Briefing

# Five ways to deliver UK aid in the national economic interest

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Key messages

- **Enlightened self-interest:** The aid budget can be spent in ways that benefit the UK, but the UK should a take a long-term perspective on the national interest and keep cost-effective poverty reduction as its top international development priority.
- **Boosting trade:** Aid can reduce barriers to international trade, to the mutual benefit of the UK economy and our trading partners. UK exporters can be supported without repeating the past errors of aid-financed export sales.
- **New markets for investments:** By creating new investment markets in developing countries, aid can accelerate inclusive and sustainable growth overseas, and improve returns for UK investors.
- **Disaster prevention:** The UK has an opportunity to help fix the humanitarian system, saving lives and millions of pounds. The UK should take the lead in creating global disaster insurance schemes that are complemented by investments in countries' disaster management systems.
- **Lead on global public goods:** The UK should take the lead in contributing to global public goods to demonstrate to the world that the UK plans to remain a bold and outward-facing nation, and to deliver benefits at home.

## Introduction

The national interest is now a guiding principle behind UK aid spending, as evident in the new UK aid strategy and statements by the new Secretary of State for International Development.

This briefing highlights five ways in which aid brings benefits to the UK, and actions that the Secretary of State can take to accomplish her mission of building a safer, more prosperous world, in a way that delivers for our national interest.

In putting the national interest at the centre of its development strategy, the UK follows other countries who have also recognised that aid is both altruistic and self-interested. Finding the right balance between dual objectives is challenging. Poverty reduction is enshrined in law as the purpose of UK aid, but the connections between overseas development and the UK national interest cannot be ignored. The Secretary of State has argued that the consequences of poverty, instability and humanitarian crises will eventually be felt just as deeply back in Britain as they are abroad. She has spoken of opportunities to build new partnerships across the world that will further our national interest, and for the Department for International Development (DFID) to work strategically with the Department for International Trade to use some of the levers at their disposal, in terms of programmes and projects.[1]

In this briefing, we suggest ways of using aid in the national interest without sacrificing its essential purpose of eradicating poverty and promoting sustainable development. The briefing is written in the spirit of joining a conversation rather than concluding it. It makes suggestions for the direction of future policy, rather than offering a definitive set of proposals.

### Scope

UK aid serves the national interest in many ways. This briefing tackles only a few of them. The focus here is the UK economic interest. Other issues such as national security, refugees and migration have significant economic implications but are sufficiently distinct from economics to merit separate treatment, and are outside the scope of this briefing. See Cummings et al. (2015) and McKenzie and Yang (2015) on migration; see Valters et al. (2015), Fearon and Hoeffler (2014) and Bobrow and Boyer (2009) on peace and security. On the soft power benefits of aid, see Goldsmith et al. (2013) and Andrabi and Das (2016). Furthermore, aid is only one element of UK global engagement, and there is much to be done beyond aid to promote both overseas development and the national interest. For a set of proposals covering trade, action on modern slavery, climate change and migration policy, and more, see Anderson et al. (2016).

## 1. Enlightened self-interest

The 2002 International Development Act requires the Secretary of State to apply one test above all: any development assistance provided should contribute to a reduction in poverty. DFID should look for 'win-win' opportunities that serve both the national interest and meet our responsibilities to the world's poorest. But serving the national interest should not become a necessary condition for everything that it does. When DFID spots cost-effective opportunities to improve the lives of people living in extreme poverty, even if there is no obvious or immediate benefit to the UK economy, it should take them.[2]

In most settings, spending money in one's own interest would imply making a positive return: the benefits exceed the cost. In the context of foreign aid, that may often be too much to ask. Rather, the UK should look for opportunities to eradicate poverty and promote sustainable development across the globe in ways that also bring some benefits to the UK, even if they do not always exceed the costs. Collier (2016) has argued that cooperation for mutual benefit may be preferred by developing countries, as it implies a genuine partnership, rather than charity.

The UK should take a long-term view on the national interest, and not simply look for immediate economic benefits. Too often the debate focuses on the short term, for example the question of whether increasing incomes in poor countries up to a point actually encourages greater migration (for example, see de Haas, 2010). Yet the solution is not to hope that countries stay mired in poverty forever. As the new Secretary of State has written: 'if we allow extreme poverty, instability and humanitarian crises to go unchecked, the consequences will eventually be felt just as deeply back in Britain as they are abroad'. In the long term, there are good reasons to believe that the UK stands to benefit unambiguously and in a number of ways from global development. A world free from poverty – a world in which the sustainable development goals are a reality – would be a better world for British citizens to live in.

