

International Economic Assistance in the 1970's — A Critique of Partners in Development

by

NURUL ISLAM*

INTRODUCTION

Foreign economic aid is at the cross-roads. There is an atmosphere of gloom and disenchantment surrounding international aid in both the developed and developing countries — more so in the former than in the latter. Doubts have grown in the developed countries, especially among the conservatives in these countries, as to the effectiveness of aid in promoting economic development, the wastes and inefficiency involved in the use of aid, the adequacy of self-help on the part of the recipient countries in husbanding and mobilising their own resources for development and the dangers of getting involved, through extensive foreign-aid operations, in military or diplomatic conflicts. The waning of confidence on the part of the donors in the rationale of foreign aid has been accentuated by an increasing concern with their domestic problems as well as by the occurrence of armed conflicts among the poor, aid-recipient countries strengthened by substantial defence expenditure that diverts resources away from development. The disenchantment on the part of the recipient countries is, on the other hand, associated with the inadequacy of aid, the stop-go nature of its flow in many cases, and the intrusion of noneconomic considerations governing the allocation of aid amongst the recipient countries. There is a reaction in the developing countries against the dependence, political and economic, which heavy reliance on foreign aid generates. The threat of the increasing burden of debt-service charge haunts the developing world and brings them back to the donors for renewed assistance and/or debt rescheduling.

Foreign aid is under attack from the "radical left" in both the developed and the developing world on the grounds that aid strengthens the hands of the

*Professor Islam is Director, Pakistan Institute of Development Economics.

political groups who are in power in the poor countries and who often happen to be conservative governments composed of a small oligarchy. They inhibit necessary socio-economic reforms and thwart efficient growth and create considerable inequities. It is alleged that aid serves as a link between the established vested interests of the rich countries and the reactionary elements in the poor countries, blocking progress in both towards a more acceptable and viable socio-economic and political world order. Aid, according to this line of reasoning, should be curtailed or eliminated until the necessary socio-political changes in attitudes and institutions take place in both the rich and the poor countries so that the poor all over the world can share the resources of the world more equitably in the context of a just world order.

Standing between the anti-aid groups is the liberal who is neither convinced of the unchanging and ultimate depravity of human beings nor believes in violent revolution as a means of social reform and economic progress. The liberals want more aid — greater commitment of the international community towards the development of the poor; furthermore, they want an improvement in the terms of aid and a change in the pattern of aid towards greater flexibility in its composition with a view to increasing its effectiveness in development. They expect private capital in the advanced country to play its role in development; they expect national states to curb their sovereignty in the interests of the "village community" — a state to which the twentieth-century development in communications has reduced the world.

It is in this context that the Pearson Commission was assigned to study the experience with international economic assistance during the past two decades and to map out a strategy of aid for the next decade. The Commission in its Report, *Partners in Development* [5], strives to lead the middle group — the liberals — and to strengthen its voice in the world community which today, more than ever before, has at its disposal resources and technology to relieve poverty and distress in the underdeveloped two-thirds of the world. The Commission's recommendations are very wide-ranging and cover almost all the ideas now familiar in the fields of world trade and investment. A necessary casualty of this approach is a certain lack of priority in their recommendations. Since its main aim is to make 'reasonable' and 'acceptable' recommendations, it often makes them weak; small improvements on all fronts rather than dramatic improvement in some may reflect a judgment on the part of the Commission of what is feasible. Only time can reveal the relevance or accuracy of this judgment.

The following discussion concentrates on only a few from amongst the wide range of issues raised by the Pearson Commission in international economic assistance. The points of view of both the donor and the recipient countries are considered with an accent on the latter. We examine the rationale of public international aid from the points of view of both sets of partners in development,

the principles of allocation of aid, various methods of increasing the effectiveness of aid in promoting growth; we make, in addition, a few observations on foreign private-investment which the rich countries, faced with a shortage of public aid funds, have increasingly tended to emphasize as an important engine of economic growth of the poor nations.

RATIONALE OF AID — DEVELOPING COUNTRIES' POINT OF VIEW

Why should developing countries seek foreign aid? The now widely familiar two-gap analysis provides a rationale; *i.e.*, developing countries in the uphill task of raising the level of investment suffer from deficiency of domestic savings as well as from that of foreign exchange. Domestic savings, even if they are adequate for meeting the demands of the target investment rate, can not always be converted into foreign exchange through either net import substitution or export expansion. An expansion of domestic output requires fixed inputs of foreign-imported capital equipment and, in many cases, imported raw materials; the exports which are predominantly agricultural and primary commodities can not be expanded to meet the growing import needs. Foreign aid meets both deficiencies and in order to do so the amount of aid inflow needs to be equal to the more dominant of the two gaps so that the target growth is achieved. Foreign aid, thus, contributes to growth by enabling the recipient country to overcome the critical bottlenecks, *i.e.*, inadequacy of saving and of foreign exchange.

Two-gap analysis assumes that foreign aid is entirely used to supplement domestic savings or to augment foreign-exchange availability for investment imports. Aid is expected not only to augment the supply of these two critical inputs necessary for development but also to finance the transfer of technology from abroad and the inflow of foreign managerial and administrative talents under various technical assistance programmes, increasing the efficiency of use of resources. Moreover, aid acts as a catalyst in persuading the recipient countries to improve the allocation of resources by the pursuit of sensible or efficient economic policies in the field of tax policy, interest policy or exchange-rate policies, *etc.* "Economic policy aimed at growth requires a certain boldness, a willingness to experiment. The growth process is still mysterious, and no decision-maker can be absolutely certain that any particular change in policy will produce the effects planned nor can any expert or adviser so guarantee. Results will depend on many variables. Moreover, developing countries live so close to the margin of subsistence that even minor economic reverses have major political and economic consequences. A cushion of foreign resources makes it possible to pursue bolder policies and take steps to accelerate development that might otherwise not be possible" [5, p. 52].

What is the experience in the past? Has economic growth been positively correlated with foreign aid? Has foreign aid always supplemented domestic

savings or foreign-exchange earnings for development? Has aid succeeded, in most cases, in inducing efficient economic policies?

