

Helpdesk Research Report: Distortionary economic impacts of aid interventions in fragile states

Date: 05.10.12

Query: Please identify findings and policy recommendations on the economic impact of humanitarian and development interventions in conflict and post-conflict environments. Where possible, focus on the impacts on factor prices, wages, commodity prices, flows of factors of production (such as human capital), and identify the key distortions that aid flows can cause by crowding out.

Enquirer: DFID

Author: Sumedh Rao (sumedh@gsdrc.org)

Contents

1. Overview
2. Peace operations
3. Crowding out
4. References

1. Overview

There is a wide range of literature that touches on the issues of economic impacts related to humanitarian and development interventions. This literature is made up of analyses and evaluations on different types of projects or programmes that have had impacts on the local economy. Within this literature the area of most relevance to conflict and post-conflict environments is that focused on peace operations. Peace operations include a wide range of humanitarian and development interventions, in addition to peacekeeping duties. These interventions are often implemented rapidly and in consequence, economic impacts may be more visible or more pronounced. Therefore, the first part of this report explores economic impacts and policy recommendations that have been identified in relation to peace operations. The second part of the report looks into 'crowding out' in relation to foreign direct investment (FDI), domestic revenue mobilisation, savings and government expenditures.

Peace Operations

Peace operations are often perceived as having negative impacts on salary levels, rents, commodity prices and general prices (i.e. inflation) (Ammitzbøll 2007; Ammitzbøll and Tychsen 2010). The generally higher **salary levels** of staff working in international organisations can put upward pressure on local staff salary levels and lead to a 'brain drain' from local organisations into international organisations (ibid). **Rents** are perceived to have risen during many peace operations. In Kosovo, after an initial rise, prices fell as the supply of housing increased and again when peace operations wound down. Evidence suggests that this may have been limited to specific types of housing, that which is in demand from international staff, and that it did not affect the wider housing market (Carnahan et al. 2006). There was no evidence that the international organisations' demand for housing 'pushed families on to the streets', though this public perception sometimes arose (ibid).

During several peace operations, the prices of basic **commodities** rose, in addition to **wider inflation** (Ammitzbøll 2007; Ammitzbøll and Tychsen 2010). There was also, in many cases, a strong public perception that inflation was due to the demand created by peace operation staff. However, evidence suggests that inflation is a significant problem in poor countries, irrespective of the presence of peace operations (Carnahan et al. 2006). Countries with peace operations had similar price volatility to neighbouring countries with no peace operations. There may have been examples of localised inflation, but there is little evidence that this spread to the larger domestic market. It is likely that changes in commodity and wider prices were attributable to factors other than the peace operations (ibid). Furthermore, changes in prices may have been part of the 'peace dividend': as a country emerges from conflict, the resumption of peace and return to business-as-usual is likely to influence prices.

Contrary to the perception of negative economic impacts, some argue that the humanitarian and development interventions that peace operations entail actually result in an overall positive economic impact on the local economy (e.g. Carnahan et al. 2006). There are local perceptions, in Kosovo and Afghanistan for example, and supporting evidence that the peace operations were a fillip to the local economy and laid the foundation for a healthier economy in the future. Peace operations restore basic security and their expenditures act as an economic boost at a point when arguably the economy needs it most (Carnahan et al. 2006). In fact, humanitarian and development interventions provide a good opportunity to stimulate the economy and these interventions can be tailored to maximise this positive effect (ibid).

The key **policy suggestions** are to:

- undertake initial economic assessments of the context prior to the intervention(s);
- integrate economic development objectives with wider objectives, keeping context in mind;
- undertake regular economic impact assessments to increase positive impacts and ameliorate negative ones.

Crowding Out

There is little evidence that aid 'crowds out' other financial flows. Aid seems to increase **Foreign Direct Investment (FDI)**. This effect seems to be most pronounced when aid is

focused on economic infrastructure, and when it is targeted at countries with especially low incomes.

Aid can undermine the ability of low-income countries to raise **domestic revenue** (i.e. taxation) unless there are specific interventions directed at strengthening revenue raising capacity. There is a strong negative correlation between aid, specifically multilateral aid, and **savings**, but it is unlikely that one causes the other. Exogenous factors, such as conflict and natural disasters, are likely to lead to people saving less and to a greater need for foreign aid.

