CHAPTER - II

Review of Literature

The review of literature is divided into three sections. The first section deals with cross-country studies, the second section deals with time series data and the third section deals with the works related mainly to India.

Cross-Country Studies:

Haavelmo\(^1\) (1963) examined the impact of foreign capital on investment. According to him investment is a function of both domestic income and foreign capital. He argues that domestic savings could be negative if foreign capital is large enough. He concluded that foreign aid substitutes instead of supplementing domestic savings.

Rahman\(^2\) (1968) in his paper attempts to see the inverse relationship between foreign aid and savings. He used cross country data for 31 less developed countries in 1962 from Chenery and Strout study. By using the ordinary least squares method, he found the regression co-efficient negative. He concluded that foreign capital is used not only for augmenting investment but also a substitute for domestic savings. From this, he advanced the behaviouristic hypothesis, namely that the Government in developing countries may "voluntarily relax domestic savings efforts when more foreign aid is available than otherwise."

While suspecting Rahman's results, Gupta\(^3\) (1970) used the same source of data for 50 countries, and ran a regression to see the effect of foreign capital on savings. According to him, foreign aid leads to economic development. It is not at all clear to him as why Rahman decided to exclude the 19 countries included
in Chenery and Strout study. It can be easily seen that the results obtained by him is just opposite of Rahman's. Not only do we find, that the co-efficient of capital inflow is positive, but also that it is not significantly different from zero. From his estimation, it would appear that foreign capital inflows have virtually no effect on domestic savings in the LDCs.

Griffin and Enos' (1970) supported Rahman's arguments, there are several points that Griffin makes in his paper. The most important argument is their paper is that foreign aid inflows reduce the domestic savings rate rather than being a supplement to domestic resources, aid often acts as a substitute for them. This mechanism operates in both the public and private sectors. Faced with inflows of foreign aid, LDC governments may reduce their tax efforts or change the composition of their expenditure towards consumption. Similarly, the availability of low-interest loans may reduce the incentive to save in the private sector. The result of this is that the savings rate falls as aid is increased. Griffin tested this proposition using cross section data for 32 LDCs in 1962-64. Griffin further argued that aid inflows caused domestic savings rates to fall. Griffin did recognise that the correlation could be interpreted in the alternative casual direction, i.e., countries received high aid because their savings rates were low, reflecting the countries under developed economies. Interestingly, though the negative correlation which Griffin found between domestic savings and foreign aid was confirmed by later researchers.

Weisskopf (1972) in his criticism of Rahman's and Griffin and Enos' results argued that they are suggestive and not conclusive, pooled data for 17 countries with income and exports (as additional variables) he concluded that the negative impact of foreign capital inflow on domestic savings applied to ex-ante savings and not ex-post savings.
Papanek⁶ (1972) in his paper re-examined the whole issue and he has found that the negative relationship between foreign aid and domestic savings (and economic development) may indicate at the most a negative correlation but not necessarily any kind of causation. He has attributed this to many reasons. Firstly, the way the data on foreign aid are deserved creates its negative association with domestic savings. Foreign aid is often estimated as the difference between domestic savings and total investment. In this kind of accounting, the foreign aid which is provided even for consumption purpose as in the case of food-aid, is treated as domestic savings. This accounting method invariably shows negative association between foreign aid and domestic savings. Secondly, the empirical results are so conflicting that it is very difficult to believe any causality. Thirdly, the specific country analysis has revealed that high inflow of foreign aid was caused by lower savings and lower rate of development. More foreign aid rushed or pressed for in times of economic crisis. Therefore it was obvious from such circumstances, that foreign aid and domestic savings and economic development came to be negatively associated.

Empirically, relating economic growth and foreign inflows, Papanek⁷ (1973) substantiated that foreign inflows increases domestic savings through increased growth rate and level of per capita income. But contrary to the earlier studies, he used domestic savings rate as an explanatory variable for the cross country study. He made a regression analysis using the data from 34 countries for the 1950s and 51 countries for the 1960s. He came to the conclusion like earlier studies that there exists a negative relationship between domestic savings and foreign aid.
Levy Victor\(^8\) (1987) study tests the effect of foreign transfer on investment rates in low income countries. The empirical findings are based as cross-country comparisons of aid flows, savings rates and investment rates over period of 6 years (1974-80). The results suggest that savings rates are fairly stable, which aid flows vary and determine investment. The evidence supports the proposition that most development assistance intended for fixed capital formation is indeed invested. The sustained increase in the aid ratio caused an equal increase in the investment rate.