It is difficult to find strong and significant statistical correlation between growth rates and aid flows either on the basis of cross-country studies or on the basis of historical studies. This conclusion remains valid whether aid as a proportion of total imports or total GNP is related to the rate of growth of GNP [5, Pp. 49-50; 10, p. 183]. Some of the reasons for the failure to obtain significant statistical correlation are obvious. A considerable part of aid in the past has been granted on noneconomic considerations for military and political purposes without any reference to the objectives of growth or the country's ability to utilise aid. It was also directed in many cases for promoting exports of the donor countries without particular reference to growth objectives in the recipient country. The experience with aid for development is short and mistakes have been made in the past. As the Commission points out, its effectiveness is expected to increase (in the future) as a result of past experience with the use of aid in both the donor and the recipient countries.

To some extent aid is expected to be negatively associated with the rate of growth in a *cross-country analysis*. This may indeed be a measure of the success of aid effort. Countries which have attained a high rate of growth should be dispensing with aid in an increasing degree and should be becoming self reliant. The higher the rate of growth a country achieves as a result of successful application of aid in the earlier period, the higher is the proportion of investment and imports financed by domestic savings and its own export earnings. Moreover, a large part of aid is directed to physical infrastructure, investment which takes place now, while the effects on growth are felt later. Similarly, aid which is devoted at present to social overheads, such as educational and training facilities and the development of human resources, will have an impact on growth in the years subsequent to the period of high aid flow.

The factors affecting economic growth are complex and they are often interrelated. A simple statistical correlation between aid and growth is unlikely to be able to distinguish the effects of aid unless all the factors are explicitly included and their effects eliminated. After all, aid has contributed in the past no more than 15-20 per cent of total resources for development and the variation in the domestic resources as well as various policies relating to the composition of investment and efficient utilisation of resources are the more crucial determinants of economic growth. The fluctuations in these latter factors are often more pronounced than those in the volume of aid. Economic growth has, however, been found to be correlated with import capacity which is the combined total of export earnings and foreign aid. A few studies which have distinguished between the effect of export earnings and that of foreign aid have found positive correlation between aid and economic growth in a cross-country

analysis. The relative contribution of these two factors differs as between the different studies; in one study an extra dollar of foreign aid contributes less to the growth of GNP¹ than an extra dollar of exports and in another study, the reverse is true² [4 ; 6]. The contribution of foreign aid is positive in both cases but is very significant in one and not so significant in the other. Similarly, studies which have used other explanatory variables such as an index of natural resources (in terms of ratio of primary exports to GNP) have found a positive correlation between growth and aid [11, Pp. 10-12].

While analysing the effect of aid on growth, the implicit assumption has been that aid is devoted entirely to investment. This is an unduly restrictive assumption. Aid in the first place supplements GNP and is a component of total resources available to a country for distribution between investment, consumption and, for that matter, augmentation of the foreign-exchange reserves of the recipient country. There is no *a priori* reason why aid should be entirely devoted to investment. The choice is a function of time preference of the individual country between present and future consumption at the margin; of the marginal returns on investment of foreign-aid resources, the interest cost of borrowing (excepting in the case of grant) and the time pattern of repayments. If the objective of economic policy is not only to maximise growth of income within a definite planning horizon but also to attain a certain increase in the rate of consumption within the planning period, it is optimum and rational policy for the aid-recipient country to devote a part of aid to consumption.

In fact, unless one assumes that output maximisation is the only objective of policy, there is no rationale for exclusive use of aid for investment purpose. Similarly, if capital coefficients of output consist of domestic and foreign-capital goods, which are not substitutable, then as soon as the supply of domestic-capital goods is exhausted, the investment effect of foreign aid will be zero and the entire aid has to be devoted to consumption if it is to be absorbed at all. The macro-economic models of Chenery, Bruno, and Strout, *etc.*, [2 ; 3] which conceive the role of foreign aid entirely in terms of raising investment, either through supplementing domestic-resource component (savings) or foreign-exchange component (raw materials and capital goods necessary for investment), allow the use of aid, for consumption purposes only in the limiting case when, with a rising level of investment, all the labour is fully employed. Under these circumstances, the shortage of labour puts an absolute limit to investment and additional aid is entirely consumed. A statistical study of a large number of countries on the basis of historical time series reveals that average propensity to allocate aid to

¹The regression coefficient of percentage change in income on foreign aid as a proportion of income varies between 0.13 and 0.10 whereas that on change in exports as a proportion of income varies between 0.21 and 0.62 [4, Pp. 283-284].

²The regression coefficient relating change in income to aid as a proportion of GNP is 0.115 or 0.065 whereas that relating to exports as a proportion of GNP is .003 or .004 [6, Pp. 89-97].

consumption and to investment is 0.45 for both [1, p. 76], while another cross-sectional study finds propensity to consume out of aid is 0.24 [12].

Once the possibility of the use of foreign aid for both investment and consumption expenditures is admitted, it is obvious that, given the identity of total resource use and resource availability, *i.e.*, $Y + F = C + I$, where Y is GNP, F is foreign aid, and C and I are aggregate consumption and investment expenditures, foreign aid is inversely related with saving. As GNP in the period in which aid inflow takes place remains unchanged, an addition to consumption out of foreign aid in the same period reduces saving because saving defined in the national accounting framework is $(Y - C)$. The proportion of GNP saved, *i.e.*, $(Y - C)/Y$, also declines from the previous level, *i.e.*, as compared with no-aid situation. The distribution of aid between consumption and investment uses, as already pointed out, is independent of the commodity composition of aid-financed imports so long as the composition of domestic output is flexible and resources are shiftable between the consumption- and investment-goods producing sectors in the economy. Various alternative situations are conceivable in terms of the effects of aid on domestic saving; it is to be noted, however, that it is never suggested that aid may, in fact, reduce the domestic investment below the level realised in the pre-aid situation. In the case of private foreign investment, it has often been alleged that the foreign enterprise with a greater command over resources and technology may discourage domestic private investment, if the infant domestic enterprise is unable to survive the competitive struggle. In the case of foreign public aid, the worst possibility is that the entire aid is devoted to consumption in which case domestic investment remains unchanged, but savings fall; if domestic consumption increases by more than the amount of pre-aid investment, there will result negative saving. It is conceivable that investment increases by more than foreign aid if the latter is entirely or even partially devoted to investment and if at the same time the domestic savings are stimulated by the inflow of foreign resources. If the savings in the pre-aid situation are frustrated owing to dearth of the foreign-exchange component of investment, foreign aid, by increasing the supply of imported inputs, can increase the investment beyond the level of pre-aid investment by more than the amount of foreign aid.