Looking at health as an example of **government expenditures**, there is evidence that increased health aid leads to a fall in government health expenditure. However, this is not a consistent effect across countries and it is unclear whether this is necessarily a bad thing. It may be that countries lack the capacity to effectively spend more government money in addition to the foreign aid; it may be an attempt to smooth out health expenditures over the long-term in light of capricious donor funding; or it may be that countries are allocating remaining funds to other high-need areas. In some cases governments have been advised by donors and international organisations to act in this way.

Overall, the complex nature of spending allocation decisions means that it is very difficult to confidently attribute changes in financial flows to a 'crowding out' effect of aid.

2. Peace operations

Contemporary peace operations include a broad spectrum of activities, in addition to standard peacekeeping roles. These include seeking to address the root causes of conflict and to build the foundations for social justice and sustainable peace (Ammitzbøll and Tychsen 2010). Interventions range from immediate humanitarian assistance and the establishment of temporary civilian administration systems, to long-term programmes of state building, economic recovery and reconciliation.

To better understand the unintended consequences of such peace operations, two sets of surveys were undertaken in Afghanistan and Kosovo (Ammitzbøll 2007; Ammitzbøll and Tychsen 2010). The authors argue that major peace operations never leave a 'light footprint' and despite well-articulated mandates, peace missions will always impact host societies in more ways than intended.

Another more comprehensive study finds that despite popular perceptions the overall inflationary impact associated with peace operations is relatively benign (Carnahan et al. 2006). In this study, research teams visited eight UN peacekeeping operations. They interviewed mission leaders, mission contractors and host government officials, as well as gathered data from the missions' books that were not routinely published in mission expenditure reports (Durch 2010).

Focusing on specific economic impacts the findings of these studies were as follows.

Salary level inflation

In both Kosovo and Afghanistan the presence of international organisations has led to inflation of salary levels (Ammitzbøll 2007; Ammitzbøll and Tychsen 2010). Kosovars

employed by the UN earned three or four times the salary than the Kosovars in government, with whom they worked alongside, doing similar jobs.

In Afghanistan the salary for domestic civil servants was set at approximately US\$30 per month (which is below the poverty line of US\$2 a day) to help downsize the civil service (Ammitzbøll 2007; Ammitzbøll and Tychsen 2010). The assumption was that the low salary would lead to an exodus of civil servants and a downsizing to an economically sustainable level. Whereas some civil servants (often the most talented and skilled) left their government jobs for international organisations, others were forced to look for alternative incomes. This is believed to have resulted in an increase in levels of corruption and furthered the drug economy.

In Cambodia, though the low level of local spending by the UN mission meant little impact on inflation, the mission did have a role in the escalating local wage and salary levels (Carnahan et al. 2006).

Rent increases

In the same manner as commodity price rises, the international presence was perceived to have led to an increase in rents in Kosovo and Afghanistan (Ammitzbøll 2007; Ammitzbøll and Tychsen 2010). The sudden increase in demand for appropriate housing to accommodate offices and staff is perceived to have resulted in a steep rise in rental costs as in many instances demand far exceeded supply. In Kabul, for instance, the monthly rent of a three-room apartment in the central part of town had gone from approximately US\$ 80-100 per month in early 2002 to about US\$ 250-300 per month by the end of 2004. Most salaries have not risen proportionally during this period, and many locals have been forced to leave their homes and find cheaper forms of accommodation on the outskirts of town. Likewise, in Kosovo many people have had to abandon living in Prishtina as they can no longer afford city prices.

In relation to Kosovo, Carnahan et al (2006) accept that there was initially a major spike in housing prices during 2000 and 2002, but that as the supply of housing increased and the number of international staff decreased, rents dropped dramatically. They did not return to their original levels, but dropped by 30 or 40 per cent from peak levels, at least with respect to the rents paid by mission staff. Though only a small decline in rental prices was noted for Kosovars during 2002, Carnahan et al (2006) conclude that this was due to the lack of data during the period of inflation prior to 2002, and that the most likely explanation for the lack of broader decline in rental prices is that they had not increased sharply in the first place.

