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The Politics of Foreign Aid*

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Abstract

Why do donor countries give foreign aid? The answers found in the literature are: (i) because donor countries care for recipient countries (e.g. altruism), and/or (ii) because there exist distortions that make the indirect gains from foreign aid (e.g. terms of trade effects) to be larger than the direct losses. This paper proposes a third answer to the above question, namely that aid is determined through the domestic political process of the donor country. The paper demonstrates how foreign aid affects the donor country's income distribution and how, in a direct democracy, the majority of voters might benefit from foreign aid giving even though the country's social welfare is reduced.

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1. Introduction

Recently there has been renewed interest in the reasons and effects of foreign aid. The work of Boone (1996), Burnside and Dollar (1997), and Alesina and Dollar (1998) analyses foreign aid flows for a large number of years and countries and tests a number of hypotheses concerning the effectiveness of aid, the allocation of aid between different recipient countries, the motives for giving aid, etc. These papers' results provide answers to the many questions that have been put forward in the extensive literature on the economics of foreign aid.

Research on political explanations of foreign aid has centered either on the *international* political interests of the donor government (defense, political influence, etc.) or on the domestic political behavior of the recipient government (democracy vs. dictatorship, fungibility of aid, corruption, etc.). The above- mentioned authors examine in detail whether the data can identify these kinds of political-economy relationships. What has not been addressed in the literature, however, is the question of *domestic* politics of the donor country in determining foreign aid flows. Given the recent proliferation of political-economy explanations for a country's economic policy choices (see Rodrik (1995) for a comprehensive survey and Dixit (1996) for a convincing justification for this approach), it seems most relevant to examine the domestic politics of foreign aid determination. The objective of this paper is to draw attention to the political process in the donor country as a pivotal force in deciding whether to give foreign aid.[1]

In motivating our interest in finding political economy explanations for foreign aid, it is worth recalling what we already know from the literature on international income transfers (see Kemp (1992) for a survey). A well-established result is that in a two-country world the donor of foreign aid becomes worse off if markets are undistorted and stable. Hence, a country that chooses its economic policies with the objective of

[1] Similar issues are addressed in Lahiri and Raimondos-Møller (1999). There, however, the main point of interest is the allocation of aid between recipient countries and how it is influenced by lobbying activities of minority groups.

maximizing social welfare would never wish to become a foreign-aid donor. The natural question raised then is how can one explain foreign aid flows?

The answer offered by the trade literature focuses entirely on the existence of distortions: given that markets face a number of distortions (domestic or international, static or dynamic, endogenous or exogenous), it is not unlikely that a transfer of income from one country to another will create indirect benefits to the donor country that are larger than the initial direct losses. Donor governments are assumed to be aware of the size of these indirect (perhaps long-term) gains and, given that they maximize social welfare, it might be optimal for them to provide some positive amount of foreign aid. In this sense, the thrust of the argument is based on standard second-best intuition.[2]

A different type of explanation for the existence of foreign aid flows is usually suggested by development economists. Foreign aid is given because donor countries are (and should be) altruistic. This strand of the literature focuses on showing that donor countries in reality help less than what they think they do. This argument is based on the negative welfare effects that conditionality rules impose or on the adverse behavioral changes that aid leads to (either by reducing the savings ratio or by inducing delays in necessary political and economic reforms); see, e.g., Cassen (1988). However, and returning to the question posed above, giving aid is nothing else than the outcome of a donor's country's social preference.

The present paper puts forward a quite different explanation of foreign aid giving, namely that it is the outcome of the donor country's domestic political process. Foreign aid, as any actual economic policy choice, is determined through a political process in which all participants pursue their self-interest rather than through the objective of maximizing a country's overall welfare. The political process can result in foreign aid giving if at least some people benefit from the country's role as a donor. If

the beneficiaries from foreign aid giving are also decisive for the choice of economic policies, then the country becomes a donor. At issue, therefore, is whether the giving of aid to foreign residents can benefit some segments of the domestic population and whether the political process enables these winners to impose their will on the rest of society.

