Foreign Finance, Investment, Aid, and Conflict: Controversies and Opportunities

14

It is to perpetuate difficulties of the South for the North to relate to us as hapless victims to dictate to regarding loans and the employment of aid.

—*Nelson Mandela, United Nations Social Summit, March 1995*

We, Ministers of developed and developing countries responsible for promoting development and Heads of multilateral and bilateral development institutions . . ., recognize that while the volumes of aid and other development resources must increase to achieve these [MDG] goals, aid effectiveness must increase significantly as well.

—*OECD 2005, Paris Declaration on Aid Effectiveness*

With the number of migrants worldwide now reaching almost 200 million . . ., remittances are an important way out of extreme poverty for a large number of people.

—*François Bourguignon, former chief economist, World Bank, 2008*

Made in one or more of the following countries: Korea, Hong Kong, Malaysia, Singapore, Taiwan, Mauritius, Thailand, Indonesia, Mexico, Philippines. The exact country of origin is unknown.

—*Integrated circuit label* [1]

14.1 The International Flow of Financial Resources

In Chapter 13, we explained that a country's international financial situation as reflected in its balance of payments and its level of monetary reserves depends not only on its current account balance (its commodity trade) but also on its capital account balance (its net inflow or outflow of private and public financial resources). Because a majority of non-oil-exporting developing nations have historically incurred deficits on their current account balance, a continuous net inflow of foreign financial resources represents an important ingredient in their long-run development strategies. These recurrent requirements are amplified by the need for targeted resources for investments in key sectors and for carrying out poverty reduction strategies.

In this chapter, we examine the international flow of financial resources, which takes three main forms: (1) *private foreign direct and portfolio investment*, consisting of (a) foreign "direct" investment by large multinational (or transnational) corporations, usually with headquarters in the developed nations, and (b) foreign **portfolio investment** (e.g., stocks, bonds, and notes) in developing countries' credit and equity markets by private institutions (banks,

Portfolio investment Financial investments by private individuals, corporations, pension funds, and mutual funds in stocks, bonds, certificates of deposit, and notes issued by private companies and the public agencies.

mutual funds, corporations) and individuals; (2) *remittances of earnings by international migrants;* and (3) *public and private development assistance (foreign aid)*, from (a) individual national governments and multinational donor agencies and, increasingly, (b) private *nongovernmental organizations (NGOs)*, most working directly with developing nations at the local level. We also examine the nature, significance, and controversy regarding private direct and portfolio investment and foreign aid in the context of the changing world economy. As in earlier chapters, our focus will be on ways in which private investment and foreign aid can contribute to development and on ways in which they may be harmful. We then ask how foreign investment and aid might best serve development aspirations. Finally, we examine the consequences and causes of violent conflict in developing nations and strategies for its prevention; and assistance with recovery from, and prevention of, civil war and ethnic strife—among the most difficult problems for economic development and a focal point for foreign aid.

14.2 Private Foreign Direct Investment and The Multinational Corporation

Multinational corporation (MNC) A corporation with production activities in more than one country.

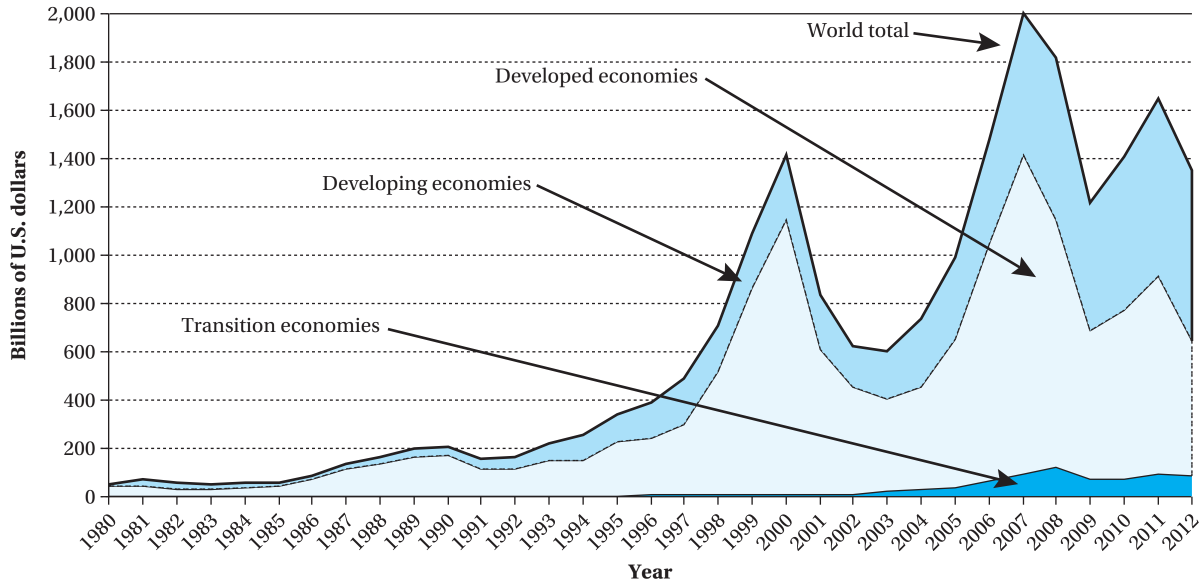
Foreign direct investment (FDI) Overseas equity investments by private multinational corporations.

Few developments have played as critical a role in the extraordinary growth of international trade and capital flows during the past few decades as the rise of the **multinational corporation (MNC)**. An MNC is most simply defined as a corporation or enterprise that conducts and controls productive activities in more than one country. These huge firms are mostly based in North America, Europe, and Japan; but a growing number are based in newly high-income economies such as South Korea and Taiwan. In recent years, a much smaller but growing number of MNCs have emerged from upper-middle-income countries such as Brazil and even some fast-growing lower-middle-income countries, most notably China. MNCs and the resources they bring present a unique opportunity but may pose serious problems for the many developing countries in which they operate.

The growth of private **foreign direct investment (FDI)** in the developing world has been extremely rapid—though volatile—in recent decades. A key part of globalization, FDI growth has come in waves, with each crest higher than the one before it, as seen in Figure 14.1. It rose from an annual rate of $2.4 billion in 1962 to $35 billion in 1990 before surging to $565 billion in 2007 (when total world FDI hit its record of just over $2 trillion). In the aftermath of the global crisis, FDI fell considerably, and in 2012, the total was some $1.35 trillion, barely two-thirds of its level five years earlier, with only a gradual global increase anticipated.

Yet, despite this overall global trend, FDI continues to play an extremely important and indeed growing role in the developing world—in 2012, inflows to developing countries were about $700 billion, an extraordinary flow of resources. Indeed, 2012 represented a new milestone: For the first time in history, developing countries received more than half of all global FDI flows. On the one hand, a significant part of this changing share over the past few years has been due to a sharp fall in investment into developed countries, reflecting the aftermath of the crisis and, in particular, the continued recession conditions in much of Europe.

FIGURE 14.1 FDI inflows, Global and By Group of Economies, 1980–2012 (Billions of Dollars)



Source: Data drawn from UNCTAD data base at http://unctadstat.unctad.org/ReportFolders/reportFolders.aspx, accessed 14 March 2014.

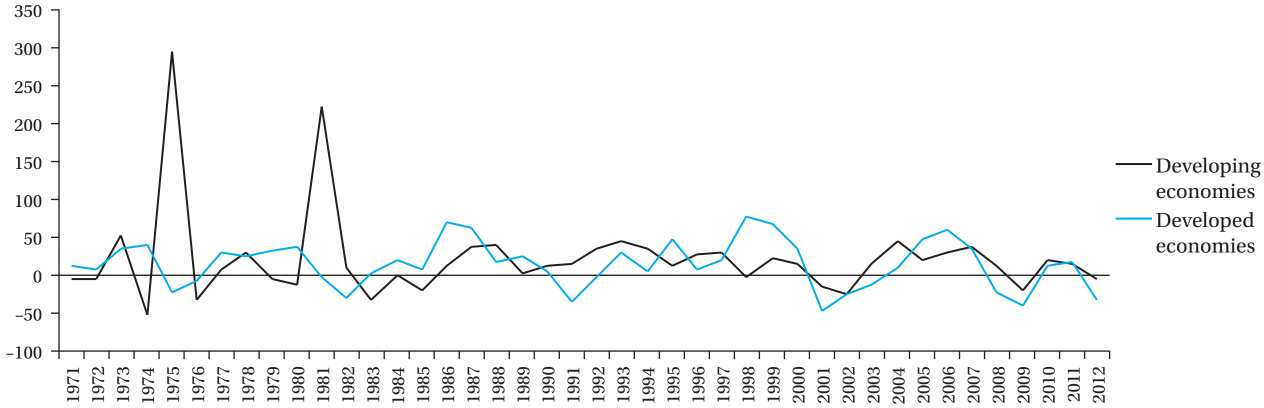
But remarkably, by 2012, developing countries were also the source of nearly one-third of global FDI outflows. Although these represent a continuation of general trends that began from the mid-1980s, they are now reaching high shares far more rapidly than anything expected by analysts at the turn of the century. This is occurring while outflows from developed countries fell sharply in 2009 in the wake of the financial crisis, rebounded for a couple of years, but by 2012–2013 had fallen back, close to the 2009 trough.[2] At the same time, these funds are originating from a small number of relatively successful middle-income developing countries; to some extent, this also reflects that the development gaps among developing countries has become greater than ever.

According to UNCTAD estimates, in 2012, a little over two thirds of the profits from FDI in developing countries were repatriated back to investor countries; on the other hand, the remainder was retained, much of that reinvested.

The instability of the growth in FDI flows over time into both developed and developing countries can be seen in Figure 14.2. Interestingly, at least since the late 1990s, the volatility of investments going into developed countries has actually been greater than those going into developing countries.

The volatility of flows to various regions is even greater than total flows. In most years, a majority of FDI goes from one developed country to another, and flows to developing countries are heavily concentrated in just a few destinations. For example, in 2009, 31% of all inflows to developing countries went to China (including Hong Kong and Macao). Africa has usually received only a small fraction of inflows. In 2009, FDI in Africa totalled $59 billion, but the share of global FDI going to Africa as a whole was just 5.3% (3.6% excluding

FIGURE 14.2 Trends in Annual Growth Rates of FDI Inflows, by Groups of Economies, 1970–2012 (Percent)



Source: World Investment Report 2013, page 71. Reprinted with permission from the United Nations Conference on Trade and Development (UNCTAD).

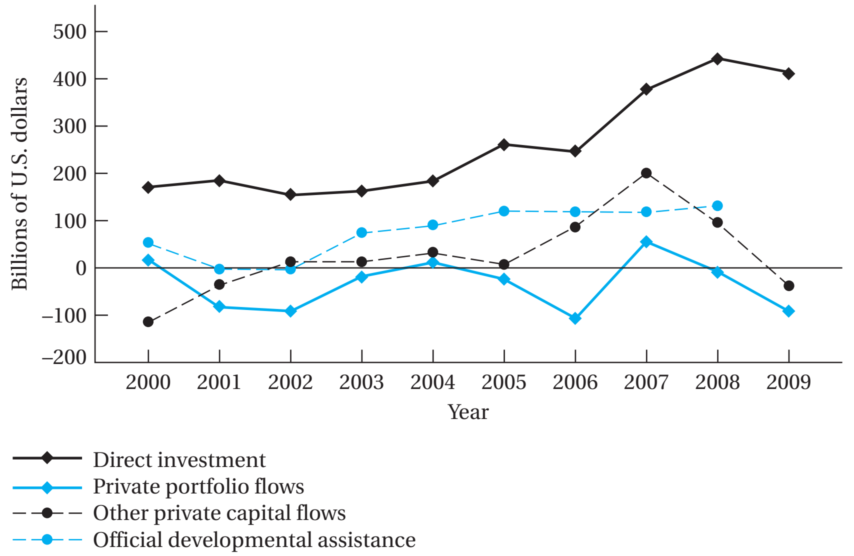
North Africa). But even this was higher than recent years, largely driven by commodities investments. Most of the 34 least developed countries in Africa received very little foreign investment. This is not surprising given the fact that private capital gravitates toward countries and regions with the highest financial returns and the greatest perceived safety. Where debt problems are severe, governments are unstable, and economic reforms remain incomplete, the risks of capital loss can be high. We must recognize that multinational corporations are not in the development business; their objective is to maximize their return on capital. MNCs seek out the best profit opportunities and are largely unconcerned with issues such as poverty, inequality, employment conditions, and environmental problems.[3]

FDI flows need to be understood in context. Despite the extraordinary growth, FDI inflows to developing countries have remained a small fraction of these countries' total investment, most of which is accounted for by domestic sources. (Note, however, that foreign investment may be qualitatively different from domestic investment and may have beneficial interaction effects in some cases, which in turn may depend on policy, as discussed later.) Nevertheless, in recent years, FDI has become the largest source of foreign funds flowing to developing countries, as Figure 14.3 shows.[4]

Globally, MNCs employ about 80 million workers in countries outside their home base. Nonetheless, in most developing countries, MNCs employ a relatively small fraction of the workforce, but the jobs tend to be concentrated in the modern urban sector. Moreover, foreign direct investment also involves much more than the simple transfer of capital or the establishment of a local factory in a developing nation. Multinationals carry with them technologies of production, tastes and styles of living, managerial philosophies, and diverse business practices. But before analyzing some of the arguments concerning incentives for, or restrictions against, private foreign investment, in general, and multinational corporations, in particular, let us examine the character of these enterprises.