In post-conflict countries housing rental fees paid by peace mission staff had the positive effect of transferring considerable amounts of wealth into the hands of the local community. However, there are mixed reports as to whether this wealth was used effectively (Carnahan et al. 2006). The housing of the standard desired by international staff – arguably luxury housing – was in short supply in most mission areas. The study of several post-conflict missions concluded that there was little if any evidence of increases in ‘luxury’ house prices affecting rents in the rest of the housing market, and that reports of tenants being pushed out of their houses to make way for international staff were rare. At the same time, the acute shortage of buildings that met ‘international standards’ created the impression that renters from

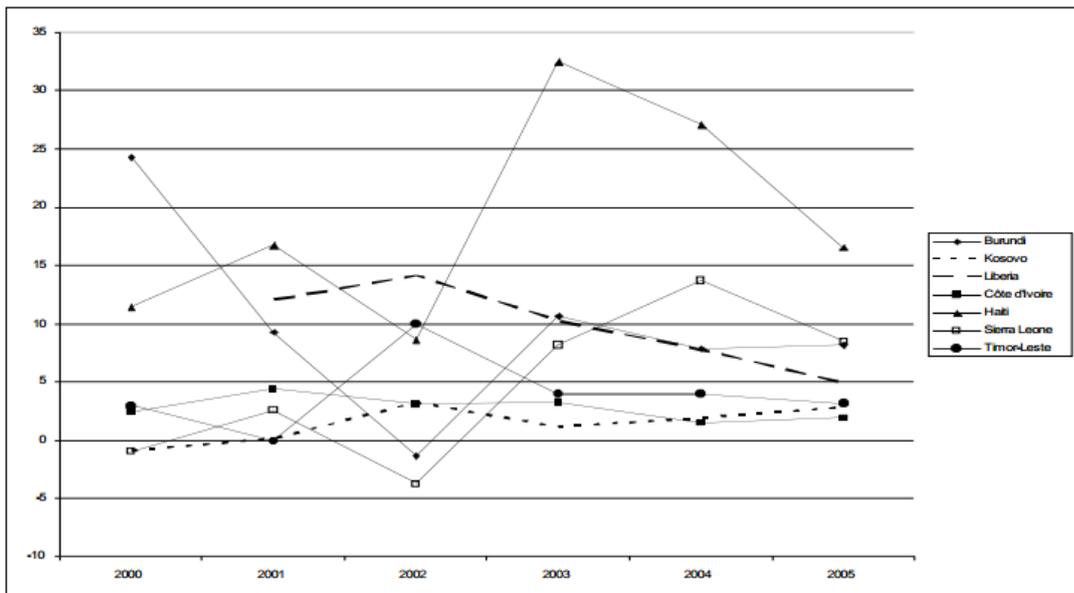
international organisations were pushing families into the streets wholesale. Though discussions at missions did not yield evidence to support this impression, allegations of any such incidents create significant problems of public perceptions.

Commodity price and wider inflation

In Kosovo and Afghanistan, the international presence was perceived to have led to an increase in the price of goods and services (Ammitzbøll 2007; Ammitzbøll and Tychsen 2010). In Afghanistan, respondents experienced a price increase of approximately 50 per cent following the arrival of the peace mission. For example, in 2004, one kilogram of meat (mutton) cost 180 Afghanis (US\$ 3.9/kg) as compared to only 80 Afghanis (US\$ 1.7/kg) in late 2002.

Carnahan et al. (2006) argue that despite popular perceptions, the overall inflationary impact associated with the missions studied was relatively benign. As Figure 1 shows, in the case of Côte d'Ivoire, Sierra Leone, Liberia and Kosovo the inflation rate was below 15 per cent and often considerably below it. In the cases of Côte d'Ivoire, Sierra Leone and Liberia, the presence of established supply routes allowed the demands of the peace missions to be met without putting undue pressure on prices. In the case of Burundi, the country experienced high inflation in 2000, well in advance of the mission, but since then has had inflation of below ten per cent.

