

Foreign Aid and the Poverty Trap: Increasing Aid Effectiveness by Limiting

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Abstract: This paper explores the practical effectiveness of foreign aid in eradicating poverty in recipient countries. In recent years, poverty traps have become a more common problem in poor countries. The population of many developing countries is in multidimensional poverty, not only facing poor living conditions, but from a macro perspective, countries are difficult to get out of the cycle of poverty due to lack of capital, technology and reasonable institutions. Foreign aid, on the other hand, mainly provides support and help to poor countries in response to these problems, which are also the main aspects of its effectiveness analyzed in this paper. Based on the existing empirical results and theoretical analysis of foreign aid, this paper holds that the effectiveness of foreign aid will change due to the different objective conditions of recipient countries. In general, while it is obvious that foreign aid can promote economic development and infrastructure construction in poor countries, the effectiveness of foreign aid is weakened to some extent due to corruption and unreasonable distribution system in some recipient countries. Therefore, foreign aid should be targeted limited according to the existing problems of recipient countries to improve its effectiveness.

Keywords: Economics and Development, Development Policy, Foreign aid, Poverty trap

1. Introduction

Generally speaking, foreign aid is aid from rich first world countries to poor third world countries. On the one hand, it aid helps eradicate poverty of third world countries, also rich countries took moral responsibility. On the other hand, it creates a burden on the donor country to some extent, such as increased taxes, and has a corruption impact on the recipient country, also reinforces the cycle of poverty [1]. Thus, debate about the actual effectiveness of global foreign aid in eradicating poverty often arise perennial.

The main purpose of this essay is to analyze the actual effects of foreign aid in different recipient countries, combining several specific aid methods and national characteristics to determine whether it is necessary to restrict global aid.

The concept of foreign aid and its effect on poverty traps are explained in detail in the first paragraph of the article. The second and third paragraphs describe the positive and negative effects of foreign aid on poor countries through specific cases, analyze the reasons and propose solutions.

Ultimately, it turns out that limiting foreign aid is not a universal approach, although it would bring more effective ways for some recipients to break the poverty trap, there are still developing countries that need assistance and can achieve positive practical results.

2. Poverty Trap and Foreign Aid

According to the statistics, there are 1.2 billion multidimensional poor people living in 111 countries around the world today [2]. The poverty faced by such a large group of people, representing nearly 20% of the global population, is severe and complex. While they face poor living standards, their lives are also affected by a lack of education and health problems. Compared with the dreadful living situation of the poor people, the predicament they are in, the poverty trap, is a more serious obstacle to their eradication of poverty. The poverty trap means that poor people are unable to escape the cycle of poverty because they lack resources and effective means. In more detail, it means not only limited resources that are difficult to support economic development, but also self-reinforcing mechanisms that hinder the adoption of technology, and even more [3]. Therefore, faced with the problems that cause such difficulties, it is difficult for developing countries to reduce poverty only through their own efforts. In such a situation, targeted foreign assistance can be a major enhancement for recipient countries. As emphasized by the [4], foreign aid is so important that it can be considered one of the most powerful weapons in the fight against poverty.

Global aid began in the period of colonialism, and after many years of development, it has gradually become universal with the process of globalization and the improvement of the level of economic development in the world. Over the course of this history, targeted global aid has helped many countries with relatively low levels of economic development escape poverty [5]. First of all, global aid has significantly promoted the international transfer of capital, technology and other production factors, rationalized the allocation of resources, and made up for the objective conditions of some developing countries in the process of economic development. In an environment of international division of labor, it is very common for poor developing countries to face the problem of shortage of their own production factors and disadvantage in international competition. Thus, targeted global aid can go some way to improving the situation of poor countries. For example, in 2007, China provided a loan of 622 million yuan to the Ghanaian government to help it complete the construction of the Bui Dam and its supporting power station, which will significantly solve the energy shortage problem in the process of Ghana's economic construction [6]. Secondly, project assistance and other aid methods provide more employment opportunities for the recipient countries, and the entry of new projects also objectively increases the financial revenue of the recipient countries. Since 2015, USAID and other donors, in cooperation with the Afghan government, have built a number of schools, provided more than 154,000 job opportunities for teachers, and carried out targeted job training for local residents, thus alleviating the structural unemployment problem in the local area to a large extent [7]. Not only does this increase the number of local jobs, but more trained teachers also mean an improvement in educational standards. As one of the infrastructures needed for the development of poor countries and their eventual escape from poverty, the development of education is very beneficial to poor countries. In addition, other studies have shown that aid at the infrastructure level can reduce the transaction costs of recipient countries, help them attract investment, improve the local business environment, and establish the foundation for local economic development [8].

