CHAPTER-I

INTRODUCTION

Foreign Aid is considered as an important instrument of the foreign policy of states after the Second World War, foreign aid has become an important aspect of foreign policies of nations designed to promote national interest. Even before the first world war, foreign capital was used as profitable mode of investment. However, it was only in the post war period that the flow of foreign aid in a planned way began, when developed western countries started contributing to the socio-economic reconstruction programs of their war allies. In 1938 the United States of America began giving aid to the Latin American countries under an educational exchange programme\(^1\).

After the second world war the United States involvement on large-scale began with the introduction of the Marshall Plan in the 1947, which brought $ 23 billion of US aid into western Europe during 1947 to 1952. The Marshall Plan involved the rehabilitation of modern highly productive societies temporarily damaged by war and thus worked successfully. The confidence in the efficiency of foreign aid was stimulated by the success of the Marshall Plan in achieving a rapid reconstruction of west European economies\(^2\).

The Foreign aid programming remained a topic of both controversy and consensus. The traditional economists argued that aid has indeed helped to promote growth and structural transformation in many Less Developed Countries (LDCs)\(^3\). On the other hand in the view of the radical "new left", economists aid is yet another instrument of world monopoly capitalism designed to exploit the countries of the third world. The World Bank and the USAID are regarded as the
creation of world monopoly capitalism designed to propagate the capitalist creed in the Third World. These institutions are accused of using aid as a bargaining instrument for obtaining favourable treatment to foreign private investment in the third world countries and for obtaining easy entry for the export of goods and services from the west and for the promotion of economic policies beneficial to the donors of aid. In the words of the Oxford economist, representative of “left wing”, Keith Griffin, “If anything aid may have retarded development by leading to lower domestic savings by distorting the composition of investment and thereby raising the capital-out-put ratio by frustrating the emergence of an indigenous entrepreneurial class and by inhibiting institutional reform.”

According to Prof. Peter Bauer representative of the right wing school opines that aid is neither a necessary nor a sufficient condition for development. It is not necessary because several developing countries such as, Hong Kong, Singapore, Malaysia, Thailand, Nigeria and Mexico made rapid progress between last quarter of nineteenth century and the middle of the twentieth century without much aid. Aid is not a sufficient condition for development because many countries which have received substantial aid have made little progress. In the absence of other essential ingredients for development such as human skills, institutions and attitudes conducive to progress, aid is likely to be wasted. It encourages misallocations of resources, weakens domestic savings efforts and allows recipient government to indulge their selfish motive for ostentatious projects.

Prof. Bauer offers analysis and historical evidence to support his conclusion that inter-governmental aid does not substantially contribute to economic development and may even retard it. He argues that the widely publicised type of large-scale, indefinite aid what might be termed mainstream foreign aid has
not served to bring about an appreciable rise in living standards in UDCs, or to promote their economic development, despite the large sums that have been and are being provided. While foreign aid may indeed, sometimes serves its commonly aroused purpose of improving economic conditions in the recipient countries, in general mainstream aid has not fulfilled and cannot fulfill the expectations which it arouse. Indeed aid often damages the development prospects of the recipients.

Moreover it is observed that the above stated views regarding the role of foreign aid may be true in the case of certain countries and may not be so in the case of others. It may, therefore be observed that geographical conditions, the level of socio-economic development, the political policies of the ruling elite, the attitude of the people towards development, and bureaucratic efficiency and level of technological advancement are some of the conditions in which foreign aid has to function. It is needless to say that these factors differ from country to country and, hence, the role and achievement of foreign aid would differ from country to country.

**IMPORTANCE OF THE FOREIGN AID:**

The purpose of an international program of aid to under developed countries is to accelerate their economic development up to a point where a satisfactory growth of rate can be achieved on a self-sustaining basis. Capital flows in the form of foreign aid, private foreign investment, and private bank lending are the principle ways by which resources can come from rich to poor countries. The transmission of technology, ideas and knowledge are other special types of resource transfer.
When discussing the constraints on development, we referred to the savings gap and the foreign exchange gap. A net capital inflow contributes to the filling of both gaps. Aid increases the amount of resources available for capital formation above what can be provided by domestic savings: Aid supplements domestic savings. It also raises the recipient economy’s capacity to import goods: aid provides foreign exchange and eases the problem of making international payments.

Countries in early stages of development assumed to have a primary need for technical assistance and institution building, and only limited need for capital assistance chiefly for infrastructure projects. As the need for capital assistance increases, the need for technical assistance shifts from general to more specific skills. The gradual increase in domestic savings, and a growing capacity to attract private and other conventional foreign capital on non-concessionary terms will progressively reduce the need for foreign aid. The assumption that the need for foreign aid is temporary and limited is underlined several recipients in Latin America elsewhere and expected to attain rapid development in ten to fifteen years but it is recognized that, in Asia and Africa, the need for aid will remain for a much longer time.