Figure 1. Inflation rates during United Nations mission tenure



Source: Carnahan et al. (2006)

Around the time of peace operations there have been significant inflationary impacts, but these have been attributable to factors other than the missions. Timor-Leste experienced inflation of around 140 per cent during 1999, but this was due to the disruption of supply associated with the conflict and the removal of government price subsidies on staple

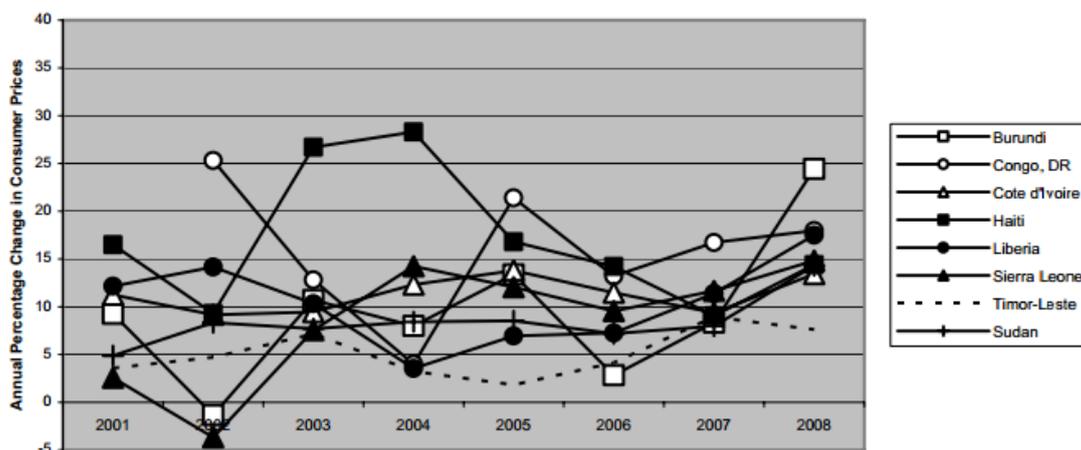
consumer items. The peace operation began after this. In Haiti, the inflation rate increased prior to the arrival of the mission and trended down once the mission was in place.

Carnahan et al (2006) conclude that very localised inflation does occur in markets serving the international community, but that there is limited evidence of it spreading to the larger domestic market.

In a follow-up study to Carnahan et al (2006), Durch (2010) argues that inflation had little relation to the presence of peace operations. Burundi's inflation rate was between three and 13 per cent while the UN mission was deployed, and jumped to 25 per cent within two years of its departure. The Democratic Republic of Congo's (DRC) inflation rate has been between 15 and 20 per cent since 2006, though the operation there increased in size and the eastern half of the country remained unstable. Côte d'Ivoire experienced a steady 11 to 14 per cent rate of inflation throughout the period of the UN mission deployment. Haiti's rate dropped by more than half in the first three years after peacekeepers were deployed, but began to edge up again. Liberia's inflation rate dropped by two-thirds after the UN mission was deployed in late 2003, to a low three per cent in 2005, but has been steadily increasing since then, to 17 per cent in 2008. Timor-Leste's inflation rates were low during the main period of peace operation through 2005, rising only after the instabilities of 2006, but levelling off thereafter without breaking into double digits. Sudan's inflation rates were low during the main period of peace operation through 2005, rising only after the instabilities of 2006, but levelling off thereafter without breaking into double digits.

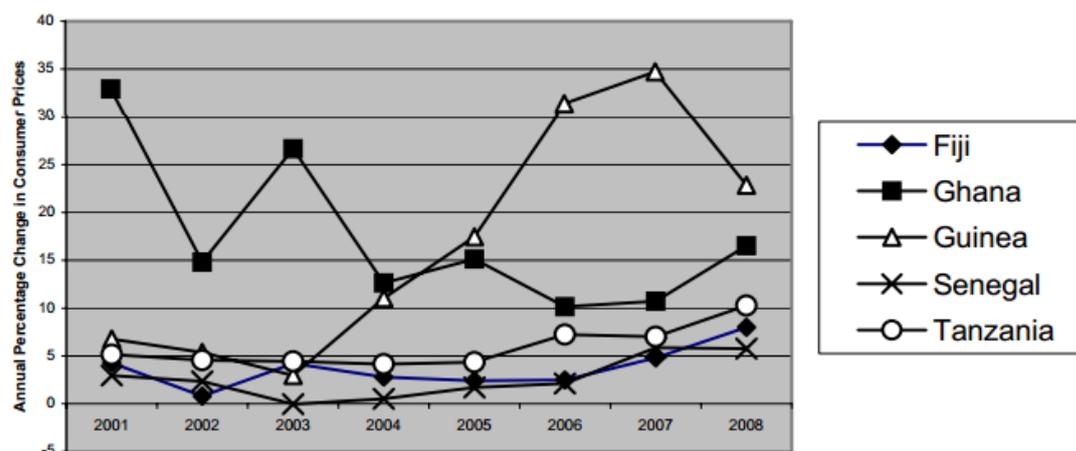
Durch (2010) argues that nations with peace operations and neighbouring nations without such operations experience similarly volatile inflation rates, suggesting that the inflation cannot be attributable to the peace operations. Figures 2 and 3 illustrate this.