Levy, Victor\(^9\) (1987) in other article focuses the effectiveness of foreign aid to developing countries on the assumption that aid flows mainly enhance current consumption rather than being channeled into investment. His paper seeks to establish what propensities of foreign assistance is used to finance current consumption. The principal hypothesis to be tested is that aid transfers include very heterogeneous components with different marginal propensities to raise consumption. Estimating the average marginal propensity to consume of all the components of aid, as is commonly done, may lead to erroneous results.

Mosley\(^10\) (1987) in his econometric study of aid/growth link explains the changes in national income as the dependent variable and aid utilisation along with domestic saving and non-concessional foreign finance, as the independent variable, thus linking the three main sources of investment funds. With output changes in a simple Harrod -Domar type of formation. This has been attempted in cross-section studies, which generally show some positive effect of aid on growth.
Studies relating to Time-Series:

Chenery and Eckstein\textsuperscript{\text{12}} (1970) took time series data for 16 Latin American Countries for the years 1950-65; and found the relation between domestic savings and foreign capital inflow was negative in twelve cases. They also argued that aid has been substituted for savings and there is a fall in rate of savings and no increase in the overall rate of growth of GNP.

Chenery and Strout\textsuperscript{\text{11}} (1966) in their paper first outlines a theoretical frame work designed to analyse the process of development with external assistance in quantitative terms. This frame work is used to evaluate the performance of the developing countries to assess their future needs for assistance under various assumption. Their statistical analysis is based on the period 1957-62. Their study includes 50 countries which account for 90 percent of the GNP of the under developed world. The data are more reliable for 31 countries only. They have adopted a uniform statistical procedure that is applied to all 31 countries. The main features of the statistical procedure are as follows:

1. All estimates were made from linear trends fitted to time series for the period 1957-62. Marginal saving rates, marginal import rates and marginal capital output ratios were computed directly from these trends.

2. The magnitude of the absorptive capacity parameter is indicated by the highest compound growth of investment for any five year period in the past decade. The growth of investment observed for 1957-62 is often well below this limit because development has been constrained by other factors.
3. Trend values for 1962 of the investment saving and import ratios to GNP are computed as a basis for future projections. The evaluation suggests a range of practical possibilities for accelerating growth through external aid. The comparative analysis suggest some international standards of performance which might facilitate the planning and execution of program of foreign assistance.

Paul Bowles\textsuperscript{12} in his paper, constructed a time series from 1960-81 for 20 LDCs. The aid figure he used is net disbursement of concessional assistance by DAC countries and multilateral agencies combined. In the 9 of the 20 countries a significant relationships between domestic savings and aid inflows didn't exist. In three of these nine countries simple regressions of the savings rate on aid revealed significant negative correlation but nothing can be inferred about causality from these correlation's. In the other 11 countries atleast one of the 4 equations for each country indicated that a significant causal relationship existed. The causal relationship between foreign aid and domestic savings are not universal and even if they do exist in certain countries, the direction of causality is likely to be influenced by the share of aid from bilateral and multilateral sources.

Rana and Malcolm Dowling\textsuperscript{13} (1988) the main objective of their study was to develop a simultaneous equation system to examine the effect of foreign capital on growth of a sample of 9 Asian developing countries for the period 1965-82. He took simultaneous equations because integration of the growth rate and the saving rate in a single model yields results which are richer than those reported in single equation model. The major findings of their paper are foreign capital flows have made a positive contribution to growth of Asian developing Countries. It only contributed by aiding in capital formation. Export performance, growth of
the labour force and domestic saving rate have also contributed favorably to growth.

**Studies relating to India:**

VKRV Rao and Dharm Narain's (1963) book is a case study which presents a synoptic picture of the changing character of aid over the two plan period in India. It highlights the association between growth in the volume of aid and increase in share of bilateral as well as of that part of aid tied to purchases in the donor country in total aid, while dealing with organisational aspects of aid operations, it throws light on such questions as how is the need for aid formulated? what are the channels through which it is given and received? what are the existing arrangements for the machinery for the repayment of aid as also for the utilisation of counter part funds.

