FOREIGN AID IN ECONOMIC DEVELOPMENT

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Abstract
Foreign aid inflows have grown significantly in the post-war period. Many studies havetried to assess the effectiveness of aid at the micro- and macro-level. While micro evaluations have found that in most cases aid 'works', those at the macro-level are ambiguous. This paper assesses the impact of foreign aid on growth and development for a large sample of developing countries. The results strongly support the view that foreign aid does have some positive impact on growth, conditional on a stable macroeconomic policy environment. It can be provided through direct or indirect investment. Foreign assistant can also provided through physical or financial form. In this paper we will study the factors, advantages and disadvantages with respect to change in their income level, standard of living etc.

Meaning of Foreign Aid:

Foreign aid means economic, technical, or military aid given by one nation to another for purposes of relief and rehabilitation, for economic stabilization, or for mutual defense. Some experts charges that aid has enlarged government bureaucracies, perpetuated bad government, enriched the elite in poor countries, or just been wasted. Other argues that although aid has sometimes failed, as they have supported poverty reduction and growth in some countries and prevented worse performance in other.

Controversies about aid effectiveness go back decades. Critics such as Milton Friedman, Peter Bauer, and William Easterly have leveled stinging critiques, charging that aid has enlarged government bureaucracies, perpetuated bad governments, enriched the elite in poor countries, or just been wasted. They cite widespread poverty in Africa and South Asia despite three decades of aid, and point to countries that have received substantial aid yet have had disastrous records such as the Democratic Republic of the Congo, Haiti, Papua New Guinea, and Somalia. In their eyes, aid programs should be dramatically reformed, substantially curtailed, or eliminated altogether. Supporters counter that these arguments, while partially correct, are overstated. Jeffrey Sachs, Joseph Stiglitz, Nicholas Stern and others have argued that although aid has sometimes failed, it has supported poverty reduction and growth in some countries and prevented worse performance in others. They believe that many of the weaknesses of aid have more to do with donors than recipients, and point to a range of successful countries that have received significant aid such as Botswana, Indonesia, Korea, and, more recently, Tanzania and Mozambique, along with successful initiatives such as the Green Revolution, the campaign against river blindness, and the introduction of oral rehydration therapy.

What is foreign aid?

The standard definition of foreign aid comes from the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD), which defines foreign aid (or the equivalent term, foreign assistance) as financial flows, technical assistance, and commodities that are (1) designed to promote economic development and welfare as their main objective (thus excluding aid for military or other non-development purposes); and (2) are provided as either grants or subsidized loans.

Grants and subsidized loans are referred to as concessional financing, whereas loans that carry market or near-market terms (and therefore are not foreign aid) are non-concessional financing.4 According to the DAC, a loan counts as aid if it has a "grant element" of 25 percent or more, meaning that the present value of the loan must be at least 25 percent below the present value of a comparable loan at market interest rates (usually assumed by the DAC – rather arbitrarily -- to be 10 percent with no grace period). Thus, the grant element is zero for a loan carrying a 10 percent interest rate, 100 percent for an outright grant, and something in-between for other loans.

The DAC classifies aid flows into three broad categories. Official development assistance (ODA) is the largest, consisting of aid provided by donor governments to low- and middle-income countries. Official assistance (OA) is aid provided by governments to richer countries with per capita incomes higher than approximately $9,0005 (e.g., Bahamas, Cyprus, Israel and Singapore) and to countries that were formerly part of the Soviet Union or its satellites. Private voluntary assistance includes grants from non-government organizations, religious groups, charities, foundations, and private companies.

