

External Assistance and its Effects on Eradicating Poverty

Meri CAZACU*, Rodica CRUDU*

Abstract

Poverty is a multidimensional socio-economic phenomenon. It entails more than the lack of income and productive resources to ensure sustainable livelihoods, its manifestations include hunger and malnutrition, limited access to education, health care and other basic services, social discrimination, high rates of disruptive or disorderly behavior and exclusion as well as the lack of participation in decision-making. Various social groups bear a disproportionate burden of poverty. After the World War II efforts in combating poverty have increased, bringing mixed results and opinions. As of today, there is a large number of specialized international organizations that focus on poverty reduction.

Key words: *poverty; foreign aid, development aid; ODA; poverty headcount*

JEL classification: *F35; I31; I32; I38*

1. Introduction

Eradicating poverty is the number 1 Sustainable Development Goal of the United Nations. The World Bank declared ending poverty by 2030 as the main goal of the organization. The International Bank for Reconstruction and Development; the International Development Association; the International Finance Corporation; the Organization for Economic Co-operation and Development, these are only some of the multiple international organizations that share the goal of poverty reduction. Poverty has been hovering over humanity, as a shadow, for millennia.

The goal of this research is to shed light on the scale of poverty and the way it is influenced by foreign aid. In order to determine what is the relationship between aid and poverty, the following objectives were set:

2. Define, classify and determine the reasons of poverty;
3. Explain why it is important to measure poverty and what methods are used to do so;

* Bachelor Degree in Economics; area of specialization- World Economy and International Economic Relations; Academy of Economic Studies of Moldova; E-mail: cazacumeri@gmail.com

* PhD., Associate professor, Jean Monnet Professor, Fulbright Alumni, Dean of International Economic Relations Faculty; Academy of Economic Studies of Moldova; E- mail: crudu.rodica@ase.md

4. Define and classify foreign aid and ODA
5. Study the debates on aid effectiveness and consider the grounds of existence of such debates
6. Study the relationship between aid and poverty in Sub Saharan Africa in order to the effectiveness of foreign aid in poverty eradication in the region
7. Analyze poverty in Moldova and the way it was influenced by foreign aid

2. External Assistance and poverty eradication: Literature review

According to the United Nations Organization “Poverty is the inability of having choices and opportunities, a violation of human dignity. It means lack of basic capacity to participate effectively in society. It means not having enough to feed and clothe a family, not having a school or clinic to go to, not having the land on which to grow one's food or a job to earn one's living, not having access to credit. It means insecurity, powerlessness and exclusion of individuals, households and communities. It means susceptibility to violence, and it often implies living in marginal or fragile environments, without access to clean water or sanitation” (Wikipedia, 2019).

World Bank provides the following definition: “Poverty is pronounced deprivation in wellbeing, and comprises many dimensions. It includes low incomes and the inability to acquire the basic goods and services necessary for survival with dignity. Poverty also encompasses low levels of health and education, poor access to clean water and sanitation, inadequate physical security, lack of voice, and insufficient capacity and opportunity to better one's life”. (World Bank Group, 2019)

Put simply, poverty represents the state of an individual which lacks a minimum socially acceptable amount of material possessions and/ or amount of money, limiting the individual's opportunities and access to basic facilities that would increase his/ her quality of life.

There are three main types of poverty described in the majority of the specialized literature:

- Relative poverty, known as relative because it is relative to the average standard of living in a person's society. What is considered high income in one country could be considered middle or low income in another. If a family's income is enough to ensure housing, clothing and nutrition adequate to preserve life, however not enough to meet the standard of living of the society, the family is considered to be in relative poverty.

- Absolute poverty, extreme poverty, or abject poverty is "a condition characterized by severe deprivation of basic human needs, including food, safe drinking water, sanitation facilities, health, shelter, education and information. It depends not only on income but also on access to services."(The UNO, 1995) These needs can be defined as those necessary for survival.