Dr. Sudhakanta Mishra (1965) in his book "Foreign aid to India" emphasis the importance of aid to India. According to his ideas interest in foreign aid is now as wide-spread as the interest in economic development itself. This is partly because without foreign aid the resources which under developed economies can provide for investment would be both quantitatively as well as technologically quite insufficient. This is not to suggest that UDCs have any proportional privileges or rights in the resources of the richer countries. But it does mean that just as acute income inequalities cannot be viewed with approval within a country, they cannot be justified on the wider plane of the world economy as well. Like most UDCs, India has naturally benefited from this changed context. In fact international assistance to India has been far more considerable than to many other countries similarly placed. The author presents here an account of the details of foreign aid to India from some important sources. He has tried to incorporate the latest available information in his details and presented them in
any easily comprehensive form of the average reader. He also refers to the qualitative aspects of foreign aid to India and makes suggestions about how we can make that aid a more effective tool for our economic development.

Stanley Katz\textsuperscript{16} (1969) used the data on income, savings and investment in India for the period 1950-61. He arrived at the conclusion that aid generated share of savings is insignificantly both in terms of increase in savings and total volume of savings.

Pandya\textsuperscript{17} (1974) used the same methodology of Katz, for the period 1961-71 and come to the conclusion that aid contribution in generating savings is insignificant. But these two studies failed to explain why such an insignificant relationship exists between foreign aid and domestic savings.

R.K. Sharma\textsuperscript{18} (1974) paper on "Costs and benefits of foreign aid " examines the benefit repercussions of expanding borrowing operations, practiced by the government of India since independence, on exports, national income, savings, availability of net aid, government revenue and volume of indebtedness. The paper is divided into 3 parts. The first part discusses the role played by the foreign aid in India's economic development. The second part discusses how foreign aid (especially tied aid) has affected the direction of India's foreign trade and foreign aid has affected India's composition of investment. The third part deals with the economic costs imposed by foreign aid on the Indian economy. Foreign aid imposes not only economic costs but also social and political costs. The paper, however, is concerned with the economic costs only. The analysis reveals the serious external debt problem created by foreign aid. The various indicates of debt - servicing obligation clearly reveal this and in the light of India's capacity to repay, put severe strain on the economy.
The main objective of R.K. Sharma\textsuperscript{19} (1977) study is to analyse the terms and conditions of foreign aid to India from 1949-75. He calculated the grant element of both bilateral and multilateral aid given to India during this period, and he also made a comparison of the terms and conditions of aid received by India from different sources. Moreover, he examined how the different forms of aid - tying affected the rates of utilisation of authorised foreign aid to India, industrial capacity in the country and the pattern of India's foreign trade. The impact of the terms and conditions of foreign aid on the balance of payments of the country, the problem of reverse flow and the benefits and costs to the Indian economy have all been taken up for consideration in this study. He has put forward suggestions for the modification of the terms and conditions of aid so that India can deserve the maximum benefit from the foreign aid which it receives without seriously damaging the interests of the donor countries.

Ghanshyam Das\textsuperscript{20} (1977) in his thesis examines two ancillary but interrelated questions and these are (1) Did India receive the high quantum of foreign aid in her plans in the past? (2) How far the financial character and composition of external assistance flow were conducive to an accelerated progress towards a steady growth? India's economic development is taken as a test case, for she has received a fairly large sums of public international capital in absolute terms (though not on a per capita basis) in her plans with the explicit objective of sustaining 5 to 6 percent rate of growth in the post perspective plan period without resort to net external borrowing.

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\(^2\) (1978) tested an equation of the form
\[ I_t = A + b Y_t + C \]
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 suggests that aid had a fairly strong positive effect on the level of investment.

Vathsala Mani\(^2\) (1978) made a unique attempt to study the impact of foreign capital in the economic development of a backward, over-populated export oriented economy by identifying the short comings of the traditional explanation of internationals capital movement and attempting at a more rational one. While examining the case of India historically, it studies the impact of foreign capital on the economy from an exclusive economic perspective. In other words, it focuses on features of the economy which have a close bearing on its capacity to absorb the inflow of foreign capital. The enquiry, therefore concerns the question whether even in the absence of the partisan policy of the British government in favour of British industries, the Indian economy could at all have responded to induction of foreign capital.

Thimmaiah\(^3\) (1979) has supported the negative relationship between domestic savings and foreign aid in Indian context for the period 1961-71. He used multiple regressions analysis. He also used lagged analysis to test whether there is any influence if not causation of foreign aid on domestic savings in India. He examined the influence of foreign aid actually utilised both loans and grants separately along with the influence of per capital disposable income rate of growth of government taxation (both direct and indirect taxation separately) and short term interest rate on the domestic savings. He concluded that foreign aid
in grants and loans discourage domestic savings of the aid recipient countries. His study did not recognise gross net foreign aid as two different concepts. In order to get good relationship between domestic savings and foreign aid, net foreign aid must be taken into account as it is productively used.

