Süleyman Demirel Üniversitesi
İktisadi ve İdari Bilimler Fakültesi Dergisi
Y. 1997, S. 2(Güz) s. 29-50.

DOES FOREIGN AID WORK ON ECONOMIC DEVELOPMENT OF DEVELOPING COUNTRIES

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Özet

Dış yardım kavramı gelişmiş ülkelerden gelişmekte olan ülkelere doğru bir finansal kaynak akışıdır. Dış yardım diye nitelendirilen bu kaynak akışının gelişmekte olan ülke ekonomilerinin kalkınması üzerindeki etkisi bu gün tartışmalı bir konudur. Bazı çalışmalar dış yardımların bu ülke ekonomilerinin kalkınması üzerinde olumlu etkilere sahip olduğunu ileri sürerken, diğer bazıları ise bunun tam tersi bir görüşe sahiptir. Bu çalışma gelişmiş ülkeler neden dış yardımlarda bulunduklarını ve aynı şekilde gelişmekte olan ülkelerin neden dış yardım aldıklarını incelemekte ve Dış yardımların olumlu ve olumsuz olduğunu ileri süren çalışmaları değerlendirmektedir.

Introduction

"The concept of foreign aid that is now widely used and accepted, is one that encompasses all official grants and concessional loans in currency or in kind, that are broadly aimed at transferring resources from developed to less developed countries on development and/or income distributional grounds"[1]. The net capital flow from advanced to less developed countries amounted to $131.5 billion in 1991[2]. 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.

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1 See TODARO M., **Economic Development** in the Thirt World, Logman, 1989, p. 482.

2 See OECD, **Development Co-operation**, 1992 Report, Table IV-1, p. 78.

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. Most underdeveloped countries such as Israel, Jordan, Gambia, Senegal, Zambia, Egypt, Nepal, Ethiopia, Syria, Bangladesh[3] 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[4].

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. Some economists argue that foreign inflow and especially aid make little contribution to economic growth, once account is taken of their effect in reducing saving, of the poor rate of return on aid-financed investment and of debt service changes. Aid may ease the lot of the recipient country's citizens by permitting higher consumption. Some critics have argued that foreign aid and foreign investment have undesirable social and political consequences.

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 possibilities[5]. 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[6].

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3 These countries are 10 largest foreign aid recipients in per capita terms in 1988. See World Bank, **World Development Report**, Washington D.C., 1990, p.128.

4 See RIDDELL R. C., **Foreign Aid Reconsidered**, ODI, The John Hopkins University Press, Baltimore, 1987.

5 See GRIFFIN K.B.-ENOS J.L., "Foreign Assistance: Objective and Consequences", **Economic Development and Cultural Change**, Vol. 18, 1970, pp. 313-27.

6 See MOSLEY P., **Overseas Aid : Its Defence and Reform, Studies in Political Economy**, Wheatsheaf Books, 1987, pp. 85-87.

1. The Definition of Foreign Aid

Foreign aid is the transfer of real resources from developed countries (DCs) to less developed countries (LDCs) on favourable terms. Development Assistance Committee (DAC) defines it as official development assistance (ODA) and technical aid. The term excludes military assistance[7]. ODA flows must satisfy all three of the following criteria;

- their primary objective must be developmental, thus it excludes military aid and private investment,

- they must be concessional[8] that is the terms and conditions of the financial package must be softer than those available on a commercial basis. DAC defines as Official Development Assistance (ODA) official flows with a grant element of greater than 25% at a 10% discount rate.

- the flows should come from governmental agencies and go to developing country governments.

Official Development Finance comprises ODA plus international flows satisfying only the first and third criteria. Flows from voluntary agencies may also counted as aid, but do not satisfy the third criterion.

The DAC concessionality criterion does not take into account problems in the measurement of the value of aid flows created by procurement tying, whereby goods procured by aid funds must be purchased in the donor country. Aid may also be tied to a project or policy conditions.

