

Foreign Aid

- **What is Foreign Aid?**
- Foreign aid is used to describe the assistance that one country gives to help another.
- *Encyclopaedia Britannica* defines foreign aid as the international transfer of capital, goods, or services from a country or international organization for the benefit of the recipient country or its population.
- Aid can be economic, military, or emergency humanitarian (e.g., aid given following natural disasters) assistance.

- 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***.
- 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.

- **Classification of Aid by DAC**
- The DAC classifies aid flows into three broad categories namely:
- ***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 \$9,000 (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-governmental organizations, religious groups, charities, foundations, and private companies.

- Other classifications include:
 - ***Bilateral***- nation-to-nation aid;
 - ***Multilateral***- aid channelled through institutions such as the World Bank
 - ***Private Organisations***
- Foreign aid could be in the form of money, goods, services, technical expertise etc.
- ***Purposes for Giving Aid***
- Foreign aid can involve a transfer of financial resources or commodities (e.g., food or military equipment) or technical advice and training.
- The resources can take the form of grants or concessional credits (e.g., export credits).

- The most common type of foreign aid is official development assistance (ODA), which is assistance given to promote development and to combat poverty in low- and middle-income countries.
- The primary source of ODA—which for some countries represents only a small portion of their assistance—is bilateral grants from one country to another, though some of the aid is in the form of loans, and sometimes the aid is channelled through international organizations and nongovernmental organizations (NGOs).
- For example, the International Monetary Fund (IMF), the World Bank, and the United Nations Children’s Fund (UNICEF) have provided significant amounts of aid to countries and to NGOs involved in assistance activities.

- (1) DAC committee of the OECD attributes the purpose for ODA to the facilitation of economic development and promotion of welfare.
- (2) *Emergency and humanitarian reasons*
 - Countries provide aid to relieve the suffering caused by natural or man-made disasters such as famine, disease, and war.
- (3) *Enhancement of national security.*
 - Countries often provide foreign aid to enhance their own security.
 - Thus, economic assistance may be used to prevent friendly governments from falling under the influence of unfriendly ones or as payment for the right to establish or use military bases on foreign soil.

- *(4) Advancement of foreign Policy*
 - Foreign aid also may be used to achieve a country's diplomatic goals, enabling it to gain diplomatic recognition, to garner support for its positions in international organizations, or to increase its diplomats' access to foreign officials.
 - Taiwan and China have used aid (among other policy tools) to try to gain support and recognition for their governments from countries around the world.
- *(5) Economic reasons*
 - Foreign aid is used to promote a country's economy.

- Such promotion could be in the expansion of a country's exports (e.g., through programmes that require the recipient country to use the aid to purchase the donor country's agricultural products or manufactured goods)
- *(6) Socio-cultural reasons*
 - Foreign aid is deployed to achieve the spreading of a country's language, culture, or religion.
- *(7) Military and strategic reasons*
 - During the Cold War, both the United States and the Soviet Union used aid to vie for the support of developing countries with little regard as to whether the aid actually was used to support development.

- The two largest recipients of U.S. foreign aid from 1980 until very recently were Israel and Egypt, as the U.S. provided financial support to back the 1979 Camp David peace agreement.
- Beginning from 2002, Iraq became the largest aid recipient in the world, and its reconstruction is likely to become among the largest single foreign aid program ever recorded.
- *(8) Maintenance of Political Linkage*
 - Many donors provide significant aid to their former colonies as a means of retaining some political influence.
 - For instance, French and British aid goes to former colonies.

- *(9) Reducing Poverty*
 - Donors generally provide their most concessional aid to the poorest countries, and some aid programmes are designed explicitly with this objective in mind.
 - For example, the United States provides food assistance by supplying agricultural products to developing countries at low prices or for free, and it gives military aid by either selling or donating weapons and other military equipment to foreign countries.
 - Many people see the main rationale for aid as fighting poverty, and although this is less important than political considerations in donor allocation decisions, it still plays an important role.

- *(10) Enhancement of International security.*
 - In recent years, foreign aid has also been directed toward several other purposes , all of which have positive effects on international security.
 - Foreign aid has been deployed to help in establishing or strengthening political institutions, and to address a variety of transnational problems including diseases and the destruction of the environment.
 - Foreign aid has been a principal vehicle for conducting the war on terrorism, a mechanism for aiding the former states of the Soviet Union, and a way to initiate new programs against acquired immune deficiency syndrome (AIDS) and global famine.

