

turn, economic growth. In fact, an IMF Occasional Paper²¹ notes that aid can create a vicious circle of poor export performance and aid dependency. However, an inflow of foreign assistance does not have to be, and often is not, undesirable. Foreign assistance can also have beneficial effects if it helps the development of economic and social infrastructure, thereby complementing private sector activities. The extent to which foreign aid is beneficial depends on whether the positive effects of aid inflows dominate their undesirable effects.

At the microeconomic level, foreign assistance would be expected to affect the labour-leisure choice of individuals and, therefore, domestic saving efforts. Aid makes it possible, on average, for individuals to maintain a given level of income and consumption without having to offer the same number of hours of work (effort) as before the inflow of aid. That is, aid can lower the opportunity cost of work, thereby encouraging economic agents to substitute work efforts with leisure. This potential adverse effect of aid on domestic savings would be more pronounced if the inflow of foreign assistance were perceived to be permanent. However, if at the macroeconomic level aid were to help the development of the social and physical infrastructure-- boosting employment and raising the productivity of the labour force and physical capital--real income would rise. Thus, by potentially raising real income, aid can boost domestic savings. Hence, while the direct effect of foreign aid on domestic savings can be negative, the indirect effect could be positive.

Given the varying assumptions about the contribution of aid to savings, investment and growth, what are the specific lessons from new growth theory? The answer would seem to be to concentrate on investment and on education/technical assistance.

7. Theory: Why Countries Are Aid Donors

On purely theoretical terms, Mosley's taxonomy²² of the theoretical case for aid is most useful, for in it one can see the implications from our discussion on growth theory above. Mosley argues that richer governments use aid for:

- the redistributive function, whereby rich states transfer resources to poorer

²¹ Michael T. Hadjmichael, et al., "Sub-Saharan Africa: Growth Savings and Investment, 1986-93", IMF Occasional Paper 118, January 1995.

²² Paul Mosley, Foreign Aid: Its Defense and Reform, University Press of Kentucky, 1994.