The main idea of this paper is developed in a standard two-country, two-good, two-factor framework in which political decisions on foreign aid are made through majority voting. Individuals have different factor endowments and, therefore, different interests in economic policies. Foreign aid is financed through a proportional income tax that is already in place. Foreign aid, therefore, reduces every person's income and this direct effect of foreign aid makes every person worse off. There exist, however, important indirect effects as well. When foreign aid leads to a terms of trade change, individuals are affected both as consumers and recipients of factor income. If each individual owned exactly the same amount of factors of production, then the standard transfer payment result would prevail, namely that the direct effect is always stronger than the indirect effects and each person of the donor country becomes worse off. If, on the other hand, the distribution of factor ownership is unequal, then the indirect effects of foreign aid might not only have a positive impact on a person's welfare but be sufficiently strong to more than offset the negative impact of the direct effect. Hence, some people might actually gain from the country's giving of foreign aid. In a direct democracy with majority voting, the median voter's preferences are decisive for the policy choice.[3] If the median voter gains from the giving of aid, the country becomes a

[2] This intuition can also be applied to the so-called three-agent transfer problem, as discussed in Bhagwati et. al. (1983).

[3] We employ the direct-democracy, majority-voting model primarily for reasons of convenience; it is the simplest political economy model with completely specified economic and political markets (Rodrik, 1995). Foreign aid giving can even more easily come about in a more realistic, but also more complex, representative democracy model with interest groups. The cost of containing free-rider problems works to the advantage of forming smaller groups with concentrated benefits. An industry with relatively few voters, such as agriculture in the United States, might easily succeed in promoting foreign aid that benefits few and hurts many.

donor of foreign aid, even though social welfare declines as a result of the aid payment.[4,5]

It generally is the case that poor recipient countries have a higher marginal propensity to consume certain goods, such as food or weapons, than rich donor countries. Hence, a transfer would raise the world prices of these goods. Individuals in the donor country whose factors of production are intensively used in the production of these goods (farmers in the agricultural sector or capital owners in the high-tech defense industry) have incentives to vote for foreign aid, as the Stolper-Samuelson effect comes into play. At the same time the incomes of people with factors that are used intensively in other sectors
will fall. Thus, while all factor owners pay a proportional income tax to finance foreign aid, the factor owners benefiting from the price-wage effect are able to achieve extra gains at the cost of factor owners that are losing from the price-wage effect.

2. Model[6]

Consider a two-country, two-commodity world in which the people of *Home* decide through majority voting whether to give aid to *Foreign* which, in turn, is willing to accept any amount of offered aid. Each country has fixed endowments with capital and labor, and each country produces both commodities using these factors. Industry production functions are subject to constant returns to scale, factors are perfectly mobile between industries, and all markets are perfectly competitive. Within Home, the *i*th person's ownership of labor and capital, respectively, is described by:

[4] The recipient country as a whole will always benefit from aid in this model. The situation where foreign aid is not accepted by the recipient country, as a result of its own political choice, is not considered in this paper.

[5] In principle, the mechanism described here can be generalized to domestic distributional transfers. In the case of domestic transfers, the costs of transferring income from one group of society to another are smaller than the costs of foreign aid, since income stays always within the country. Differences in marginal propensities to consume between donors and recipients, on the other hand – which is the driving force behind price changes – tend to be larger when transfers are international.

[6] The general structure of the income distribution model is based on Mayer (1984).

$$[L(i), K(i)].$$

(1)

We explicitly assume that every person owns one unit of labor, such that $L(i) = 1$, and that $0 \leq K(i) \leq K(I)$, where $K(I)$ is the endowment of the capital-richest person.