- **Who Gives Aid, and Who Receives It?**
- Historically, most aid has been given as **bilateral** assistance directly from one country to another.
- Donors also provide aid indirectly as **multilateral** assistance, which pools resources together from many donors.
- The major multilateral institutions include the World Bank; the International Monetary Fund; the African, Asian, and Inter-American Development Banks, and various United Nations agencies such as the United Nations Development Programme.

- In terms of total dollars, the United States has consistently been the world's largest donor (except in the mid-1990s when Japan briefly topped the list).
- In 2004 the U.S. provided \$19.7 billion in ODA, with Japan, France, the United Kingdom, and Germany the next largest donors. (Including OA, the U.S. provided a total of \$21.3 billion).
- However, when aid is measured as a share of donor income, the most generous donors are Norway, Denmark, Luxembourg, the Netherlands, and Sweden, each of which provided between 0.79-0.92 percent of GDP in 2004.

- Saudi Arabia provided aid equivalent to about 0.69 percent of its income.
- The United States is one of the smallest donors by this measure at about 0.17 percent of U.S. income in 2004, just over half of the 1970 level of 0.32 percent and less than one-third of the U.S. average during the 1960s.
- Donors have pledged since the 1960s to devote 0.7 percent of their income as aid, most recently at Financing for Development Conference in Monterrey in March 2002, but only a small handful of donors have achieved this level of aid.

- 150 countries and territories around the world received aid in 2004.
- The largest ten recipients, each of which received more than \$1.4 billion. Iraq and Afghanistan together received nearly \$7 billion.
- These amounts are unprecedented for two countries and account for about 7.5 percent of the global total.
- Aid is typically measured in one of three ways:
 - Total dollars;
 - As a share of GDP, or
 - Per capita.

- Each measure reveals different things.
- Total dollar amounts clearly are important, but they do not tell the entire story.
- Aid measured as a share of GDP indicates its size relative to the entire economy, and is perhaps the most common measure.
 - But it can be misleading since a high ratio can be indicative of low GDP or a large amount of aid.
 - The amount of aid needed to immunize 1 million children can look like a large share of GDP in a poor country and a small share of GDP in a richer country, when the amount per child might be roughly the same.

- On a per capita basis, the aid flows to some of the largest recipients are fairly small.
 - Bangladesh received \$1.4 billion in aid in 2004, but this was equivalent to just 2 percent of its GDP or about \$10 per Bangladeshi.
 - By contrast, Nicaragua received a slightly smaller amount, \$1.2 billion in 2004, but for its 5.5 million people this was equivalent to about \$225 dollars per person.
 - For small countries, a little bit goes a long way. Tiny Sao Tome and Principe received just \$33 million, but this translated into 67 percent of GDP and about \$209 per person.
- Thus, to get a clear picture, it is helpful to look at all three measures of the amount of aid.

- Generally speaking, aid is one of the largest components of foreign capital flows to low-income countries, but not to most middle-income countries, where private capital flows are more important.
- Aid flows averaged 2.8 percent of GDP in low-income countries in 2004, but just 0.2 percent of GDP in upper-middle-income countries.
- It is commonly claimed that the decline in aid flows to developing countries in the 1990s was more than offset by a rise in private capital.
- While this is true for developing countries in aggregate, the rise in private capital flows was heavily concentrated in a handful of middle income countries.
- In low-income countries, private capital rose much more slowly, and remained significantly smaller than aid.

- **Uses of Aid**
- Most donor countries give aid for several reasons outside the philanthropic reasons they often put forward.
- Aid has come to be deployed as a tool for achieving several objectives. These include:
 - 1) To push for economic reforms;
 - 2) To dismantle anti-free trade laws and regulations;
 - 3) To stimulate domestic economies of donor countries;
 - 4) To dismantle state-owned enterprises and ensure privatisation;
 - 5) To facilitate the creation of code of conduct and rule of law necessary for their businesses to operate and thrive.