Two central characteristics of multinational corporations are their large size and the fact that their worldwide operations and activities tend to be

FIGURE 14.3 Net Capital Flows to Developing Countries, 2000–2009



Source: From United Nations Conference on Trade and Development (UNCTAD), *World Investment Report* 2009, ch. 1, p. 5. Reprinted with permission from the United Nations.

Note: Drawn from IMF data, which include new EU member states from eastern Europe but excludes the now high-income South Korea and Singapore.

centrally controlled by parent companies. They are the major force in the rapid globalization of world trade. The 100 largest nonfinancial, multinational corporations now account for over $8 trillion in sales. MNCs have become, in effect, **global factories** searching for opportunities anywhere in the world. Many MNCs have annual sales volumes in excess of the GDP of the developing nations in which they operate. The scale of these corporations is immense. Six of them accounted for more sales in 2008 than the GNI of all of South Asia and sub-Saharan Africa combined. Most poorer countries are dwarfed in size by the major MNCs. This large scale of operations, combined with limited competition, confers great bargaining power.[5]

Global factories Production facilities whose various operations are distributed across a number of countries to take advantage of existing price differentials.

Note, however, that just as South-South trade plays a growing role, direct South-South investment has increased recently. This growing trend may open up new opportunities for developing countries on both the outflow and inflow sides. In fact, in many of the least developed countries, FDI from other developing nations, particularly China, plays a leading role.[6]

Still, many people in the developing countries tend to believe, rightly or wrongly, that multinational corporations operate with the blessing of their home governments and with national resources at their disposal in the event of a significant dispute. A majority of developing countries, especially the smaller and least developed ones, understandably feel overwhelmed in attempting to bargain with such powerful entities. The success of China in negotiating better deals with MNCs regarding technology transfer and taxation has had limited applicability elsewhere because no other developing nation has China's combination of great size and strong central government authority.

In sum, enormous size confers substantial economic (and sometimes political) power on MNCs vis-à-vis the countries in which they operate. This power is greatly strengthened by their predominantly oligopolistic market positions, that is, by the fact that they tend to operate in worldwide product markets dominated by a few sellers. This situation gives them the ability to manipulate prices and profits, to collude with other firms in determining areas of control, and generally to restrict the entry of potential competitors by dominating new technologies, special skills, and, through product differentiation and advertising, consumer tastes. Although a majority of MNC investments are still directed to other developed countries, most developing countries, given their small economies, feel the presence of multinational corporations more acutely than the developed countries do.

Historically, multinational corporations, especially those operating in developing nations, focused on extractive and primary industries, mainly petroleum, nonfuel minerals, and plantation activities where a few "agribusiness" MNCs became involved in export-oriented agriculture and local food processing. Recently, however, manufacturing operations and services (banks, hotels, etc.) have occupied a dominant share of MNC production activities. Moreover, production for export to the MNC's home country and other developed markets today tends to predominate over production for consumption in the host developing countries.

Private Foreign Investment: Some Pros and Cons for Development

Few areas in the economics of development arouse so much controversy and are subject to such varying interpretations as the issue of the benefits and costs of private foreign investment. If we look closely at this controversy, however, we will see that the disagreement is not so much about the influence of MNCs on traditional economic aggregates such as gross domestic product (GDP), investment, savings, and manufacturing growth rates (though these disagreements do indeed exist) as about the fundamental economic and social meaning of development as it relates to the diverse activities of MNCs. In other words, the controversy over the role and impact of private foreign investment often has as its basis a fundamental disagreement about the nature, style, and character of a desirable development process. The basic arguments for and against the impact of private foreign investment in the context of the type of development it tends to foster can be summarized as follows.[7]

Traditional Economic Arguments in Support of Private Investment: Filling Savings, Foreign-Exchange, Revenue, and Management Gaps The pro-foreign-investment arguments grow largely out of the traditional and new growth theory analysis of the determinants of economic growth. Private foreign investment (as well as foreign aid) is typically seen as a way of filling in gaps between the domestically available supplies of savings, foreign exchange, government revenue, and human capital skills and the desired level of these resources necessary to achieve growth and development targets. For a simple example of the "savings-investment gap" analysis, recall from Chapter 3 that the basic Harrod-Domar growth model postulates a direct relationship between a country's net savings ratio, s, and its rate of output growth, g, via the equation $g = s/c$, where c is the national capital-output ratio. If the desired rate of national output growth, g, is targeted at 7% annually and the capital-output ratio is 3, the needed rate of annual net saving is 21% (because $s = gc$). If the saving that can be domestically mobilized amounts to only, say, 16% of GDP, a "savings gap" equal to 5% can be said to exist. If the nation can fill this gap with foreign financial resources (either private or public), it will be better able to achieve its target rate of growth.

Therefore, the first and most often cited contribution of private foreign investment to national development (i.e., when this development is defined in terms of GDP growth rates—an important implicit conceptual assumption) is its role in filling the resource gap between targeted or desired investment and locally mobilized savings.

A second contribution, analogous to the first, is its contribution to filling the gap between targeted foreign-exchange requirements and those derived from net export earnings plus net public foreign aid. This is the so-called foreign-exchange or trade gap. ("Two-gap" models are discussed more fully later in this chapter.) An inflow of private foreign capital can not only alleviate part or all of the deficit on the balance of payments current account but also function to remove that deficit over time *if* the foreign-owned enterprise can generate a net positive flow of export earnings. Unfortunately, as noted in the case of import substitution, the overall effect of permitting MNCs to establish subsidiaries behind protective tariff and quota walls producing for domestic consumption is often a net *worsening* of both the current and capital account balances. Such deficits in those cases usually result both from the importation of capital equipment and intermediate products (normally from an overseas affiliate and often at inflated prices) and the outflow of foreign exchange in the form of repatriated profits, management fees, royalty payments, and interest on private loans. A large and growing share of MNC production in developing countries involves adding (labor-intensive) value to components for reexport, but this brings little foreign exchange into the economy.

The third gap said to be filled by private foreign investment is the gap between targeted governmental tax revenues and locally raised taxes. By taxing MNC profits and participating financially in their local operations, developing-country governments are thought to be better able to mobilize public financial resources for development projects.

Fourth, there is a different type of gap in management, entrepreneurship, technology, and skill presumed to be partly or wholly filled by the local operations of private foreign firms. Not only do multinationals provide financial resources and new factories to poor countries, but they also supply a "package" of needed resources, including management experience, entrepreneurial abilities, and technological skills that can then be transferred to their local counterparts by means of training programs and the process of learning by doing. Moreover, according to this argument, MNCs can educate local managers about how to establish contact with overseas banks, locate alternative sources of supply, diversify market outlets, and become better acquainted with international marketing practices. Finally, MNCs bring with them the most sophisticated technological knowledge about production processes while transferring modern machinery and equipment to capital-poor developing countries. It has long been assumed that some of this knowledge leaks out to the broader economy when engineers and managers leave to start their own companies. Such transfers of knowledge, skills, and technology are assumed to be both desirable and productive for the recipient nations.[8]

Arguments against Private Foreign Investment: Widening Gaps There are two basic arguments against private foreign investment, in general, and the activities of MNCs, in particular—the strictly economic and the more philosophical or ideological.

On the economic side, the four gap-filling, pro-foreign-investment positions just outlined are countered by the following arguments:

1. Although MNCs provide capital, they may lower domestic savings and investment rates by substituting for private savings, stifling competition through exclusive production agreements with host governments, failing to reinvest much of their profits, generating domestic incomes for groups with lower savings propensities, and inhibiting the expansion of indigenous firms that might supply them with intermediate products by instead importing these goods from overseas affiliates. MNCs also raise a large fraction of their capital locally in the developing country itself, and this may lead to some crowding out of investment of local firms.
2. Although the initial impact of MNC investment is to improve the foreign-exchange position of the recipient nation, its long-run impact may be to reduce foreign-exchange earnings or at least make the net increase smaller than it appeared, as a result of substantial importation of intermediate products and capital goods and because of the overseas repatriation of profits, interest, royalties, management fees, and other funds.
3. Although MNCs do contribute to public revenue in the form of corporate taxes, their contribution is considerably less than it might appear as a result of liberal tax concessions, the practice of **transfer pricing**, excessive investment allowances, disguised public subsidies, and tariff protection provided by the host government.
4. The management, entrepreneurial skills, ideas, technology, and overseas contacts provided by MNCs may have little impact on developing local sources of these scarce skills and resources and may, in fact, inhibit their development by stifling the growth of indigenous entrepreneurship as a result of the MNCs' dominance of local markets.

Transfer pricing An accounting procedure often used to lower total taxes paid by multinational corporations in which intracorporate sales and purchases of goods and services are artificially invoiced so that profits accrue to the branch offices located in low-tax countries (tax havens) while offices in high-tax countries show little or no taxable profits.

Government policies in developing countries may be directed toward mitigating some of these concerns. Many academic and political thought leaders in developing countries have commonly raised a number of more fundamental objections. First, the impact of MNCs on development is very uneven, and in many situations, MNC activities reinforce dualistic economic structures and exacerbate income inequalities. They tend to promote the interests of a small number of local factory managers and relatively well-paid modern-sector workers against the interests of the rest by widening wage differentials. They divert resources away from needed food production to the manufacture of sophisticated products catering primarily to the demands of local elites and foreign consumers. And they tend to worsen the imbalance between rural and urban economic opportunities by locating primarily in urban export enclaves and contributing to excessive rural-urban migration.

Second, it is argued that multinationals typically produce products only demanded by a small, rich minority of the local population, stimulate inappropriate consumption patterns through advertising and their monopolistic market power, and do this all with inappropriate (capital-intensive) technologies of production that as a result create comparatively little employment. The latter is perhaps the major criticism of MNCs in light of the substantial employment problems of developing nations. Investment from other developing countries may be more conducive to employment expansion, but this is a new phenomenon, and the picture is not yet entirely clear.

Third, as a result of the first two points, local resources tend to be allocated for socially undesirable projects. This in turn tends to aggravate the already sizable inequality between rich and poor and the serious imbalance between urban and rural economic opportunities.