2. Motives and Objectives of Foreign Aid

Many economists searched the allocation and some determinants of foreign aid flows to developing countries and tried to answer two questions concerning foreign aid: 1) Why do countries give foreign aid? and 2) What do the receiving countries do with it?. Some of them, like Maizels and Nissanke (1984), Mosley (1985), Frey and Schneider (1986), Ruttan (1989) and Gang and Khan (1990) looked at what factors determine how much aid a country gives. Many other researchers, like Griffin and Enos (1970),

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[7] Foreign aid in the Turkey context, unless otherwise specified, follows the DAC definitions.

[8] Concessionality is measured by the grant element of the aid, where this is the grant equivalent of the aid expressed as a percentage of its face value. Grant equivalent is the face value of the aid minus the present value of repayment. DAC define as concessional any aid having a grant element of over 25%, using a 10% discount rate.

Weisskoff (1972), Papenek (1973), Mosley, Hudson and Horrell (1987) dealt with the second question.

The economic objectives of foreign aid are to alleviate poverty and increase savings, investment and rate of growth of GNP in developing countries. However, development assistance has not always succeeded in achieving these objectives because in many cases donor motives for giving aid and recipient motives for accepting it conflict with the economic objectives of foreign aid. As Todaro (1989) indicates, "There are likely to be fundamental differences in attitudes and motivations between donor and recipient countries" (Todaro, M.P. 1989, p.485). Thus, foreign aid is a complex term, especially, when it is used to cover a variety of resource transfers from developed countries to developing countries. Many of these may be military and/or political in nature and have nothing to do with assisting economic development.

It has been argued that the transfer of resources from developed countries to developing countries on commercial terms provide some benefits for both developed and developing countries[9]. However, as stated by Ruttan (1989) this argument may not be valid for official development assistance which includes grant elements.

Maizels and Nissanke (1984) investigate the underlying principles of foreign aid allocation and motives of donor and recipient. They tested donor interest and the role of recipient need in determination of foreign aid inflows by setting two alternative models to bilateral and multilateral aid flows for 80 countries. Their empirical evidence shows that donor's self-interest plays a relatively large role in bilateral assistance while foreign aid from multilateral sources are allocated and play large role on recipient need criteria.

2.1. Donor Motives For Giving Foreign Aid

There are several motives which inspire financial assistance from public bodies on concessionary terms, such as humanitarian, political, commercial, military and economic. As it is indicated by Mende (1973), "terms like aid and development assistance have humanitarian and charitable connotations. A naive logic would lead one to believe that aid is directed

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[9] See, KRUEGER A.O., "Aid in Development Process", **World Bank Research Observer 1**, January 1986, 1986, pp. 57-78.

either where there is greatest poverty or alternatively, where it can be best employed to put an end to an intolerable situation. Even cursory examination of data shows that this not the case" (Mende, T., 1973, p.67). The direction of U.S. aid shows that it is obvious that aid does not always go to the poor[10]. Some development .assistance may be motivated by moral and humanitarian desires to assist the less fortunate, but there is no significant evidence to suggest that over longer periods of time donor countries assist others without expecting some corresponding benefits.

The official aid reports generally point out the humanitarian aspect of foreign aid with its usefulness in promoting social stability in the recipient countries. However, the development motifs of foreign aid still take large part in official reports of donor governments and the OECD Development Assistance Committee (DAC)[11]. Moreover, many donor countries consider their national economic interest, political and strategic interest as well.

2.1.1. Moral and Humanitarian Motives

There are moral and humanitarian motives to assist poor countries. The objectives of most donors have an ingredient of moral obligation stressing that social welfare should be promoted in the LDCs so as to decrease the disparity between the two groups. Both Ohlin (1966) and Pearson (1969) have broadly endorsed the view that aid is a passage to global peace since tensions within the destitute nations are reduced. National boundaries are quite artificial constructions, therefore, developing countries accept assistance not only from national governments as a part of their regular aid program, but also from many voluntary and charitable organisations, and from emergency and disaster relief funds[12].

The thesis that nations extend aid out of a sense of sympathy and charity has been rejected by Griffin and Enos (1970), and they say: "We believe there are other reasons for which foreign aid is given, and by which donor countries judge its effectiveness. Philanthropy is not one of these. Individuals may be humane and disinterested, but nations are not. When

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10 See table, **Direction of United States Official Development Assistance**, 1985, in Todaro, M., (1989), "Economic Development in the Third World" p. 484.