Preferences of factor-owning individuals are assumed to be homothetic and identical within a given country, but different between countries. Hence, aggregate demand of a country is independent of the distribution of income and depends on the country's total income only, and the two countries have different marginal propensities to consume at given prices. The *i*th person's indirect utility function in Home is:

$$U(i) = U[p, I(i)],$$

(2)

where p is the price of good two in terms of good one and $I(i)$ is spendable income of individual i. Income of individual i, in turn, is given by:

$$I(i) = [w + rK(i)][1 - t],$$

(3)

where w and r are the returns on labor and capital respectively, and t is the proportional income tax rate. All people face the same factor returns, are subject to the same tax rate, and own the same amount of labor; their incomes differ from each other solely due to differences in capital ownership. The tax rate is set in a way to finance the chosen foreign aid payment, T:

$$T = t(wL + rK),$$

(4)

where L and K denote Home's total endowment with labor (which also equals the number of people) and capital, respectively. Using (4), one can restate the ith person's income of (3) as:

$$I(i) = \phi(i) I ,$$

(5)

where $\phi(i) = [w + rK(i)]/[wL + rK]$ is the ith person's share of total factor income earned and $I = [wL + rK - T]$ is spendable income for the entire country. Noting that total factor income earned equals the country's value of goods produced, we can write:

$$I = I(p,T) = X_1(p) + pX_2(p) - T ,$$

(6)

where X_j indicates Home's total production of commodity $j = 1,2$.

In order to restate the ith person's income share expression, we first define $\theta = w/r$ as Home's wage-rental ratio. In the Heckscher-Ohlin model, $\theta = \theta(p)$ and $\theta_p(p) = d\theta/dp$, the Stolper-Samuelson derivative, is positive (negative) if the second good is labor (capital) intensive in production. Then:

$$\phi(i) = f[p, K(i)] = \frac{\theta(p) + K(i)}{\theta(p)L + K} .$$

(7)

A person's income share is directly related to her capital ownership; but it also depends on the price of the second good. Differentiating the above expression with respect to p yields:

$$\frac{\partial \phi(i)}{\partial p} = \frac{\rho_p(p)L[k - K(i)]}{[\rho(p)L + K]^2},$$

(8)

where $k = K/L$ is Home's aggregate capital-labor endowment ratio or, stated differently for our purposes, the average person's capital-labor ownership ratio. Noting that $K(i)$ is the ith person's capital-labor ownership ratio, (8) states that a price increase of the second commodity raises a person's income share if the person owns relatively more than the average person of the factor that is employed intensively in the production of the second good. For example, if person i is relatively capital-rich, such that $K(i) > k$, and the second good is capital intensive, $\rho_p(p) < 0$, then the ith person's income share rises with a price increase of the second good.

There are no impediments to trade, and there are no domestic production or consumption taxes. Consequently, prices faced by consumers and producers are the same in both countries. For a given amount of transfers, the relative price of the second good is determined through the balance of trade equation:

$$pM_2(p,T) = M_1^*(p,T) - T,$$

(9)

where $M_2(p,T) = C_2(p,I) - X_2(p)$ is import demand for good two by Home, $M_1^*(p,T) = C_1^*(p,I^*) - X_1^*(p)$ is import demand for the first good by Foreign, C_j denotes a country's aggregate consumption of good j, I was defined by (6), and an asterisk indicates that the variable belongs to Foreign. Differentiating (9) with respect to T yields the terms-of-trade effect of a transfer payment:

$$\frac{dp}{dT} = \frac{m_2^* - m_2}{M_2[\varepsilon + \varepsilon^* - 1]},$$

(10)

where $m_2^* = p(\P C_2^*/\P I^*)$ and $m_2 = p(\P C_2/\P I)$ are the marginal propensity to consume good two in Foreign and Home, respectively; $\varepsilon = -(p/M_2)(\P M_2/\P p) > 0$ and $\varepsilon^* = [p/(M_1^* - T)][\P M_1^*/\P p] > 0$ are the two countries' respective uncompensated import elasticities of demand. To assure stability of the world exchange system, the sum of the import elasticities of demand must exceed one; i.e. $\varepsilon + \varepsilon^* - 1 > 0$. Thus, in line with the literature, a transfer from Home to Foreign increases the second good's price if Foreign's propensity to consume the second good exceeds Home's.

