

**The Distributional Consequences of Foreign Transfers:  
Do they Reduce or Exacerbate Inequality?**

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**Abstract**

This paper studies the impact of foreign transfers on the recipient country's aggregate economic performance as well as its distribution of wealth and income within a dynamic two-sector dependent economy framework. The transfers may take the form of a pure flow of resources that are devoted to debt reduction, or alternatively they may be allocated to the productivity enhancement of the traded or nontraded sector, via investment in the sector's infrastructure. We show how the effect of the transfer on the aggregate economic performance depends crucially upon: (i) the relative capital intensities of the two productive sectors, and (ii) the allocation of the transfers across the sectors. The consequences for wealth and income inequality depend not only upon these two factors, but also upon (iii) the recipient economy's access to the world financial market. Most of the analysis is carried out using numerical simulations, where we characterize the dynamic evolution of both the aggregate economy and wealth/income inequality. Whether growth and inequality are positively or negatively associated over time depends upon the three factors noted above. In this regard the analysis can be reconciled with the contrasting range of empirical evidence.