An increase in consumption facilitated by flow of aid has undesirable implications for future growth not only because investment is less than it otherwise would have been if aid were entirely devoted to investment but also because a high level of consumption sustained by foreign aid may bring about changes in consumption habits. In other words, the upward shift of the consumption function may not be reversible when foreign aid, depending upon the exigencies of the policies followed by the donor countries, falls. Moreover, it is conceivable that the slope of the consumption function changes as a result of aid-financed additional consumption so that the marginal saving rate falls.

The moral as well as the rationale of the preceding discussion is that savings are a function not only of income but also of total resources at the disposal of a country and these consist of domestic product and foreign aid. It is not suggested that saving (redefined as income plus foreign aid minus consumption) declines consequent on the aid inflow. It may decline in the unlikely event that consumption increases by more than the amount of foreign aid. Similarly, propensity to save as a proportion of total resources (GNP and foreign aid) may fall if the propensity to save out of the additional resources of foreign aid is lower than the propensity to save out of income in the pre-aid situation. Thus, we may conclude that while economic growth is a complex phenomenon and a function of a large number of factors and while the statistical correlation between growth and aid is not self evident partly due to the difficulties inherent in a statistical exercise of the type mentioned earlier, the contribution of aid to growth is recognised. The extent of such contribution in any actual case depends upon the circumstances of each country, *i.e.*, how it uses additional resources put at its disposal. The crucial factor is whether the country receiving aid pursues policies conducive to generating forces of growth. Availability of additional resources through aid is a necessary but not sufficient condition for generating growth. The fact that a certain amount of aid is consumed may even have a beneficial effect on development if aid is spent on human-resource development or on straightforward consumption of the poorer sections of the people, which either provides incentives for greater productive effort or increases sheer physical ability for harder work under circumstances where consumption and nutritional standards are very low [10].

The Commission recognises that employment and distribution of income are important targets of development during the decade of the 1970's. A high rate of growth generates greater resources for distribution and provides greater flexibility for meeting demands of social justice. But a high growth rate is not a sufficient condition. Positive policy measures are necessary, within the context of a higher growth rate, to expand employment and to achieve a more equitable distribution of income. It is now increasingly suggested that conflicts between growth and distributive equity have been exaggerated. In a developing world it is necessary, in the interest of growth, to open up maximum avenues and sources of initiative and enterprise. Even when it is true that the rich save a larger proportion of income than the poor, it is not at all clear that the degree of inequality currently prevailing in many developing countries is a necessary price to pay or that a wider diffusion of investment opportunities and of productive employment will not, in the aggregate, increase the total savings of the economy. Furthermore, employment is an objective by itself. It satisfies human need for useful and creative activity and for participation in the tasks and benefits of development.

Development targets in the 1970's should include the objectives of employment and income distribution in specific, quantitative terms. For example,

there is a growing consensus that an improvement in the standard of living of the lowest 25 per cent of the population should be a specific development target; similarly, specific sectors and projects can and should be identified for the purpose of providing employment. A greater emphasis on distributive justice as a necessary goal of development in the next decade will provide a partial, if not a complete, answer to the critics of foreign aid who are on the left of the political spectrum.

How much aid should the poor countries, such as Pakistan, seek? The Commission suggests that if the developing world succeeds in growing at the minimum rate of 6 per cent per annum in the years to come, say until the turn of the century, they would be able to achieve self-sustaining growth. What does self-sustaining growth in this context mean? There are various ways of looking at it. One, the developing countries will receive no net inflow of foreign resources; there will be gross capital inflow which would just offset the outflow in terms of repayments and interest or dividend payments. This gross inflow will be at ordinary commercial terms at which foreign funds, equity or loan capital can be borrowed in the international capital market. Second, while the developing countries will not receive any concessional public aid, they will receive a net inflow, *i.e.*, the gross inflow received on commercial terms will exceed the gross outflow, but then this net inflow should enable the developing world to grow at more than 6 per cent, say, after 2,000 A.D. In other words, self-sustaining growth in both cases implies that the developing world will be able to grow at 6 per cent without any net inflow of resources from abroad at concessional terms. They should be able, in the Commission's view, to attain a marginal rate of saving of 22-25 per cent to increase exports at a rate faster than income and to achieve a rate of investment of about 20 per cent by the end of the century which, thereafter, will be sustained with domestic savings. In both cases, moreover, they would continue to receive capital inflows at commercial terms, which would necessarily be mostly private foreign investment, in order to service the outstanding debt at the end of the century. The larger the outstanding debt, the larger is the need for private foreign capital to meet the debt-service payments and to grow at the same time at 6 per cent per annum. In order to keep the debt-service burden manageable for the developing world, the Commission recommends 40-year loans at 2-per-cent interest with 7 to 10 years' grace period. These are terms which are substantially more concessional than those prevailing today.

From the foregoing discussion, it appears that the amount of aid which a country should seek in the next few decades is closely linked with the amount of nonconcessional capital inflow and private investment which she considers acceptable on socio-political grounds at the turn of the century or whatever is the length of the perspective-planning period. There is an underlying presumption that the greater the dependence on foreign capital, private and public, the

greater is the sacrifice involved in terms of political and economic dependence. International aid, as is explained later, is unlikely to be divorced entirely from a certain loss of political manoeuvrability or freedom in the internal and/or external affairs of a country even though no overt strings are attached. Similarly, it is also felt by the developing countries that domestic economic policies suffer from a loss of flexibility if a very significant proportion of domestic capital stock is owned by foreign direct investment.