3. Individually Optimal Aid Payments

Moving on to the political choice of foreign aid, we first focus on how much aid is best for a given individual. Each person realizes that a foreign aid payment affects her welfare, as expressed in (2), in three different ways: First, each person has to pay higher taxes to finance the aid. Second, each person faces a different price as a consumer whenever the transfer leads to a terms-of-trade effect. Third, each person receives a different amount of factor income in response to the terms-of-trade effect. Given the feasible set of aid payments, $0 \leq T \leq X_1(p) + pX_2(p)$, and assuming that $U(i) = U\{p(T), \phi[p(T),K(i)]I[p(T),T)]\}$ is strictly concave in T, person i will favor some positive level of foreign aid if

$$\frac{dU(i)}{dT} = \frac{\partial U(.)}{\partial p}\frac{dp}{dT} + \frac{\partial U(.)}{\partial I(i)}\left\{\phi(i)\left[\frac{\partial I}{\partial p}\frac{dp}{dT} + \frac{\partial I}{\partial T}\right] + I\frac{\partial \phi(i)}{\partial p}\frac{dp}{dT}\right\} > 0$$

when evaluated at $T = 0$. Using Roy's identity and the homotheticity of preferences assumption, we substitute $-[\partial U(.)/\partial p]/[\partial U(.)/\partial I(i)] = c_2 = \phi(i)C_2(i)$, as well as $\P I/\P p = X_2(p)$ and $\P I/\P T = -1$, to rewrite this condition for favoring some form of foreign aid as:

$$\frac{dU(i)}{dT} = \frac{\partial U(.)}{\partial I(i)} \mathsf{f}(i) \left\{ \left[-M_2(.) \frac{dp}{dT} - 1 \right] + I \frac{\partial \mathsf{f}(i)}{\partial p} \frac{p}{\mathsf{f}(i)} \frac{dp}{pdT} \right\} > 0. \quad (11)$$

The bracketed term inside the braces must always be negative, as is well known from the traditional literature on the transfer problem (the direct plus indirect welfare effect of a transfer on the country as a whole is always negative). Hence, a necessary condition for a foreign aid payment to lead to an increase in the welfare of a person in the donor country is that the transfer raises the income share of this person, as expressed by the second term inside the brace. Considering equations (8) and (10), such an increase in the *i*th person's income share will occur if Foreign's propensity to consume exceeds Home's for that good which uses the factor relatively intensively of which person *i* owns relatively more than the average person. Specifically, the *i*th person's income share will rise if her capital ownership ratio exceeds (falls short of) that of the average person and Foreign has a higher propensity to consume the capital (labor)-intensive good than Home.

Provided (11) is satisfied for person *i*, this person will have a positive most preferred level of foreign aid, denoted by *T(i)*, at which

$$-\left[M_2(.) \frac{dp}{dT} + 1 \right] + I \frac{\partial \mathsf{f}(i)}{\partial p} \frac{p}{\mathsf{f}(i)} \frac{dp}{pdT} = 0. \quad (12)$$

Given a person exists for whom *T(i) > 0*, the question arises whether we can say anything about the optimal amount of aid of other people, with different capital ownership. In order to establish such a relationship between a person's individually optimal foreign aid level and her capital ownership, let us note first that only the second term in (12) depends on the value of *K(i)*. If the second term rises with *K(i)*, then people with higher *K(i)* values want to give more foreign aid and people with lower *K(i)* values want to give less foreign aid. After substitution of (8) into this second term, differentiation with respect to *K(i)* yields:

$$\frac{\partial\left\{I\dfrac{\partial \mathsf{f}(i)}{\partial p}\dfrac{p}{\mathsf{f}(i)}\dfrac{dp}{pdT}\right\}}{\partial K(i)} = \left[I\frac{\partial \mathsf{f}(i)}{\partial p}\frac{p}{\mathsf{f}(i)}\frac{dp}{pdT}\right]\left[\frac{\mathsf{r}(p)+k}{[K(i)-k][\mathsf{r}(p)+K(i)]}\right].$$

(13)

The first term on the right-hand side of (13) is positive, as it is the necessary condition for the individual's optimality of giving any aid (see (11)). The sign of the second term depends on whether the individual owns more or less capital than the average person in the country.

