

Types and nature of foreign aid economics essay



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The lessening of the strategic importance of foreign aid has been reinforced by the end of the Cold War which led to its decreasing flows in the 1990s. Though the quantity of aid has decreased significantly, the amount of aid agencies has been seen to shoot up from approximately 7 in 1960 to around 50 by the 1990s. The multilateral institutions, most importantly being the World Bank and the International Monetary Fund have taken a somewhat distinguished right over the fiscal policies of the developing world. These organizations enforce firm circumstances on the beneficiary countries and intimidate them to withdraw aid if the states of affairs promised to them are not fulfilled. To some degree, aid flows have encouraged growth and structural change in the beneficiary countries, particularly in the period of natural calamities and post-war reconstruction. However, it is explicitly stated that the implications of foreign aid on growth and expansion are inadequate since foreign aid is frequently aimed at political and military fields in contrast to human development (Hang Le and Ataullah, 2007).

2. 2. 3 Types and nature of foreign aid

Foreign aid has an extremely diverse and heterogeneous nature. We cannot give a single figure to it and analyze the whole situation based on just one figure (Mavrotas, 2002).

2. 2. 3. 1 Sources of foreign aid

At least four different categories of aid are presented in literature: “ project aid with a rather lengthy gestation period, technical assistance, and food aid and other commodity aid which adds directly to consumption.” To these four types of foreign aid, emergency or relief aid could be added as a distinct category, given its rising importance in recent years (Mavrotas, 2002).

2. 2. 4 Theories and models of foreign aid in literature

2. 2. 4. 1. The dual gap model

A theoretical model of foreign aid in literature is the dual gap model. The Dual-gap theory emphasizes the role of imports and foreign exchange within the development process. The characteristic contribution of the dual-gap analysis is that though foreign exchange is the leading constraint, it points to the dual role of foreign borrowing in increasing not only scarce domestic saving but also foreign exchange. It is evident that domestic provision requires domestic saving; and that foreign provision of goods requires foreign exchange. There is always a need for a minimum amount of foreign exchange to sustain the growth process. The model takes both the traditional and modern view on foreign assistance- as a boost to domestic saving and, on the other hand, import of goods necessary for growth with the aid of foreign assistance. The dual-gap analysis also presents a more relevant theory of trade for developing countries which justifies protection and import substitution (Ahmed, 2001)

2. 2. 4. 2 The foreign exchange gap

The foreign exchange gap is defined as the deficit on the country's current account where the balance of payments exceeds the capital inflows. The foreign exchange gap is a concept very pertinent to developing countries. They are usually characterized as being short of capital, since their saving and investment rates differ from developed nations. With external aid and other forms of monetary assistance, developing and underdeveloped countries can get initial capital required to embark on the pathway to industrialization. Once industrialization is underway, the problem of domestic

saving resolves gradually. The two gap model is based on the assumption that for developing countries to maintain high growth and industrialization, foreign currency is needed to import capital equipment, raw materials and intermediate goods. Thus foreign exchange gap can become a big development constraint.

Hence, recipient countries may require foreign aid in order to cater to their foreign exchange gap.

2. 3 A review of the demand and supply side factors of foreign aid

2. 3. 1. Demand side factors and the three gap model

As opposed to macroeconomic growth models of full employment, the three-gap model unambiguously considers the interplay between ' capacity expansion and capacity utilization'. In addition, less data requirement of the model makes it well-suited to countries such as China and Pakistan, where the reporting, coverage and accessibility of time series data is very limited. Gap analysis assumes that the incremental capital-output ratio and other behavioral indicators are fixed in the medium-term and that there is restricted replacement and substitution between domestic and foreign resources.

According to the three-gap model, the expansion and utilization of current productive capacity is constrained by not only the domestic and foreign savings, but also by the impact of fiscal limitations on government spending and hence on its public investment choices (Zhang and Chen, 2006).

2. 3. 1. 1 Motives of Recipient Countries of Foreign Aid

Many beneficiaries obtain aid from some OECD benefactors annually. Recent research suggests that corrupt recipient governments, especially of the developing world, have incentives to comply with donor objectives in the public health sectors but they will do so in aid sectors, in which compliance is less costly. This strategy allows corrupt recipients to achieve at least some developmental tasks successfully, hence justifying additional aid inflows (Dietrich, 2011).