Aside from the economic benefits covered below, other direct long-term benefits from UK aid range from the global population stabilising at a lower level as development accelerates demographic transition, which reduces pressure on scarce natural resources, to developing countries becoming safer, more prosperous and enjoyable places for our children to visit, work or live in.[3] Richer countries tend to take better care of their environments, they are more secure and less prone to exporting crime, conflict and diseases, and dedicate more of their resources to producing cultural and technological goods that enrich us all.

### Recommendation

When the UK spots cost-effective opportunities to help the world's most vulnerable, even if there is no obvious benefit to the UK, it should take them. The UK should look for opportunities to promote development overseas and which bring benefits at home, but self-interest must not become a necessary condition for all UK aid spending.

## 2. Boosting trade

Since the UK voted to leave the European Union, there has been some interest in exploring the potential for foreign aid to leverage better trade deals for the UK with emerging economies (see DFID, 2016; Swinford and Riley-Smith, 2016). This cannot mean using aid as a direct incentive, which would be contrary to the International Development Act, and would also be ineffectual since the countries to which we most want market access are the least reliant on aid. Rather, friendly relations established through aid are more likely to yield enhanced cooperation on trade. Regardless of what trade deals are struck, aid can bring benefits to the UK economy via trade in a range of ways (see Carreras et al. (2016), who estimate that foreign aid confers net economic benefits on the donor).

From an economic perspective, the main benefits of trade arise through imports. Exports are what we sell in order to pay for imports. By improving transport infrastructure and the functioning of markets in developing countries, aid can reduce the costs of doing business. This improves the terms of that trade so that the UK is able to get more for its money. But we need a strong export industry to pay for those imports. There is also undeniable political pressure to use UK aid to promote UK exports. There is potential to boost exports without compromising on cost-effective poverty reduction, but support for UK exporters must be smart.

Firstly, it needs to be remembered that foreign aid can be expected to boost demand for UK exports without any other measures to promote exports, because sending pounds sterling abroad can be likened to giving away UK export vouchers. No matter what aid is intended for and how many times it changes hands in the process, ultimately, British currency only has two uses: to purchase UK exports or to be held in foreign exchange reserves (for a short, non-technical explanation, see Barder, 2009). But there are some sound economic reasons to promote exports, grounded in the same market failures that justify policy interventions in other areas. For example, economists are increasingly aware of what they call 'search and matching frictions' that separate buyers from sellers – economic diplomacy can be seen as way of raising matching efficiency (Eslava et al., 2015). There is a public good aspect to helping UK exporters learn about the demands of developing economies, and sharing that knowledge with other UK firms. So using aid to steer demand towards chosen exporters will usually be the wrong approach. Finding ways to mitigate market failures in international trade that harm both developing countries and UK exporters is the better route.

The UK should also heed the lessons of history: we know better than most the perils of using aid to directly finance exports. The Pergau dam affair was a landmark case. UK aid was used to finance a grossly uneconomic hydroelectric power project in Malaysia, to facilitate an arms deal that was eventually deemed unlawful by the UK high court (Provost, 2012). It also ended the career of the Foreign Secretary, Douglas Hurd. In the aftermath, new legislation banned the practice of 'tying' aid to UK goods and services. The senior civil servant most closely involved with Pergau, Sir Tim Lankester, has said that at the time, it was thought possible to balance the twin objectives of promoting development and promoting exports, but that proved not to be the case and the Department of Trade and Industry overruled the Overseas Development Administration, the predecessor to DFID. It has been reported that the new Secretary of State is seeking ways of using aid to fund non-combat defence spending, within existing rules, but will stress that DFID 'will not be an extension to the defence budget but act in conjunction with it'. She must be equally as forthright in preventing aid from becoming a tool of the Department for International Trade and UK Export Credit agency.

The UK remains strongly committed to value for money; this comprises a whole chapter of the UK Aid Strategy. The Secretary of State should ensure that any spending in this area raises the efficiency of UK trade with developing countries in a neutral fashion, to the benefit of all exporters, rather than directing business towards particular firms that would otherwise be uncompetitive.

### Recommendation

The UK should keep the focus of export promotion on addressing market failures in international trade, rather than indirectly using aid to finance export sales.

## 3. New markets for investment

Income from overseas investments is an important part of how the UK finances its current account deficit. The health of the global economy has a direct impact on UK investors – for example, UK investors already have over £40 billion invested in Africa (ONS, 2016). The UK is also a global financial centre and home to many pension funds, private equity funds and other investors. In the wake of the financial crisis, interest rates are low and savers are searching for yield. An increased supply of high-return overseas investments would have clear benefits for the UK, both as saving vehicles for UK citizens and for those whose business it is to select and manage investments on behalf of international clients.

