Box D Foreign aid makes good macroeconomic sense

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On 25 November 2020, the UK government took the decision[3] to reduce the budget for foreign aid from 0.7 to 0.5 per cent of gross national income (GNI) in 2021. On 13 July 2021, Parliament voted in favour of maintaining these cuts, following the Chancellor's Statement[4]. This reduces the amount of aid available in 2021 by approximately £4.5 billion compared to what otherwise would have been the case. The announcement does not meet commitments in the main party election manifestos. Nor does it meet targets set in the 2015 International Development Act (although this Act allows for deviations in a single calendar year under certain fiscal circumstances). A UN resolution adopted in 1970 established the Official Development Assistance target of 0.7 per cent of donor countries' GNI. Fifty years later, the UK was one of just six countries that had achieved this target, alongside Germany, Denmark, Luxembourg, Norway and Sweden.

A £4.5 billion cut represents a small saving to the UK in the short term (0.4 per cent of planned total managed public expenditure of £1,053 billion in 2021). The bulk of this will fall on UK bilateral aid. Figure 1 illustrates UK bilateral aid flows in 2019 relative to the size of GDP in the recipient countries. These flows constitute a crucial source of finance in countries with limited access to international capital markets, and where extreme poverty rates tend to exceed 30 per cent. For example, a 30 per cent "cut" in UK aid to fragile countries such as South Sudan or Somalia would leave a hole in the countries' financial resources in excess of 1 per cent of GDP. Estimates by Miller and Roger (2021) suggest that UK bilateral aid to Ethiopia will be halved in 2021, an amount worth a quarter of a percentage point of Ethiopian GDP. Devex is tracking reports by aid agencies and other sources on the impact of UK aid cuts[5], which have reported significant budget cuts in many other poor countries, including Bangladesh, Central African Republic, Myanmar, Nigeria, South Sudan, Somalia and Yemen. This will pose a substantial cost in these aid recipient countries.

Mitchell, Hughes and Ritchie (2021) estimate that, based on the Government's reported estimates of aid results over the period of 2015-2020, a cut in UK foreign aid of this magnitude could prevent 5.3 million children a year from being immunised against basic diseases, at a cost of 100,000 lives each year, and 4.5 million children a year may lose out on a decent education. The United Nations Development Programme has issued a Statement on UK funding cuts[6], stating that preventing the UK cuts to their organisation alone could have helped 1.2 million people to have better access to basic services; 350,000 people in crisis-affected countries to get a job; 280,000 people to gain access to justice; and 23 million hectares of land and marine habitats to be protected, improved or restored.

The aid cut fails to take into account macroeconomic spillover effects. Holland and te Velde (2012) simulated the effects of aid on both donor and recipient countries using the NiGEM model. They modelled the empirical effects of aid on growth and productivity by applying historical social rates of return from infrastructure spending (Briceño-Garmendia, Estache, and Shafik, 2004) and econometric estimations of the effects of Aid for Trade on reducing trade costs (Cali and te Velde, 2011). The scenarios suggested that an increase in aid that raises growth and productivity in recipient countries – for example, when directed towards infrastructure investment and reducing trade costs – has positive spillover effects on the rest of the world, by reducing consumer prices and expanding the volume of trade, including in those countries providing aid. In short, aid at this kind of level tends to pay for itself. A survey of the literature on aid studies supports the positive relationship between development aid and economic growth (Arndt, Jones and Tarp, 2016), although weak institutions and poor governance in recipient countries may limit the potential returns from development assistance (Bräutigam and Knack, 2004).

The UK benefits directly from external aid through the creation of UK-based jobs, through higher levels of exports and through cheaper imports from aid recipient countries. Mendez-Parra and te Velde (2017) estimate that UK bilateral aid provided 12,000 jobs in 2014 through aid-trade linkages (without tying aid). Cutting aid directly reduces the number of UK-based jobs. The UK also derives indirect benefits from its external aid through the provision of global public goods such as addressing climate change, conflict resolution, or supporting the timely vaccination of the global population.