Fourth, multinationals use their economic power to influence government policies in directions that are unfavorable to development. They are able to extract sizable economic and political concessions from competing governments of other developing countries in the form of excessive protection, tax rebates, investment allowances, and the cheap provision of factory sites and essential social services. This phenomenon is often referred to as a "race to the bottom." As a result, the private profits of MNCs may exceed social benefits. In some cases, these social returns to host countries may even be negative. Alternatively, an MNC can avoid much local taxation in high-tax countries and shift profits to affiliates in low-tax countries by artificially inflating the price it pays for intermediate products purchased from overseas affiliates so as to lower its stated local profits. This transfer pricing phenomenon is a common practice of MNCs and one over which host governments can exert little control as long as corporate tax rates differ from one country to another. Some estimates place the lost revenue as a result of transfer pricing in the scores of billions of dollars.[9]

Fifth, MNCs may damage host economies by suppressing domestic entrepreneurship and using their superior knowledge, worldwide contacts, advertising skills, and range of essential support services to drive out local competitors and inhibit the emergence of small-scale local enterprises. Through the privatization of public corporations and the use of debt-for-equity swaps to reduce debt burdens, MNCs have been able to acquire some of the best and potentially most lucrative local businesses. They can thereby crowd out local investors and appropriate the profits for themselves. For example, in a quantitative study of 11 developing countries outside the Pacific Basin, higher foreign direct investment was accompanied by lower domestic investment, lower national saving, larger current account deficits, and lower economic growth rates.[10]

Finally, at the political level, the fear is often expressed that powerful multinational corporations can gain control over local assets and jobs and can then exert considerable influence on political decisions at all levels. In extreme cases, they may even, either directly by payoffs to corrupt public officials at the highest levels or indirectly by contributions to "friendly" political parties, subvert the very political process of host nations (as occurred with International Telephone and Telegraph in the 1970s in Chile).

Box 14.1 attempts to summarize the debate about multinationals in terms of seven key issues and the questions that surround each of them: international capital movements (including income flows and balance of payments effects), displacement of indigenous production, extent of technology transfer, appropriateness of technology transfer, patterns of consumption, social structure and stratification, and income distribution and dualistic development.

Reconciling the Pros and Cons Although the forgoing discussion and Box 14.1 present a range of conflicting arguments, the real debate ultimately

BOX 14.1 Seven Key Disputed Issues about the Role and Impact of Multinational Corporations in Developing Countries

1. International capital movements (income flows and balance of payments)
   - Do they bring in much capital (savings)?
   - Do they improve the balance of payments?
   - Do they remit "excessive" profits?
   - Do they employ transfer pricing and disguise capital outflows?
   - Do they establish few linkages to the local economy?
   - Do they generate significant tax revenues?
2. Displacement of indigenous production
   - Do they buy out existing import-competing industries?
   - Do they use their competitive advantages to drive local competitors out of business?
3. Extent of technology transfer
   - Do they keep all R&D in home countries?
   - Do they retain monopoly power over their technology?
4. Appropriateness of technology transfer
   - Do they use only capital-intensive technologies?
   - Do they adapt technology to local factor endowments or leave it unchanged?
5. Patterns of consumption
   - Do they encourage inappropriate patterns of consumption through elite orientation, advertising, and superior marketing techniques?
   - Do they increase consumption of their products at the expense of other (perhaps more needed) goods?
6. Social structure and stratification
   - Do they develop allied local groups through higher wage payments, hiring (displacing) the best of the local entrepreneurs, and fostering elite loyalty and socialization through pressures for conformity?
   - Do they foster alien values, images, and lifestyles that are incompatible with local customs and beliefs?
7. Income distribution and dualistic development
   - Do they contribute to the widening gap between rich and poor?
   - Do they exacerbate urban bias and widen urban-rural differentials?

Source: Based on Thomas Biersteker, *Distortion or Development: Contending Perspectives on the Multinational Corporation* (Cambridge, Mass.: MIT Press, 1978), ch. 3.

centers on different ideological and value judgments about the nature and meaning of economic development and the sources from which it springs. The advocates of a central role for private foreign investment tend to be free-market proponents who firmly believe in the efficacy and beneficence of the market mechanism, where this is usually defined as a hands-off policy on the part of host governments. As noted, however, the actual operations of MNCs tend to be monopolistic and oligopolistic. Price setting is achieved more as a result of international bargaining and, in some cases, collusion than as a natural outgrowth of free-market supply and demand.

Theorists who argue against the activities of MNCs are often motivated by a sense of the importance of national control over domestic economic activities and the minimization of dominance-dependence relationships between powerful MNCs and developing-country governments. They see these giant corporations not as needed agents of economic change but more as vehicles of antidevelopment. Multinationals, they argue, reinforce dualistic economic structures and exacerbate domestic inequalities with inappropriate products and technologies. Rightly or wrongly, they view MNCs as modern incarnations of colonial devices such as the British East India Company. Many analysts advocate a more stringent regulation of foreign investments, a tougher bargaining stance on the part of host governments, a willingness on the part of developing countries to shop around for better deals, the adoption of performance standards and requirements, increased domestic ownership and control, and a greater coordination of developing-country strategies with respect to terms and conditions of foreign investment. One example of such coordinated strategies was a decision in the 1980s by the Andean Group in Latin America to require foreign investors to reduce their ownership in local enterprises to minority shares over a 15-year period. In an even earlier example, Tanzania adopted a similar policy of securing a controlling share of foreign enterprises. Not surprisingly, the annual flow of private foreign investment declined in both the Andean nations and Tanzania. Many such "indigenization" requirements have since been rolled back in much of the developing world. But China, with its great bargaining power, is the most successful example of the use of this strategy.

The arguments both for and against private foreign investment are still far from being settled empirically and may never be, as they ultimately reflect important differences in value judgments and political perceptions about desirable development strategies. Clearly, any real assessment of MNCs in development requires case studies of a given MNC in a specific country.[11] Perhaps the only valid general conclusion is that private foreign investment can be an important stimulus to economic and social development as long as the interests of MNCs and host-country governments coincide (assuming, of course, that they don't coincide along the lines of dualistic development and widening inequalities). Maybe there can never be a real congruence of interest between the profit-maximizing objectives of MNCs and the development priorities of developing-country governments. However, a strengthening of the relative bargaining powers of host-country governments through their coordinated activities, while probably reducing the overall magnitude and growth of private foreign investment, might make that investment better fit the long-run development needs and priorities of poor nations while still providing profitable opportunities for foreign investors.

Corporate social responsibility Nongovernmental self-regulation by corporations or consortia of corporations (possibly with consumer group representation), to attempt to ensure compliance with acceptable international norms of ethical practice such as avoidance of cruel, coercive, or deceptive labor practices.

The growing acceptance of the **corporate social responsibility** movement has been championed as an opportunity to seek common ground. Rather than primarily supported by corporate managers, citizens of rich countries have pressured corporations based in their countries to perform in a more socially responsible manner in developing countries. For example, there was great attention to conditions in Bangladesh apparel factories following the 2013 factory fire and building collapse disasters that killed over 1,000 workers, and European and North American companies felt pressure to create consortia to monitor that sourcing met international norms. Accordingly, there is a growing interest in certification through independent appraisals that worker rights have been respected, that environmentally sound practices have been used, and that other ethical standards have been met. However, such monitoring is costly, as often are the improved conditions that they help bring about. In this situation, multiple equilibria may be present (see Chapter 4) —consumers may be willing to pay a little more for goods that were sourced in a manner that is not harmful to human and sustainable development, but only if a sufficient number of others are doing the same. A credible watchdog organization has fixed costs and can only be supported with a sufficient markup in prices, so that it may be an equilibrium for no or few consumers to engage in socially responsible sourcing of products. But if the proportion that does so increases with the fraction of others who do, there is a classic complementarity. It may become the case that people expect to see such verifications, for example, to see that wood in a dining room table at a dinner party was sourced responsibly. The basic logic of such mechanisms is readily captured with multiple equilibrium models of the general type examined in Chapter 4.[12]

Perhaps the strongest argument in favor of encouraging MNCs is that they facilitate the transfer of know-how from developed to developing countries. Dani Rodrik surveyed the literature and concluded that so far, there has been little evidence of any horizontal spillovers, that is, transfers of knowledge from MNCs to local producers of the same type of product.[13] However, Garrick Blalock and Paul Gertler reported both statistical and managerial case study evidence for Indonesia that provides indications that MNCs strategically transfer technology to local vendors so that multinationals can procure high-quality inputs at low cost. And Beata Smarzynska Javorcik found evidence of positive productivity spillovers for local suppliers for the case of Lithuania. Thus, there is at least a suggestion that there may indeed be some significant technology spillovers but that the spillovers are vertical rather than horizontal.[14]

Another striking trend is the emergence of state-owned enterprises (SOEs) in FDI. Even as the number of SOEs has fallen, the size of those that remain has grown as governments have pursued “national champion” strategies in targeted industries. This has resulted, in many cases, in expanded market power—and reserves to power foreign investments. A substantial and growing portion of FDI to developing countries is now originating from SOEs based in China, a lower-middle-income country in which SOEs continue to play a central role in the economy. We return to the topic of the role of SOEs in detail in Chapter 15, section 15.6. Moreover, we should note that the role of sovereign wealth funds (SWFs) has similarly grown; some of the important players are originating in upper-middle-income countries.

The next decade should prove to be an interesting time to reassess the quantitative and qualitative impact of MNC investments in developing countries. As a result of the widespread adoption of market reforms, open economies, and privatization of state-owned enterprises, MNCs have been intensifying their global factory strategy, particularly in Asia and Latin America. They will add to national output, create some jobs, pay some taxes, and generally contribute to a more modern economy. But they will also gravitate toward the most profitable investment opportunities, purchase local factories in depressed developing economies at "fire sale" prices, engage in transfer pricing, and repatriate profits. In a very different vein, a majority of developing countries are now making efforts to *promote* targeted FDI so as to complement their broader industrialization strategies, often through investment promotion agencies (IPAs). It is to be hoped that ways can be found in which MNC profits and broad-based national development can be served simultaneously.

Private Portfolio Investment: Benefits and Risks

In addition to foreign direct investment, the most significant component of private capital flows has been in the area of portfolio investment.[15] With the increased liberalization of domestic financial markets in most developing countries and the opening up of these markets to foreign investors, private portfolio investment now accounts for a significant and currently rising share of overall net resource flows to developing countries. Basically, portfolio investment consists of foreign purchases of stocks (equity), bonds, certificates of deposit, and commercial paper. As usual, the middle-income countries have been the favored destination of these flows, with sub-Saharan Africa all but neglected.

As in the case of the FDIs of multinational corporations, the benefits and costs of private portfolio investment flows to both the investor and the developing-country recipient have been subjects of vigorous debate.[16] From the investor's point of view, investing in the stock markets of middle-income countries with relatively more developed financial markets permits them to increase their returns while diversifying their risks.

From the perspective of recipient developing countries, private portfolio flows in local stock and bond markets are a potentially welcome vehicle for raising capital for domestic firms. Well-functioning local stock and bond markets also help domestic investors diversify their assets (an option usually open only to the wealthy) and can act to improve the efficiency of the whole financial sector by serving as a screening and monitoring device for allocating funds to industries and firms with the highest potential returns (this topic—and an analysis of the domestic financial system more generally—is examined in detail in Chapter 15).

But from the macro policy perspective of developing-country governments, a key issue is whether large and volatile private portfolio flows into both local stock and short-term bond markets can be a destabilizing force for both the financial market and the overall economy. Some economists argue that these flows are not inherently unstable.[17] Developing countries that rely too heavily on private foreign portfolio investments to camouflage basic structural weakness in the economy, as in Mexico, Thailand, Malaysia, and

Indonesia in the 1990s, are more than likely to suffer serious long-term consequences. Like MNCs, portfolio investors are not in the development business. If developed-country interest rates rise or perceived profit rates in a developing country decline, foreign speculators will withdraw their "investments" as quickly as they brought them in. What developing countries need most is true long-run economic investment (plants, equipment, physical and social infrastructure, etc.), not speculative capital. A number of developing countries now combine incentives for the former and disincentives for the latter. Controls were strengthened in the years following the 2008 global financial crisis as potentially destabilizing "hot money" poured into several middle-income countries in response to low interest rates in developed countries.