- The GSUP has recently come up with the term ultra-poverty to describe an even more severe form of poverty experienced by those living far below the extreme poverty line. “The individuals living in these households (the majority headed by women, which is explained by the fact that women are more prone to living in poverty due to unequal pay and education) face a wide array of unique

challenges and burdens even within their extremely poor communities. They live on the margins, confronting isolation that prevents them from benefiting from government-led social protection programs or market-led initiatives, like microfinance. Many of those living in ultra-poverty are invisible, even to their closest neighbors. Their lives are undocumented. They lack birth certificates and don't appear on government lists" (Reed et all, 2017, p.14). Ultra-poverty is the most severe form of poverty on the planet.

The economic thought on poverty has changed dramatically over the last two hundred years. In the 19th century poverty was considered a natural phenomenon; it was inevitable and there was neither need nor sense in fighting it. As the global society evolved, a new perception of poverty emerged and it became accepted as a serious problem. Numerous methods of measuring poverty were developed in order to help identify the poor and develop strategies for combating poverty. There a few widely used methods of measuring and quantifying poverty:

- The headcount index measures the proportion of the population that is poor.
- The poverty gap index measures how far the impoverished falls below the poverty line (the poverty gaps) as a percentage of the poverty line
- The poverty line, which "may be thought of as the minimum expenditure required by an individual to fulfil his or her basic food and nonfood needs". (Khandker& Shahidur, 2009, p. 10)
In 2015 the absolute poverty threshold was updated to \$1.90 per day in terms of 2011 PPP reflecting the same purchasing power across all countries.

After the World War II, active efforts started to be made in order to alleviate poverty throughout the world. Foreign aid became the most used instrument in combating poverty with the implementation of the Marshal Plan. After the reconstruction of Europe and the reversal of the damage caused by the war to the belligerent countries, developing economies became the main focus of foreign aid donors.

In her book, Carol Lancaster defines foreign aid as "a voluntary transfer of public resources, from a government to another independent government, to an NGO, or to an international organization (such as the World Bank or the UN Development Program) with at least a 25 percent grant element, one goal of which is to better the human condition in the country receiving the aid". (Lancaster, 2007, p.9). This definition is very close to the one provided by the OECD which the organization uses to measure Official Development Aid (ODA).

According to the OECD, ODA refers to "flows to developing countries and multilateral institutions provided by official agencies, including state and local governments, or by their executive agencies, each transaction of which meets the following test: a) it is administered with the promotion of the economic development and welfare of developing countries as its main objective, and b) it is concessional in character and contains a grant element of at least 25% (calculated at a rate of discount of 10%)". (OECD, 2019) Foreign aid includes a wide spectrum of resource flows (cash, service, commodities).

It is important to make the distinction between development aid, or foreign aid, and ODA. The core and most basic difference between these is the fact that ODA is bilateral (aid is provided by

specialized institutions and/ or governments to governments), and foreign aid is a looser concept that may also include multilateral aid (assistance provided by specialized institutions and or governments to the civil society of the receiving country).

3. Basic findings of the research

Even though significant progress has been made in poverty reduction, there are still regions in the world where poverty is predicted to stay in the two digits for the following decade at the very least. This led to the division of economists and researchers into two camps, namely advocates and critics of foreign aid, the latter supporting the idea that aid does not contribute to poverty alleviation and even damages the developing countries that receive the aid by fueling corruption and making the receiving economies dependent on assistance for normal operation.

Looking from aside at the issue of no common opinion on the effectiveness of foreign aid in poverty eradication, it appears obvious that either the claims of aid advocates or those of aid critics have grounds for existence.

For instance, due to the fact that the majority of aid provided by the donor nations is tied, the developing countries that receive can be harmed economically. To illustrate this point, there is the example of Eritrea, which is obliged to buy goods and services from abroad, using aid money, in order to build a network of railways despite the fact that it is much cheaper to use local goods and expertise for that purpose. Moreover, critics also argue that some of the foreign aid is stolen by the corrupt governments and policies become more oriented towards what will attract more aid and less towards reaching and helping the poor.

There are also examples of positive effects of foreign assistance. In Namibia an aid project in the form of welfare, paying citizens a social security of only \$13 a month, helped people honor their children's tuition fees. As a result, the number of children going to school increased dramatically to 92%, child malnutrition rates decreased by over 30% and economic activity increased by 10%. (Wikipedia, 2019) Advocates say that for the countries that receive foreign assistance in time of natural disasters and medical help, such as vaccines for diseases, a time will come when they will be able to improve their economic state. Eventually, these countries will no longer need aid but instead, be the ones to provide aid to the nations that need it, like Peru, Japan and China.

