Chapter 6

The International Evidence

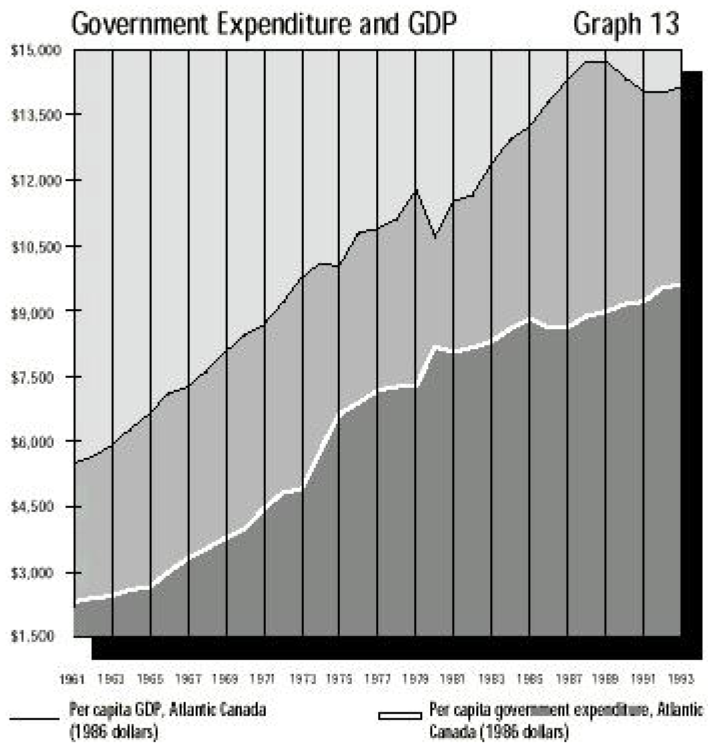
Foreign aid programs were launched long before there was compelling theory, or compelling evidence, that proved they could work. The stated goal of these was to alleviate poverty and promote growth. The massive aid programs that began after the second world war, but only took off in the 1960s, are an unprecedented economic experiment. ... [The] literature on the empirical impact of foreign aid is surprisingly limited. (Boone, 1994b)

Much the same could be said for Canada's attempts to resolve regional disparities. Boone's words contain a clear echo of Savoie's comments quoted at the beginning of this book. Foreign aid is one of three analogous situations that may throw some light on the Atlantic Canada experience. The other two are:

- Fiscal retrenchment: A cut back in government borrowing has some similarity with a reduction in regional subsidies. (A reduction in regional subsidies would not have the same interest rate impact as a fiscal retrenchment, and this will be discussed below.)
- Regional assistance programs in other developed countries, namely in Europe, the United States and Australia. Boone has published the most definitive examination of the impact of foreign aid, concentrating on investment and growth. Aid could have a positive impact on growth through several channels: public investment in productive activities; reduced domestic taxes to encourage private sector investment; or provision of capital to finance worthwhile projects which could not be otherwise financed due to imperfections in the world capital market. [19]

As well, it can have a beneficial impact by providing essential social services. Boone examines a large basket of countries — countries of roughly similar circumstance which nonetheless receive differing levels of aid. This type of comparison is well-suited to pick up any impact aid may have on growth or investment. On the surface, one would certainly expect some aid-related pick up in investment, since Boone includes only aid which has "the objective of promoting economic development or welfare". (Boone, 1994a, pg. 1) His results can be quickly summarized: the level of aid has no impact on either investment or growth. He finds that the marginal propensity to consume from aid is insignificantly different than one and that the marginal propensity to invest is insignificantly different from zero. [20]

Aid also has no impact on economic growth. Government is a key mechanism which funnels aid into consumption. "Government consumption rises by approximately three quarters of total aid receipts" (Boone, 1994b, pg. 4). Something of the same nature seems to have occurred in Atlantic Canada. (See Graph 13.) Worse, Boone finds no significant aid impact on human welfare indicators such as "infant mortality, primary schooling ratios nor life expectancy. I argue this is strong evidence that aid flows primarily benefit a wealthy political elite." (Ibid.) Many recipient countries have despotic, repressive and rent-seeking political systems, unlike Atlantic Canada. However, Boone's result show that "liberal political regimes do not use aid any differently from the most oppressive regimes. ... These findings suggest that all political regimes allocate foreign aid to a high income political elite.. " [21] (Ibid., pg. 26)



Boone's findings (1994b) suggest an interesting analogy with the situation in Atlantic Canada. Boone, supported by his review of the literature, shows that foreign aid is in large measure motivated by the interest of the donor nations -- predominately their political interests -- rather than pure altruism. Something similar may be said of the situation in Canada; regional subsidies provided a demand stimulus for producers in Central Canada so long as Canada was surrounded by trade barriers. That benefit for Central Canada has dissipated as trade barriers have fallen. So, too, has support for regional subsidies.

Alesina and Perotti (1995) discuss the impact of fiscal retrenchments in OECD countries. A fiscal retrenchment would have much the same impact as a reduction in regional subsidies in that it would cut the inflow of external funds and reduce economic distortion. However, a fiscal retrenchment has the added advantage of, in most cases, lowering real interest rates as government deficits and ultimately the debt levels fall. Alesina and Perotti compare nations which try to get their fiscal houses in order by reducing expenditures with nations that attempt to balance the budget with increased taxes. Both approaches should have a roughly similar impact on interest rates.

Successful adjustments (a minority of the total) rely mostly on cuts in transfer programmes and in government wages and employment. Unsuccessful adjustments rely primarily on increases in taxes, leaving transfer programmes and government wages and employment untouched or even increased (pg. 210).

> *[W]e find that 'hell does not break loose' even after several years of fiscal adjustments, unemployment is lower after the adjustment than before. We do not find either that growth is systematically lower. We also find that growth is much higher and unemployment lower than after unsuccessful adjustments. (pg. 237)*

A corollary of the view that large regional subsidies suppress growth through economic distortions is that the removal of such distortions should, with some lag, have a positive impact on growth. Alesina and Perotti's conclusion provides indirect support for that, reinforced by comments by Giavazzi in a discussion on the paper. Giavazzi notes that changes in the debt-to-GDP "...are to a large extent explained by movements in the GDP." (Ibid., pg. 241) This, in turn, suggests that Alesina and Perotti's measure of "success" is in large part dominated by GDP growth, meaning that cutbacks in government spending, far from reducing growth as is feared in Atlantic Canada, actually help spur growth.

One area which deserves further examination is the regional development experience of other nations. Neither the United States nor Australia has anything like Canada's regional programs, yet their peripheral regions seem to be doing at least as well relatively as Atlantic Canada, and the long-poor southern United States, with market distortions caused by racism at least partially reduced, has entered a much celebrated renaissance. (See, for example, *The Economist*, "Survey: The American South", 1994.) Meanwhile, European policy-makers seem to be as frustrated by their lack of regional development success as Canadian policy makers, giving rise to an increasing scepticism about the effectiveness of regional programs.