11 See OECD, **Development Co-operation**, Development Assistance Committee, (Paris: Annual).

12 See THIRWALL A.P., **Growth and Development: with Special reference to Developing Economies**, McMillan Press, London, 1989, p .319.

people collect together to promote their own interests, they lose their sympathy for others" (Griffin and Enos, 1970, p.314).

Further, as far as the LDCs are concerned, humanitarianism is not a cogent reason. Abbot (1973) has stated: "They reject the whole notion of humanitarianism and substitute for it the more uncomfortable concept of conscience money, in which the donors are seen not as acting out of the goodness of their hearts, so as to speak, but rather as paying the debts of past injustices, exploitations and so on. In other words, the donors are only atoning for their past misdeeds" (Abbot, 1973, p.7).

2.1.2. Political, Commercial and Military Motives

The donor's primary motives for giving aid is political rather than moral and humanitarian. The political purposes have been to obtain strategic advantages and to cultivate the aspirations of the donor such as democracy and communism, among others. The termination of World War II. witnessed the gradual emergence of liberated nations who required assistance for progress. Foreign aid made its debut in the LDCs partly to meet this response and partly to obviate them from allying with the Soviet Union. Foreign aid, especially in the United States, was assigned the role of winning friends and countering enemies. It was opined that if developed countries like the United States do not help nations which are determined to develop economically, they will turn to Russia[13].

It is generally the case that Foreign aid will not be given to one's enemies. For instance a large part of American aid to LDCs was allocated on the grounds of keeping intact American's political interest as far as possible. The friendly countries are usually those which would help the U.S.A. to protect against the danger of the spread of communism. Soviet foreign aid was also similar the U.S.A. foreign aid[14]. Furthermore, as Todaro (1989) said, "the direction of total aid is not always given to the neediest countries. Less than half of bilateral development aid goes to the fourty six countries with the lowest incomes. Most aid based on political and military considerations goes to relatively well-off Third World countries" (Todaro,

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[13] See FRIEDMAN M., "Foreign Economic Aid: Means and Objectives", Yale Review, Vol. 47, 1958.

[14] See GHATAK S., **An Introduction to Development Economic**, Allen and Unwin Ltd., London, 1986, p. 129.

1989, p.483). Indeed, Egypt and Israel are of geopolitical significance to the United States and thus receive more aid than the normal.

Bilateral assistances are also largely a matter for the donors concerned. In practice, it often reflects political and military objectives (Thirlwall, 1989). Therefore, it can be said that especially the decision to grant aid to the another country is fundamentally a political decision. In other words, Economic aid from the powerful to the powerless countries is an instrument of power politics.

Apart from political and military motivations, there are also some commercial motives for giving aid as they procure economic benefits as a result of their aid programmes. This is apparent as donors are increasingly tending towards providing loans instead of grants. Here, "tied aid" either by source (i.e. loans or grants have to be spent on the purchase of donor country's goods and services) or by project (funds can only be used for specific projects) can be an example of commercial motives[15]. In addition, some interest groups in the DCs provide some benefits from aid. These interest groups include exporters of goods and services bought by aid-recipient countries, those who have extended loans and credits to aid-recipient governments whose ability to repay them depends critically on continuing to receive aid funds, and those engaged in the aid industry as politicians, administrators and experts[16].

2.1.3. Economic Motives

As it is stated by Thirlwall (1989), "there are some economic motives for developed countries investing in developing countries, not only to raise the growth rate of the developing countries, but also in their own-self interest to raise their own welfare" (Thirlwall, 1990, p.320). In this case, international aid can be mutually profitable. This economic motives of foreign aid employ some assertions that foreign aid promotes exports from and employment in the donor countries. For example, it is obvious that the United States economy gains some benefits from the assistance program where exports of goods and services are subsidised by foreign aid. Food

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[15] See TODARO M.P., **Economic Development in the Third World**, 4.ed., Longman, 1989, p. 485--89.

[16] See BAUER, P.T-Yamey, B. "The Political Economy of Foreign Aid", **Lloyds Bank Review**, 1981.

grains producers benefits from food assistance, the engineering firms gains from contracts associated with infrastructure development projects[17].