Aid has both beneficial as well as some adverse impacts on the country’s growth and development of an economy. Appropriate policies have to be undertaken to minimise the adverse effects of aid on domestic savings, inflation etc.

specific studies tried to measure the impact of aid on one or two variable such as growth, savings, investment etc. such as Stanley Katz(1969), Pandya(1972), Thimmaiah(1977), Mangat Ram Agarwal(1980), Rubin(1982), Badri Narayanan(1988). In this context, the study attempts to bridge the gap with the following ways to examine the relationship among foreign aid and other variables like GNP, Saving, Investment, Exports and Population specifically in Indian context. An attempt is also made to study the role of aid in the economic development of India, in comparison with South Korea and Colombia.

Objectives of Study :

1. To examine the impact of aid on economic growth by examining its effect on savings, Gross Domestic Capital Formation, Exports, Private Investment, Population with special reference to India.
2. To examine the pattern of aid which is changing recently in the case of developing countries and
3. To study the role of aid and its importance in the economic development of India in comparison with South Korea and Colombia.

Sources of Data:

SCHEME OF THE STUDY:

1. Introduction of the problem to be studied, objectives and methodology.

2. Review of the existing literature.

3. Foreign aid to developing countries

4. Foreign aid to India during five year plans including share of aid in total investment, share of aid in public plan outlay, share of aid in imports and the purpose of utilisation. Empirical testing of objectives of the study with reference to India are also presented in this chapter.

5. The role of Foreign Aid in the economic development of South Korea and Colombia.

6. Comparative analysis of Foreign Aid and its role in the economic development of India in comparison with South Korea and Colombia.

7. Summary and Conclusions.

Methodology [ REVIEW OF EARLIER STUDIES ]:

1. Gustav F Papanek [1973] article "Aid, Foreign Private Investment, Savings and growth" clearly saying that investment is one of the major determinants of growth.
His methodology suits the present study’s first objective i.e., impact of foreign aid on growth of India. The present study used the following 3 formulas.

1. Growth = a + b savings + c aid + d foreign private investment + e other foreign inflows.

2. Growth = a + b savings.

3. a + b aid + c savings.

2. Victor Levy [1987] examines to what extent the inflow of resources contribute, the economic growth. The methodology followed in this study is to find out the impact of aid on investment.

\[ \left( \frac{1}{Y} \right)_i = \hat{a} + \hat{a} \left( \frac{S}{Y} \right)_i + \hat{T} \left( \frac{A}{Y} \right)_i \]  \hspace{1cm} (1)

ratio of GDI of \(_{(i)}\) country GPS in \(_{(i)}\) country PDA in \(_{(i)}\) country GDP GDP GDP

Victor Levy also examines the possibility that the link between aid and domestic investment varies with the level of development of the economy. This hypothesis is based on the reasoning that a large and more developed economy is more likely invest a higher share of its aid receipts, where as the least developed economies might have a greater tendency to use aid to maintain a subsistence level of consumption.
Therefore he extends the equation the value of \( T \) is permitted to vary with the measure of development \( (Z_t) \) of the economy.

\[
\left( \frac{1}{Y} \right)_t = a + a \left( \frac{S}{Y} \right)_t + \left( T_0 + T_1 Z_t \left( \frac{ODA/Y}{Y} \right)_t \right) \quad (1)
\]

The Logarithm of income per capita was used to measure the level of development, so that the spread of the variable would not be dominated by the few largest observation.

The additional aid may induce the public sector to use domestic resources for current consumption. This hypothesis implies a negative correlation between domestic saving rate and the aid ratio.

3. Amit Bhaduri and Rume S Karstein says in order to capture the demand and the supply implications of foreign aid it is necessary to distinguish between the different forms in which aid is used as free foreign exchange, aid tied to specific imports, aid as commodity import support for consumption, investment or intermediate goods.

The author assumes inflows of foreign finance called foreign aid are always used up within the short period for covering the trade deficit.

Measuring relevant variables in domestic currency at constant prices.

\[ M - E = A \]

where \( M = \) imports of goods and services.
E = exports of goods and services.

A = net inflow of foreign aid (equals gross by assumption)

The extremely concessional nature of foreign finance as pure grant entails that it is not the recipient but the donor who decide the level of aid. Therefore, foreign aid may be treated as an exogenous variable from the point of view of the recipient country.

4. Pradumna B. Rana & J. Malcolm Dowling Jr.[1988] their idea is that the South recognised that trade leads to growth and it also gives more emphasis to concessional flows from North which stimulate or accelerate rapid economic growth and remove widespread poverty.