- 7) To boost the economy of the donor and To create a new set of consumers.
 - Bilateral aid is often designed at least partially to help support the economic interests of certain firms or sectors in the donor country. Multilateral aid is less prone to these pressures, although by no means immune.
 - One study found that tying aid added 15-20 percent to its cost, thus significantly reducing its impact on recipient countries. Donors have begun to reduce the amount of aid that they tie, but the practice is still widespread among some donors. The U.S. no longer reports the share of its aid that is tied, but historically it has been around 75 percent. Greece ties about 70 percent of its aid, and Canada and Austria more than 40 percent. By contrast, Ireland, Norway, and the U.K. do not tie any of their aid.
 - Many donors “tie” portions of their aid by requiring that certain goods and services be purchased from firms in the donor’s home country, or that it be used for specific purposes that support groups in the donor countries (such as universities or business consulting firms). Automobiles, airline tickets, and consulting services financed by U.S. foreign aid in most cases must be purchased from U.S. firms. Tying aid can give it more political support at home, but it can also make it more costly and less effective.

- **Foreign Aid and Poverty.**
- Although the emphasis of ODA is on the promotion of economic development and welfare of developing countries, the nature of deploying aid does not suggest exclusive preoccupation with tackling poverty and promoting in the poorest countries of the developing world.
- There are certain throw-backs:
 - Not all aid goes to low-income countries;
 - Wide disparities in the per capita allocation of aid and most generous per capita allocations do not go to the poorest countries.
 - Many aid programmes in donor countries cover an assortment of activities that have no bearing to development. 2/3rd of all aid by DAC members are spent in donor countries.
 - Donors of aid prefer to finance physical capital installations that help their own firms and exporters and are quite unwilling to support operating cost of aid-funded undertaking.

- **Foreign Aid and Development**
- There are contending arguments about the development impact of foreign aid.
- These arguments will be evaluated under the theoretical headings of:
 - Modernisation theory
 - Dependency theory
- **Modernisation Theory**
- Modernisation theorists believe that most foreign aid is designed to meet one or more of four broad economic and development objectives:
 - (1) to stimulate economic growth through building infrastructure, supporting productive sectors such as agriculture, or bringing new ideas and technologies,
 - (2) to strengthen education, health, environmental, or political systems,
 - (3) to support subsistence consumption of food and other commodities, especially during relief operations or humanitarian crises, or
 - (4) to help stabilize an economy following economic shocks.

- To the modernisation theorists, there are **three** key channels through which aid might spur growth:
- **First**, the classic view is that aid augments saving, finances investment, and adds to the capital stock.
- In this view, poor countries are unable to generate sufficient amounts of saving to finance the investment necessary to initiate growth, or at best only enough for very slow growth.
- In the strongest version of this view, the poorest countries may be stuck in a poverty trap in which their income is too low to generate the saving necessary to initiate the process of sustained growth (Sachs, et. al., 2004).
- A related argument is that aid might help relax a foreign exchange constraint in countries that earn relatively little foreign exchange, a view that was popularized through the early “two-gap” models of economic growth.
- **Second**, aid might increase worker productivity through investments in health or education.
- **Third**, aid could provide a conduit for the transfer of technology or knowledge from rich countries to poor countries by paying for capital goods imports, through technical assistance, or through direct transfer of technologies such as the introduction of new seeds and fertilizers in the Green Revolution.

- The explanation of modernisation theorists about the uneven manifestation of the effect of aid is located in the recipient country characteristics.
- They argue that aid works better in countries with good policies and institutions. The appeal of this approach is that it can explain why aid seems to have supported growth in some “well-behaving” countries but not others.
- This has become the conventional wisdom among donors.

- **Dependency Theory**
- Dependency theorists argue that aid has no effect on growth, and may actually undermine growth.
- They suggested a variety of reasons why aid might not support growth. These include:
- **First**, aid simply could be wasted, such as on limousines or presidential palaces, or it could encourage corruption, not just in aid programmes but more broadly.
- **Second**, it can help keep bad governments in power, thus helping to perpetuate poor economic policies and postpone reform. Some argue that aid provided to countries in the midst of war might inadvertently help finance and perpetuate the conflict, and add to instability.
- **Third**, countries may have limited absorptive capacity to use aid flows effectively if they have relatively few skilled workers, weak infrastructure or constrained delivery systems. (Aid could help redress these weaknesses, but it may not be aimed to do so).

