The Long-Run Aid-Output Relationship: The Role of Edgeworth Substitutabiity (Complementarity) Between Public and Private Consumption

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Abstract

Foreign aid finances both public consumption and investment in developing countries. However, its long-run impact on output in recipient countries remains ambiguous. We show in a tractable general equilibrium model that when public consumption substitutes for private consumption in an Edgeworth Pareto sense, aid earmarked for public consumption decreases the marginal utility of private consumption and raises the marginal disutility of labor. This induces a simultaneous fall in private consumption and labor supply thereby diminishing and potentially, outweighing the positive effect that aid-financed public investment has on output. In contrast, Edgeworth complementarity between private and public consumption reinforces the positive effect of aid-financed public investment. This is because aid allocated to public consumption raises the marginal utility of private consumption and reduces the disutility of labor. These results have important implications for policies regarding aid allocation as well as ongoing studies that examine aid effectiveness in general equilibrium models.

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