The business groups and government of U.K. also expect that tied bilateral aid is likely to gain greater commercial benefits on the U.K. economy. This tied bilateral aid generates UK. exports, with associated benefits in term of output, employment and the balance of trade, which in turn generate tax revenue that partially offsets the cost of aid to government[18]. Morrissey (1990) in his study, however, showed that multilateral aid has greater impact on the donor economy than tied bilateral aid.

It can also be case that if foreign aid is useful in stimulating the growth rate of national income in a developing country, the effect of foreign aid can expand the demand for goods and services of developed countries[19].

The economic motives splash the aid documents of most of the donors and financial institutions and multilateral organisations. A sample would run as follows:

a) to cultivate a conducive environment in developing countries for self-sustained growth;

b) to act as a catalyst in the recipient country by complementing the activities of the general masses towards rapid, economic growth;

c) to provide the foreign exchange to the LDCs for importing required capital goods and machinery;

d) to bridge the gap between domestic investment and savings;

e) to help in the introduction and adoption of modern technology and alter the composition of output and employment.

Economically, the donor will also gain if it is able to penetrate into the markets of developing countries.

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17 See **Ruttan,** V. W., "Why Foreign Economic Assistance?", **Economic Development and Cultural Change**, Vol. 37, No.2, 1989.

18 See MORRISSEY O., "The Impact of Multilateral and Tied Bilateral Aid on the U.K. Economy", **Journal of International Development**, Vol:2, No:1, 1990.

19 See **Ruttan** V. W., "Why Foreign Economic Assistance?", **Economic Development and Cultural Change**, Vol. 37, No. 2, 1989.

2.2. Recipient Motives for Receiving Foreign Aid

It is well known that LDCs, at least until recently, have been very eager to accept foreign aid, even in its most stringent and restrictive forms. It has been given much attention to receiving foreign aid. A primary motive for receiving aid is political as foreign aid provides greater political leverage to the existing leadership to maintain its power and suppress opposition.

Another major reason is clearly economic in concept and practice. According to Todaro (1989), developing countries have often tended to accept uncritically the proposition that foreign aid is a crucial and essential ingredient in the development process. There are some successful cases such as Israel, Taiwan and South Korea. Hence, foreign aid supplements the scarce domestic resources of developing countries; it contributes towards the economy transforming structurally. It is also contributes to the achievement of developing countries' take-offs into self-sustaining economic growth. Therefore, the economic rationale for foreign aid in developing countries is largely on their acceptance of what they require to promote their economic development. Hence, conflicts generally arise, not out of any disagreement about the role of foreign aid, but over its amount and conditions. Todaro (1989) concluded that "naturally, developing countries would like to have more aid in the form of outright grants or long term low-cost aid with minimum strings attached" (Todaro, 1989, p.490).

Moreover, recipients use aid for commercial reasons as they shift resources from their destined projects or programmes to other non-productive purposes. This is known as the fungibility of aid[20]. It is argued that government are enable to alter their spending patterns to subvert the sectoral distribution of expenditure desired by donor countries. Indeed Mosley indicates that in some countries reluctance to raise taxes, or to collect the taxes that are due, forces governments of these countries to drain some overseas aid into the recurrent budget[21]. He argues that the trend in tax effort is a good indicator for the extent to which foreign aid is switched into consumption. He tested the tax effort in the aid growth relationship, and his

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[20] For fungibility of foreign aid, see PACK H.-J. R. PACK, "Is Foreign Aid Fungible? The Case of Indonesia", **The Economic Journal**, Vol. 100, 1990.

[21] See MOSLEY P., "Aid, Savings and Growth Revisited", **Bulletin of the Oxford University Institute of Economics and Statistics**, Vol. 42, 1980; May, and also Mosley, P. and Hudson, J. and HORREL S. "Aid , the Public Sector and the Market in Less Developed Countries", **The Economic Journal,** Vol. 97 Sept., (1987).

result showed that within the group of high aid receivers those with less than average growth performance are mainly those in which tax effort is falling and those with above average growth performance are exclusively those in which tax effort is rising. Mosley then expanded the test to an open economy model where he incorporated a country's foreign exchange position in the relationship, but it did not change his result. Since government controls the choice of tax rates and tax bases, he suggested that countries that used aid to finance recurrent expenditure were exercising a deliberate preference for lower levels of taxation than they would have done in the absence of foreign aid.

