Seminar Questions on Aid

1. What does the emprical litterature on aid effectiveness show with respect to aid and growth.

2. Discuss problems with using cross country data to find the effect of aid on growth.

3. Discuss possible solutions.

4. **Aid, incentives and conditionality:** There is a donor and a recipient. The donor has a fixed budget M that can be consumed domestically C or be given in aid a to a recipient poorer country: $M = C + a$. In the recipient country there are two groups (assumed to be of equal size here); the poor and the rich. The government in the recipient country can tax the rich with an amount t per individual and transfer to the poor, we allow t to be negative. The donor can target support to the poor in recipient country. Hence the consumption of the poor and the rich in the recipient country is $c_p = I_p + t + a$ and $c_r = I_r - t$. Suppose the donor

   only cares about the poor in the recipient country and has a welfare function that is given by $U(C, c_p)$ which is increasing and concave in both arguments. Suppose that the recipient government care both about the rich elite and the poor in the poor country and that their preferences can be represented by $u(c_p, c_r)$ that is increasing and concave in both arguments and have $u'_{c_i} \to \infty$ if $c_i \to 0$.

   - In absence of aid what is the condition for the recipient government choosing $t > 0$.

   - How would a optimal aid contract look like if it could be enforced? Would it increase the consumption of the poor by more than the external aid?

   - Show that without a contract, aid given to the poor in the poor country will be partly offset by domestic policy?

   - Show that if the recipient country chooses t before the donor chooses a it will choose a lower t than if they make decisions simultaneously.

   - Will it help if the donor country declares that it will only help poor countries that do lower t to attract more aid? Why not? Explain why this situation is a bit like a situation where a government has declared that it will not rescue individuals who take excessive risk, or will never pay to ransom to kidnappers.