But at the same time, although some interventions in global aid have promoted poverty reduction in recipient countries, they have also brought some negative effects on those countries. These negative effects generally include corruption and unfair distribution systems. Consider India's unequal distribution system, where data show that the top 10 percent of income earners received 66 percent of the growth from 1980 to 2016, The bottom 50% of earners saw only an 11% increase [9]. In those

36 years, although India's economy has made remarkable progress, the unequal distribution system has also exacerbated the gap between the rich and the poor, thus severely hindering the progress of breaking the poverty cycle. Thus, in some real situations, global aid may even lead to the continuation of the poverty cycle in recipient countries and hinder the sustainability of economic development [10].

3. Foreign Aid and Effectiveness

Poverty traps are situations where households cannot escape poverty due to a combination of low asset levels and unfavorable economic conditions. They are defined by asset space thresholds and ranges where increasing returns may prevail. A household experiencing a temporary income shock below poverty line without degrading its asset base may recover to pre-shock well-being. However, losing productive assets may lead to a poverty trap. Governments can't tell the difference between two distinct patterns of poverty that has a completely different meaning since the situation is dynamic [11]. For instance, a continuous cross-sectional result for a poverty rate of 33% may reflect a society in which the same one-third of the population is persistently poor over and over again. In such a society, there will be poverty experienced by only a few, but intense and indefinite for them. Alternatively, poverty is a purely temporary phenomenon through the repeated observation of same group of people. They often swap places based on random outcomes based on age or other demographic data. Over time, all households will be poor a third of the time, so the burden of poverty will be shared equally.

Since poverty is a multidimensional phenomenon including conventional, privately held productive and financial wealth, as well as social, geographic, and market access positions that confer economic advantage. It seeks to identify the critical asset thresholds that households need to achieve in order to escape poverty by focusing on assets. This approach provides a more comprehensive and forward-looking analysis of poverty that can help policymakers design more effective poverty reduction strategies. It can help distinguish between deep-rooted, persistent structural poverty and poverty that is more transitory in nature, which can inform the design of appropriate policy interventions. The most productive form of poverty is transitional poverty, which can be alleviated through macroeconomic regulation. Entrenched poverty is challenging to address. The different types of intervention are included that can be divided into short-impact aid, long-impact aid, and aid for humanitarian purposes. Short-impact aid is an aid disbursement funding an intervention that can plausibly raise GDP per capita within roughly four years to a permanently higher level and it's the main focus. Long-impact aid funds an intervention that might permanently raise GDP per capita but is unlikely to do so within roughly four years of the disbursement. Aid for humanitarian purposes has a negative association with growth. The study particular attention to the subcategory of aid that is likely to have a significant impact on growth over a four-year period, accounting for about 45% of all aid by our classification. The study figures out a strong, positive, causal relationship between so-called "short-term" aid and economic growth over a four-year period. The effect is large, with conservative estimates estimating associations two to three times larger than those found in studies all foreign aid. However, aid for education expansion may only be visible in aggregate indicators after a significant proportion of the population has completed their education. This means that there may be a long lag between receiving aid and determining aggregate effects. Short-term aid may have some immediate impact, but long-term effects are likely to be more significant. Therefore, short-term assistance is the best option for these countries, where most of the transitional poverty is predominant.

The specific effect of the foreign aid on those countries with large proportion of transitional poverty can be considered into three sides, and each of this side have the positive effects. The economic, health, and education sectors are interconnected, with infant mortality rates, life expectancy, and education levels influencing these aspects. Transitional funding from the government drives people to spend 90% of their income, while the remaining 10% is deposited in an account. This

leads to a significant increase in GDP and new expenditures, resulting in a significant increase in GDP. Investment from abroad also creates new jobs for the structurally unemployed or seasonal unemployed, maximizing resources and ensuring long-term impact on education and health.