Moreover, there are good reasons to suggest that the dependence on foreign aid for economic development should not be so heavy that if, for whatever reason, aid is cut off or its flow interrupted, the recipient country would be unable to sustain a minimum rate of growth on her own resources; this holds true during the intervening period, *i.e.*, the period during which a poor country has not attained a self-sustaining growth in the sense in which the Commission defines it. The minimum desirable rate of growth is to be decided by each society by its own choice; it will probably in all cases have to be higher than the rate of growth of population. The rate and pattern of domestic-resource mobilisation as well as of import substitution and export expansion should be such that this critical minimum rate of growth must be sustained, if necessary, without aid. Even if a very poor country, to begin with, may not be in this position, it should be the aim of development policy to reach this stage within the shortest possible time [13]. It is not that a developing country should, in fact, grow at this minimum rate and plan to repay all debts at the end of the perspective-plan period but that she should plan to repay the outstanding debt at the end of the period to the extent which is consistent with the target of politically acceptable flow of nonconcessional aid and private foreign investment. She can indeed decide to develop with a large inflow of commercial capital and generate a higher growth rate, before or after the perspective-plan period, provided she stands ready to dispense with foreign aid of any kind, at any moment, and still continue to grow at the minimum acceptable rate. Such a policy would minimise the dislocation in the domestic economy in the event of the interruption of aid flow, which is subject to external forces beyond the control of the recipient countries.

RATIONALE OF AID — DEVELOPED COUNTRY'S POINT OF VIEW

The crisis which confronts international aid today has its source not so much in the developing countries as in the "depressed" aid climate in the donor countries. The Commission strives hard to allay pessimism about the growth prospects of the developing world. That the developing world has achieved in the last decade a growth rate of 5 per cent is no mean achievement; more so in view of the fact that they had relied mainly on their own resources, foreign aid supplying only 15 to 20 per cent of the total investment resources. Even if aid helps the growth of poor nations, the critical question asked today is: why must the rich nations aid the poor in their development effort. That poverty anywhere

is a threat to prosperity everywhere, especially in a shrinking world linked by instant communications, does not appear so real and crucial to the immediate self interest of the rich nations. Admittedly, the growth of the poor nations helps widen the market for the rich and exploits resources for use by all, both the rich and the poor nations. That violence and instability are positively correlated with poverty and, therefore, that aid contributes to international peace is not convincing; revolutions often catch on when positive improvements in the levels of living take place and expectations and hopes are raised, since grinding poverty more often than not generates apathy and inertia rather than instability.

The ultimate sanction of foreign aid in the opinion of the Commission is the moral obligation of the rich to help the poor and for the strong to aid the weak. Whether this motive can sustain continued aid for many years and for many countries is doubtful. It appears on the basis of any realistic appraisal that the rationale of foreign aid in the coming years will be derived from a mixed bag of political, moral and economic considerations. It is not necessary to prove that aid can buy allies or stave off potential enemies or that it really ensures peace. If the politicians and policy-makers in the rich nations come to believe in the political role of aid then aid will flow at least partly from considerations of political objectives. The poor countries have to live with this rationale in the foreseeable future.

The Commission recommends a target for the supply of aid by the rich nations, *viz.*, 1 per cent of GNP by 1975, including both public aid (0.7) and private investment (0.3). There is no particular economic argument for 1 per cent of GNP, which has no reference to the per capita incomes or the state of balance of payments of the individual donor countries and which may, therefore, involve inequity in international sharing of the burden of foreign aid. However, the absolute magnitude of the burden is so small that the Commission neglects considerations of equity in burden sharing. It is attainable in spite of the competing claims on resources in the domestic economies of the developed countries. The Commission considers this target of aid consistent with the various estimates of aid requirements of the developing countries based on 6-per-cent growth rate. The fixation of a target and its acceptance by the donor countries is expected to provide a focal point for mobilising public opinion and political support for aid in the developed countries by serving as a symbol of the moral pressure of the world community on the rich and the affluent nations.

HOW TO ALLOCATE AID?

The studies undertaken by OECD Development Assistance Committee [10] show that in the past there has been a marked tendency for each recipient country to receive a minimum amount regardless of its size, plus a certain amount related to the size of its population. Aid as a percentage of GNP is not related

to per capita income. However, aid receipts as a share of imports of the recipient countries appear to be strongly related to a combination of per capita income and some index of import needs [10, Pp. 157-187]. More illuminating is a detailed study of the allocation of foreign aid by different international organisations and individual countries [8]. The distribution of aid by the UN agencies seems to have been governed by random factors — not particularly related to relative degrees of poverty or considerations of absorptive capacity or the rates of growth. However, this does not seem very irrational, given the fact that the largest portion of the UN aid is technical assistance and pre-investment surveys, *etc.*, and given the diverse pressures exercised on a world organisation for a widest possible distribution of aid among the member countries. The intercountry distribution of IBRD loan seems to be positively related with population and per capita income; very small and poor countries seem to receive no aid from the IBRD. The per capita income, as a significant explanatory variable, derives its rationale from the fact that a higher-income country has a greater ability to effectively use as well as repay and service the debt. The US bilateral loans seem to follow the same pattern, *i.e.*, positive correlation with GNP and population, excepting that two additional factors emerge as important explanatory variables, *viz.*, noneconomic relationship with the recipient countries, such as strategic considerations, as exemplified by the amount of military assistance received by the recipient country, as well as the amount of foreign-exchange reserves. The later phenomenon indicates the importance of nonproject aid for balance-of-payments support which often figures in bilateral aid operations. The most significant variable explaining the intercountry allocation of US government grants, as against loans, is the strategic consideration as indicated by the amount of military assistance received by the country concerned³.