In summary, private portfolio financial flows have risen and fallen dramatically in recent decades. Their volatility and the fact that they respond primarily to global interest-rate differentials, as well as to investor perceptions of political and economic stability, make them a very tenuous foundation on which to base medium- or long-term development strategies.[18] Asia's financial collapse in 1997, Russia's in 1998, Brazil's currency turmoil in 1999, Argentina's crisis in 2001–2002, and the dramatic downturn in flows to developing countries in 2009 underlined the instability or fragility of global capital markets.[19] Rather, developing countries need to focus first on putting fundamental conditions for development into place, because evidence shows that both MNCs and portfolio investors follow growth rather than lead it.[20]

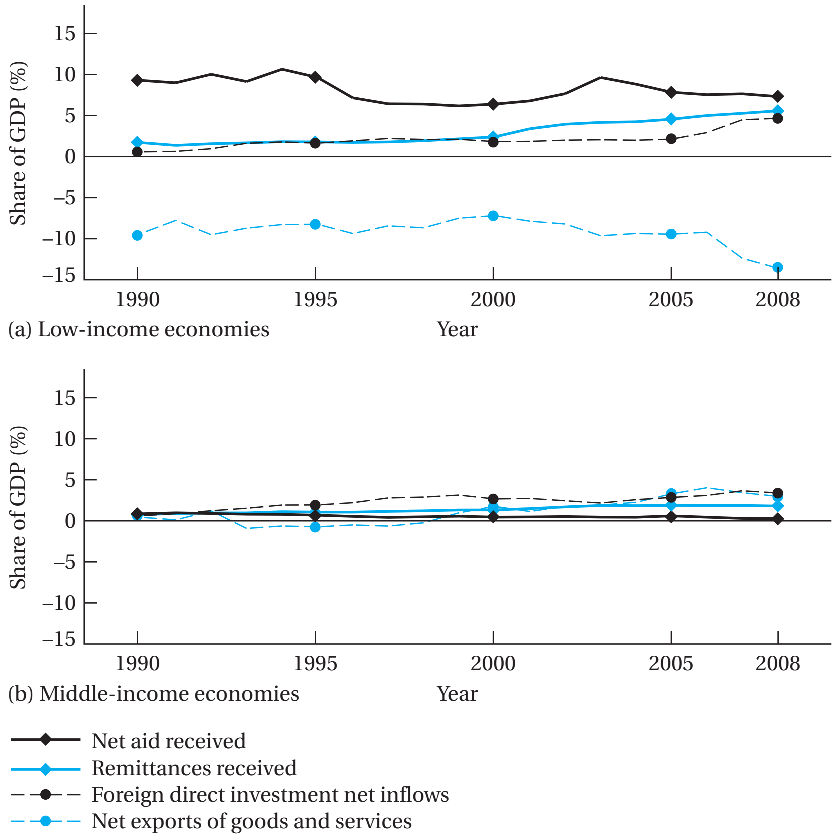
14.3 The Role and Growth of Remittances

Wage levels in the high-income economies are approximately *five times* the level of wages for employment in *similar occupations* in the developing nations on average, after adjusting for purchasing power parity.[21] This provides an obvious incentive for migration, and indeed, hopeful migrants often take great personal risks to make the journey to the United States, Europe, and even developing-country destinations. In part because of these incentives, by 2010, there were an estimated 200 million migrants worldwide. But about half of all migrants leaving a developing nation move to other developing nations.

As noted in Chapters 2 and 8, there are legitimate concerns that out-migration can hamper development prospects because of the loss of skilled workers via this "brain drain." Balancing this concern is the benefit through remittances to relatives in migrants' countries of origin, beyond the gains to the successful (legal or illegal) migrants themselves. When migrants are low skilled and the recipients of remittances are poor, the potential development and poverty reduction advantages become clear. Migrants often build houses for their families and send money that is vital for keeping children in school and better fed. Thus, remittances now provide a significant pathway out of poverty. Indeed, the World Bank reports that based on household surveys, remittances have substantially reduced poverty in such countries as Guatemala, Uganda, Ghana, and Bangladesh.

Figure 14.4 shows various resource flows to developing countries over the period 1990–2008. Remittances have increased dramatically in this century, exceeding 5% of GDP of low-income countries, outpacing FDI and

FIGURE 14.4 Sources of External Financing for Developing Countries, 1990–2008



Source: International Bank for Reconstruction and Development/The World Bank, *World Development Indicators.* Copyright © 2010 The World Bank. Reprinted with permission.

approaching inflows from aid. However, remittance flows are very uneven across developing countries. Table 14.1 lists the top 15 remittance recipient countries, ranked by dollars and by share of GDP, in 2008. India and China had the largest remittances, but Mexico was in third place. And as the table shows, in 15 countries, remittances represented at least 11% of GDP. Note, however, that in the wake of the financial crisis, remittances declined in all regions from 2008 into 2010 except in South Asia, where they remained stable.

The growth of recorded remittances is due in part to improved accounting; some analysts view even the statistics of recent years to be subject to considerable undercounting. But other important factors include the rising number of migrants and advances in financial intermediation that reduce the costs to migrants of remitting funds to their families. Thus, the rapid rise in remittances is a genuine phenomenon. Indeed, forecasts project that remittances could exceed $500 billion in 2016. Further reductions in costs and other impediments to remittances would also lead to further benefits.

TABLE 14.1 Major Remittance-Receiving Developing Countries, by Level and GDP Share, 2008

	Inflow of Migrants' Remittances (millions of U.S. dollars)	Annual Change (%)	Share of Remittances in GDP (%)
Ranked by Volume			
India	45,000	27.8	3.7
China	34,490	5.0	0.8
Mexico	26,212	3.4	2.4
Philippines	18,268	12.1	10.8
Nigeria	9,979	8.2	4.7
Egypt	9,476	23.8	5.8
Bangladesh	8,979	38.8	11.0
Pakistan	7,025	17.1	4.2
Morocco	6,730	0.0	7.6
Indonesia	6,500	5.3	1.3
Lebanon	6,000	4.0	20.7
Vietnam	5,500	0.0	6.1
Ukraine	5,000	11.0	2.8
Colombia	4,523	0.0	1.9
Russian Federation	4,500	9.7	0.3
Ranked by Share of GDP			
Tajikistan	1,750	3.5	34.1
Lesotho	443	0.0	27.4
Moldova	1,550	3.5	25.3
Guyana	278	0.0	24.0
Lebanon	6,000	4.0	20.7
Honduras	2,801	6.7	19.8
Haiti	1,300	6.4	18.0
Nepal	2,254	30.0	17.8
Jordan	3,434	0.0	17.1
Jamaica	2,214	3.3	17.1
El Salvador	3,804	2.5	17.0
Kyrgyzstan	715	0.0	14.2
Nicaragua	771	4.2	11.5
Guatemala	4,440	4.4	11.2
Bangladesh	5,979	36.8	11.0

Source: *UNCTAD Trade and Development Report*, p. 23 (New York: United Nations, 2009), tab. 1.6. Reprinted with permission from the United Nations.

It is important to stress, however, that migration is not always voluntary and may result from human trafficking; even when departure is voluntary, it is often done with imperfect information about working conditions; and exploitation and abuse are not uncommon. Clearly, for migration to bring the maximum social benefit to people in developing countries, improved regulations and protections for what the International Labor Organization terms "irregular status" migrants and the working conditions of migrants will be essential, as will improved willingness of developed countries to accept reasonable increases in migration.

14.4 Foreign Aid: The Development Assistance Debate

Conceptual and Measurement Problems

In addition to export earnings and private foreign direct and portfolio investment, developing countries receive two other major sources of foreign exchange: public (official) bilateral and multilateral development assistance and private (unofficial) assistance provided by nongovernmental organizations (NGOs). Both of these activities are forms of **foreign aid**, although only public aid is usually measured in official statistics.

Foreign aid The international transfer of public funds in the form of loans or grants either directly from one government to another (bilateral assistance) or indirectly through the vehicle of a multilateral assistance agency such as the World Bank.

In principle, all governmental resource transfers from one country to another should be included in the definition of *foreign aid*. Even this simple definition, however, raises a number of problems.[22] For one thing, many resource transfers can take disguised forms, such as the granting of preferential tariffs by developed countries to exports of manufactured goods, particularly from the least developed countries. This permits developing countries to earn more foreign exchange from selling their industrial products in developed-country markets at higher prices than would otherwise be possible. There is consequently a net gain for developing countries and a net loss for developed countries, which amounts to a real resource transfer to the developing world. Such implicit capital transfers, or disguised flows, should be counted in qualifying foreign-aid flows. Normally, however, they are not.

However, we should not include *all* transfers of capital to developing countries, particularly the capital flows of private foreign investors. Private flows represent normal commercial transactions, prompted by commercial considerations of profits and rates of return, and therefore should not be viewed as foreign aid. Commercial flows of private capital are *not* a form of foreign assistance, even though they may benefit the developing country in which they take place.

Economists have defined *foreign aid*, therefore, as any flow of capital to a developing country that meets two criteria: (1) Its objective should be noncommercial from the point of view of the donor, and (2) it should be characterized by **concessional terms**; that is, the interest rate and repayment period for borrowed capital should be softer (less stringent) than commercial terms.[23] Even this definition can be inappropriate, for it can include military aid, which is both noncommercial and concessional. Normally, however, military aid is excluded from international economic measurements of foreign-aid flows. The concept of foreign aid that is now widely used and accepted, therefore, is one that encompasses all official grants and concessional loans, in currency or in kind, that are broadly aimed at transferring resources from developed to less developed nations on development, poverty, or income distribution grounds. Unfortunately, there often is a thin line separating purely developmental grants and loans from sources ultimately motivated by security or commercial interests.

Concessional terms Terms for the extension of credit that are more favorable to the borrower than those available through standard financial markets.

Just as there are conceptual problems associated with the definition of *foreign aid*, there are measurement and conceptual problems in the calculation of actual development assistance flows. In particular, three major problems arise in measuring aid. First, we cannot simply add up the dollar values of grants and loans; each has a different significance to both donor and recipient countries. Loans must be repaid and therefore cost the donor and benefit the recipient less than the nominal value of the loan itself. Conceptually, we should deflate or discount the dollar value of interest-bearing loans before adding them to the value of outright grants. Second, aid can be tied either by *source* (loans or grants have to be spent on the purchase of donor-country goods and services) or by *project* (funds can only be used for a specific project, such as a road or a steel mill). In either case, the real value of the aid is reduced because the specified source is likely to be an expensive supplier or the project is not of the highest priority (otherwise, there would be no need to tie the aid). Furthermore, aid may be tied to the importation of capital-intensive equipment, which may impose an additional real resource cost, in the form of higher unemployment, on the recipient nation. Or the project itself may require the purchase of new machinery and equipment from monopolistic suppliers while existing productive equipment in the same industry is being operated at very low levels of capacity. Finally, we always need to distinguish between the nominal and real value of foreign assistance. Aid flows are usually calculated at nominal levels and tend to show a steady rise over time. However, when deflated for rising prices, the actual real volume of aid from most donor countries has declined substantially in recent decades despite a recent uptick.

Amounts and Allocations: Public Aid

Official development assistance (ODA) Net disbursements of loans or grants made on concessional terms by official agencies, historically by high-income member countries of the Organization for Economic Cooperation and Development (OECD).