Returns on investment can be high for bad reasons: protection from competition, exploitative practices, and so forth. But returns can also be high for good reasons: the economy is growing. Returns to investment ought to be high in developing countries because capital is scarce and there should be great opportunities to invest in new enterprises. However, in practice a multitude of factors combines to reduce returns, including poor business-enabling environments and the absence of complementary inputs to production (see Caselli and Feyrer, 2007 on

returns to capital; and Jones, 2011 on complementary inputs to production).

The UK has been a long-term investor in supporting the enabling environment for private sector growth in developing countries, by helping them put in place the building blocks of free and fair markets; sound macroeconomic management; clear and consistently applied policies, regulations and laws; secure property rights; and functioning commercial courts. Infrastructure is another vital ingredient.

From the perspective of UK investors, the problem is not merely the supply of investment opportunities, but the difficulties in locating and understanding those opportunities, and acquiring familiarity with overseas markets. One of the objectives of DFID's Development Capital programme and the activities of the UK's development finance institution, CDC Group, is to 'crowd in' private investors into projects and new enterprises. But the real prize lies in 'demonstration effects', the second-round impact of those deals, where other investors follow the path that Development Capital has blazed, creating new markets in new places.

Yet, while there is clear mutual benefit from bringing investment to countries in need of it, not all investments have the same impact on poverty. The connections between poverty and higher levels of private investment and trade are not straightforward, and DFID has been criticised in the past for failing to ensure its activities benefit the poorest and most vulnerable (see ICAI, 2014). The Secretary of State must ensure that Development Capital and other instruments are judged in terms of the value for money they represent as drivers of inclusive and sustainable growth to eradicate poverty.

UK aid has a strong track record on promoting economic development and both DFID and cross-government bodies like the Prosperity Fund are intent on doing more. But the benefits these activities confer on the UK may not always be fully appreciated.

### Recommendation

Aid can benefit UK investors by driving inclusive and sustainable growth overseas and by addressing market failures in capital markets. But the Secretary of State must ensure that support from the aid budget is proportional to poverty impact.

## 4. Disaster prevention rather than a costly cure

The UK is one of the world's most generous humanitarian donors, but a perennial problem is that money only really becomes available to respond to humanitarian crises once they are in full swing, people have started dying and massive economic damage has been done. The UK government has the opportunity to break this perverse dynamic. The UK should invest more in disaster risk management and response systems within countries, and take a lead in the creation of financing structures such as disaster insurance and catastrophe bonds that release funds rapidly and predictably.

While aid spending is set by the 0.7% target, investing money to reduce future humanitarian obligations will not save the UK money in the sense of reducing total aid spending, but it will free up the aid budget for spending on areas of more direct benefits to the UK. It is in the national interest to spend less money coping with disasters that could have been prevented.

This is about more than cutting the short-term costs of humanitarian responses. There is ample evidence that natural disasters have a long-term impact on economic growth and human development, and can sometimes be a contributory factor to conflict. The present war in Syria was preceded by a decade-long drought during which the water table plummeted, wells ran dry and farmland collapsed into a dust bowl. More than a million farmers joined massive shantytowns on the outskirts of Aleppo, Homs, Damascus and other cities. These events may have increased vulnerability to the subsequent conflict (Kelly et al., 2015).

DFID chief economist Stefan Dercon has recently co-authored a book, *Dull Disasters? How planning ahead will make a difference*, and is also chair of a working group with the Center for Global Development (see Clarke and Dercon, 2016; Talbot and Barder, 2016). The Secretary of State should study their recommendations carefully. Continued leadership by the UK on this issue would be particularly valuable because otherwise politics can often conspire to maintain the dysfunctional existing system: politicians like to be seen saving lives and disasters avoided are not so visible to voters. Tanner et al. (2015) set out the benefits of disaster risk management and how to improve the incentives for such investments.

Solving this problem is both a matter of reforming the international humanitarian financing architecture and investing in disaster management systems within countries. Ethiopia has just suffered its worst drought for 50 years, and although the scale of the emergency eventually overwhelmed domestic resources, famine was avoided thanks to early warning systems, an extensive food security network and a comprehensive social safety net, developed with the support of donors including the UK.

One key element is a transparent and rules-based decision-making system, with roles assigned in advance and finances already in place. Another important part of the solution is insurance-based and forecast-based financing, to deliver funds where they are needed rapidly and predictably, thereby curtailing suffering and saving UK aid pounds in the long (and even short) term. Funding for insurance must be complemented by resilience-building investments, which make the residual risks to be transferred via insurance as small as possible (see Surminski, 2016).