A more effective method for evaluating the causal influence of foreign aid on economic growth has been established by the writers. This approach entails an expanded collection of regional fixed effects, along with indicators for initial human capital and geographic conditions [12]. Additionally, a selective range of covariates and a reliable regression estimator that accounts for variations amongst countries are included in this strategy. This is believed to be the most persuasive one in today studies.

To effectively control for variations in economic development across regions or countries, one could utilize regional fixed effects and initial human capital and geographic condition indicators. Additionally, in cases where data quality or measurement error differs amongst countries, a robust regression estimator could be used to take these factors into consideration. These methods would prove advantageous in measuring the impact of foreign aid on economic growth, especially in instances where limited data availability, weak institutions, or political instability pose challenges to measurement.

There is a correlation between the inflow of aid and the decline in the share of agriculture in GDP, indicating that aid stimulates faster development of the non-agricultural sector and that aid has a positive impact on tax revenues because it increases spending in the social sector, particularly education. The main industries in those developing nations are farming or straightforward assembly. They can only make textiles and plastics, which are the most basic products. They depend on mass production and a large workforce, which results in their extremely low income. However, as more people acquire education and find better-paying jobs, they can gradually move to a higher income level with help from others. In this way, the key social outcome impacts demonstrate the benefits of this strategy, such as aid's highly positive causal impact on the average number of years spent in school.

Main worry of study is that, in the short term with aid, all of the indicators of income investment per capita budget life infant mortality and average years of schooling have a floating increase. In other words, it accelerates industrial development, reduces poverty over the long term, but has no effect on inequality. Further research has revealed that the effects on government income, investment spending, and social outcomes are very significant, and these indicators are sensitive. He has influenced economic growth in a variety of ways by promoting it through aid, such as the accumulation of material capital and the improvement of human capital, especially in the areas of education and health.

4. Negative Effects and Restrictions

Although foreign aid to the poor has a tangible positive effect on breaking the poverty trap, it is not effective enough to be used as a long-term solution to poverty. In their empirical study, Mahembe and Odhiambo [13] studied the causal relationship between foreign aid, poverty and economic growth in developing countries through dynamic panel data estimation technology and VECM Granger causality test. The study points out that in terms of long-term causality, the long-term relationship between poverty and foreign aid is superficial when the poverty rate is taken as the dependent variable. This means that it is difficult for foreign aid to be used as an effective measure to eliminate poverty in the long run, especially for recipient countries that have had certain economic development achievements. It is undeniable that, generally speaking, foreign aid does promote the economic development of the recipient countries. In response to this fact, in the discussion of economic development policy, it is assumed that greater economic development results will gradually benefit the general population and thus eventually break the cycle of poverty [14]. But economic growth cannot completely replace poverty eradication as the most important goal of foreign aid. It is not desirable to wait for the achievement of economic development to "trickle down" to the poor, which

is even the reason for intractable poverty in some developing countries. Because poverty reduction requires both economic growth and a process of distribution, the process of actively redistributing resources to the poor [9]. This process greatly depends on the allocation of resources and the system of recipient countries, which makes the process of poverty reduction need to consider more influencing factors. For example, if there is a problem with the way resources are allocated in the recipient country, or if the state system is corrupt, it may be questionable whether foreign aid is actually distributed to the poor. In summary, these aspects suggest that foreign aid needs to be looked at more carefully, with the underlying goal of breaking the poverty trap, as well as whether it needs to be more clearly planned by limiting it.