The Commission recommends an increase in the proportion of multilateral aid from the present figure of 10 per cent to 20 per cent of total aid. The suggestion that multilateral assistance involves no political considerations is not entirely true, to the extent that the international organisations are dominated by powerful rich member countries. One can argue that a poor country receiving aid on a bilateral basis from a number of rich countries can partly neutralise the political influence of one country against that of the other. Multilateralisation of aid through the international agencies, on which the big donors are not able to exercise a dominating influence, may not be highly attractive to them so that with an increase in the share of the multilateral aid, total aid may suffer; the pressure for political control of the international agencies by the big donors may also increase correspondingly. So long as the use of foreign aid for non-economic purposes is not entirely eschewed, an unlikely possibility at the present state of international relations, the dilemma is not easy to resolve.

³The analysis of the allocation of aid given above relates to the distribution of total rather than per capita aid. The distribution of per capita aid follows the same considerations with slight variations [8].

The Commission recognises the problem and urgently pleads for partnership between the donor and the recipient countries in a multilateral institutional framework like consortium and consultative groups, *etc.*, in which they would mutually monitor each others' policies and performance, formulate the criteria of economic performance and evaluate the performance of recipient countries on the basis of periodic reviews. In this multilateral framework of mutual consultation, while the recipient countries will consult the donor countries on the issues of economic policy and undertake to meet agreed standards of economic performance and efficient use of aid, the donor countries, in turn, will undertake to ensure an adequate and steady flow of aid and allocate aid according to the criteria of economic performance. It is necessary to remember that the aid relationship between the poor and the rich nations is basically unequal; to expect anything else is unrealistic. The equal opportunities of participation in the multilateral forums for aid negotiations do not alter the basic fact of inequality of bargaining power; the mutual monitoring of policies of the debtor and the creditor countries, however desirable, can seldom extend to a critical analysis of the policies of the donor countries with the same effectiveness and ease as is usual in the case of the poor, debtor countries.

The criteria of performance which have been suggested by the Commission for judging successful economic performance are improvements in two specific ratios, *i.e.*, the savings-income ratio and the ratio of exports to income. This is on the assumption that a rise in the marginal saving rates or in the export income ratios will help achieve self-sustaining growth. The reliance on these two criteria can only be partial partly because of the statistical difficulties of measurement and partly because of their vulnerability to the influence of external factors. This implies that necessarily one has to go beyond these critical ratios to the particular economic circumstances, internal and external, confronting the recipient countries as well as to an evaluation of the whole gamut of economic policies.

One can think of at least four sets of considerations which should ideally govern the allocation of aid. They are: *a)* needs of developing countries; *b)* domestic development efforts including social, economic and institutional reforms and systematic effort in the implementation of necessary measures; *c)* performance in making productive use of external assistance, *i.e.*, effective application in areas where gains are the greatest; and *d)* resources and potentialities of the countries themselves, so that resources are used where opportunities for exploiting known resources exist. The criterion *d)* is more relevant to the flow of private international investment; the criterion *a)* really is based on the principle of international solidarity and equity rather than the criterion of efficiency. An appropriate combination of the criteria of efficiency and equity is a matter of value judgment. No foolproof mechanism in terms of simple criteria, which the Commission started out to devise, is available.

INCREASING EFFECTIVENESS OF AID

There are certain aspects of the current aid flow which vitally affect the developmental impact of aid as well as the real value of net aid which poor countries receive. Three issues in this general area are of central importance; composition of aid in terms of programme and project aid, tying of aid to sources of supply in the donor countries and terms of aid, *i.e.*, rate of interest, maturity and grace period, *etc.*, which govern the debt-service payments.

The Pearson Commission strongly endorses the demand, persistently made by the debtor countries that for enabling them to absorb more aid effectively and to overcome the crucial bottlenecks on the domestic front, the donor countries should increase the flow of programme loans and move away from the overwhelming reliance on project loans as at present. This is particularly relevant where, as in Pakistan, the relatively higher proportion of project aid in the past has resulted in considerable production capacity, a large part of which remains unutilised for lack of imported raw materials and spare parts. A greater availability of programme loans or commodity assistance will accelerate growth with little or no addition to capital stock. The financing of the local costs of development programme, where necessary, is also recommended. If aid is to fill the gap in domestic savings, the financing of local expenditures, as is found by experience in many African countries, is an essential form of capital assistance. Moreover, the financing of local expenditure assumes critical importance with the increasing emphasis on investment in population control, education, research, health and housing, *etc.*, all of which have a relatively small foreign-exchange component. This implies that foreign-resource inflow takes place in terms of wage goods and/or raw materials for the production of wage goods.

Insofar as the fungibility of aid and domestic resources is now widely admitted and insofar as the efficient use of aid is to be basically a function of overall economic policies and of the pattern of resource use, the insistence on project aid loses its strongest rationale. While, on the one hand, project aid is intended to stimulate self-help for meeting the local expenditure of the aided project, on the other hand, it may, as well, direct domestic resources away from the more productive uses, just because foreign aid is available for a project which may be of low priority. One would have expected the Commission to provide some empirical evidence of how the efficient use of aid as well as the process of development is affected by the present aid policy of not financing local costs and insistence on project assistance.

On the question of tied aid, the Commission makes no radical suggestions. It recommends institutional arrangements for ensuring greater competition in the developed countries when bidding for contracts; it suggests the untying of aid funds in respect of their expenditure in the developing countries. The predominance of tied aid is an important instance of inequality in the aid rela-

tionship, not only because tied aid is to be repaid in untied foreign-exchange earnings of the debtor country but also because the balance-of-payments difficulties, which is the major justification put up by the donor countries for tying aid, arise not from any actions or policies of the poor countries but from those of the rich countries in their mutual trade relations. The rich countries follow restrictive practices in their mutual economic relationships; the surplus, developed countries neither inflate nor adjust the exchange rate and liberalise trade but instead prefer to accumulate foreign-exchange reserves.

One of the critical problems facing the recipient countries is the mounting debt-service burden for many of them. In countries like Pakistan, the debt-service charges constitute about 20 per cent of the foreign-exchange earnings. It is often suggested that the debtor countries should eschew further borrowing when the debt-service charges impose such a heavy and inflexible burden on its foreign-exchange resources. Whether a particular ratio of debt-service charges is critical or not depends partly on the scope for export expansion and import substitution, on the one hand, and on the prospects of aid in the future, on the other.