Figure 2: Inflation rates for states with peace operations



Source: Durch (2010)

Figure 3: Inflation rates for states neighbouring those with peace operations



Source: Durch (2010)

In addition, there were local opinions and evidence of positive economic impacts.

Strengthening the economy

Most of those surveyed in Afghanistan viewed the international community's support to the country as laying the foundations for a healthier economy (Ammitzbøll 2007; Ammitzbøll and Tychsen 2010). The international presence was perceived to have benefited most sectors, including the transport and construction sectors, the hotel and restaurant industry, as well as food and retail stores. In Kosovo, the general perception was that international organisations had created an increased demand for goods and services that boosted the local economy. The international presence was perceived to have stimulated business growth and entrepreneurship in the areas of real estate, restaurant businesses, retail, entertainment and transportation, but also prostitution.

Carnahan et al (2006) conclude that peace operations have had an overall positive economic impact. They argue that there are strong economic benefits from the restoration of basic security. Staff subsistence allowance spending, local procurement and the hiring of national staff acts as a significant economic boost at a time when the economy needs it most: when it is recovering from conflict.

Policy suggestions

These studies (Ammitzbøll 2007; Ammitzbøll and Tychsen 2010; Carnahan et al 2006; Durch 2010) come to similar conclusions in that many unintended negative consequences of peace operations can be foreseen, controlled or remedied. They make the following policy suggestions.

- Undertake an initial assessment of the economic environment from which to evaluate likely economic impacts.

- Integrate economic development objectives with the peace operation, specifically:
 - incorporate concern for economic development in the explicit mandates of peace missions;
 - try to enhance the local economic impact through mission spending and taking into account the economic consequences of decisions in other domains;
 - be more conscious of the mission's economic impact and the relationship between economic recovery and other mission objectives;
 - set staff wages (including privileges and other benefits) so as to attract personnel with the relevant skills, but also with local wages in mind;
 - undertake procurement with local prices and context in mind.
- Carry out regular impact assessments and in-depth consultations with key local stakeholders to establish and respond to ongoing local economic impacts.

Carnahan et al. (2006) conclude that the relatively benign inflationary impact of the missions can be interpreted as evidence that there is even greater scope for increased support for local economic activity through better tailoring peace operations. As Durch puts it: 'peacekeepers may be incidental economic peacebuilders, but incidental need not mean inadvertent' (Durch 2010: 179).

3. Crowding out

Foreign Direct Investment (FDI)

Selaya and Sunesen (2008) find that aid on average has a small but positive effect on drawing in FDI. When aid is disaggregated, aid that is focused on social infrastructure (i.e. education, health and water supply) and economic infrastructure (i.e. energy, transportation and communications) helps draw in FDI. On the other hand, aid focused on investments in physical capital (i.e. contributions to directly productive sectors such as agriculture, manufacturing, trade, banking and tourism) crowds out FDI.

Kapfer et al (2007) find no statistically significant effect of aid on FDI. However, similar to Selaya and Sunesen (2007), they find that aid aimed at promoting the development of infrastructure in areas of communication, energy capability and transportation is associated with increased levels of FDI. The authors favour loans for communications and transportation to draw in higher levels of FDI.

Blaise (2005) also find positive effects of aid to infrastructure projects and FDI. Kimura and Todo (2007) find no such positive infrastructure effect, but did find that in the case of Japanese aid there was a vanguard effect: Japanese aid promotes FDI from Japan, while having no impact on FDI from other countries. This vanguard effect was not found with other donors and their FDI, or at an aggregate level.