Mangat Ram Agarwal\(^2\text{4}\) (1980), the purpose of his paper is to measure statistically the impact of foreign capital inflows and changes in the price level over a period of time on the aggregate domestic savings and its various components and economic growth in developing countries particularly in India during the period 1960-1976. A sample of 23 countries from the regions of Latin America and Asia is chosen for the study. The study finds that aggregate domestic savings in developing countries in general and aggregate domestic saving, house and private sectors in India are inversely related to foreign capital flows. The association between foreign capital inflows and the rate of growth of domestic product of India is found to be insignificant. The change is the prices as a variable has a positive but statistically insignificant regression co-efficient in estimated equations revealing that the inflationary trends in India have not influenced the propensity to save the different sectors, though there may be flight from the currency effect i.e., the holding of real assets rather than assets fixed in nominal value.

Kalipada Deb\(^2\text{5}\) (1982) in his study attempts to examine, how far the use of foreign resources are responsible for the misdirection, inefficiencies and corruption in our development efforts. It looks into the resource base of the country and the development aimed at the balance of socio-economic and political forces and distortion of plan priorities and the strengthening of foreign powers grip on the economy for an unending exploitation. The study explores, for the first time, the systematic approach involved in foreign private investment,
technical collaborations and foreign aid for developing the country's dependence. The contribution of the bureaucrats, policy makers and the domestic business houses in this process have also been analysed. The aim of this work is to look into the experience of India, the largest of the developing countries in such a type of development. It goes specifically, into the questions like: who are the beneficiaries? who bore the burden of development? How maximum exploitation made possible? What was the role of national bourgeoisie played? There is some piece meal works looking into certain aspects of cost and export earnings, foreign aid, private investment etc., but there has been any comprehensive analysis looking into the whole gamut of problems and costs in a systematic manner. The author concludes the utilisation of foreign aid was a very slow process, and this contributed greatly to delay in development and increased cost. The delays were, of course, caused by foreigners and the Indian administration.

The most elaborate recent attempt is Rubin (1982). He regressed Indian Public Sector gross fixed Capital formation on foreign aid inflows and an array of other variables - government consumption, agricultural output and domestic and foreign inflation. His definition of aid was similar to that of Chaudhari's in that it excluded food aid, but his figures were net, rather than gross of repayments and deflated (by a US Producer Price Index) to a 1970 price base. According to his results he comes to a conclusion that aid does not simply 'finance' projects, in the sense that it provides for expenditures that would not have been undertaken otherwise — foreign aid appears to be much a subsidy to maintain reserves as a way of financing new spending. New aid meant new public investment. Any excess of investment over saving is financed by aid, other foreign inflows, or depletion of foreign-exchange reserves.
Badri Narayanan (1988) has treated foreign aid (utilised) as distinct from foreign capital. The main focus in his paper is on foreign aid at every stage of analysis to bring out the necessary correlation between domestic savings and aid inflows. He used time series data for the period 1961-81 and multiple regression analysis. The results in his study shows that foreign aid and terms of gross and net aid and domestic savings are negatively related. In both the cases, logged and non-logged analysis, the results are consistent and significant. The effect of loans component of foreign aid on domestic savings is significantly negative. These results were also reinforced when other explanatory variables of domestic savings like exports and GNP were incorporated into the analysis. At a disaggregated level, the findings of the study show that there is a negative relation between government savings and gross and net inflow of aid.

Howard White (1992) (The Macro economic impact of development Aid ! A critical survey) is of the view that the early literature explained aid's macro economic impact in the context of the dual gap model showing a clear link between aid and growth. Many now believe that the empirical evidence shows there to be no such relationship. This paper critically reviews the different theoretical perspectives - the dual gap model, the savings debate, recipient fiscal response, and aid as Dutch Disease - and the empirical debates an aid, savings and growth. The basis for denying a relationship between aid and growth is shown to be weak though more recent areas of research offer promising directions for future work. Aid effectiveness is assessed against the rhetoric of recipient and donor governments that its objective is to increase the welfare of the population of the recipient nations. The impact of aid on the level of national income and the growth and distribution of that income is taken as the main indicator of aid's impact. The sizable literature on aid effectiveness may divided
in various ways but the most important distinction is that between microeconomic evaluation of projects and macro economic assessments of aid impact. This article is concerned with latter of these.
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