Two questions regarding the debt-service burden of the developing countries need to be reexamined. Firstly, what is the rationale of repayment of loans by the rich to the poor nations? After all, US assistance to the Marshall-Plan countries (the second richest and developed group of countries in the world) after the Second World War was in the form of grants to the extent of 80 per cent of the total aid. Viewed in this light, the case for grants to the poorest countries of the world today is much stronger. Admittedly, the development assistance to the Western European countries was a one-time, short-term operation, lasting for about four years only. In the case of poor countries, it has turned out to be a long-term continuing commitment spreading over several decades. Undoubtedly, there is a grant element, though of a declining magnitude, in the loans which are extended today. But it is nonetheless not clear why, if the rich countries are to transfer resources for the development of the poor, the resources should flow back (at least in the foreseeable future); why the poor should not be encouraged instead to reinvest the entire resources generated out of the investment of the external aid.

One economic argument in favour of repayment and interest charges is that it ensures an efficient use of external aid for economic development. The obligation for debt-service payments does not necessarily ensure efficient use of aid; the efficient use of loan funds can be associated with an overall inefficiency in the use of the domestic resources which any way finance the bulk of total investment. However, one may argue that if the entire aid is to be given in the form of grants, it may affect the quantum and flexibility of total resource flow to the developing world as a whole. For one thing, this may reduce the aggregate amount of capital flow to the developing countries. There is the usual

resistance of the Parliaments and Congress to "give away". Moreover, with a given total quantum of aid which is limited in relation to the needs of the competing and increasing number of claimants for foreign assistance, the repayment of loans by a given recipient country enables the donor countries to redistribute resources over time among the other poor nations in response to their needs and the productivity of investment, which change over time as between the different countries. Repayments create, so to speak, a revolving fund and enable a periodic reassessment and consequent reallocation, if necessary, of the external resources to the individual recipient countries.

This line of reasoning indicates that it is not efficient to extend all the economic assistance in the form of grants, especially since economic aid is expected to be a long-term phenomenon. However, it does emphasize the need for a much larger share of outright grants than at present, in the total economic assistance, especially for the poorer ones among the developing countries. Secondly, it is necessary to recognise that so long as a developing country requires a net inflow of resources, new loans have to be contracted in order to repay the old debts. This has been the historical experience with many of the developed countries in the past. Faced with heavy debt-service charges many debtor countries have requested the rescheduling of debt by the donor countries. The system of rescheduling, which needs to be repeated every few years, is inefficient and creates uncertainty; it further brings a bad name to the debtor country. The opportunity which the rescheduling operations offer for a mutual consultation on and reappraisal of economic policies of the debtor countries is only of marginal value and should be available any way under the system of periodic reviews recommended by the Commission. What is necessary is to ensure that the need for debt rescheduling does not arise in the normal course of events — a possibility which can only be ensured if development assistance is put on a stable long-run basis not only in terms of its maturity, but also in terms of the commitment on the part of the donor countries to assist the poor countries on a long-term basis.

The foreign-exchange difficulties which the debt-service burden gives rise to are partly due to the fact that while the new loans are available mostly in terms of tied aid, which increase the cost of repayments, the repayments and interest payments are required in terms of multilaterally convertible foreign exchange. One way of overcoming the asymmetry between the form of aid and the method of its repayment is for the donor countries to accept repayment in terms of the local currencies of the debtor countries; this method of repayment is familiar in the case of aid granted by the socialist countries. Alternatively, debt-service payments of a particular recipient country may be available for expenditure in the other developing countries but not in the developed countries. This will have the additional advantage of promoting trade between the developing countries as a whole. The tying of repayments from the individual debtor

countries to the exports of the developing world as a whole undoubtedly violates the principle of comparative advantage in the same way that tying of aid does in the first place. This is admittedly a suboptimal, second-best solution. Certainly, the untying of aid from the developed countries is the optimum solution from the point of view of the efficient use of world resources.

PRIVATE FOREIGN INVESTMENT

The above discussion relates to the quantum and allocation of capital inflow channelled through the governments of the developed countries. Private foreign investment plays a critical role in the Commission's recommendations on the ways and means of increasing international financial resources for development. Private investment is expected to contribute 0.3 per cent of the GNP of the rich countries by 1975 or even more than that, if the public-aid target of 0.7 per cent of GNP is not reached by that time. Private foreign investment, the Commission hopes, not only helps fill the capital or savings gap but also brings along with it scarce foreign exchange as well as certain essential missing factors of production like technology, results of research and development, management, entrepreneurship, and skill.

Do they in fact do so? The Commission admits that they did not undertake any detailed empirical analysis but they believe that their positive judgment on the substantial contribution of foreign direct investment to the development of poor countries is right. The Commission recommends very strongly the positive role of private investment for yet another reason, *i.e.*, "those who risk their own money may be expected to be particularly interested in its efficient use", implying that private investment is more productively used than aid administered and granted by the government agencies in the developed countries.

The contribution of private foreign investment can be judged with reference to its impact, firstly, on the growth of income and output and, secondly, on the balance of payments. That the contribution of foreign investment is often a subject of considerable controversy is partly due to the fact that while its immediate impact is easily identified, there has seldom been a systematic analysis of its indirect costs and benefits. The indirect effects on the balance of payments and growth, for example, involve, among other things, two sets of questions: *a*) what is the alternative use of the domestic resources which are employed in foreign enterprises and what is the impact on the balance of payments of the alternative use of such resources? *b*) does foreign investment make a net addition to the total pool of investible resources in a country or does it replace or discourage domestic saving or investment? Does the foreign enterprise adopt different technology, in terms of relative inputs of capital and foreign exchange, than domestic enterprise? Is technology employed by foreign enterprises appropriate for the recipient countries, given its relative factor endowments?

What effects does it have on the evolution of technology in the domestically owned sector of the economy? Questions have been raised as to whether the multinational corporations with their world-wide production facilities and inter-firm trade in final output and components may not, in fact, restrict exports from or encourage imports of components and raw materials into one or more developing countries.