The fungibility of foreign aid is a theoretical phenomenon. The government of a developing country adjusts its allocation of expenditure, which is equal to domestic resources plus foreign aid, between two goods or sectors to achieve its highest benefit. The foreign aid funds designated for one project may be spent on another as government alters its expenditure pattern. More recently, Cashel-Cordo and Craig (1990) and Gang and Khan (1991) investigated the fungibility of foreign aid empirically.

The impact of foreign aid on recipient fiscal behaviour, that foreign aid will offset taxes and that government expenditure will rise by less than the value of the aid inflows, has been criticised by White (1993). He stated that the model of Mosley, P. and Hudson, J. and Horrel, S. (1987) does not incorporate any of the feed back effects from foreign aid through higher income. His study presents a simplified version of Mosley *et al* (1987), in which aid can increase current income, and showed that "the conclusion that foreign aid displaces taxes is a partial result that need not hold once feedback effects are considered" (White, 1993, p.306).

He reached to conclusion that the impact of foreign aid on income may feed back into higher savings and there is a possibility that aid will lead to an increase in taxes and an increase in government expenditure in excess of the value of the aid inflows. "The impact of aid on these variables depends crucially upon the relationship between aid and private investment. If aid crowds out private investment then there is a greater possibility that aid will reduce taxes, and it may even reduce national income" (White, 1993, p.311).

Fungibility of foreign aid highlights the recipient motives for receiving aid. Indeed, foreign aid inflows are switched from productive purposes to non productive or wasteful forms of recurrent expenditure. These include enlarging the army, paying off debts, reducing taxes and reducing borrowing. Furthermore, recipient motives are not always directed towards poverty alleviation and benefiting the poor. This is apparent since property interests in developing countries are aligned to governments and thus the benefit of foreign aid goes primarily to the rich. Recipient governments rarely target aid and self loans to agricultural and rural areas. This is a contradiction in the objectives of aid which are primarily to alleviate poverty among the masses and increase growth rates.

3. Foreign Aid and Economic Development

The economic objectives of foreign aid are to induce high growth rates in LDC's which in turn will generate additional domestic savings and investment. however, there is much dispute as to whether development assistance to LDC's has been successful in achieving theese objectives. There have been numerous attempt to investigate the effects of foreign capital in terms of direct foreign investment, and foreign aid and other foreign inflows on developing countries, their results have been conflicting. These studies investigated economic development related to foreign capital in Latin America [Griffin and Enos (1970), Bernal (1984)]; in Sub-Saharan Africa [McGowan and Smith (1978)]; in Canada [Globerman (1976)] and in LDCs [Rosenstein-Rodan (1961), Chenery and Strout (1966), Papenek (1973a), Gupta (1975), Stoneman (1975), Gulati (1978), Rothgeb (1984), Schneider and Frey (1985)].

Aid antagonists like Bauer claim there is a negative causal relationship beetween aid and growth in LDC's. This is because aid retards growth by substituting for savings and investments rather than supplementing them. Bauer (1976) argued that although private foreign investment is beneficial to growth in developing countries, the same things cannot be said about foreign aid, even if the presences of this aid inflow remedies market distortions in some cases, it creates them in others by reducing the supply of government effort and obstructing investment from the private sector. He expressed that "foreign aid is painly not indispensable to economic progress, and indeed likely to obstruct it, and that the other arguments are also defective" (Bauer, 1976, p.95).

Foreign aid advocates, however, argue that aid helps promote growth and investment in LDC's. As it is stated by Mosley (1987, p.119), the main theoretical case for aid rests on the presumption that foreign aid could fill the shortage of international capital. Therefore there is a positive causal relationship between aid and growth. The emprical tests of both aid advocates and aid antagonist have been subject to much criticism over their stastical errors and their simplistic assumptions of the aid-growth relationship.