- Fourth, aid flows can reduce domestic saving, both private saving (through its impact on interest rates) and government saving (through its impact on government revenue).
- Fifth, aid flows could undermine private sector incentives for investment or to improve productivity. Aid can cause the currency to appreciate, undermining the profitability of the production of all tradable goods (known as the Dutch disease).
- Sixth, food aid, if not managed appropriately, can reduce farm prices and hurt farmers' income.
 - Food aid can sometimes undermine local food production if an influx of food drives down prices
 - It could also distort the production pattern of agricultural produce towards the production of cash crops instead of food.
- Seventh, it may encourage the mentality that poverty is natural and inevitable and therefore undermine the development of appropriate policies for exiting poverty.
- Eighth, aid serves the interests of the donor countries more than those of the recipients. In some cases, the motivation for aid is the creation of enabling environment for firms of the donor countries to make more profits.
- Ninth, Hayter (1971) sees aid as a ploy introduced by the West to ensure the preservation of the Third World within the periphery of the global capitalist system. In other words, aid is given to the Third World countries to sustain them at the periphery of the capitalist system.

- **The Forces that led to the Rise of Foreign Aid**
- 1) The emergence of new states
 - Following the 2nd World War, the 19th century empires disintegrated and much of Africa and Asia achieved political independence.
 - Following the compromise between the US and then USSR in 1955, new states were regularly admitted to the UN.
- 2) Cooperation among the newly emergent states under the auspices of the UN
 - By the end of the second post war decade, the UN had 122 members of which 87 were developing countries. These countries as a result of their shared experience and desire to be incorporated into the mainstream of the international system began to cooperate.
- 3) Coordinated demands by the less-developed countries.
 - Within the General Assembly and the UN Economic and Social Council (ECOSOC), the less-developed countries began to form groups and make coordinated demands.
 - It was at the ECOSOC and its subcommittees and the general Assembly and its subcommittees that the less-developed countries began to formulate and eventually to coordinate common demands for aid and for greater participation in the management of aid

- 4) International conference of developing countries.
 - An international conference of developing countries was held in Bandung, Indonesia in 1955.
 - The conference was attended by 29 Asian and African countries where common problems were discussed.
 - Although discussions centred on political problems such as decolonisation, and nonalignment, various economic proposals emerged.
 - The major economic recommendations called for changes in trading relations, particularly the establishment of commodity agreements to improve trade with less developed countries.
 - There were also recommendations for the establishment of a new aid institution and for the allocation by the World Bank of a greater part of its resources to Africa and Asia.
- 5) Communist expansion
 - The communist takeover of China in 1949 and the Korean conflict in 1950 led to change in the thrust of American foreign policy.
 - The US expanded its security interest to certain parts of the South, particularly those states bordering the Soviet Union and the Chinese People's Republic and to certain Middle Eastern Countries and began a fairly significant military and economic assistance programme for aid to these countries

- 6) Communist policy of helping the 3rd World in 1956.
 - During the Stalinist era, the Soviet Union had little interest in the South. The only Soviet aid went local communist parties.
 - This changed after the death of Stalin in 1953.
 - In 1955, the USSR concluded arms agreement with Egypt and started negotiation for financing Asian Dam. India, Syria, Indonesia and Afghanistan benefitted fro Soviet aid.
 - Because of the new Soviet interest and activity in the South, 3rd World demands for development took on greater importance.
 - The emerging Southern states became area of competition in the Cold War.
 - In 1956/7, the US policymakers turned their attention for the first time to a serious consideration of foreign economic aid to developing countries.
 - The basis was the recognition that economic assistance to the South could be a powerful tool in the Cold War era
 - An important point to note is that while the american foreign aid grew out of the undercurrents of the Cold War, the foreign aid of France and Britain was a necessary outcome of their history of colonialism.

- **The Failure of Aid**
- 1) New form of dependence
 - Aid did not transform the South and therefore had little impact on North-South relations.
 - It did not necessarily lead to growth. The simple link between aid and economic growth postulated in theory and policy was proven incorrect
- 2) Aid has had different effects on different countries.
 - Taiwan, Pakistan and Korea had massive aid inflow which constituted a major percentage of total investment and was a source of technological improvements.
 - In Mexico and Thailand growth took place without significant aid inflow.
 - In India aid had little impact on economic growth
- 3) Growth did not lead to social welfare.

- 4) Aid does not seek to promote development.
 - During the cold war era, aid from both divides was aimed at strengthening their allies and dethroning the rival economic system.
 - Development, therefore, was their least consideration.
 - Since the collapse of the former USSR, the amount of American aid has nose-dived and continued to decline and its focus has shifted.
 - The terrorist attack on September 11, 2001 introduced a new consideration in proffering aid.
 - Now most of US aid is targeted at achieving its security desires . Thus, Thus, the United States has provided huge amounts of foreign aid to Pakistan, Jordan, Egypt and Turkey considered allies in the fight against international terrorism.