Types of Foreign Aid

1) **Direct investment**: Direct investment means that the concern of the investing country exercise de facto control over the assets created in the capital importing country by means of that investment. Direct investments may take many forms:

- The formation in the capital importing country of a subsidiary of a company of the investing country.
- The formation of a concern in which a company of the investing country has a majority holding

- The formation in the capital importing country of a company financed exclusively by the present concern situated in the investing country.
- Setting up a corporation in the investing country for a specific purpose.
- Creation of the fixed assets in the other country by the nationals of the investing country. Such concerns are known as multinational corporations (MNC)

2) **Indirect investment**: indirect investment better known as portfolio' or 'rentier' investment consists mainly of the holding of the transferable securities, shares or debentures by the nationals of some other country

FOREIGN AID AND ECONOMIC DEVELOPMENT

The role and effects of foreign aid in the economic development of developing countries have been and are controversial issues. In the last decade much has been written on different aspect of aid. No study of economic aid can get very far unless there is first an attempt to define exactly what is meant by the term "Aid". Generally, foreign aid is advocated as necessary for the promotion of economic development in the least developed countries (LDC's). The purpose of foreign aid programme to LDC's is to accelerate their economic development up to a point where a satisfactory rate of growth can be achieved on a self sustaining basis. Thus the general aim of foreign aid is to provide in each LDC a positive incentive for maximum national effort to increase its rate of growth. However, the effects of foreign aid on the economic development of developing countries have been controversial issues. Some economic studies of foreign aid suggest that it is successful, as the other studies find no relationship between foreign aid and growth rate of output and suggest that it also retards economic growth in developing countries by leading to the structural distortions of the economy.

It is generally contended that foreign resources could play a vital role in promoting economic development in the less developed countries. This is explained in term of concepts such as "the savings gap" and "the foreign exchange gap. The purpose of an international program of aid to underdeveloped countries is to accelerate their economic development up to a point where a satisfactory rate of growth can be achieved on a self sustained basis. The general aim of aid is to provide in each underdeveloped country a positive incentive for maximum national effort to increase its rate of growth. Most underdeveloped countries such as Israel, Jordan, Gambia, Senegal, Zambia, Egypt, Nepal, Ethiopia, Syria, Bangladesh78 depend on external resources to increase their per capita income. Foreign resources have played an important role in the economic development of many economically high-income group countries of today like Taiwan, South Korea,

Singapore.

The increased income, saving and investment which aid indirectly and directly make possible will shorten the time it takes to achieve self-sustaining growth. The overall aim of development aid is not to equalize incomes in different countries, but to provide ever country with an opportunity to achieve steady growth.

Recently numerous essays have concluded that only a fraction of foreign resource inflows have been additive to domestic saving, while a large share were used to increase consumption. Also some recent articles have argued that there is almost no increase in growth from foreign resources. They agree that aid and other foreign inflows reduce domestic saving and are used in part to increase consumption. If all of the aid is allocated to current consumption, there is no increase in future consumption possibilities80. If all of the aid is allocated to investment and there is no shifting of present investment into consumption, then there is no increase of current consumption but an increase in the future consumption.

Foreign economic assistance is a provision of financial and physical forms of assistance to the developing countries for strengthening their economies.
Different terms of foreign economic assistance/loans are as under:

1. Bilateral aid means when one country provides loan to another country.
2. Multilateral aid, when loans or Aid is provided by international agencies such as World Bank, International Finance Corporation, I.M.F., International Development Agency, Asian Development Bank, Islamic Development Bank, Pakistan Development Forum.
3. Tied aid is given provided machinery or raw material is purchased from loan given country.
4. United aid is given without any pre-condition, borrower can use it according its needs and requirements and from any country.
5. Food aid is provided in terms of wheat, rice etc to overcome food shortage.
6. Technical Assistance is consultancy services, technical expertise and installation of heavy projects etc.
7. Grants are given on humanitarian grounds for help in famine, floods and earthquake, which are not to be repaid to donor country.
8. Soft loan is repaid after 25 years and interest rate is from 1% to 3%.

9. Hard loan is paid with 25 years and interest rate is more than 3%.
10. Project Aid/Assistance loan is give for completion on one particular project.
11. Direct foreign investment means foreign countries companies invest in industrial and services projects in Pakistan for the sake of profit

FACTORS DETERMINING THE AMOUNT OF FOREIGN AID FOR THE ECONOMIC DEVELOPMENT

1) Availability of Funds:

Developed countries have enough capital to export these does not appear to be a excess of surplus in such countries. With the exception of the United States, there are few countries that can spare so much capital as to bring it up to 10 – 15 billion dollars annually, required by LDC's. some of the developed countries like Canada and Australia themselves borrow from the united states and great Britain to finance there development projects. But it does not mean that these countries cannot provider foreign aid to the LDCs.