4. Case study on Sub Saharan Africa

Sub Saharan Africa is the brightest example of extremely high poverty rates that do not seem to decrease despite the massive foreign aid flows to the region. As of today, Sub Saharan Africa concentrates the majority of the people living below the poverty line in the world. The region receives the most assistance as compared to other countries and regions, the persistence of poverty catching the attention of donors and other aid recipients.

In 1960 the majority of aid provided to Sub Saharan Africa was bilateral, the proportion changing throughout the 1970s to 2012, the bigger share of aid (approximately 40%) towards the region being allocated by multilateral donors. DAC donors have consistently accounted for the largest proportion of assistance, at around 60% each decade since the 1960s. (Lauren Tait, Abu Siddique and Ishita Chatterjee, 2016)

In order to test the influence of development aid on combating poverty in Sub Saharan Africa a linear time series econometric model was estimated. The data was collected for the period between 2001 and 2017 from the World Bank official website. The variables under study are the poverty headcount index (H) which represents the regressand, ODA received (O), GDP per capita (Y) and the poverty gap index (G). The results of the tests run in the econometric model showed that the variable which has the strongest effect on the poverty headcount index is the GDP per capita. As the economy of Sub Saharan Africa grows, more and more people are lifted out of poverty and the poverty gap narrows down. This econometric model showed that the ODA allocated to Sub Saharan African does not directly influence the share of impoverished people in the total population of the region. It does, however, contribute to the overall economic growth, in this particular case to the increase of GDP and GDP per capita, which consequently leads to the decrease in the headcount index.

Over the years, significant progress has been made in combating poverty in Sub Saharan Africa. Even though it still remains the region with the highest concentration of people living below the poverty line, slowly but surely the income of people living in the region grows allowing them to escape poverty. Economic growth is a crucial factor in eradicating poverty and despite the fact that ODA does provide a push towards increased rates of growth, it should not become the driving factor of economic growth in Sub Saharan Africa. Dependence on aid is a big problem for the region, and nonetheless ODA is helpful in the short run, in order to ensure prosperity in the long run, Sub Saharan Africa should be weaned off of foreign aid.

5. Case study on the Republic of Moldova

Another group of countries that seems to be stuck in perpetual poverty is the former Soviet Union. Poverty in these countries has its specifics, it is mostly spread out in rural areas and it greatly affects women. Another characteristic of poverty in post Socialist republics, is the fact that it manifested itself in two major waves: a sharp increase in poverty rates in the 1990s and the stabilization and gradual decrease in the 2000s. One more interesting thing that can be attributed to this group of countries, is the strong effect that remittances sent from abroad have on the increase of consumption and reduction of the poverty headcount subsequently.

Moldova, as a former Soviet republic, was hit hard after the dissolution of the USSR. The poverty headcount has skyrocketed in the early 90s, inflation hit hard and the lack of gold and foreign currency reserves conditioned Moldova to fall deep into debt. Overtime, the number of people living in extreme poverty has decreased considerably, mostly due to Official Development Aid flows to the country. To

prove the strong effect that ODA has on decreasing poverty in the Republic of Moldova, an econometric study was conducted on the country. For this model the same variables, within the same timeframe, were used as in the case of Sub Saharan Africa, with the addition of the share of remittances in the GDP. Remittances were added to the equation because they represent a significant contribution to the GDP of Moldova.

The covariance matrix showed, and the results of multiple tests confirmed that, the ODA provided to the Republic of Moldova has a strong positive effect on poverty alleviation in the country. Not only does the poverty headcount decrease, the poverty gap narrows down reflecting an increase in the population's income and overall standard of living respectively. The model confirmed that remittances are one of the driving factors of poverty rates deceleration, and thus state policies must be designed in order to weaken the dependence of Moldova on transfers from abroad.

Another important observation that must be mentioned, is the fact that Moldova seems to depend too much on development assistance in its fight against poverty. Actions should be taken in order to promote economic growth and prosperity driven poverty eradication, otherwise Moldova risks an accelerated increase of population living under the poverty line in the long run.