### Recommendation

The UK should take the lead in creating insurance-based financing structures, complemented by strong country systems, that disburse funds rapidly to organisations with well-defined roles.

## 5. Leading the world on global public goods

Prime Minister May and the Secretary of State for International Development have emphasised that, post-Brexit, Britain is a bold, globally-engaged, outward-looking nation. That requires continuing the UK's leading role in delivering global public goods. A public good brings benefits to all, regardless of who paid for it. Public goods are a classic problem in economics: in the absence of policy intervention, people will free ride on the efforts of others and too little will be invested in public goods. The UK will not be 'walking tall' if it free rides on the efforts of others; the UK must continue to step forward, even when others will not.

Exemplary public goods are global security, the natural environment and pandemic prevention. The UK has a particularly strong track record on security: UK bilateral aid is already focused on fragile states and the UK has been instrumental in pushing institutions like the World Bank to do more to create jobs and bring stability to countries that would otherwise be sources of global instability (for a recent analysis of fragility and conflict as 'public bads', see McKechnie, 2016). In addition to continuing UK leadership on these classic global public goods, the Secretary of State could increase UK aid investments in another public good: knowledge.

Knowledge can be a public good, if placed in the public domain. The creation of a new drug or procedure, free of patent protection, is a true global public good. The UK is already leading the way by accelerating the development of vaccines and drugs to eliminate the world's deadliest infectious diseases, and to share that knowledge with the world. Angus Deaton, winner of the 2015 Nobel memorial prize in economics, has argued that aid does not need to be spent in developing countries to benefit developing countries. The Ross Fund, launched with £1 billion in the new Aid Strategy, is a good example of this. But the UK could do more.

The World Bank's International Finance Corporation (IFC) has invested in Silicon Valley companies with the aim of conferring benefits on developing countries. One IFC investment is in micro-satellite technology to improve crop management and drought response in developing countries. The UK should find similar ways to invest aid in UK technologies and to generate knowledge that can be our contribution to the world. Possible examples are technologies that could completely transform the renewable energy landscape, such as next-generation batteries and grid-scale energy storage solutions, or low-cost water desalination.

Of course, a good deal of private investment is already directed at new technologies; the purpose of aid funding would be to reduce the price at which these technologies are made available, or to discover and demonstrate their commercial viability in, for example, sub-Saharan Africa. This could be an area for Development Capital investments. In some instances, aid funded technologies could be made open-source, or licenced on favourable terms or otherwise sold at a discount. Multilateral institutions are often the right vehicle for investments in global public goods and the UK has been instrumental in driving this agenda, for example by establishing the Global Innovation Fund. DFID already part-funds Innovation UK, which has an Energy Catalyst programme. But there is scope for UK aid to play an even larger role in making the UK a global leader in transformational technologies for sustainable development.

### Recommendation

The UK should continue to use aid to bring stability to fragile states, and build on initiatives like the Ross Fund, the Global Innovation Fund and Innovation UK to develop new transformative technologies to share with the world.

## Conclusion

UK aid serves the national interest in many ways, and there are many ways beyond aid in which the UK can help others while helping itself. This briefing has looked at just five directions in which the new Secretary of State for International Development can guide UK aid spending to accomplish her mission of spreading prosperity and eradicating poverty in ways that deliver for the national interest.

We have focused on the national economic interest. We recommend that the UK: takes a long-term perspective on the national interest; uses aid to maximise the potential for mutual gains from international trade; uses aid to improve the investment climate and create new markets for UK investors; takes a lead in reforming the humanitarian system so that it becomes better configured towards disaster prevention rather than crisis response; and builds on the UK's strong track record on global public goods by investing in UK technology and placing it in the public domain.

This briefing is a contribution to the debate on what aid in the national interest means in practice, and introduces some arguments that require further analysis to make full policy recommendations. In particular, more work is needed to evaluate the economic case for aid-funded export facilitation and to identify market failures and how they can best be addressed.

# Notes

1 Responses to questions from the International Development Committee, 14 Sept 2016. Available at www.parliament.uk
2 As Duncan Green has pointed out in a recent blog, one risk of the national interest imperative is that civil servants will only present proposals that can be seen as double wins, at the expense of worthwhile development projects that are not demonstrably in the national interest.
3 Conversely, crises such as Ebola can take a massive toll on the growing tourism industry in the affected locations; see Shankman (2015).

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