The increasing interest in foreign direct investment in recent years is partly a response to the relative inadequacy of public aid for development. If that is so, the high cost of foreign capital and entrepreneurship is a necessary supply price against which the recipient country is to set its own demand price for such capital and entrepreneurship. The difficulty which the developing countries face does not relate only to the availability of capital but also to the availability of technology from alternative sources. The knowledge of the technical processes of production is increasingly the exclusive preserve of the giant corporations of the developed countries which spend large amounts on research and development. In this case, the high price of foreign direct investment represents partly the scarcity price for the supply of technology. The attempt by the poor countries to develop their own technology involves costs which, in many cases, are very high and may indeed be infinite, considering the underdeveloped state of science and technology in the majority of poor countries.]

It is in this context that the Commission's recommendation for an increase in the share of public expenditure in the developed countries on research and technology which is directed towards meeting the needs of the poor countries assumes critical importance. The international agencies, it suggests, should develop research centres in the developing countries, both on a regional and on a national basis, for the development of science and technology suited to the needs of poor countries. The international corporations seldom find it worthwhile to devote their research and development expenditure to evolve appropriate technology for the poor countries since their operations in the labour-abundant poor countries often constitute a small fraction of their total operations all the world over.

The developing countries faced with a "situation" in which the total gross inflow of the aggregate equity capital falls short of the gross outflow of foreign repatriations and remittances, frequently threaten to nationalise the foreign enterprises or restrict their outward remittance. There are two issues here. Firstly, there is the question whether the costs of a particular foreign direct investment are considered inordinately high, given the alternatives available for obtaining capital and technology from abroad. This has partly been discussed above. Moreover, profits may be very high owing to the monopolistic conditions or the high rates of effective protection in the recipient country. In the latter case, the adverse effects may be sought to be mitigated by the taxation of mono-

poly profits or by a reduction of the effective rates of protection; alternatively, the recipient country may prevent foreign direct investment from these specific lines of activity, a recommendation which the Pearson Commission endorses. Apart from this, the mere fact that in a particular line of investment at a point of time, out-payments exceed the inflows of capital does not necessarily imply a high cost of foreign investment. For any borrower of equity or loan capital, the repayment or repatriation necessarily implies a net outflow, unless fresh borrowing is undertaken. However, there are specific instances where the outflow on account of a particular enterprise is high because there is no reinvestment of earnings in the host country due to the policies pursued either by the parent company abroad or by the host country.

Secondly, a problem which seems to worry many developing countries is that the total gross inflow of foreign investments at a particular point of time or over a period of time falls short of the total outflow on account of the dividends and the repatriation of capital. In a poor country, short of both savings and foreign exchange, the excess of the total outflows over the total inflows is obviously a cause for concern. Only a mature debtor country at a high level of income and foreign-exchange earnings is able to sustain such an outflow. In addition to the various factors discussed earlier, which increase the rate of return and consequently the magnitude of foreign remittances, this situation is partly due to the fact that the rate of growth of foreign-owned capital stock is lower than the rate of remittances. It is only an acceleration in the gross flow of foreign capital which can reverse the direction of the net flow. The threat of expropriation or restriction on remittances has often the unintended result of raising the expected rate of return necessary to attract the current and future inflow by way of an insurance against such risks. This further aggravates the problem of net outflow by raising the burden of remittances.

If there occurs an acceleration in the current gross inflow in order to reverse the net outflow, as the Pearson Commission strongly recommends, the proportion of the national capital stock owned by foreigners increases correspondingly, a situation which, for political and psycho-sociological reasons, is not often favoured by the poor countries. This is the familiar problem of "alienation" of the capital stock of the host country; the resultant increase in the degree of dependence of a country on the interests and policies of foreign corporations may not be consistent with the social, economic and political objectives of the recipient country. The developing countries are indeed in a dilemma in this respect. The Commission notes with approval the restrictions placed by the host country on the amount of local borrowing undertaken by the foreign enterprises since this results in an extension of their control over the capital stock of the host country without the compensating benefits of a flow of capital from abroad. This measure will not contribute much to the resolution of the basic dilemma.

As one surveys the world-wide operations of the international corporations, one finds that a large number of poor countries are often faced with a small number of multinational corporations. The political implications of this unequal confrontation are aggravated because of the insistence by the foreign corporations on the rights of extra-territoriality. On the one hand, the developed countries insist on exercising their rights of control and regulation over their own citizens wherever they are, even if they operate within the boundaries of foreign sovereign states. On the other hand, the latter insist on exercising their sovereign rights on individuals and institutions operating within their frontiers, irrespective of their nationality. The confrontation between the multinational corporations and the recipient, poor nations often tends to turn into confrontations between the nation states themselves. Faced with this dilemma, the Commission hopes and pleads for restraint on the part of the developed countries. They "should as far as possible keep aid policy and disputes concerning foreign investment separate"; an appropriate solution "may be renunciation of the principle of extra-territoriality by all the member states of the United Nations and, for the long term, the eventual creation of a system of international incorporation of companies doing business in more than one country" [5, p. 107].

H. G. Johnson harbours more radical, one may say, *utopian*, hopes that since the concept of the nation states is not entirely consistent with the concept of the multinational corporations, the world community should eventually settle for a world government. In this case, however, the problems of poverty of the developing countries may lend itself to an easier solution through direct fiscal transfers, as within a national economy, combined with the politically neutral and economically beneficial operations of the giant corporations. To quote, this is "an issue which should be seen in terms of a more general and fundamental problem of reconciling the traditional and anachronistic conception of an 'isolated state' with the economic and political facts of a rapidly economically integrating world economy in which there is an increasing mobility of goods, capital, labour (at least educated labour) and knowledge. In the long run, we shall have to become one world, politically as well as economically" [7].