Returning to the individual optimality condition for foreign aid, as presented in (12), we can thus see that the second, positive term in (12) rises with *K(i)* if the person who favors some positive level of foreign aid owns more capital than the average person, but it declines with *K(i)* if the person who favors some positive level of foreign aid owns less capital than the average person.

First, let us consider the case of $K(i) > k$. Using (8), this means that the second term in (12) can be positive only if the price of the capital-intensive good goes up in response to the transfer; that is, $\mathsf{r}_p(p)[dp/dT] < 0$. Hence, person *i* is capital-rich and benefits from a transfer that raises the price of the capital-intensive good. Equation (13) then states that, for $K(i) > k$, there exists a direct relationship between a person's capital ownership and the percentage gain in her income share from a transfer that raises the price of the capital-intensive good. This means that for any person *n* with capital ownership $K(n) > K(i)$, the second term of (12) is larger than for person *i*, implying that the *n*th person's individually optimal transfer, *T(n)*, also exceeds that of person *i*, *T(i)*. It also means that there exists some $K(h) < K(i)$ such that person *h* is indifferent between paying the transfer and not paying. Person *h* is the marginal supporter of foreign aid; all people with higher capital ownership support a positive amount of aid, whereby the amount is increasing with the amount of capital owned, and all people with lower capital ownership prefer no aid payments at all. This relationship is

expressed in Figure 1, where the critical assumption is that the transfer raises the price of the capital-intensive commodity.

Figure 1: (about here)

Second, let us consider the case of $K(i) < k$. Figure 2 illustrates the corresponding relationship between individually optimal transfer payment and a person's capital ownership when the good whose price rises in response to the transfer is labor intensive, meaning that $r_p(p)[dp/dT] > 0$. In this case, the second term in (12) is positive because person i is capital poor. Equation (13), in turn, states that the value of this second term of (12) rises with a decline in capital ownership. Accordingly, individuals without capital ownership favor the highest amount of foreign aid. As capital ownership rises up to $K(h) < k$, the individually optimal amount of aid declines until it reaches zero for the marginal aid giver, person h. All people with more capital than person h will always favor zero aid.

Figure 2: (about here)

So far we have established that, if there exists a person in whose interest it is to give foreign aid, then foreign aid will also be desired by all other people with more capital ownership if the aid payment raises the price of the capital-intensive good and by all people with less capital ownership if the aid payment raises the price of the labor-intensive good. Hence, we have to show that it is at least possible that there are some people for whom equation (12) holds at some positive value of $T(i)$ or, stated differently, that the inequality of equation (11) holds when evaluated at $T = 0$.

With this objective in mind, we write each of the terms inside the brace of (11) explicitly. Denoting the income-compensated import elasticities of demand by:

$$e = -\frac{p}{M_2}\left[\left(\frac{\partial C_2}{\partial p}\right)_{du=0} - \left(\frac{\partial X_2}{\partial p}\right)\right] > 0$$

$$e^* = \frac{p}{M_1^* - T}\left[\left(\frac{\partial C_1}{\partial p}\right)_{du=0} - \left(\frac{\partial X_1}{\partial p}\right)\right] > 0\,,$$

and realizing that $\varepsilon = e + m_2$ and $\varepsilon^* = e^* + m_1^*$, one can show that the first term inside the brace can be expressed as:

$$-\left[M_2(.)\frac{dp}{dt} + 1\right] = -\frac{e + e^*}{\varepsilon + \varepsilon^* - 1} < 0\,.$$

(14)

The second term inside the brace of (11), in turn, can be stated as:

$$I\frac{\partial \phi(i)}{\partial p}\frac{p}{\phi(i)}\frac{dp}{pdT} = \frac{I}{pM_2}\frac{\rho(p)[k - K(i)]}{[\rho(p) + k][\rho(p) + K(i)]}\frac{(m_2^* - m_2)}{(\varepsilon + \varepsilon^* - 1)}\omega\,,$$

(15)

where $\omega = \rho_p(p)p/\rho(p)$ expresses the percentage change in the wage-rental ratio in response to a percentage change in the second good's price; its absolute value must exceed one, due to the magnification effect in the Stolper-Samuelson relationship, and it is positive for a labor-intensive and negative for a capital-intensive second good.

