight for the control of valuable resources and commodities), and the resource effect (increases in the price of commodities controlled by conflicting parties can finance the capability to fight. Cali then recommends five objectives for using trade in conjunction with other measures to support stability in conflict-affected countries: preventing conflicting sides from gaining access to commodity revenues and spending them, promoting labor-intensive exports, strengthening trading relations with neighbors, and focusing on the broader conflict resolution at the political level. Recognizing the unique challenges for the Aid-for-Trade initiative in fragile and conflict-affected countries, the G7+ (an organization fragile and conflict-affected countries) together with development partners, and civil society adopted a New Deal of Engagement in Fragile States at the High-Level Forum on Aid Effectiveness in South Korea in 2011. The deal proposes gradual goals, moving from fostering inclusive political settlement and conflict resolution, to establishing and strengthening people's security, addressing injustices, and increasing people's access to justice, generating employment and livelihoods, and managing revenue and building capacity for accountable and fair service delivery. [OECd] Fourth, improving the monitoring process of the Aid-for-Trade is crucial. Currently, the World Trade Organization (WTO) and The Organization for Economic Co-operation and Development (OECD) are the two international organizations that periodically monitor the quantity and quality of aid-for-trade. However, the monitoring is mainly based on collating self-reported statistics and is not real-time, highlighting the need to further improve the monitoring process for Aid-for-Trade. Last but not least, an important debate on Aid-for-Trade has been whether its focus should be narrow or broad. [Hynb]

Some scholars argue that the Aid-for-Trade definition is extremely broad, including everything ranging from trade-related infrastructure to trade-related adjustments, ultimately overloading the initiative and decreasing its effectiveness. [Adh] As a result, this broadness could create difficulties in separating trade-related infrastructure from other infrastructures [Calc] and distinguishing between ODA and Aid-for-Trade. [Lai] Generally, ODA is considered Aid-for-Trade if the recipient country identifies the projects and programs as trade-related development priorities. Critics consider such assertion as vague, arguing that it makes almost all economic components of ODA as part of Aid-for-Trade. However, others consider the criterion advantageous because it allows the inclusion of some projects, seemingly unrelated to trade but very important for trade (mainly non-tariff barriers such as health regulations), in Aid-for-Trade. The concept Trade-Related Assistance (TRA), developed by DAC, can help address the problem. TRA includes only Aid-for-Trade components with clear trade-related purposes. [Nil] The TRA criterion is an improvement, but several ambiguities still engulf the way donors identify and register the trade development components of Aid-for-Trade. Overall, the WTO and OCDE strongly support broader objectives for the Aid-for-Trade including poverty reduction, inclusive growth, gender equality, and environmentally sustainable growth

5 Conclusions

This paper suggests that foreign aid or free trade alone have not been able to achieve a sustained reduction in poverty in developing countries. As a complementary approach, the Aid-for-Trade initiative has proven successful in using aid to help developing countries overcome their trade capacity limitations and fully exploit the trade benefits to achieve sustained economic growth and reduce poverty. As such, I believe that the prolonged International Politics controversy of "Foreign Aid vs Trade for reducing global poverty?" may have found a better answer in Aid-for-Trade as an approach that combines foreign aid and trade to create an efficient tool for improving poverty in developing countries.

References

[Ace]

[Adh]

[Ali]

[Ane]

[Bus]

[Cala]

[Calb]

[Calc]

[Col]

[Eas]

[Fara]

[Farb]

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