2) Capacity to Absorb Capital:

LDCs should get as much as they could usually invest. Absorptive capacity covers all the ways in which the ability to plan and execute development projects, to change the structure of the economy and to reallocate the resources in circumscribed by the lack of crucial factors, by institutional problem or by unsuitable organization. The structure of the economy along with its utilization capacity will have an important bearing on a countries absorptive capacity. World Bank States in their 4th Annual Report: " the principal limitation upon bank financing in the development field has not been lack of money but lack of well prepared and well planned projects ready for immediate execution. The project must not only be build to be absorbed, they must be productive." The amount of capital that can be utilized by the LDCs is determined by the availability of complimentary resources. It will remain unutilized if complementary resources are unavailable. Uneven infrastructure in LDCs keep the capacity to absorb foreign aid Low.

3) **Availability of Resources**:

If an LDC has little adequately developed human and natural resources it will act as an impediment to the effective use of foreign capital. It will be all the more difficult for such a country to utilize the available foreign aid if it lack in human and natural resources. But the latter should not acts as limit to economic development.

4) The Will and Effort to Develop:

Perhaps the most important facto is the will and effort on the part of the recipient country to develop. Capital received from abroad does not fructify, unless it is desired and paralleled by an effort on the part of the recipient country.

5) Capacity of the Recipient Country to Repay Loans:

This is very pertinent problem. For the burden of servicing loans acts as barrier to the borrowing of large funds by LDCs. This, in itself, can be attributed to their extreme poverty. The capacity for the repayment, however, hings on their capacity to export and there ability to augment their foreign exchange resources. Overtime, the only determinant of the capacity to repay is the loans contribution to the productivity of the economy as a whole, and the capacity of the system to skin off the necessary portion of that productivity in taxes or pricing, and reallocates resources so as to transfer debt service abroad. The requirement for the payment is that the fiscal systems raise the necessary funds, and the transformation occurs to shift resources to export increasing and import decreasing lines. If the loans flow in a steady and increasing stream and for very long periods with liberal terms of repayment, the problem of repayment is easy.

ADVANTAGES OF FOREIGN AID

1) **Foreign Loan Bridges Saving Gap and Balance of Payments:** In developing or underdeveloped economy (UDE) due to low national income and poverty, per capital income is very low hence rate of savings is very low. Low savings rate cannot help in capital formation and economic development. Similarly in these economies imports are greater than exports therefore there is always deficit in balance of payments. Foreign loan, aid not only bridges domestic savings gap but also helps in overcoming balance of payments problem.

2**) Development Requirements are Met:** Developing economies wants to develop agriculture, industry, power and natural resources of the country but due to lack of foreign exchange, required technology could not be imported. Foreign aid and loan facilities help Government to import the required technology and basic raw material with which different sectors of economy can develop and due to utilization of modern machines productivity is enhanced. Thus productivity of various sectors of economy increases.

3**) Establishment of Modern Economic and Social Infrastructure:** Economy of a country cannot grow without the presence of economic infrastructure i.e., availability of gas, power, transport and communication. Similarly social infrastructure (i.e., education, training and health facilities), is also essential. These infrastructure facilities require local and foreign capital, which is very limited in UDE. Foreign aid helps government to establish these infrastructures. When construction and other development activities are started in the country, these generate employment opportunities for the people.

4**) Level of Technological Increases:** With the help of foreign aid which is in the way of technical collaboration or project aid, modern machines are used, which produce super quality goods in greater numbers. Hence by using goods of high quality consumers are benefited.

5**) Meeting Emergencies**: Foreign aid help to meet emergencies. Whenever there is an earthquake, flood or some other natural calamities, Food Aid program provides different types of food items such as wheat, dry milk etc.

6**) Defense Modernization:** Developing economies wants to modernize its defense capabilities, which can only be possible provided foreign aid is available. Modern Fighter Planes, F-16 and other modern warfare technology can only be secured with the help of foreign aid and loan, as theses economies do not have sufficient foreign exchange to finance this crucial requirement of the country.