The money volume of **official development assistance (ODA)**, which includes bilateral grants, concessional loans, and technical assistance, as well as multilateral flows, grew from an annual rate of under \$5 billion in 1960 to \$50 billion in 2000 and to over \$128 billion in 2008. However, the percentage of developed-country gross national income (GNI) allocated to official development assistance declined from 0.51% in 1960 to 0.23% in 2002 before improving to 0.33% by 2005 and to 0.45% in 2008 as part of a campaign to increase assistance in the wake of the continued lag in human development in sub-Saharan Africa—a major initiative at the G8 meetings in Britain in 2005.[24] Although the full promise of these meetings was far from met, some significant progress was made. It remains to be seen how the long recession and fiscal crises in many high-income countries will affect these ratios in the coming years. Table 14.2 shows the disbursement of ODA by some of the principal donors, both in total amount and as a percentage of GNI in 1985, 2002, and 2008. Although the United States remains the largest donor in absolute terms, relative to others it provides the lowest percentage of GNI—0.18% in 2008, compared to an average of 0.45% for all industrial donor countries and well below the internationally agreed UN target of 0.70%. Only five countries are currently providing ODA in excess of this target: Sweden, Norway, Denmark, the Netherlands, and Luxembourg. Sweden led with a full 1% of GNI contributed. Not only is the U.S. ODA-to-GNI ratio the lowest among industrial countries, but it also declined sharply from its level of 0.31% in 1970 to reach a nadir of about 0.11%, before rebounding to about 0.18%. It should be noted, however, that U.S. citizens provide an additional \$17.1 billion in direct NGO grants, which accounts for 72% of the global total. This raises the fraction to

TABLE 14.2 Official Development Assistance Net Disbursements from Major Donor Countries, 1985, 2002, and 2008

	1985		2002		2008	
Donor Country	Billions of U.S. Dollars	Percentage of GNI	Billions of U.S. Dollars	Percentage of GNI	Billions of U.S. Dollars	Percentage of GNI
Canada	1.6	0.49	2.0	0.28	4.8	0.33
Denmark	—	—	1.6	0.96	2.8	0.87
France	4.0	0.78	5.5	0.38	10.9	0.40
Germany	2.9	0.47	5.3	0.27	14.0	0.40
Italy	1.1	0.26	2.3	0.20	4.9	0.23
Japan	3.8	0.29	9.3	0.23	9.6	0.20
Netherlands	1.1	0.91	3.3	0.81	7.0	0.86
Sweden	—	—	2.0	0.83	4.7	1.00
United Kingdom	1.5	0.33	4.9	0.31	11.5	0.40
United States	9.4	0.24	13.3	0.13	8.0	0.18
Total (22 countries)	29.4	0.35	58.3	0.23	121.5	0.45

Source of data: World Bank, *World Debt Tables, 1991–1992* (Washington, D.C.: World Bank, 1992), vol. 1, tab. 2.1; World Bank, *World Development Indicators*, *2004* and *2010* (Washington, D.C.: World Bank, 2004, 2010), tabs. 6.9 and 6.10.

about 0.3% of national income, still below countries such as Britain, Canada, France, and Germany. Moreover, for added perspective, although in 2012 developed countries spent about $120 billion on aid, they also spent triple this amount, some $360 billion, on agricultural subsidies that often harmed developing-country exports; rich countries also committed about $1.4 trillion to military defense expenditures.

ODA is allocated in some strange and arbitrary ways.[25] South Asia, where nearly 50% of the world's poorest people live, receives $8 per person in aid. The Middle East and North Africa, with well over triple South Asia's per capita income, receives *nine times* the per capita aid! Table 14.3 shows the regional distribution of ODA in 2008.

The patterns of aid become even clearer when examined at the individual-country level. In 2008, by far the largest recipient was Iraq, with $9.9 billion

TABLE 14.3 Official Development Assistance (ODA) by Region, 2008

Region	ODA per Capita (U.S. $)	GNI per Capita (U.S. $)	ODA as a Share of GNI (%)
Middle East and North Africa	73	3,237	1.9
Sub-Saharan Africa	49	1,077	4.3
Latin America and the Caribbean	16	6,768	0.2
East Asia and the Pacific	5	2,644	0.2
South Asia	8	963	0.8
Europe and Central Asia	19	7,350	0.2

Source of data: World Bank, *World Development Indicators, 2010* (Washington, D.C.: World Bank, 2010), tabs. 1.1 and 6.16.

in aid, or approximately $321 per capita. The second-largest recipient was Afghanistan, at $4.9 billion, or $168 per capita. Some 20 countries received at least $1 billion in aid. But India, with by far the largest number of extremely poor people in the world, received just $2 per person in aid. And while Jordan, a middle-income country, received $126 per person, Niger, considered the poorest country in the world, received just $41 per person. Aid per capita to the least developed countries in Africa has increased significantly, however, since 2005. But these per capita receipts are still less than such middle-income countries as Serbia, Bosnia, and Herzegovina, Albania, Macedonia, Lebanon, and Georgia, each of which received more than $100 per capita.[26]

It is clear that the allocation of foreign aid is only partly determined by the relative needs of developing countries. Much bilateral aid seems to be based largely on political and military considerations. Multilateral aid (e.g., from the World Bank and various UN agencies) is somewhat more economically rational, although here, too, the rich often seem to attract more resources per capita than the poor.

Because foreign aid is seen differently by donor and recipient countries, we must analyze the giving and receiving process from these two often contradictory viewpoints.

Why Donors Give Aid

First and foremost, donor-country governments give aid because it is in their political, strategic, or economic self-interest to do so. Some development assistance may be motivated by moral and humanitarian desires to assist the less fortunate (e.g., emergency food relief and medical programs), and certainly this has been the international rhetoric in the increases in aid in the first decade of the twenty-first century, which may reflect the fact that ordinary citizens are often more charitable than their leaders. Still, it is doubtful that over longer periods of time, donor nations assist others without expecting some corresponding benefits (political, economic, military, counterterrorism, antinarcotics, etc.) in return. We focus here on the foreign-aid motivations of donor nations in two broad but often interrelated categories: political and economic.

Political Motivations Political motivations have been by far the more important for aid-granting nations, especially for the largest donor country, the United States. The United States has viewed foreign aid from its beginnings in the late 1940s under the Marshall Plan, which aimed at reconstructing the war-torn economies of western Europe, as a means of containing the international spread of Communism. When the balance of Cold War interests shifted from Europe to the developing world in the mid-1950s, the policy of containment embodied in the U.S. aid program dictated a shift in emphasis toward political, economic, and military support for "friendly," less developed nations, especially those considered geographically strategic. Most aid programs to developing countries were, therefore, oriented more toward purchasing their security and propping up their sometimes shaky regimes than promoting long-term social and economic development. The successive shifts in emphasis from South Asia to Southeast Asia to Latin America to the

Middle East and back to Southeast Asia during the 1950s and 1960s and then toward Africa and the Persian Gulf in the late 1970s, the Caribbean and Central America in the 1980s, and the Russian Federation, Bosnia, Ukraine, and the Middle East in the 1990s, with a renewed focus on the Islamic nations after 2001, reflected changes in U.S. strategic, political, security, and economic interests more than changing evaluations of poverty problems and economic need. Recent increases in aid to African countries with public health crises, including HIV assistance, may be due in part to concerns that the disease may spread internationally or lead to a destabilizing state collapse and possible havens for terrorists. Another motivation to reduce poverty abroad may be to prevent or reduce the flow of refugees and other migrants.

Even the Alliance for Progress, inaugurated in the early 1960s with great fanfare and noble rhetoric about promoting Latin American economic development, was formulated primarily as a direct response to the rise of Fidel Castro in Cuba and the perceived threat of Communist takeovers in other Latin American countries. As soon as the security issue lost its urgency and other more pressing problems came to the fore (the war in Vietnam, the rise in U.S. violence, etc.), the Alliance for Progress stagnated and began to fizzle out. Our point is simply that where aid is seen primarily as a means of furthering donor-country interests, the flow of funds tends to vary with the donor's political assessment of changing international situations and not the relative need of potential recipients.

The behavior of other major donor countries, such as Japan, Great Britain, and France, has been similar to that of the United States. Although exceptions can be cited (Sweden, Denmark, the Netherlands, Norway, and perhaps Canada), by and large these Western donor countries have used foreign aid as a political lever to prop up or underpin friendly political regimes in developing countries—regimes whose continued existence they perceived as being in their own national security interests. It still remains to be seen how much the renewed rhetorical focus on extreme poverty in the period following the 2005 G8 summit in Britain portends a historic change in the prioritization of aid, but there is no doubt that political and business considerations will remain very important.

Economic Motivations: Two-Gap Models and Other Criteria Within the broad context of political and strategic priorities, foreign-aid programs of the developed nations have had a strong economic rationale. This is especially true for Japan, which directs most of its aid to neighboring Asian countries, where it has substantial private investments and expanding trade. Even though political motivation may have been of paramount importance for other donors, the economic rationale was at least given lip service as the overriding motivation for assistance.

Let us examine the principal economic arguments advanced in support of foreign aid.

Foreign-Exchange Constraints External finance (both loans and grants) can play a critical role in supplementing domestic resources in order to relieve savings or foreign-exchange bottlenecks. This is the so-called two-gap analysis of foreign assistance.[27] The basic argument of the **two-gap model** is that most

Two-gap model A model of foreign aid comparing savings and foreign-exchange gaps to determine which is the binding constraint on economic growth.

Savings gap The excess of domestic investment opportunities over domestic savings, causing investments to be limited by the available foreign exchange.

Foreign-exchange gap The shortfall that results when the planned trade deficit exceeds the value of capital inflows, causing output growth to be limited by the available foreign exchange for capital goods imports.

developing countries face either a shortage of domestic savings to match investment opportunities or a shortage of foreign exchange to finance needed imports of capital and intermediate goods. Basic two-gap and similar models assume that the **savings gap** (domestic real resources) and the **foreign-exchange gap** are unequal in magnitude and that they are essentially independent. The implication is that one of the two gaps will be "binding" for any developing economy at a given point in time. If, for example, the savings gap is dominant, this would indicate that growth is constrained by domestic investment. Foreign savings may be used as a supplement to domestic savings. (However, decision makers in a country with a shortage of savings may be unable or unwilling to divert purchasing power from consumption goods to capital goods, either bought domestically or from abroad. As a result, "excess" foreign exchange, including foreign aid, might be spent on the importation of luxury consumption goods.) An outstanding example of savings-gap nations would be the Arab oil exporters during the 1970s.

When the foreign-exchange gap is binding, a developing economy has excess productive resources (mostly labor), and all available foreign exchange is being used for imports. The existence of complementary domestic resources would permit them to undertake new investment projects if they had the external finance to import new capital goods and associated technical assistance. Foreign aid can therefore play a critical role in overcoming the foreign-exchange constraint and in raising the real rate of economic growth.

Algebraically, the simple two-gap model can be formulated as follows:

1. *The savings constraint or gap.* Starting with the identity that capital inflows (the difference between imports and exports) add to investible resources (domestic savings), the savings-investment restriction can be written as

$$I \leq F + sY \tag{14.1}$$

where F is the amount of capital inflows. If capital inflows, F, plus domestic saving, sY, exceeds domestic investment, I, and the economy is at full capacity, a savings gap is said to exist.

2. *The foreign-exchange constraint or gap.* If investment in a developing country has a marginal import share, m_1 (typically ranging from 30% to 60%), and the marginal propensity to import out of a unit of noninvestment GNI (usually around 10% to 15%) is given by the parameter m_2, the foreign-exchange constraint or gap can be written as

$$(m_1 - m_2)I + m_2Y - E \leq F \tag{14.2}$$

where E is the exogenous level of exports.

The term F enters both inequality constraints and becomes the critical factor in the analysis. If F, E, and Y are initially assigned an exogenous current value, only one of the two inequalities will prove binding; that is, investment (and therefore the output growth rate) will be constrained to a lower level by one of the inequalities. Countries can therefore be classified according to whether the savings or foreign-exchange constraint is binding. More important from the viewpoint of foreign-aid analysis is the observation that the impact of increased capital inflows will be greater where the foreign-exchange gap (Equation 14.2) rather than the savings gap (Equation 14.1) is binding. Two-gap models have been used to provide rough estimates of the relative impact of foreign aid on investment and growth in developing nations.

The problem is that such gap forecasts are very mechanistic and are themselves constrained by the necessity of fixing import parameters and assigning exogenous values to exports and net capital inflows. In the case of exports, this is particularly constricting because a liberalization of trade relations between the developed and the developing world would contribute more toward relieving foreign-exchange gaps than foreign aid. Although E and F are substitutable in Equation 14.2, they can have quite different indirect effects, especially in the case where F represents interest-bearing loans that need to be repaid. Thus, the alteration of import and export parameters through government policy in both developed and developing countries can have a deep impact on whether the savings or foreign-exchange constraint is restricting the further growth of national output. A third, **fiscal gap** may also be important, because domestic savings availability for investment and foreign exchange availability for capital goods imports may have little impact on private-sector investment and growth without complementary public investments in roads and other forms of infrastructure, or in human capital. But such government investments may raise the rate of return from private investment sufficiently to make them viable.