Comparing the magnitudes of (14), which represents the welfare effect of a transfer to the average person of the country, and (15), which represents the redistribution of income effect due to a transfer, we make the following observations about the possibility that the latter outweighs the former. First, necessary conditions for (15) to be positive are that donor and recipient country have different propensities to consume and that person *i* is different from the average capital owner; person *i* must be

relatively capital-rich when aid raises the capital-intensive good's price and relatively capital-poor when aid raises the labor-intensive good's price. Second, a person's redistribution of income effect becomes larger relative to the average welfare effect the more her capital ownership differs, in either direction from that of the average person and the greater the differences between the two countries' propensities to consume. Third, for sufficiently unequal distributions of capital ownership and sufficiently large differences in propensities to consume there exists a person *i* for whom the redistribution effect outweighs the average welfare effect, evaluated at $T = 0$.

4. Political Choice of Aid through Majority Voting

Having examined the individual person's preferences for foreign aid, we next consider the political process through which individual policy preferences are transformed into a country's chosen policy. For convenience sake, we assume that foreign aid policy is determined in a direct democracy through majority voting.[7] Within the feasible set of aid payments, $T > 0$, each person casts a vote that reflect her self-interest. Under majority voting, a political equilibrium level of foreign aid is established when it is not possible to assemble a majority of voters to change this aid level. Given our assumptions of foreign aid being the only issue under consideration and of each voter having a unique individually optimal level of aid giving, the political aid choice under majority voting is determined by the median voter's most preferred level of aid, denoted by $T(m)$. Provided $T(m) > 0$, majority-determined foreign aid will be positive even though it is not in the interest of the average inhabitant of this country to give foreign aid.

Figures 1 and 2 show monotonic relationships between individuals' factor ownership and foreign aid preferences. Accordingly, for a given distribution of capital ownership, as described by $F(\mathsf{k})$, with density function $f(\mathsf{k})$ for $0 \leq \mathsf{k} \leq K(I)$, the median owner of capital, $\mathsf{k}(m)$ also

becomes the median voter on foreign aid, whereby $\kappa(m)$ is determined by the condition:

$$\int_0^{\kappa(m)} dF(\kappa) = \frac{1}{2}. \qquad (16)$$

If the distribution of capital ownership is symmetric, then capital ownership of median voter and average capital owner is exactly the same, such that $\kappa(m) = k$. Since the average capital owner will never want her country to become a donor of foreign aid, a necessary condition for the political process to yield a positive amount of aid payments is that the distribution of capital ownership is skewed, either to the right or to the left.

When the distribution of capital ownership is such that the majority of individuals owns more capital than the country's average capital owner, then $\kappa(m) > k$ and the possibility emerges that majority voting will lead to foreign aid giving provided this aid's indirect effect is to raise the price of the capital-intensive good. Recalling the earlier stated identification of capital ownership of the marginal aid giver, $K(h)$, there will be foreign aid giving if $\kappa(m) > K(h)$.

The likelihood of actual political choice of aid by capital-rich people is rather small, given the real-world distributions of factor ownership rarely, if ever, show a majority of capital rich individuals. Does this, therefore, make the political argument behind foreign aid giving something that is technically possible but in reality not occurring? The answer is in the negative for at least three reasons. First, most political systems do not permit all factor owners to vote, as was assumed above. Importantly, voter eligibility rules tend to fall most heavily on individuals who do not possess much capital, such as migrant workers, teenage workers, inmates of prisons, recent legal and illegal immigrants, and so on. If one looked at the capital ownership distribution of eligible voters only, it