Poverty eradication is a common goal of donors and recipients, but the process is influenced by both sides. When donors provide funds as foreign aid, blind foreign aid can undermine its effectiveness by ignoring the specific needs of recipient countries. At the same time, if foreign aid is sufficient, whether it can actually achieve the goal of promoting poverty reduction has a lot to do with the recipient countries themselves. Like the poverty trap that many recipient countries are facing, while low-income and vulnerable poor countries are prone to a cycle of stable growth and misdirected aid, high middle-income countries are facing rising domestic inequality [15]. On the one hand, for low-income poor countries, the problems they face will lead to insufficient resources to reduce poverty. On the other hand, high middle-income poor countries face the problem of misallocation of resources. Regardless of the category of poor countries, but especially for the second category, poverty eradication requires not only economic development, but also the redistribution of new domestic resources to the poorest populations [9]. Because these two problems are very likely to be encountered by a poor country in the process of breaking the poverty trap, how to allocate resources through reasonable systems and ways is very important for poor countries. The establishment of efficient distribution means a more complex process. Like corruption, it is hard to ignore when considering the impact of foreign aid and the effectiveness of poverty eradication. Moyo [10] believed that foreign aid would make recipient countries face more serious corruption problems. No matter whether the causal relationship between foreign aid and corruption is true or not, corruption is indeed a problem that cannot be ignored. Because corruption affects not only the redistribution of new resources at home, but also the way foreign aid is delivered. When corruption is a problem in recipient countries, especially in low-income poor countries, aid agencies often channel funds through NGOs and contractors rather than the recipient governments [9]. While this approach does, to some extent, reduce the impact of corruption in recipient countries on the effectiveness of foreign aid, Page and Pande further argue that such actions may not improve, or even undermine, the ability of states to provide intangible infrastructure for their citizens in the long run. If foreign aid continues in this way for too long, it will be difficult for weakened domestic institutions to be accountable to their responsibilities. Because the poverty trap means more than just a shortage of money, a lack of infrastructure, tangible and intangible, is also the reason why poor countries struggle to eradicate poverty.

Based on corruption and unequal distribution of domestic resources, it is necessary to take corresponding restrictions on foreign aid, so as to ameliorate and solve these problems to some extent. First, Schudel [16] argues that aid to the poor can be provided through direct cash transfers to avoid potential corruption problems and mismanagement. This approach clearly targets corruption and resource allocation, trying to help the poor in a simpler and more direct way. Although such aid also weakens domestic institutions in recipient countries, it compensates for the corresponding problems. As in the short term, approaches to aid that are divorced from national institutions in recipient countries can inhibit effective local information about specific circumstances and mechanisms to take into account citizens' preferences [9]. Since direct cash transfer creates a closer connection between the donor and the recipient, it will be more possible for local information and citizens' preferences to

be transmitted to the donor in a direct and effective way. However, although this approach has advantages, and to a certain extent, it does avoid the problem that corruption in recipient countries undermines the effectiveness of foreign aid, it also creates new problems. On the one hand, foreign aid without the participation of governments and NGOs will be more unstable. Since aid is transferred directly from the donor to the recipient, there is a lack of third-party management and supervision in this process. While the involvement of third parties may bring problems such as corruption, it also ideally provides for a stable source of funding. On the other hand, aid has become too fragmented to have a fundamental impact. Since financial assistance is now directly distributed to the poor, in addition to bringing them additional income to help them out of poverty, it cannot effectively improve and solve the environment that causes poverty, such as the lack of infrastructure. Secondly, the level and type of spending undertaken by the government does matter to economic performance [17]. Therefore, an aid approach that is consistent with the national system of the recipient country can be advocated, that is, close cooperation with local governments and organizations. This type of aid limits foreign aid by requiring cooperation with domestic institutions in the recipient country. This collaborative approach also strengthens the capacity of local institutions to provide intangible infrastructure to citizens. As Dixit [18] suggests, aid is delivered to poor countries in a progressively improved way by working with existing alternatives and evolving them. The reason for this is not only that existing institutions can provide existing and available ways to provide assistance to the poor, saving the cost of setting up new institutions in recipient countries, but also avoiding the problem of weakening domestic institutions. However, such cooperation does not have a very effective way to prevent and deal with the predictable corruption problems.

5. Conclusion

There is no denying that targeted foreign aid has helped many countries with relatively low levels of economic development escape poverty. But in the incomplete process of sustainable development, the fact that foreign relief has some negative impacts in history.

Starting from classic cases, this paper questions whether the poor countries rescued by the world really get rescue. Through data analysis, experimental theory and valuation strategy, combined with viewpoint and theoretical analysis, the conclusion is drawn. Foreign aid would make a difference in most poor countries. This paper does not conduct further analysis of the experimental model, because the experimental model has been well covered in other literature. This paper uses cases of different countries to describe more story-like. Foreign aid is not universal and requires different levels of analysis and consideration in different countries. For most countries that still face multidimensional poverty, enhanced foreign assistance remains imperative. But the way in which foreign aid is restricted is also important for recipient countries with a widening wealth gap and corrupt domestic systems.

Author's Contributions

Yuchen Feng, Luying Meng and Yatong Lv contributed equally to this work and should be considered co-first authors.

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