Fiscal gap Deficiencies of government investments including infrastructure and human capital that are complementary to—raise the rate of return from—private investment.

Three, gap models have been used to account for this in understanding why growth has commonly failed to pick up during structural adjustment.[28]

Growth and Savings External assistance is also assumed to facilitate and accelerate the process of development by generating additional domestic savings as a result of the higher growth rates that it is presumed to induce. Eventually, it is hoped, the need for concessional aid will disappear as local resources become sufficient to make development self-sustaining. In reality, much aid is not invested, and if it is, the productivity of that investment is often very low.[29] However, among the main reasons for this are the very "strings" attached to foreign aid.

Technical Assistance Financial assistance needs to be supplemented by **technical assistance** in the form of high-level worker transfers to ensure that aid funds are used most efficiently to generate economic growth. This skill-gap-filling process is thus analogous to the financial-gap-filling process mentioned earlier. Sustainable development impact requires a focus on training in recipient countries.

Technical assistance Foreign aid (either bilateral or multilateral) that takes the form of the transfer of expert personnel, technicians, scientists, educators, and economic advisers, and particularly their use in training local personnel, rather than a simple transfer of funds.

Absorptive Capacity Finally, the amount of aid is considered in relation to the recipient country's **absorptive capacity**, its ability to use aid funds wisely and productively (often meaning as donors want them to be used). Typically, the donor countries decide which developing countries are to receive aid, how much, in what form (loans or grants, financial or technical assistance), for what purpose, and under what conditions on the basis of the donor countries' assessment of domestic absorptive capacities (particularly for the least developed countries). But many types of assistance, such as resources for building

Absorptive capacity The ability of a country to absorb foreign private or public financial assistance (to use the funds in a productive manner).

infrastructure or for training (e.g., of government officials or health or education workers) itself increases absorptive capacity. It has been said that what one donor sees as a constraint on the ability of a country to use conventional aid, another sees as an opportunity to have more leveraged impact with new forms of assistance.[30] In any case, in practice, the total amount of aid rarely has much to do with developing-country absorptive capacities because, typically, foreign aid is a residual and low-priority element in donor-country expenditures. In most instances, the recipient countries have little say in the matter.

Economic Motivations and Self-Interest The arguments on behalf of foreign aid as a crucial ingredient for successful development should not mask the fact that even at the strictly economic level, definite benefits accrue to donor countries as a result of their aid programs. The strong tendency toward providing interest-bearing loans instead of outright grants and toward tying aid to the exports of donor countries has saddled many countries, often among the least developed, with substantial debt repayment burdens. It has also increased their import costs because aid tied to donor-country exports limits the receiving nation's freedom to shop around for low-cost and suitable capital and intermediate goods. **Tied aid** in this sense is clearly a second-best option to untied aid (and perhaps also to freer trade through a reduction of developed-country import barriers). For example, a large fraction of U.S. aid has been spent on American consultants and other U.S. businesses.[31]

Tied aid Foreign aid in the form of bilateral loans or grants that require the recipient country to use the funds to purchase goods or services from the donor country.

Why Recipient Countries Accept Aid

The reasons why developing nations have usually been eager to accept aid, even in its most stringent and restrictive forms, have been given much less attention than the reasons why donors provide aid. The major reason is probably economic. Developing countries have often tended to accept the proposition—typically advanced by developed-country economists and supported by reference to success stories such as Taiwan and South Korea to the exclusion of many more failures—that aid is a crucial and essential ingredient in the development process. It supplements scarce domestic resources, it helps transform the economy structurally, and it contributes to economic growth. Thus, the economic rationale for aid is based in part on their acceptance of the donor's perceptions of what the poor countries require to promote economic development.

Conflicts generally arise, therefore, not out of any disagreement about the role of aid, but over its amount and conditions. Naturally, any developing country would like to have more aid in the form of outright grants or long-term, low-cost loans, with a minimum of strings attached. This means not tying aid to donor exports and granting greater latitude to recipient countries to decide for themselves what is in their best long-run development interests. Unfortunately, a good deal of aid that comes in this form has either been wasted in showcase but unproductive projects (e.g., an elaborate parliamentary building, an oversize airport) or actually has been plundered by corrupt government officials and their local cronies. Much of the criticism of the historical patterns of foreign aid—that it wastes resources, that it bolsters corrupt regimes, that it is appropriated by the rich at the expense of the poor—is justified. Some recipients in the past have accepted aid simply because it was there, and they were not held accountable. A few leaders simply wish to leave no stone unturned in their quest for poverty alleviation, as perhaps describes Mozambique in the 1990s. They have been in the minority. The impact of the spread of democracy, press freedom, and the rule of law, including anticorruption drives, on the effectiveness of aid remains an open question.

Second, in some countries, aid is seen by both donor and recipient as providing greater political leverage to the existing leadership to suppress opposition and maintain itself in power. In such instances, assistance takes the form not only of financial-resource transfers but also of military and internal security reinforcement. This phenomenon was clearly at work in Central America in the 1980s. The problem is that once aid is accepted, the ability of recipient governments to extricate themselves from implied political or economic obligations to donors and prevent donor governments from interfering in their internal affairs can be greatly diminished.

Finally, whether on grounds of basic humanitarian responsibilities of the rich toward the welfare of the poor or because of a belief that the rich nations owe the poor nations reparations for past exploitation, many proponents of foreign aid in both developed and developing countries believe that rich nations have an obligation to support economic and social development, particularly in the least developed countries. They often link this moral obligation with the need for greater freedom of choice for recipient developing countries in the allocation and use of aid funds.

In sum, while there is no doubt that the least developed countries will need more assistance to escape from the vicious circle of poverty, fresh approaches are needed to ensure effectiveness.

The Role of Nongovernmental Organizations in Aid

One of the fastest-growing and most significant forces in the field of development assistance is that provided through private **nongovernmental organizations (NGOs)**. As we noted in Chapter 11, NGOs are voluntary organizations that work with, and on behalf of, mostly local grassroots organizations in developing countries. They also represent specific local and international interest groups with concerns as diverse as providing emergency relief, protecting child health, promoting women's rights, alleviating poverty, protecting the environment, increasing food production, and providing rural credit to small farmers and local businesses. NGOs build roads, houses, hospitals, and schools. They work in family-planning clinics and refugee camps. They teach in schools and universities and conduct research on increasing farm yields.[32]

Nongovernmental organizations (NGOs) Nonprofit organizations that are often involved in providing financial and technical assistance to developing countries.

NGOs include religious groups, private foundations and charities, research organizations, and federations of dedicated doctors, nurses, engineers, agricultural scientists, and economists. Many work directly on grassroots rural development projects; others focus on relief efforts for starving or displaced peoples. Some familiar NGOs include Save the Children, CARE, Oxfam, Planned Parenthood, Doctors Without Borders, World Vision, the World Wildlife Fund, Habitat for Humanity, Africare, Heifer, Christian Aid, Project HOPE, and Amnesty International. Funding through developed-country NGOs for aid activities in developing countries grew from just under $1 billion in 1970 to over $23 billion in 2008.[33] Many NGOs give local control to their developing-country affiliates or other local groups they support. Increasingly, indigenous NGOs such as BRAC in Bangledesh are becoming active in international assistance (see the case study for Chapter 11).

NGOs have two important advantages. First, being less constrained by political imperatives, most NGOs are able to work much more effectively at the local level with the people they are trying to assist than massive bilateral and multilateral aid programs can. Second, by working directly with local people's organizations, many NGOs are better able to avoid the suspicion and cynicism on the part of the mostly poor people whom they serve that their help is insincere or likely to be short-lived. It is estimated that NGOs in developing countries are affecting the lives of some 250 million people; the fact that their voices are increasingly being listened to in the halls of developed-country governments and at international conferences on development makes it clear that the nature and focus of foreign aid are changing rapidly. NGOs have several other important comparative advantages in relation to government and the private sector but also some serious limitations, sometimes called *voluntary failure* (with reference to these private voluntary organizations), as described in detail in Chapter 11. One critical question is whether international NGOs can sustainably transfer their knowledge and capabilities to domestic NGOs and other community-based organizations.[34]

The Effects of Aid

The issue of the economic effects of aid, especially public aid, like that of the effects of private foreign investment, is fraught with disagreement.[35] On one side are the economic traditionalists, who argue that aid has indeed promoted growth and structural transformation in many developing countries.[36] On the other side are critics who argue that aid does not promote faster growth but may, in fact, retard it by substituting for, rather than supplementing, domestic savings and investment and by exacerbating balance of payments deficits as a result of rising debt repayment obligations (when aid takes the form of loans, even if at reduced interest rates) and the linking of aid to donor-country exports.

Official aid is further criticized for focusing on, and stimulating the growth of, the modern sector, thereby increasing the gap in living standards between the rich and the poor in developing countries. Some critics on the left would even assert that foreign aid has been a force for antidevelopment in the sense that it both retards growth through reduced savings and worsens income inequalities.[37] Rather than relieving economic bottlenecks and filling gaps, aid—and, for that matter, private foreign investment—not only widens existing savings and foreign-exchange resource gaps but also may even create new ones (e.g., urban-rural or modern-sector–traditional-sector gaps). Critics on the right charge that foreign aid has been a failure because it has been largely appropriated by corrupt bureaucrats, has stifled initiative, and has generally engendered a welfare mentality on the part of recipient nations.[38]

But one of the most promising developments of the new century has been the emphasis on rigorous testing of the impact of development assistance. In 2005, national and multilateral officials who were concerned with international development met in Paris and agreed to place greater emphasis on monitoring and systematically measuring aid effectiveness.[39] Accompanying this policy emphasis is a growing acceptance of the value of evaluating programs with greater rigor. One major trend is to encourage evaluation through randomized trials.[40] Clearly, not all valuable development activities can be studied with these methods; methods must follow from relevant development economics questions and cannot be the primary driver of the questions that are asked.[41] And it is often hard to generalize beyond the local experiment to other locations where conditions differ—known as the *external validity problem*. But when feasible and appropriate, randomized trials are a powerful method. In recent years, randomization has been adapted to study a growing range of education, health, microfinance, and social welfare programs.[42]

Finally, many critics have noted that FDI volumes are now more than 15 times that of foreign aid flows. This is an important trend. On the other hand, aid remains larger than FDI in many of the countries that are in most need of assistance, including fragile states. Indeed, FDI flows toward countries that are less in need of aid; and capital flight is a chronic problem in fragile and conflict-ridden countries. Moreover, even if FDI flow to a country is much higher than its aid flow, this clearly does not mean that the economic development or poverty impact of investment is also proportionately higher than that of aid.[43]

After years of aid weariness, polls have shown that the public is increasingly willing to support increases in government aid budgets and to donate development assistance via NGOs, and the development crisis in many of the least developed countries, especially in sub-Saharan Africa, has mobilized public opinion in support of greater development assistance. Poll numbers also suggest that the upturn in public support for aid was at least temporarily weakened in the aftermath of the recent global financial crisis.