2. 3. 1. 2 Policies of recipient countries regarding foreign aid

Many developing nations experience a phenomenal debt burden in lieu of the increasing tendency towards giving loan aid as opposed to giving aid as grants while tying aid to the donor countries' exports. Given the ambiguous effects of foreign assistance and inadequate power over the quantity of aid received, practitioners and policy makers in developing nations make an effort to seek substitute basis for overseas capital, such as foreign private investment and direct and portfolio investment.

Also, the conditions imposed by aid agencies such as IMF and World Bank, may lead to limitations on policy autonomy of the recipient country and become influential in dictating governments of recipient countries. Observed evidence recommends that aid has not added intensely to the growth and economic development of beneficiary countries and in many cases it has amplified inequalities among different groups (Hang Le and Ataulloh, 2011). Many studies even suggest that aid has the potential to delay the timing of important improvements and changes by giving supplementary capital to

vested benefits which persuade authorities of the recipient country to refuse to accept adjustments (Casella and Eichengreen, 1996).

2. 3. 2. Supply side factors

2. 3. 2. 1 Determinants of donor's aid allocation policies

The mounting propensity toward giving aid in the form of loans as opposed to giving aid in grants and towards fixing aid to the donor countries exports is a way of the donor to increase the debt burden of the recipient country so that it becomes economically dependent on it for servicing its debt (Le and Atallah, 2011). Foreign Aid institutions, such as WB and IMF, have become even more dominant in using the governments of recipient country in their own strategic interests.

Bermeo (2011) studies data to investigate the relationship between foreign aid and the possibility of democratization in aid recipients. According to him, the association of democratization and foreign aid lies on individuality of the aid benefactor. In the period 1992 to 2007, aid from democratic donors was found to be linked with an increase in the probability of a democratic transition. It suggested that self-governing and independent donors use limited aid capital to support democracy. However, within the same phase, foreign assistance from authoritarian governments shows a negative relationship with democratization. Authoritarian donors are doubtful to embrace democracy endorsement in their purpose to determine the policy of aid. China, for example, puts small conditionality on the aid it extends and does not prioritize democratization.

Examining the websites for the Abu Dhabi Fund for Development, the Kuwait Fund for Arab Economic Development and The Saudi Fund for Development confirms that problems of governance are not listed as big priorities for these donors. The Saudi Fund clearly puts its stance forward that loans it makes are without any stipulations and that it has direct deals with government departments of developing nations in sponsoring developments projects, providing direct evidence that it does not follow new ways of directing aid which many OECD donors comply with. It is possible that the difference seen in the contrast between democratic and authoritarian aid is in their association with regime change and is driven by the choice of recipients to a great extent.

Balla and Reinhardt (2008) have another viewpoint. They find that donors have responded to balanced incentives to decrease recipient poverty and further donor political and economic goals. Every bilateral donor conditions aid on conflict. The U. S. allocates huge amounts of development aid to countries bordering a conflict, in both pre- and post-Cold War times. However, controlling for development levels and donor economic and political interest, ' most donors reduce aid to a recipient with an in-house or nearby intense conflict' (Balla and Reinhardt, 2008).

It is seen that most western donors give substantial amounts of foreign aid to corrupt countries. While this might suggest a policy failure to some, it may well be indicative of donor practice that is often overlooked in literature: recipient governments' ' good behavior' in foreign aid sectors, irrespective of their poor national institutions, matters for allocation. ' When evaluating the high fiduciary risks associated with spending money on the world's poorest

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and often most corrupt countries, donors look for specific sector-related progress' (Dietrich, 2011).

2. 3. 3 Politics and geopolitics of foreign aid

2. 3. 3. 1 Geopolitics and foreign policy

Many democratic aid donors state the promotion of democracy as a major goal in their foreign policy. The United States Agency for International Development (USAID) puts forward the view the view that their work gives support to evenhanded economic growth while extending U. S foreign policy motives by helping in sustaining growth, trade, agriculture, democracy, humanitarian assistance, global health and conflict prevention.

The United Kingdom's Department for International Development (DFID), however, gave shape to a Governance and Transparency Fund which redresses issues which enable citizens of nations to voices their views and hold their governments accountable to their actions (Bermeo, 2011).