6. Conclusion

Analyzing the two case studies described in this paper, it becomes clear that both of the theories regarding foreign aid effectiveness in poverty reduction are fair and should be considered. Most importantly, it seems that aid has different effects depending on the country or region that is the recipient. This can be attributed to the fact that overall there is one common system of aid provision and implementation, which does not work the same everywhere. The biggest issues faced by the system are poor governance in receiving states, high levels of corruption that feed off of the provided aid, high costs of feasibility studies and research that is done in order to assess the needs and possibilities of aid recipients and the inability of official aid provided to governments to reach the poor.

Many times, by trying to ease poverty in developing states, the developed economies unintentionally hinder the local business environment. One example that illustrates the unintentional harm that is done to the poor regards the clothes donated to Africa by compassionate citizens from all over the world. Often times these clothes are sold for cheap on the local markets, creating completion for the local textile producers and tailors. In his interview with SPEGEL, Shikwati said “No one in the low-wage world of Africa can be cost-efficient enough to keep pace with donated products”. He mentioned that in 1997, 137 000 people were employed in Nigeria’s textile industry. By 2003 this number dropped to 57 000. (Shikwati, 2005) Unfortunately, the results are the same in all other industries where overwhelming compassion and the fragile African markets intersect. All of these factors together lead to an increased dependence of developing countries on foreign aid.

It is clear that at this point in time there is no better alternative for foreign aid. At the same time there are examples of aid effectiveness in eliminating poverty, like Japan, Peru and China. Important

recommendations that can be derived from this research in order to promote poverty reduction are as follows:

- Make an effort to channel a bigger share of foreign aid through NGOs than through governments, as it was proven by economists that NGOs do a better job at reaching the poor and fighting the problem at its roots;
- Support local businesses through investments in order to develop the local business environment and foster the entrepreneurial spirit, instead of making donations of products that will flood the local markets and drive the local producers out of business;
- Wean the developing countries off of aid and promote poverty reduction through economic growth and a rising standard of living in order to avoid falling back into poverty in the long- run;
- Stop tying aid in cases when it clearly does not benefit the receiving country or when the receiving country can use the aid received to solve the problem with less expenses and a greater effectiveness;
- Consider a higher poverty line in order to estimate the number of people living in extreme poverty, \$1.90/ day does not reflect the minimum necessary amount of money needed to cover the most basic and simplest of needs anymore.

As it was proven by the two econometric models generated for this paper, overall foreign aid does contribute to poverty reduction, either directly or indirectly depending on the region or country receiving aid. Even though experts estimated that the goal of ending poverty in the whole world by 2030 most likely will not be achieved, every day thousands of people escape poverty, whether that is due to foreign aid or not. It is certain that poverty rates will continue to go down, which means that efforts of the global community in fighting poverty are not in vain.

References:

- Glossary of statistical terms. OECD. (Online) (Cited: 25 February 2019) Available: <https://stats.oecd.org/glossary/detail.asp?ID=6043>.
- Khandker, Jonathan Haughton and Shahidur R. (2009), Handbook on poverty and inequality. Washington DC, p. 10
- Lancaster, Carol (2007), Foreign Aid: diplomacy, development, domestic politics. USA: The University of Chicago, p. 9. ISBN 9780226470450.
- Larry Reed, Jean Francois Tardif, Veronica Brown, Anne Hastings, Jesse Marsden, Shaifali Puri. The Global State of Ultra-Poverty, A global analysis of the greatest opportunities to end ultra-poverty by 2030. <https://www.ultra-poverty.org/assets/downloads/gsup-2017-report.pdf>
- Lauren Tait, Abu Siddique and Ishita Chatterjee. Foreign Aid and Economic Growth in Sub-Saharan Africa. Crawley: University of Western Australia, 2016. pp.5-6
- Shikwati, James. For God's Sake, Please Stop the Aid. SPIEGEL. July 4, 2005.
- World Bank Group. The World Bank. (Online) (Cited: January 22, 2019.) Available: <http://www.worldbank.org/en/topic/poverty>.