As Mosley indicates the literature on aid and growth in LDC's has passed through three phases:

The first phase: Rosenstein-Rodan (1961), and Chenery and Strout (1966), argued that all capital inflows represented net additions to an LDC's productive capabilities. The channel of this effect was expressed sometimes through the Harrod-Domar growth model and at other times in terms of the "two-gap" models, where economic growth is obtained by the removal of foreign exchange and/or the savings gap. The Harrod-Domar model expressed by a formula $g=s/v$ where g is growth rate of output, s is the savings rate and v is the incremental capital-output ratio states that the growth rate of output is equal to the savings rate divided by the incremental capital-output ratio. In the 1950's and 1960's this analysis is used much, for example, Chenery and Strout (1966) argued that foreign aid is a supplement to domestic savings and hence raised the growth rate of output to $(s+a)/v$ where a is foreign aid as a percentage of recipient GNP. This increase in the growth rate would raise income, and then the saving rate would increase because the marginal saving propensity is greater than average saving propensity in developing countries and hence the higher growth rate would become self sustaining without the need of further inflows of foreign aid. Thus, according to this view, inflows of foreign aid would have the effect of raising the savings rate in subsequent periods.

However, Chenery and Bruno (1962) and Chenery and Strout (1966) did not distinguish between different types of foreign capital and ignored the interaction that might exist between the savings and foreign exchange gaps.

The second phase: Griffin (1970), Griffin and Enos (1970), Weisskopf (1972), Areskoug (1976), challenged the assumption that foreign capital inflows add to capital formation without disturbing domestic savings and consumption. They criticized the simplitic findings of the former group and emphasised that not all aid was an increment to the capital stock of LDC's since some aid was diverted for consumption purposes. Aid may also raise the capital output ratio (v). Consequently, "if giving aid to a poor country depresses that country's savings rate- or raises its capital output ratio- to a sufficient extent then there is a possibility that aid may immiserize the recepient"[22]. They performed emprical tests through cross sectional regression relating aid to savings rates across a sample of LDC's. These studies represented statistically significant negative correlations between foreign aid and domestic savings in most cases.

Griffin and Enos (1970) found that it is inversely related to the ratio of foreign aid to GNP. According to Griffin and Enos (1970), in general, foreign aid has neither accelerated growth nor helped towards faster democratic political regimes. If anything aid may have retarded development by leading to lower domestic saving by distorting the composition of investment and thereby raising the capital-output ratio, by frustrating the emergence of an indigenous entrepreneurial class and by inhibiting institutional reforms.

Griffin and Enos (1970), Weisskopf (1972), Areskoug (1976) have not only critized the basic assumptions of the capital-oriented foreign aid models, but also suggested that, in some countries at least, foreign aid might impair rather than promote growth. This view was based on statistical findings that foreign aid does not add an equivalent amount to total investment. It was further suggested that foreign aid increases consumption, and thus reduces the savings rate.

The Third Phases: Papenek (1972, 1973) severely criticised the methodology of his predecessors. Firstly authors were found quilty of combining aid with other foreign resource inflows. Secondly, they ignored the data problems that arise from using savings as an independent variable when in most LDC's is calculated as a residual. "Most important of all, they inferried one way causal relationship from aid to saving levels in LDC's from an undoubted negative correlation between these two variables when what was more probably happining in many countries was that both lower savings ratios and high aid levels stemmed from an extraneous third factor i.e. political and / or economic arises in the recepient country"[23].

Instead, Papenek (1973a) was the first researcher who divided foreign capital into three components: foreign investment, foreign aid and other foreign inflows. He treated economic growth as a dependent variable

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[22] See MOSLEY P., HUDSON, J. and HORREL, S. "Aid, the Public Sector and the Market in less Developed Countries" , **The Economic Journal**, Vol. 97, Sep., 1987, p. 617.

[23] See MOSLEY P., "Aid, Savings and Growth Revisited", **Bulletin of the Oxford University Institute of Economics and Statistics,** Vol. 42, May, 1980, p. 79.

with domestic savings, foreign aid, foreign investment and other foreign inflows being independent variables. He also incorporated the domestic savings ratio as an additional explanatory variable. He found that savings and all foreign capital inflows explained over a third of growth and that foreign aid had a substantially greater effect on economic growth than the other variables. He estimated the following equation for eighty five coutries.

$$y= 1.5 + 0.20\ (S) +0.39\ (FA) +0.17\ (FDI) +0.19\ (OFI)$$

$$(6.0) \qquad (5.38) \qquad (2.5) \qquad (2.1)$$

$$R^2=0.37$$

(t statistics in paranthesis)

The estimated equation reveals that the aid coefficient is very significant and higher in absolute terms than any other coefficients. Papenek suggested that aid is more productive than domestic resources and other capital inflows.