However, given the complex political and economic implications of private foreign investment in the context of a developing economy, it appears that a substantial reliance by developing economies, specially those which do not feel politically strong, on private investment as an engine of growth in the immediate future is unlikely. Historical experience indicates that it is often easier to benefit from the developmental impact of private foreign investment after a) public investment, domestic and foreign, develops an adequate level of social and economic infrastructure, and b) after domestic private enterprise attains a reasonable size and competence, if necessary, with technical and managerial assistance from abroad. A viable and strong domestic private enterprise is better able not only to negotiate joint collaborative enterprises but also to withstand the

competition of the foreign corporations in the domestic economy. It is worth serious consideration whether the international agencies can not play a more active role in helping poor nations in bargaining and negotiating investment agreements with the multinational corporations.

CONCLUSION

The crisis of confidence in the role of foreign aid which led to the establishment of the Pearson Commission can be traced to a host of factors in both the developed and the developing countries. Undoubtedly, too much was expected of foreign aid by the donor countries and the political limits to economic policy-making in both the developed and developing countries were not clearly recognised. From the developed countries' point of view, the intermingling of political, moral and economic motives behind foreign aid can only be partially resolved in the years to come. Because of political considerations, aid often does not seem to promote socio-economic reforms necessary for development. It is readily seen that aid can not avoid strengthening the hands of those who are in power at the time of aid inflow; but if it does not discriminate between particular regimes in individual countries, in terms of quantum and terms of aid flow, then at least the forces of change within each country do not have to contend with the likelihood that pressure for a change within a country would bring in the aid donors on the side of the *status quo*. Basically, the donor countries must eschew, implicitly and explicitly, any preference for or against the socio-political forces within each country. To maintain such a position in practice is extremely difficult, especially if one remembers that aid has to be approved by the political processes of the Parliament or the Congress in the donor countries; to meet this difficulty with honesty and ingenuity is a great challenge. It is, however, essential to separate the administration and allocation of economic aid, as far as possible, from that of aid for noneconomic purposes, through strengthening multilateral institutions.

Experience of the last development decade has hopefully brought home the lesson that growth has to be combined with social justice and that targets of development must include not only rate of growth of GNP but also employment and equitable distribution of income. It will be a major task for the donors and recipients of aid alike in the next decade to devise ways and means of using aid to further these objectives. If the aid-givers are to recognise and act upon the moral obligation of the rich to help the poor nations, then the privileged groups and regions in the aid-recipient countries must undertake by the same token to spread widely the benefits of development within the recipient country. This should be a part of the mutual obligation of the donors and recipients of aid.

To revive and indeed to strengthen the declining interest in aid in the donor countries would require systematic and concerted efforts on the part

of the leaders of public opinion in these countries. For this, one needs more than a Pearson Commission; it is necessary to undertake a more direct persuasion of the political processes or forces in the rich countries. While some of the advanced countries have responded favourably to the Commission's target for aid, many others including the United States, remain lukewarm to the concept of and commitment to a fixed target. As far as the allocation of aid between the developing countries is concerned, they will have to live with an unequal sharing of the benefits of aid as between themselves. Moreover, it should be acceptable to the developing world as a whole that a country with a per capita income, let us say, of 300 dollars or more, should not seek concessional aid and that a much larger proportion of grant, if it is available, should go to the poorest among the developing countries. One should probably add that a united approach, for that matter combined bargaining, on the part of all the developing countries is necessary not only for seeking concessions in trade from the developed countries, as is attempted to be done under the auspices of the UNCTAD, but also in the field of international assistance.

The Commission's discussion of the role of foreign private investment lacks critical analysis. A systematic analysis of the costs and benefits, direct and indirect, of foreign private investment from the recipient countries' point of view is urgently called for. Given the implications of inequality between the poor nations and the multinational corporations as well as lack of adequate social and physical infrastructure in many countries, a major role for private foreign enterprise in economic development is unlikely in the near future. Indeed one of the major tasks in the 1970's is to devise ways and means of ensuring a net gain from foreign private investment and of balancing it with an acceptable degree of noneconomic or political cost.

As one scans the future of partnership in development, one is left with an uneasy feeling that in the fields of public aid, private investment and trade, the poor nations will remain unequal partners in the years to come; as domestic efforts for development are intensified and as the poor countries grow and achieve diversification of their economies, the inequality will hopefully diminish over time.

REFERENCES

1. Arskoug, Kaj, *External Public Borrowing: Its Role in Economic Development*. (New York: Praeger Publishers, 1969).
2. Chenery, H.B. and A. Strout, "Foreign Assistance and Economic Development", *American Economic Review*, September 1966.
3. Chenery, H.B. and M. Bruno, "Development Alternatives in an Open Economy, The Case of Israel", *Economic Journal*, March 1962.

4. Cohen, B.I., "Relative Effects of Foreign Capital and Larger Exports of Economic Development", *Review of Economics and Statistics*, May 1968.
5. Commission on International Development, *Partners in Development*. Report of the Commission on International Development. (Chairman L. B. Pearson). (New York: Praeger Publishers, 1969).
6. Hagen, Everett E. and Oli Hawylyshyn, "Analysis of World Income and Growth 1955-1965", *Economic Development and Cultural Change*, Vol. 18, No. I, Part II, October 1969.
7. Johnson, Harry G., *The Multi-National Corporation as an Agency of Economic Development: Some Exploratory Observations*. A Paper prepared for the Columbia University Conference on International Economic Development, February 15-21, 1970.
8. Levitt, M.S., "The Allocation of Economic Aid in Practice", *The Manchester School*, June 1968.
9. Lewis, W.A., *The Development Process*. Executive Briefing Paper 2. (New York: UN Center for Economic and Social Information, 1970).
10. Organization for Economic Cooperation and Development, *Development Assistance: 1969 Review*. (Paris: OECD, December 1969).
11. Papanek, G.F. and S.C. Jakubiak, *Aid and Development*. Paper presented at the Dubrovnik Conference of the Development Advisory Service of Harvard University, June 1970.
12. Rahman, M. Anisur, "Foreign Capital and Domestic Savings: A Test of Haavelmo's Hypothesis with Cross Country Data", *Review of Economics and Statistics*, February 1968.
13. Rahman, M. Anisur, "Perspective Planning and Self-Assured Growth: An Approach to Foreign Capital from Recipient's Point of View", *Pakistan Development Review*, Vol. VIII, No. 1, Spring 1968.