In general, there is little research on aid crowding out FDI with a specific focus on conflict or post-conflict states. Arazmuradov (2011) looked at the relationship between aid and FDI in Kazakhstan, Kyrgyzstan, Turkmenistan, and two countries which could be considered as fragile states: Tajikistan and Uzbekistan. The study shows that of the five Central Asian countries, only in Kyrgyzstan and Tajikistan do foreign aid catalyse FDI inflows. The author

concludes that a relationship between foreign aid and FDI is only present in countries with low per capita GDP.

Domestic Revenue Mobilisation

A paper looking at the relationship between aid and domestic tax revenue with a more recent and comprehensive dataset supports earlier findings of a negative association between net Official Development Assistance (ODA) and domestic tax revenues (Benadek et al 2012). However, the authors conclude that although aid has a particularly strong negative effect on domestic tax revenues in low-income countries and in countries with relatively weak institutions, this relationship appears to have weakened following greater efforts at mobilising domestic revenues in many countries. The authors argue that policymakers and donors should pay particular attention to strengthening revenue raising capacity to ensure that ODA flows have a net 'additionality' in resources.

Savings

Nushiwat (2007) identifies eleven studies which have found a strong negative correlation between foreign aid and savings. However, when foreign aid is broken down between multilateral aid and bilateral aid, the negative effect is attributable to the multilateral component of foreign aid (Nushiwat 2007). The author concludes that the effect of bilateral aid on the recipient countries' domestic savings is likely to be positive and that multilateral aid's negative effect on savings may be caused by exogenous conditions rather than a crowding out effect. Such exogenous conditions can include deteriorating economic and political situations, disasters, droughts, wars and civil wars. Countries experiencing such exogenous factors, which include many conflict and post-conflict countries, will have low savings and high inflows of multilateral aid.

Government expenditure: health

A 2010 study concluded that when governments receive international aid for healthcare projects, their own health spending gets 'crowded out', or displaced, but this crowding out does not occur when international aid is given to non-governmental organisations (Lu et al. 2010). The authors do note, however, that much of their data was estimated (given the lack of reliable data) and the displacement effect may be because government ministries are unable to 'absorb' the aid – they can only spend so much money on health at a certain time given limitations of capacity. Roodman (2012) criticises the analysis of this study on methodological grounds. Batniji and Bendavid (2012) note that this 'crowding out' is highly variable across countries and current evidence about aid displacement cannot be used to guide policy.

Ooms et al (2010) argue that relations between international health aid and government health funding may be too complex to capture as Lu et al. (2010) have done. Governments may be compensating for exceptional international generosity to the health sector by reallocating government funding to other, less well-funded but crucial sectors. Governments might be anticipating future volatility of international health aid and reducing health expenditure in one year to smooth out longer-term flows. Stuckler et al. (2011) note that in

some cases the funding agency, such as the World Bank and IMF, explicitly advise governments to divert aid to reserves to cope with aid volatility and keep government spending low.

4. References

Arazmuradov, A. (2011) '*Foreign aid, foreign direct investment and domestic investment nexus in landlocked economies of Central Asia*', University of Bergamo

http://mpra.ub.uni-muenchen.de/36881/1/MPRA_paper_36881.pdf

Ammitzbøll, K. (2007) 'Unintended consequences of peace operations on the host economy from a people's perspective' in Aoi, C., de Coning, C and Thakur, R. (eds) *Unintended consequences of Peacekeeping Operations*, United Nations University Press, Tokyo: Japan

Ammitzbøll, K. and Tychsen, M. (2010) 'The Unintended Economic Consequences of Complex Peace Operations on Host Societies' in Feichtinger, W., Gauster, M. and Tanner, F. (eds) '*Economic Impacts of Crisis Response Operations: An Underestimated Factor in External Engagement*' Republik Österreich, Bundesminister für Landesverteidigung und Sport

http://www.bundesheer.at/pdf_pool/publikationen/eco_impacts_10_united_economic_consequences_ammitzboell_tychsen.pdf

Batniji R. and Bendavid, E. (2012) 'Does Development Assistance for Health Really Displace Government Health Spending?', Reassessing the Evidence' *PLoS Med* 9(5)

<http://www.plosmedicine.org/article/info%3Adoi%2F10.1371%2Fjournal.pmed.1001214#>

Benedek, D. et al. (2012) '*Foreign Aid and Revenue: Still a Crowding Out Effect?*', IMF Working Paper WP/12/196