[7] Note that the policy choice in a representative democracy could be the same as in a direct

becomes far more likely that one will encounter one with a majority of capital-rich people in the real world. Second, our analysis assumed that every person whose welfare is affected by the foreign payment, through paying the tax and factor return changes, will actually vote and that there are no costs of participation in the political process. In other words, there is no free rider problem among voters and the participation costs are negligible. Both these assumptions are quite strong, however. If, more realistically, one assumed that the probability of voting is a function of the net benefit or net loss from a proposed policy choice, then the actual voters' factor ownership profile might become quite different from that of the population as a whole. It is quite possible that capital-rich people will become a majority of actual voters. Third, it is entirely possible that the policy is dictated by capital-poor rather than by capital-rich people. If a country has a majority of capital-poor people, the median voter's capital ownership will be less than that of the average factor owner; that is, $k(m) < k$. Provided the foreign aid payment results in a price increase of the labor-intensive good, the possibility emerges that capital-poor people vote in favor of foreign aid payments, as can be seen from Figure 2. The median voter's capital ownership is to the left of k. If $k(m)$ is also less than capital ownership of the marginal supporter of foreign aid, such that $k(m) < K(h)$, then the capital-poor majority of voters in Home will indeed vote in favor of aid to Foreign.

5. Concluding Remarks

This paper formulated a political economy model of endogenous foreign aid determination and proposed it as a new explanation for foreign aid giving. It is an explanation that is complementary to the existing approaches on this issue, i.e. the second-best approach of trade theory and the altruism approach of development economics. The political economy approach to aid giving is important since in reality the adoption of all economic policies is critically affected by domestic policy considerations.

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democracy provided perfectly competitive political markets prevail (see Hillman (1989)).

The key behind the political explanation of foreign aid is that aid giving affects the international terms of trade which, in turn, changes the distribution of income among factor owners in the donor country. The income distribution effects of aid giving will be significant if there are sizable differences in propensities to consume between donor and recipient country and the domestic distribution of factor ownership is quite unequal. It is likely that at least some people will benefit from aid giving if these conditions prevail. Should the beneficiaries from aid giving also be decisive in choosing economic policies, the political choice of the donor country will be to give foreign aid.

We formulated a political economy model of foreign aid under the assumption that the distribution of income effects are determined in a standard Heckscher-Ohlin model and that foreign aid policy is adopted through majority voting in a direct democracy. Our choice of economic and political models was motivated by a desire to formulate a specification of endogenous aid policy formation that is both complete and easily tractable. The underlying implications from our simple model, however, carry over to more realistic, though less tractable descriptions of the political process as well. In fact, political choice of foreign aid is even more likely to come about in a representative democracy with interest groups.

There exists a huge literature on the endogenous choice of trade policies in the presence of interest groups, as surveyed in Hillman (1989), Rodrik (1995), and Helpman (1995). Groups of individuals with common interests, such as people with the same factor ownership, try to influence economic policies by offering financial contributions or information to politicians or competing parties during elections or to the government currently in power. Given such an alternative political process, one can show that a relatively small group of people with common interests can easily succeed in shaping foreign aid policy that benefits the small group and hurts the vast majority of the population. For example, the farming industry might succeed in promoting a foreign aid policy that substantially

raises demand for its products, benefiting farmers but hurting everyone else.

A small interest group might succeed in setting a donor country's aid policy preferences because the benefits from aid might be very concentrated while the losses are widely dispersed (see Baldwin (1982) and Hillman (1989) among others). Even though the country suffers a net loss in the aggregate, the per capita gains of the few beneficiaries might be vastly larger than the per capita losses of the many losers. This inequality in magnitude of individual welfare effects can be seen in equation (11) of our model as well. The average decline in welfare due to aid giving is adjusted by a change in the *i*th person's income share. When foreign aid benefits one industry only, the large gains in income shares by few gainers is accompanied by very small income share losses of many losers, as the sum of all income share changes must be zero. Given this situation, the large number of losers might have far less of an incentive to form a foreign aid-opposing interest group than the few aid-supporting gainers. Interest group formation is not without costs. Importantly, there are the costs of containing the free-rider problem and these costs tend to rise with the size of the group, not just in total but also per capita. Accordingly, the many losers from giving foreign aid might not even form an interest group to oppose the influence-seeking by a given industry. The few gainers, with higher per capita gains and lower per capita organizing costs, will form an interest group and influence policymakers through contributions and information conveyance. Accordingly, an industry that represents a small part of the entire voting public succeeds in directing a country's foreign policy towards giving aid.