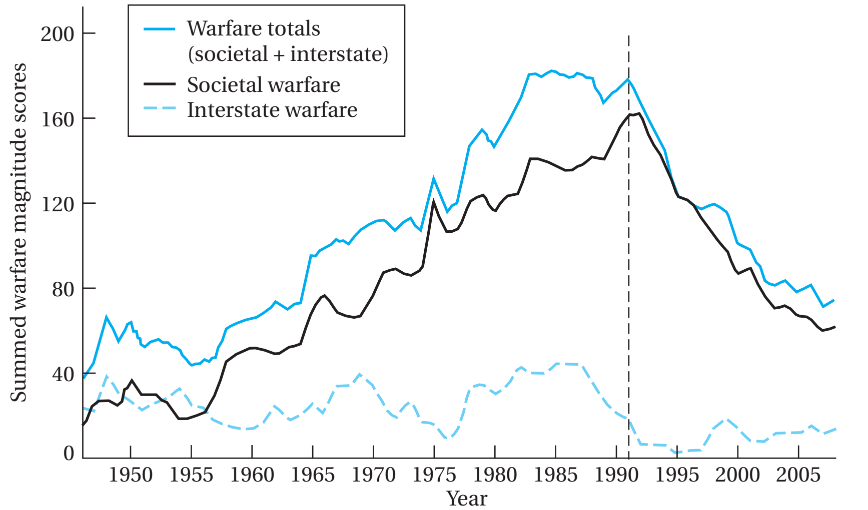
The attention to improved assistance to reduce extreme poverty, particularly in its increased focus on the 49 least developed countries at the UN 2010 Millennium Development Goals summit, the improvements in accountability and evaluation of aid that have taken more shape since the Paris Declaration, and some enhancement of resources are hopeful signs that aid will become more effective and more targeted toward people living in poverty. And foreign aid has played a crucial role in assistance with conflict resolution, postconflict recovery, and making the transition to resumed development. We take up the problem of violent conflict in developing countries in the next section.

14.5 Conflict and Development

The Scope of Violent Conflict and Conflict Risks

Physical security is the foundation for human capability; assurance of security may be the most fundamental of all institutions for development. Violent conflict has held back progress in many of the poorest countries. In addition to the horrors of the conflicts and their aftermaths themselves, economic harm can also be caused by expectations of likely future conflicts and doubts about how they could be resolved or how high growth could be resumed in this environment. This uncertainty could, for example, discourage investment and entrepreneurship and accelerate a brain drain. Thus, work on the consequences, causes, and potential curative and preventive remedies for violent conflict

FIGURE 14.5 Global Trends in Armed Conflict, 1946–2008



Source: Monty G. Marshall and Benjamin R. Cole, *Global Report 2009: Conflict, Governance, and State Fragility*, Center for Global Policy and Center for Systemic Peace, Systemicpeace.org, December 7, 2009. Reprinted with permission from the Center for Systemic Peace.

and improvement of conditions that may lead to such conflict has become an important part of the field of economic development.

The number and intensity of violent conflicts grew for nearly half a century following the end of World War II but reached a peak by the early 1990s. Since then, such conflicts have decreased substantially, as seen in Figure 14.5, which summarizes violent conflict incidence over time, adjusted for magnitude. But the intensity and consequences of societal warfare, particularly ethnic war, remains at unacceptably high levels, comparable to the 1960s.

There has been an encouraging drop in armed conflict in Africa in recent years. But the trend for societal conflicts to occur more commonly in the least developed countries has resulted in longer and more difficult periods of postconflict reconstruction and state fragility. Recovery efforts are more often focused on overcoming situations of destroyed infrastructure and housing, environmental decay, collapse of health and education, lack of services to assist traumatized victims, and general loss of social capital.[44] Thus, the costs of renewed conflict are very high, making prevention even more important than ever.

The Consequences of Armed Conflict

Violent conflict harms health in ways both obvious and unexpected. People not involved in violence can be affected almost immediately as parents lose their livelihood or become refugees and children are forced to work. Recovery from the consequences can take many years. Conflict can cause children to miss out on schooling in their most formative years, harming their well-being over a lifetime. And it can take years to mend a torn social fabric that might help cushion the fall.

Health The immediate effect of war is the most visible. At first, more men die than women, primarily as a result of the fighting itself. Over time, more women die, as they suffer the lingering consequences much more. Maternal mortality can be shockingly high—an estimated 3% in conflict areas such as the Democratic Republic of Congo (DRC).[45] Scholars have found that the long-term effects of conflict fall most heavily on women, diminishing their access to health, social welfare services, and education.[46]

Rape has become a weapon of terror. Many victims die in rape attacks, and many more suffer long-term health consequences, including AIDS and chronic depression. As Nina Birkeland summarizes, "in conflicts with an ethnic dimension, systematic rape has commonly been used to destabilize populations and destroy community and family bonds."[47] Refugee children and women are at particular risk for rape and sexual exploitation.

In addition, Thomas Plumper and Eric Neumayer report, "in makeshift refugee tent camps…infectious diseases such as diarrhea, measles, acute respiratory diseases, and malaria, but also sexually transmitted diseases including HIV/AIDS, spread more easily, often turning into epidemics."[48] Weakened refugees die at a much higher rate from diseases they would not have caught under normal circumstances and might have survived under conditions of more rest, better nourishment, and less stress. Problems cross national borders; for example, it has been estimated that an additional 1,000 international refugees leads to an extra 1,400 cases of malaria in a host country.[49]

Mozambique suffered greatly from the 1975–1991 civil war after the Portuguese colonialists finally left. In 1990, the under-5 mortality rate was an abysmal 249 per 1,000—but already much lower than some of the figures reported in the 1980s during major conflict. In 2008, this number had fallen to 130 per 1,000, lower than in 17 other countries—a very long way yet to go, but real progress.[50] International assistance was critical in reducing child mortality; such assistance is most effective when improvement in health is also a national priority, which it apparently was in Mozambique where a prime minister in office from 1994 to 2004 was a medical doctor who had previously served as the minister of health.[51]

When war ended in Sierra Leone in 1999, the maternal mortality rate was reportedly 1,800 per 100,000 births—one of the worst in the world. The under-5 mortality rate was 286 per 1,000 live births, which fell to a still very high 194 by 2008.[52]

Just when public health programs are most needed, funds are shifted to the military, and according to an IMF estimate, government spending on health falls at an annual rate of 8.6% during violent conflicts.[53] Family incomes are generally lower, so people are also challenged to pay for needed care.

Long-term negative consequences of conflict for child nutrition have been found in studies of Burundi and Zimbabwe. Long-term health consequences depend on the nature of the conflict. There is evidence that future deaths and health consequences are predicted less by battlefield deaths than by the scope of genocide (where victims of violence are identified by communal characteristics, usually ethnicity or religion) or political killings (where victims are people in ideological opposition to the dominant group or government) that occurred.[54]

Destruction of Wealth Violent conflict destroys capital, and some of what is not destroyed is diverted to destructive activities. Additional wealth is often shipped abroad. One study found that on average, a tenth of a country's wealth is transferred abroad between the beginning and the end of a conflict, largely as capital flight, as better-off residents seek to protect their wealth.[55]

An IMF study found that "the total economic cost of the conflict in Sri Lanka between 1983 and 1996 amounted to about $4.2 billion, twice the country's 1996 GDP."[56] Per capita income in Nicaragua was $4,276 when civil war began—already very low. But by its end, per capita income had fallen to just $1,913. This represented "an annual decline in per capita income of about 6.5 percent—compared to the average growth rate of 2.5 percent after the civil war, the relative loss in wealth was almost 10 percent per year."[57]

In some countries, fighting is very localized. But one study found an average annual growth of −3.3% in countries in conflict as a whole (for countries with enough data to estimate it).[58] Moreover, "by the end of the typical civil war incomes are around 15 percent lower than they would otherwise have been, implying that about 30 percent more people are living in absolute poverty."[59] Not surprisingly, conflict causes increases in unemployment.[60] No wonder civil war has been called "development in reverse."[61]

Worsening Hunger and Poverty It is not surprising that in many conflict countries, food production drops; one survey found this had happened in 13 out of 18 conflict countries studied. The International Food Policy Research Institute found that in conflict and postconflict countries, more than 20% of the population usually lacks access to adequate food (and, in some cases, the percentage is far higher). Far more people were food insecure than the numbers that had been considered in need of humanitarian assistance. In sub-Saharan Africa, food losses in the 1980s and 1990s due to conflict were equivalent to more than half of all aid received in that period. Hunger is also a weapon of war. Fighters have cut off food supplies and attempted to starve opposing populations into submission; they also steal food aid.[62]

Poverty increases through declines in opportunities to earn incomes but also through direct outcomes of fighting. Killing or driving off farm animals is a weapon of war; other animals may starve. Many affected by conflict in Mozambique and Uganda lost all or nearly all of their cattle. Other farm resources may be despoiled. When people, many of them very poor, are forced to flee their villages, their land is typically occupied, often by the forces that drove them out. In most cases, a majority never recover their houses and property. In the aftermath of conflict, affected areas may be slow to recover for reasons ranging from lack of working capital to poisoned resources and the dangers of land mines.[63] The rights of displaced widows and children, in particular, are often given no regard by the authorities. Institutions to resolve property disputes may be dysfunctional or never are established.[64] These are some of the factors extending the consequences of conflict well after the end of fighting.

Loss of Education In eight countries in conflict for which data were available, the IMF found that during the conflict, education spending fell at a rate of −4.3% per person per year. Moreover, sometimes children cannot risk the walk to school because of the danger of violence. And both government soldiers and rebels have destroyed schools that symbolize the hopes of a village. Instead of getting an education, many children work long hours to survive. And under conditions of lawlessness and impunity, trafficking and kidnapping into sex slavery, child soldiering, and other abhorrent conditions have been documented. A study of children abducted into child soldiering in Uganda found that they lose nearly a year of schooling, on average. Combined with a greater incidence of injuries, later loss of income is substantial. But after a conflict ends, enrollment and attendance at school increases, often dramatically.[65]

A Torn Social Fabric Violent conflict or its imminent threat creates refugees— one estimate is an additional 64 refugees per 1,000 people on average from a civil war, 45 per 1,000 from coups, and 30 per 1,000 from guerrilla warfare.[66] According to the United Nations, by the end of 2008, there were about 26 million internally displaced persons (IDPs) due to "conflict, generalized violence or human rights violations." More than half were from five countries—Sudan, Colombia, Iraq, the DRC, and Somalia. There may be more refugees in total than ever before, and another 20 million or more have had to flee their countries. In fact, the impact of civil wars is often felt over a period of many years and hundreds of miles away, well beyond border countries.[67] But the number of IDPs has fallen dramatically in some countries that were once nearly synonymous with violent conflict, such as Timor-Leste and Uganda, where refugees are returning home. Less than half of the world's IDPs are now from Africa, and the region is making progress.[68]

In Colombia and many other countries, civil war has provided an opportunity for drug gangs to carve out territory with impunity and often to form unholy alliances with either rebel or government forces. This leads to further unraveling of the social fabric, from collapse of rule of law to ruined lives of addicts.

As concluded in the 2010 Millennium Development Goals Report, "armed conflict remains a major threat to human security and to hard-won MDG gains. Large populations of refugees remain in camps with limited opportunities to improve their lives."[69]

The Causes of Armed Conflict and Risk Factors for Conflict

Both econometric analysis and case study evidence suggest that conflict is more common in countries with lower incomes, slow growth, medium to large populations, significant oil production, poor institutions, a large percentage of excluded ethnic minorities, ethnic divisions more generally, severe stress on basic resources, and opportunities to profit from high-value commodities for export.[70] As you will see, the good news is that most places that are *diverse* (ethnically or in other ways) do not have violent conflict, and places with high inequalities across *individuals* usually do not have violent conflict. So it is not just economic and not just cultural: The problem seems to be worse when there are high inequalities across groups that people identify with.