<http://www.imf.org/external/pubs/ft/wp/2012/wp12186.pdf>

Blaise, S. (2005), 'On the link between Japanese ODA and FDI in China: A microeconomic evaluation using Conditional Logit Analysis', *Applied Economics*, vol. 37, pp. 51-55

<http://www.tandfonline.com/doi/abs/10.1080/0003684042000281534>

Carnahan, M., Durch, W. and Gilmore S. (2006) '*Economic Impact of Peacekeeping Final Report*' Peace Dividend Trust

http://buildingmarkets.org/sites/default/files/economic_impact_of_un_peacekeeping_march_2006.pdf

Durch, W. (2010) 'The Economic Impact of Peacekeeping: An Update' in Feichtinger, W., Gauster, M. and Tanner, F. (eds) '*Economic Impacts of Crisis Response Operations: An Underestimated Factor in External Engagement*' Republik Österreich, Bundesminister für Landesverteidigung und Sport

http://www.bundesheer.at/pdf_pool/publikationen/eco_impacts_04_eco_impact_an_update_durch.pdf

Kapfer, S., Nielsen, R. and Nielson, D. (2007) '*If You Build It, Will They Come? Foreign Aid's Effects on Foreign Direct Investment*', Paper prepared for the 65th MPSA National Conference.

https://pedl.byu.edu/Documents/If%20You%20Build%20It_%20Will%20They%20Come_%20Foreign%20Aids_%20Effects%20on%20Foreign%20Direct%20Investment.pdf

Kimura, H. and Todo, Y. (2007) '*Is foreign aid a vanguard of FDI? A gravity equation approach*', RIETI Discussion Paper Series 07-E-007.
<http://www.rieti.go.jp/publications/dp/07e007.pdf>

Lu, C. et al. (2010) 'Public financing of health in developing countries: a cross-national systematic analysis', *The Lancet*, vol 375 iss 9723 pp 1375-1387
[http://www.thelancet.com/journals/lancet/article/PIIS0140-6736\(10\)60233-4/abstract](http://www.thelancet.com/journals/lancet/article/PIIS0140-6736(10)60233-4/abstract)

Nushiwat, M. (2007) 'Foreign Aid to Developing Countries: Does it Crowd-out the Recipient Countries' Domestic Savings?', *International Research Journal of Finance and Economics*, iss. 11
<http://www.eurojournals.com/irjfe11%20munth.pdf>

Ooms, G. et al. (2010) 'Crowding out: are relations between international health aid and government health funding too complex to be captured in averages only?', *The Lancet*, vol. 375 iss 9723 pp 1403-1405
[http://www.thelancet.com/journals/lancet/article/PIIS0140-6736\(10\)60207-3/fulltext](http://www.thelancet.com/journals/lancet/article/PIIS0140-6736(10)60207-3/fulltext)

Roodman, D. (2012) 'Doubts about the evidence that foreign aid for health is displaced into non-health uses' *The Lancet*. Vol 380 iss 9846 pp972-3
[http://www.lancet.com/journals/lancet/article/PIIS0140-6736\(12\)61529-3/fulltext](http://www.lancet.com/journals/lancet/article/PIIS0140-6736(12)61529-3/fulltext)

Selaya, P. and Sunesen E. (2008) '*Does Foreign Aid increase Foreign Direct Investment?*', Discussion Paper 08-04, Department of Economics, University of Copenhagen
<http://www.econ.ku.dk/english/research/publications/wp/2008/0804.pdf/>

6. Additional information

Contributors

Nicolas Lemay-Hebert (University of Birmingham)
Gary Milante (World Bank)
Giacomo De Giorgi (Stanford University)
Rubina Jasani (University of Manchester)
Michael Carnahan (AusAID)
William Durch (Stimson Centre)
Josephine Liebl (European Peacebuilding Liaison Office)

Suggested citation:

Rao, S. (2012) *Distortionary economic impacts of aid interventions in Fragile States (GSDRC Helpdesk Research Report)*. Birmingham, UK: Governance and Social Development Resource Centre, University of Birmingham.

About Helpdesk research reports: Helpdesk reports are based on 3 days of desk-based research. They are designed to provide a brief overview of the key issues; and a summary of some of the best literature available. Experts are contacted during the course of the research, and those able to provide input within the short time-frame are acknowledged.