7**) Increase in Tax Revenue:** When foreign loan is utilized for established of industries and social overheads then economic activities grow, goods and services are produced, foreign trade is increased, all these factors increase Government's income through different tax sources.

8) To raise the standard of living: All this implies that the foreign aid tends to raise the level of national productivity, income and employment. Which, in turn, lead to real wages for labour, lower prices for consumers and rise in their standard of living.

9) To Increase State Revenue: When private foreign investors invest in various industries in LDCs, they get profit and royalties. The government of the capital receiving country levies taxes such profits and royalties which increase their revenues.

10) To Solve the Problem Of BOP: Foreign aid overcomes the BOP's difficulties experienced by an LDC in the process of development. To accelerate the rate of development it needs to import capital goods, components, raw material, technical know – how etc. but on the other hand export to developed countries are stagnant or have tendency to decline. The gap between exports and imports leads to the balance of payment difficulties. It is though foreign capital that an underdeveloped country can meet all its import requirement, and at the same time avoid the problem of balance of payment.

Disadvantages of Foreign Aid

Foreign economic assistance and Foreign Aid result in the following disadvantages.
1) Increase in Foreign Aid's Debt servicing: developing countries has already borrowed too much foreign loans and is still borrowing. Now in order to pay interest Pakistan is. Thus debt burden is continuously increasing.

2) Increase in Production Cost: In results in the increase in the cost of project because of interest, heavy remuneration and other fringe benefits, which are given to foreign experts.

3) Habit of Dependence on Foreign Loan and Misuse of Aid: Aid receiving countries do not exert and do not make policies to develop their economy with their own domestic resources. They do not pay attention for development of technology. They just become entirely dependent on others. Major portion of aid particularly commodity aid is misappropriated by the concerned Government officials.

4) Exploitation by Donor Countries:Sometimes loan giving countries interfere in the defense and foreign affairs of the recipient country. That's why it is said that there are always political strings attached to the bilateral loans.

5) Commodity Aid Discourages Domestic Agriculture Output: When aid is in terms of commodity such as wheat etc, which many times is provided at a very nominal price,

discourages local production of that commodity because of higher cost of production within the country. This situation discourages local agricultural production.

6) Dependence of Imported Raw Material from Donor Country: If donor country has assisted in establishing imported substitution industry then raw material for the industry will have to be imported from loan given country otherwise industry will not continue its production because particular raw material is not available locally. This causes heavy foreign exchange burden on economy.

7) Project Tied Loans for Less Priority Projects: Sometimes a donor country may give project tied loans for those projects which for the time being may not be on the priority list of borrower and may not be very much feasible. In this way donor can burden the economy of borrower country because principal amount as well as interest has to be paid while project is not needed and is not worthwhile.

8) Savings Investment and Balance of Payments Gaps: LDCs are obtaining foreign aid for bridging gap between domestic savings and investment and also to improve balance of payments position but till now it has not been able to accomplish this task, rather both gaps are continuously increasing.

9) Proportion of Tied Aid and Severity of Hard Terms Increased: As the time passes by, it is becoming difficult for underdeveloped countries to obtain foreign aid. The donor countries have increased terms of aid by raising rate of interest and the repayment period has reduced.

10) Foreign Aid Does Not Improve Earning Capacity: Foreign aid has failed to improve the income earning capacity of LDCs and they are now saddled with large external public debts.

CONCLUSION:

A large inflow of foreign aid is neither feasible nor desirable for LDCs foreign aid provide crucial support to the development plans, but the developed countries are not ready to supply aid to the extent required by the less developed. So India and other developed countries should make tremendous efforts to boost their exports so that in a decade or so they have a trade surplus. Expansion of exports is also essential to pay for increasing imports. Larger exports are needed for debt service repayment. But the policy for that favors trade and not aid can be successful only if there is increase in domestic savings equal to the rise in export earnings. Trade will substitute for aid when larger export earning raise national income and this lead to increase saving. In fact, greater trade opportunities are like greater aid flows. However, countries that are in the early phase of development should not think of substituting trade for aid because they can only develop their trade through aid over the long run. Although greater trade possibilities for such countries have some resource element in them, they are more complementary to aid flow then substitutable for them. Development requires trade and aid.

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