Horizontal Inequalities Frances Stewart proposes that the presence of major "horizontal inequalities" (HIs) or inequalities among culturally defined groups significantly raises the risk of conflict.[71] She argues that "when cultural differences coincide with economic and political differences between groups, this can cause deep resentment that may lead to violent struggles."[72] In her framework, it is "a combination of cultural differences and political and economic inequalities running along cultural lines that, in part at least, explain contemporary violent conflict." She notes that group inequalities have been a significant factor in conflict among other regions and countries in Côte d'Ivoire, Rwanda, Chiapas, and Sudan. Stewart proposes that an analysis of Côte d'Ivoire (see the case study at the end of Chapter 5) "suggests that it is where there are both socio-economic and political HIs *in the same direction* that conflict is most likely. Conversely, where one group has political power and another is economically privileged (as in Malaysia and for much of the time Nigeria), or governments are broadly inclusive, conflict seems to be less likely." She concludes: "These findings have important implications for development policy. They suggest that policies to correct economic, social and political HIs should be prioritized in multi-ethnic societies—as part of general development policies—especially in post-conflict environments."[73]

Natural Resources for Basic Needs Basic-needs resource scarcity—especially shortages of food, fertile land, and water—may contribute to conflict or ongoing risks of conflict; for example, the UN concluded that the crisis in Darfur had water and other natural resource scarcity at its root.[74] Clashes among pastoralist groups in northern Kenya are often attributed to drought and to water scarcity more generally. Colin Kahl argues that scarcity can increase the risk of violent conflict and cites quantitative studies that suggest that population size and density are significant conflict risk factors; countries that are highly dependent on natural resources, as well as those experiencing high rates of deforestation and soil degradation or low per capita availability of arable land and fresh water, have higher risks of conflict.[75] But low rainfall may matter primarily because it leads to lower growth, particularly in agricultural economies.[76] Climate change may exacerbate existing problems.[77] A 2009 study found that historically in Africa, a 1°C rise in temperature leads to a 4.5% increase in civil war in the same year; the authors concluded that projections of future temperature trends imply a 54% increase in armed conflict incidence by 2030, with "an additional 393,000 battle deaths."[78] Though only rarely, if ever, does (worsening) resource scarcity *directly* cause violent conflict, it is likely an important *compounding* factor in many cases.[79]

Struggle to Control Exportable Natural Resources The presence of high-value exportable resources such as diamonds, oil, and hardwood, without accepted or enforceable rules for how their benefits will be distributed, also appears to be an underlying factor in violent conflict. Paul Collier argues that what he terms the conflict trap "shows how certain economic conditions make a country prone to civil war, and how, once conflict has started, the cycle of violence becomes a trap from which it is difficult to escape." He finds that countries are prone to civil war when faced with low income, slow growth, and dependence on primary commodity exports.[80]

Resources that are not usually thought of as exportable may be becoming more so. As water grows scarcer—with current problems of receding shorelines of inland bodies of water, aquifer depletion, salination, and projected future problems due to climate change—the price of water is rising, and in response, exports of water are beginning.[81] Eventually, if rights of indigenous groups to use the water they need are not secured, groups who can control water may find its export value temptingly high.

The Resolution and Prevention of Armed Conflict

Importance of Institutions To appreciate the challenges of resolution and prevention, recall from Chapter 2 the critical importance of institutional quality and the deep difficulties of improving them.[82] Legal rules and informal norms define and reinforce the ways that interests of different groups, even when strongly opposing, can be resolved, at least to the point where development can proceed. Good institutions provide a foundation of basic security and rights, to successfully prevent or at least strongly mitigate risks of armed conflict that is likely to retard and set back progress. A good institution in this context facilitates conflict resolution, avoiding violence and doing so in a way that allows capabilities to grow. Without improvements in underlying institutions, purely political agreements come with the danger of relapse or can fail to create conditions for balanced economic development. With the perception that whatever one side gains the opposing side loses, no benefits of cooperation will be apparent to adversaries, and there is little or no framework for sharing benefits of growth. Unless democratic institutions are well designed, there is a risk that politics—even "fair" majority-rule elections—will establish a dominant winner and, in effect, disenfranchise losers.[83]

Moreover, military expenditures are possibly a cause of conflict, not merely an effect of conflict. The share of low- and middle-income country military expenditures in world spending has been rising—for example, from 14% in 1990 to 24% in 2009. The Stockholm International Peace Research Institute concluded that "the distribution of global spending in 2012 shows what may be the beginnings of a shift from the West to other parts of the world, in particular Eastern Europe and the developing world."[84]

Two important institutions (introduced in Chapter 2) are checks and balances on executive authority and contract enforcement. Without checks on authority, those in opposition who have much to gain (and much to lose) may see little alternative to violence. But in such situations, why don't the rulers "buy off" the opposition? In many instances, they do so; but when they do not, an underlying problem is the inability to credibly enforce a contract of settlement between rulers and opposition: Once the rulers (or the state, more generally) becomes sufficiently strong, it has an incentive to renege on the agreement—with possibly dire consequences for the opponents. Aware of this risk, again the only resort of the opposition may be violence, unless the rulers are somehow able to commit to carrying out the agreement; difficulties of finding a way to do so credibly is an example of what is known as the **commitment problem**; a credible solution is known as a "commitment device." These perspectives point up the importance of specialized institutions for conflict resolution and make it a priority of international assistance to help establish agreed

Commitment problem An inability to make a "credible promise" to honor a contractual agreement due to the presence of incentives to renege; sometimes a "commitment device," such as posting a large bond, can be implemented that automatically invokes high penalties on the reneging party, thereby creating a "credible threat," allowing agreement to be reached and honored.

rules for resolving conflicts—and the subsequent enforcement of agreements—before conflict turns violent. Until such institutions take root, this helps explain how international enforcement of agreements has been effective.[85]

Global Actors In postconflict development, engagement by global, regional, national, and community-level actors is critical. National security—again, a foundational institution—cannot be taken for granted when violence crosses borders and remnant violent and criminal forces are still active in cross-border enclaves, as the Lords Resistance Army was until recently in Uganda. Multinational organized crime has plagued other countries. The UN may potentially play a more active coordinating role. Other international organizations and agencies provide funds and capacity building.

New international rules and agreements are helping to reduce the problem of incentives for conflict by creating controls on exports and imports of high-value resources.[86] Moreover, business, government, and civil society are partnering to foster international voluntary arrangements to reduce financial incentives for war or to ensure that resources do not fund conflict. For example, some 50 members of the WTO agreed to trade only diamonds certified as free of conflict by the voluntary Kimberley Process. In addition, some 32 countries have agreed to voluntarily implement the Extractive Industries Transparency Initiative (EITI), under which firms publish what they pay governments for resource extraction, the government publishes what it earns, and a multistakeholder group and outside auditors reconcile these figures to ensure that the money from resources goes to the public that owns them.[87]

Regional Actors: An Africa-wide Approach Postconflict reconstruction is also a problem for multination regional cooperation. The African Union has played an increasing role in addressing violent conflict and its aftermath, particularly through peacekeeping operations. Once a peace agreement is signed and a functioning transition or permanent government is in place, support for postconflict economic development becomes central. Here the African Development Bank (AfDB) plays an active role; its Fragile States Unit positions fragile states it works with along a continuum spanning two stages. In stage 1, governments have to show a commitment to consolidate peace and security and have unmet social and economic needs. In stage 2, governments must demonstrate that they are improving macroeconomic conditions and pursuing sound debt policy, have sound financial management policy, and exhibit transparency of public accounts. The AfDB has targeted nine postconflict countries for programs: Burundi, Central African Republic, Côte d'Ivoire, Comoros, DRC, Guinea Bissau, Liberia, Sierra Leone, and Togo.[88] However, the ultimate effectiveness of the AfDB's promising work remains to be fully demonstrated.

National Actors The state must be strong enough to reliably protect its citizens from violence and to carry out other important roles that only government can play. State *fragility* is a big part of the problem. But there must also be effective checks and balances. A harsh regime that suppresses violence and rebellion but keeps resources and power in the hands of a small elite is likely to produce only a temporary solution to preventing violence; there is little reason to anticipate that such a state will promote other aspects of development. Even if state monopoly on violence suppresses overt conflict, the result may reinforce inequalities. Multilateral outside assistance may be needed to establish basic peace and security; then it is crucial to ensure broad opportunities and to make the gains from cooperation more apparent. This process will help make efforts to establish democratic institutions more likely to succeed.[89] Despite the great difficulties, there has been clear progress as the number of functioning democracies, even among very poor countries, has increased steadily, and people of many nations are adapting well to the often arbitrary boundaries across ethnic lines established by the colonial powers.

Corruption is often part of the struggle for resources, particularly exportable natural resources. Addressing corruption may help prevent conflict before it breaks out. And corruption is generally viewed as particularly destabilizing in postconflict situations. One problem is that "post-conflict environments present officials with low-risk opportunities for corrupt activity. This is further magnified because post-conflict countries often attract or justify relatively high levels of aid."[90]

Frances Stewart notes that "both political and socioeconomic inequalities are of major relevance to political outcomes: Strong political HIs mean that leaders of groups feel politically excluded and are thus more likely to lead opposition and possibly rebellion; while socioeconomic inequalities mean that the people as a whole have strong grievances on ethnic lines and are thus likely to be more readily mobilized."[91] Since the evidence suggests that it is "a combination of cultural differences and political and economic inequalities running along cultural lines that, in part at least, explain contemporary violent conflict,"[92] it becomes important to find the means for inclusive economic development, and political participation—for example, federalism or proportional representation.

Trust among former warring parties or parties at risk must be rebuilt. Conflict can be understood as a problem of multiple equilibria with failure to coordinate, which may depend on social norms about conflict and cooperation.[93] Bad equilibria may result from a set of expectations that conflict cannot or will not be peacefully resolved. If only a few citizens are lawless, they are much easier to control than in an environment of general lawlessness. We can use Figure 4.1 in Chapter 4 to illuminate the problem. If most actors expect high conflict, their best response may be to prepare for conflict or even strike preemptively. But if no conflict is expected, it may make much more sense to follow nonviolent strategies for livelihoods and investments. In this situation, an important focus must be on changing expectations toward low likelihoods of future conflict and that violators will be severely punished. Again, building institutions that solve commitment problems between opponents can help.

Focus on Education UNESCO's Education for All (EFA) points up the mutually reinforcing relationship between low education and violent conflict. The fact that conflict harms education—by destroying infrastructure, injuring or killing students and teachers, and so on—is obvious. EFA notes that education also affects conflict, as conflict may originate in an ideology that may be widely disseminated through education. The EFA framework thus calls for "conflict-sensitive" education and policy initiatives, termed "reconstruction education." Broadly applicable lessons are stressed; for example, learning how to deal with educating displaced families in conflict areas is not region-specific, and lessons learned, say, from the Swat Valley of Pakistan may help in the DRC, even though the conflicts themselves are very different. EFA argues that education can contribute to peace, stability, and nation building.[94]

Local, "Community-Driven" Economic Development Economic participation at the local level is very important, and some research has found that community-driven development (CDD) can play an important role. Patrick Barron notes that "effective CDD projects can distribute resources quickly and to remote, rural areas. In devolving decision-making they can help ensure [that] resource distribution is fair and popularly accepted." He also argues that such programs can provide incentives for "collective action that can work across conflict divides." Finally, "CDD tries to prevent the erosion of the social and institutional bases necessary for the management of development in nonviolent ways."[95]

For example, evaluations of the KALAHI Comprehensive and Integrated Delivery of Social Services project in the Philippines found positive economic impacts; it operates "in some conflict-affected and post-conflict areas, but also in others where violence is not a significant problem."[96]

James Manor also examined local CDD programs in postconflict environments and concluded: "Almost all of the successful programs that we studied entailed consultative mechanisms to draw local preferences, knowledge, and energies into the policy process and to provide external resources to local communities. These mechanisms worked especially well when they were coupled with efforts at democratic decentralization."[97]

The study of community development and other strategies for conflict prevention and postconflict recovery is still at an early stage, but new results are now being reported regularly. An assessment by Ghazala Mansuri and Vijayendra Rao also concluded that CDD is more effective when implemented in a "context-specific manner, with a long time-horizon, and with careful and well designed monitoring and evaluation systems." Some programs have been "captured" by elites for their own purposes, so close monitoring is essential. It is difficult to reach general conclusions because of self-selection: Projects that are internally initiated by participants and funded later could have greater impacts; but people organize when their conditions lead them to anticipate a higher chance of success. Yet a program instigated by researchers may be perceived as propped up by temporary outside engagement, leading elites to stall or resist change; even so, a recent experimental study in Sierra Leone found CDD led to more market activity and to improvements in local public goods such as functioning primary schools and community grain-drying floors, though not in women's decision-making influence or the raising of local revenue for community purposes. This is an important and growing field in economic development.[98]

The emphasis on fragile and conflict states in development assistance has never been stronger. Addressing state fragility is expected to be a centerpiece of the new Sustainable Development Goals.