Gupta (1975), Stoneman (1975), Gulati (1978), McGowan and Smith (1978) and Bradshaw (1985) also found positive relationships between foreign capital and economic growth.

The fourth phase was pionered by Mosley (1980, 1987): Mosley criticised Papenek's theoritical basis and atempted to estimate a modified equation relating aid to growth. Mosley criticisms were focused on the followings. Although, there is a time lag between commitment, disbursement and the gestation period of foreign aid, the studies do not use any lag structure. Mosley also questioned the validity of Ordinary Least Squares (OLS) estimation of parameters in that if there is a two-way causation between growth and foreign aid then the OLS does not give good estimation. According to Mosley, the assumption that foreign aid is exogenously determined is not plausible, as he believes that there is a two-way causation because once the political and strategic benefits are ensured, foreign aid is given according to the requirements of the recipient country. More specifically, foreign aid related to and is influenced by the income level of the recipient country. The hypothesis that foreign aid influences growth of income and in conjunction with the above proposition makes both income and foreign aid interdependent. In such an instance, Two Stage Ordinary Least Squares (TSLS) is the more appropriate estimation technique, as the use of OLS is likely to bring forth biased estimation of parameters; not as Papenek (1973a) has done.

Mosley (1980) found a negative relationship between foreign aid and growth in his 83 LDC case and a positive relationship for growth for the 37 countries by using TSLS. He continues, "It is likely that this little more than a reflection of the fact that the poorest countries attract the most aid in proportion to their income, and that the poorest countries save least, not a genuine causal relationship. Positive and significant relationship between aid and growth noted by Papenek in the 1960s appears to have collapsed as applied to the less developed countries as a whole" (Mosley, 1980, p.90).

It has been argued that as the dependence on aid varies from country to country, aid operates differently in different administrative, infra-structural and policy environments. Mosley (1980) found that the proportion of growth explained by aid, and private capital can vary from 4 to 25 percent. In addition, if the aid recipient countries were divided into a poor group, with per capita below $300 at 1977 prices, and middle income group above that level, a strong and positive relationship was indicated between foreign aid and growth. For the middle income group, the relationship was negative but not significant.

The equations Mosley (1980) has estimated contain all the explanatory variables used by Papanek plus " aid lagged five years" as explanatory variables. Using the TSLS method the two significant results which he has obtained suggest that aid lagged five years is positively related with growth in the case of 35 poor countries and that UK donated aid, particularly to poor African countries showed significant positive contributions to growth. Thus he concludes that "the positive and significant relationship between growth and aid noted by Papenek in the 1960's appears to have collapsed as applied to the less developed countries as a whole" (Mosley, 1980, p.90), but the relationship between foreign aid and growth is still positive for the poorest countries[24].

According to Mosley, Hudson and Horrell (1987), multiple linear regression equation which relates growth in the recipient country, as an independent variable, to a cluster of possible casual influences, including aid as independent variables, is a simple model which implies that aid has some kind of leverage on growth. Thus they considered the apparent effectiveness of foreign aid in the light of a model which decomposes the impact of

[24] See MOSLEY, P., "Aid Savings and Growth Revisited", **Bulletin of the Oxford University Institute of Economics and Statistics**, Vol. 42, May, 1980, p. 90.

foreign aid into three different component parts. These are "the direct effects of the aid disbursement", "indirect effects on the spending pattern of the public sector of the recipient country", and lastly the effect of foreign aid on the prices of some goods, "raises the prices of some goods, depresses the price of some others and hence has side effects on the private sector of the recipient economy through the price system" (Mosley, Hudson and Horrell, 1987, p.616-617).