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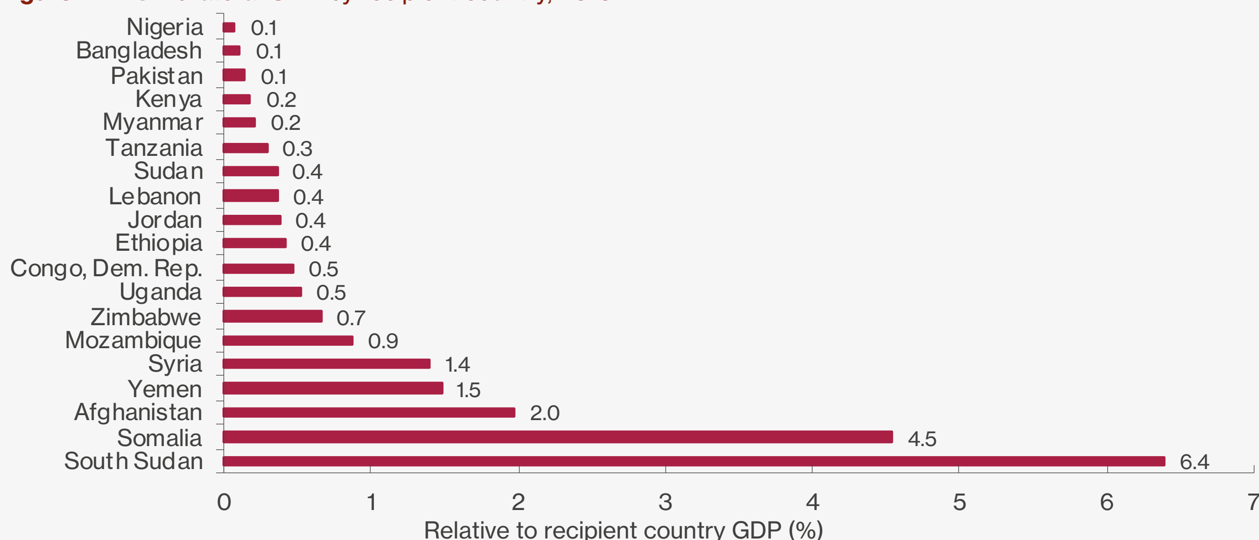
2 Overseas Development Institute. The authors are grateful to Jagjit Chadha and Barry Naisbitt for helpful comments and suggestions.
3 https://www.gov.uk/government/publications/spending-review-2020-documents/spending-review-2020
4 https://questions-statements.parliament.uk/written-statements/detail/2021-07-12/hcws172
5 https://www.devex.com/news/tracking-the-uk-s-controversial-aid-cuts-99883
6 https://www.undp.org/for_the_record/Statement_on_UK_funding_cuts

Interest rates are currently at historic lows in the UK, and despite rising levels of aggregate debt, UK debt interest payments as a per cent of total government spending are also historically low. By contrast, countries such as Lebanon, Somalia, Syria, Yemen and Zimbabwe are effectively shut out of capital markets, or face a borrowing premium in excess of 10 per cent. At the same time, investment needs in the poorest countries are high. With support from sound institutions and leadership, this investment can yield high domestic and global returns when targeted well, for example towards trade facilitation, physical and social infrastructure, and human capital accumulation.

Finally, the fiscal tests established by the Government [7] to determine when it will revert to the aid commitments set in the 2015 International Development Act deviate markedly from the standard principles governing HM Treasury's fiscal policy. The tests fall short of recommendations for a new fiscal framework discussed in Chadha, Küçük and Pabst (2021). The tests make spending on a specific category conditional on both attaining a current budget surplus and a decline in the aggregate stock of debt. The UK's fiscal policy has traditionally avoided hypothecation and direct earmarking. The specific tests have been met only 5 times since 1990, and according to current forecasts may only be met by 2025-6 at best. This would imply a reduction of UK aid by £25 billion compared to maintaining an aid budget of 0.7 per cent of GNI. The tests also ignore the fact that aid flows should often be viewed as investment rather than current spending. The returns from this investment, as described above, have the potential to reduce the debt stock. In other words, cutting expenditure on aid may, in fact, delay the stabilisation of public finances in the UK.

In conclusion, the recently announced cuts in UK aid provide negligible direct savings for the UK, place immediate burdens on poor countries, eliminate UK-based jobs and other positive spillover effects from external aid, and set a poor precedent for macroeconomic policy. These decisions to cut aid should be reconsidered and take into account the available macroeconomic evidence.

Figure 1 UK bilateral ODA by recipient country, 2019



Source: Derived from Foreign, Commonwealth & Development Office, Statistics on International Development, September 2020; IMF World Economic Outlook Database, April 2021; United Nations National Accounts Main Aggregates Database, December 2020.

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7 https://questions-statements.parliament.uk/written-statements/detail/2021-07-12/hcws172

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