2. 3. 3. 2 Geopolitics and foreign aid

Tingley (2009) uses a time-series cross-sectional data set to examine the influence of changes in political and fiscal variables. According to him, as governments become more and more conservative, their aid effort starts to fall. Domestic political variables emerge to influence aid effort, however, only for aid to low income countries and multilaterals as compared to aid effort to middle income countries which remains unaffected. This emphasizes donor economic and international strategic interests as reasons of donor aid policy may be misjudged. His results also suggest foundations of aid volatility that might pressure recipient growth prospects (2009).

2. 3. 3. 3 Governance and its relation to foreign aid

Burnside and Dollar's (2000) study introduces governance into the effectiveness of aid debate. They analyze the fact that aid increases overall economic growth in the recipient country, provided it is used optimally with good governance practices and fiscal and monetary policies. They shift their focus from policies to institutions, finding empirical support and evidence for a multiplier effect of good governance.

The focus of research aid effectiveness is the conditioning effect of political institutions. Kosack (2003) also looks into the conditioning effect of democracy but adds the aspect of human development to it too. He shows that more democratic governments are more efficient at channeling aid by improving peoples' lives, as calculated with the Human Development Index (Dietrich, 2011).

Recent research suggests that corrupt recipient governments, especially of the developing world, have incentives to comply with donor objectives in the public health sectors but they will do so in aid sectors, in which compliance is less costly. This strategy allows corrupt recipients to achieve at least some developmental tasks successfully, hence justifying additional aid inflows (Dietrich, 2011). This implies huge loopholes in good governance by recipient countries.

There are examples that state otherwise. Good governance practices can be found in corrupt recipient countries too. Bangladesh, which ranks among the world's most corrupt countries by Transparency International (2006), received US\$ 833 million in foreign aid in 2006, of which only US\$ 170

million was health-related aid. Despite extremely high corruption levels, the country has shown notable success over the last couple of years in improving the condition of basic health services. Donor representatives appreciate Bangladeshi collaboration in addressing essential needs of their citizens, particularly on child health outcomes. Whether a country is receptive to the donor's calls will have an effect on the nature and size of foreign aid.

Similarly, Mali, which is also seen as a corrupt country recently received a positive mentioning by an OECD health aid assessment (2009), but accomplished very little in other sectors. Targeted and sustained immunization, special government programs to reduce pneumonia-related deaths, national awareness campaigns on the treatment of diarrhea, better sanitation, and better access to safe water. For theories of aid effectiveness focused on the quality of governance, such stories might appear inconsistent. The high corruption scores should mean that Bangladesh's government would direct substantial amounts of public health aid for private gain and less to leave aside for development purposes (Dietrich, 2011).

There is growing agreement that aid transparency and good governance must be improved to get better aid effectiveness. Aid transparency can be defined as complete accessibility of aid information in a systematic and timely manner, which would allow community contribution and membership in government accountability (Ghosh and Kharas, 2011). Greater transparency helps donor nations to evaluate their aid programs more efficiently.

Some countries, such as the US, provide aid through multiple agencies, often with overlapping responsibilities. The result is a confusing replication of activities and diffuses accountability.

‘ Greater transparency is necessary for recipient country citizens to be able to hold their government accountable over discrepancies in the figures for foreign aid spent and received. For example, in Afghanistan, an official at the Ministry of Finance when interviewed by Oxfam America said that since 2001, the US had pledged \$32 billion in aid but less than 20% (\$6 billion) was recorded in the government databases. This means that Afghans have no way of knowing what happened to the other \$26 billion that the US could have spent in their country. 18 With greater transparency of how much aid is coming into their country, citizens and government officials can have a greater say in how best to use the funds’ (Ghosh and Kharas, 2011).

2. 4 Foreign aid inflow, tax reforms and tax effort

2. 4. 1 Aid effectiveness on tax effort

The relationship between aid effectiveness and tax effort can be highlighted using the case of Pakistan as a typical developing nation. Pakistan was among the major aid beneficiary countries in the 1960s, 70s, and 80s. Unfortunately, the benefits of such aid could not reach the society as a whole, especially in areas of fiscal revenues. Foreign aid failed to induce the government to develop a sound education standard for the country. Though Pakistan had a great influx of aid within this time period, the enrollment rate in schools of children- and the overall illiteracy rate- continued to being at its former level (approximately 59-65%). Other Asian countries such as Malaysia and Sri Lanka which got only a partial share of aid comparative to Pakistan in <https://assignbuster.com/types-and-nature-of-foreign-aid-economics-essay/>

the 1970s were successful in improving the literacy rates significantly. Other indicators, like employment and health, present the same depiction.