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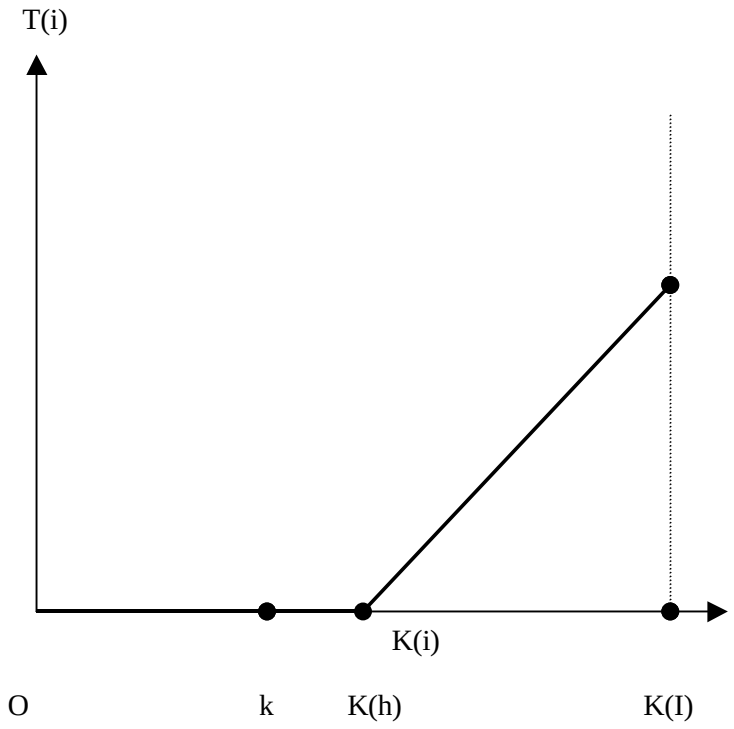

Figure 1: Individually optimal aid as a function of capital ownership when price of the capital-intensive good rises.

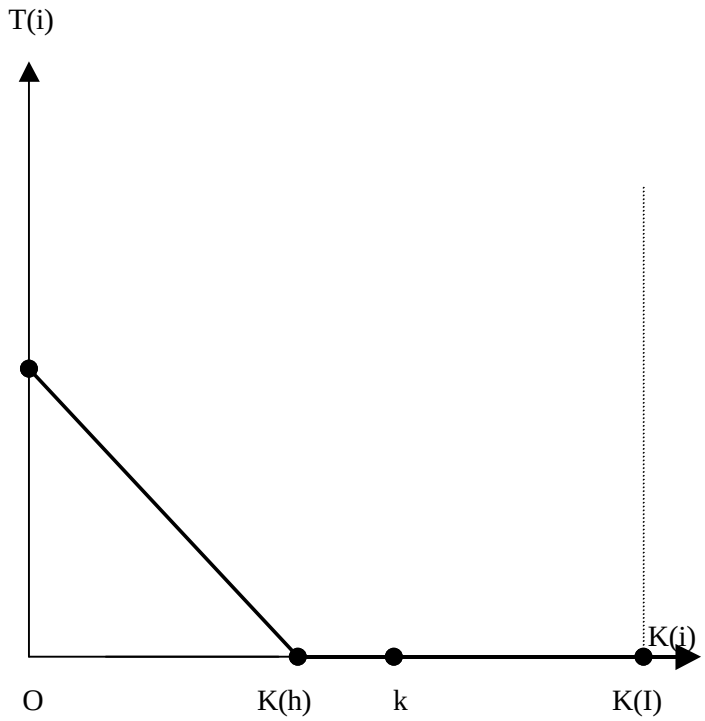

Figure 2: Individually optimal aid as a function of capital ownership when price of the labor-intensive good rises.