Their model: Simultaneous Model.

\[
GR = a_0 + a_1 \cdot \text{AID} + a_2 \cdot \text{FPI} + a_3 \cdot s + a_4 \cdot CX + a_5 \cdot CLF
\]

\[
( a_1 > 0, a_2 < 0, a_4 > 0, a_5 > 0 ) + Ut \quad \quad \quad \quad \quad \quad \quad \quad \quad (1)
\]

GR = Growth rate of GDP.

AID = Foreign Aid as % of GDP

FPI = Foreign Private investment (including long-term borrowing) as % of GDP.
The above model consists of 2 endogenous variables and 5 exogenous variables. (AID, FPI, CX, CLF and GDPN). They followed indirect least square technique to estimate the equations.

While estimating the above equations they faced 2 problems.

1. Low quality of data.

2. Lack of long time series.

The first problem not solved. The 2nd one is solved by pooling cross-sector and time-series data of 9 developing Asian Countries 1965-82.

The results are quite satisfactory. The results show that foreign investment and growth of labour force have a favourable and statistical significant effect on growth of Asian developing countries. While the effect of foreign aid export performance is also favourable, these variables are only marginally significant. (i.e., the co-efficient is larger than standard error).
The major finding of this paper is that foreign capital flow have made a positive contribution to the growth of Asian developing countries where as foreign direct investment contributed to capital formation and investment efficiency. Foreign aid increased capital formation only.

The other major findings of the paper is that export performance, growth of the labour force and domestic saving rate have also contributed favorably to growth. In relative terms, foreign private investment and export performance have contributed more than aid, supporting the North's position on self-reliant approaches for developing countries.

Also the growth of labour force and higher domestic savings have contributed more than foreign capital flows.

In the case of the recipient countries, the most important implication is that if the countries wish to achieve rapid economic growth, maximum efforts will have to be directed towards increasing productivity of labour force and towards mobilising domestic resources.

The recipient country should be careful in deciding which type of foreign capital to encourage and the type of policy to adopt.

Haavelmo [1963] proposed an interesting hypothesis about a developing country's savings function \( It = a \{ Y(t) + H(t) \} \) where \( I \) stands for gross investment, where \( Y \) for GNP and \( H \) for capital flows. He says that investment
is a function of income including what they get from foreign countries. He concluded that domestic savings are negative if \( H \) is large enough.

According to Rahman[1968] Domestic savings depend not only on income but also negatively on foreign capital inflows. He modified the above formula slightly.

\[
lt = ay(t) + bH(t).
\]

Since \( l(t) = S(t) + H(t) \) where \( S(t) \) denotes domestic savings we get domestic savings function.

\[
S(t) = a y(t) + b' H(t)
\]

where \( b' = b - 1 \),

\[
\frac{S(t)}{y(t)} = \frac{H(t)}{y(t)} = a + b'. \quad \ldots \ldots \ldots \ldots \ldots \ldots \ldots (1)
\]

Rahman used 31 less developed countries data and estimated the equation. He concluded by seeing the results that foreign capital is used not only for augmenting investment but also as a substitute for domestic savings.

6. Econometric studies of aid to India, however take a different task, using investment as the dependent variable and aid (along with various government budget indicators and sometimes the level of national income itself) as the independent variable for e.g. Chaudhuri (1978) tested an equation of the form.
\[ I_t = a + b Y_t + c A_t \]

Where \( I \) is investment, \( Y \) is Net National Product and \( A \) is gross utilised aid (including a small but unspecified amount of concessional finance with a grant element too low to constitute aid) minus food aid. Here food aid was excluded on the grounds that it was not intended to finance public investment. The analysis thus suggests that aid had a fairly strong positive effect on the level of investment.

**Methodology of the study:**

The Chapter Foreign Aid to India is a comprehensive one. It covers the amount of aid flown to India during the planning period and the amount actually utilised. The share of aid in total plan outlay in total investment, in plan-wise (1951-1996) was calculated. The ratio of aid to total imports (1974-1996) were calculated. The purpose-wise distribution of foreign aid by the Government to various sectors during the planning era is also incorporated. In the context of developing countries, the study noted the changing pattern of aid in the form of an increase in the concessional component of aid (Table 3.3).

The present study attempts to analyse, the impact of aid on the economy. For Indian economy, the study covers for the period 1963-94. The availability of the data on all variables required in the study was from 1963 onwards. Data on Aid were available plan-wise only from 1950 to 1963. The non-availability of year-wise data prior to 1963 is the reason for the analysis to begin from the year 1963.

The study made use of trend analysis to quantify the growth rates of variables used in the study decade-wise. Secondly, from the above stated review studies, a
few equations were estimated using simple linear regression method in the Indian context for the period, 1963-1994 and are discussed below. Finally a comparative study for a period 1980-90, of India, South Korea, and Colombia was done to assess the impact of aid on Growth, Savings, Investment and other variables.
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