It has been argued particularly by Papenek (1972), that not only is the economic performance of a country influenced by aid inflows, but inflows are influenced by economic performance, and in particular are stimulated by balance of payment crises and natural disasters in recipient countries. Whereas these crises are not necessarily correlated in any way with the growth of GNP, the possibility of simultaneous causation obviously exists. Therefore, Mosley, Hudson, and Horrell (1987) consider this simultaneity problem and they used a simultaneous equations system to overcome this matter. In their model, foreign aid is expressed as a function of various indicators of recipient need, including growth of GNP, the level of per capita GNP, and overall mortality as a measure of welfare. In addition, the member countries of the Arab League and OPEC were included as dummy variables to account for a number of the cases of abnormal foreign aid flows during the 1970s. Mortality is taken itself as an endogenous variable and therefore the system consists of three relationships:

"Growth= foreign aid, other financial flows, savings, growth of literacy rate, growth of export.

Foreign aid= Per capita GNP at the beginning of the period, mortality at the beginning of the period, growth rate of GNP, OPEC and Arab league dummies.

Change in Mortality= foreign aid, per capita GNP at beginning of the period, growth rate of GNP" (Mosley, Hudson and Horrell, 1987, p.632).

One of the several attempts at measuring the impact of both domestic and foreign resources on the actual growth performance of the developing countries has been made by Gupta (1975) and Gupta and Islam (1983). He pointed out that the above studies only allowed for the direct effects of foreign capital inflows on growth and did not properly specify the indirect effects through savings. Therefore he tried to specify and estimate a model which allows for both the direct and the indirect effects of dependency rates and foreign capital inflows on savings rates.

Gupta and Islam (1983) involved demographic factors in the form of dependency rates in their model to partly explain the lower saving rate of the LDC's and used a simultaneous equation model. They treated the components of foreign capital (Foreign aid, foreign private investment and other foreign inflows) as an exogenous variable and both the growth of GNP and savings as endogenous variables. They have found that the domestic savings as well as foreign capital make a positive contribution to growth and they reached the point that foreign capital has some positive role to play and that foreign capital will still continue to play a crucial role in the relations between the developed and developing countries in the near future. Using the single equation estimates in their model, it can be seen clearly that foreign aid is more productive than private investment, and in most cases the coefficient of foreign private investment is not significant. Thus, on the basis of strong evidence in favour of foreign aid against foreign private investment from single equation results, foreign aid is more useful than foreign private investment.

Conclusion

Foreign Aid antagonists and aid advocates have tried to judge the effect of aid on savings, investment and growth in LDC's. However, there are many problems regarding the essessment of the effectiveness of aid. As Bauer indicates, "This difficulty arises partly because of the familiar problem of discerning the causal, functional relationship between specified variables when a situation or process is effected simultaneously by numerous past and present influences operating with various time lags"[25]. This is more evident when relating the performance of an economy to the operation of the inflow of foreign aid.

The effectiveness of aid, however, depends largely upon both the donor and recepient motives and how these may be aligned or conflicting with the objectives of aid. This is also depends on the extent to which aid is tied to capital projects rather than being disbursed in forms such as food aid, balance of payments support and debt relief which do not necessarily have any development component at all. Whether the recepient uses aid to

[25] See BAUER, P.T-YAMEY, B., "The Political Economy of Foreign Aid", **Lloyds Bank Review**, 1981, p. 98.

increase savings and investment rather than switch aid resources to consumption and other nonproductive purposes, also determine the effectiveness of aid.

However, evidence shows that donor countries are increasing aid tying. This is, of course, in the best of interest of the donor country as opposed to the poverty stricken recepient country. It does not serve to increase growth in LDC's but has an adverse effect on growth, employment and the balance of payments. Thus, it is suggested that donor countries must avoid tying of aid, especially joint tying by source and by commodity as it leads to monopolistic explotation.

Finally, it is argued that the amount of aid should be increased. However, in the light of the conflicting motives of donors and recepients, it is not likely that such an increase will alleviate poverty. Since the beginning of the Gulf crises the international community has been asking for more aid to the countries like Ethiopia, where crop failure and famine are having drastic effects on the poor. However, due to political motivations more aid has been directed towards Egypt and Israel for their political support of the crises. Hence, unless the reforms outlined before take place, any increase in the amount of aid will not necessarily have a notiable effect on the LDC's.

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