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Short Communication

IMPACT OF FOREIGN AID IN THE ECONOMIC DEVELOPMENT OF RECIPIENT COUNTRY

Mustafa Murshed[1], Mosammat Mustari Khanaum[2]

1. Senior Assistant Secretary, Ministry of Public Administration, Government of Bangladesh
E-mail: mustafa_murshed@yahoo.com
2. Senior Assistant Secretary, Ministry of Agriculture, Government of Bangladesh

INTRODUCTION

Foreign aid, economic growth and economic development are burning issues confronting development economists and researchers today. This is simply because some of the researchers support the view that foreign aid lead to growth while others argue that aid does not contribute to economic growth and thus have a negative impact on economic development in the recipient country. Since the 1960s, foreign aid starts its journey, but still there are controversial arguments on whether the major aim for its institution has been achieved or not.

Foreign aid is the donations of money, goods, or services from one nation to another. Such donations can be made for a humanitarian, altruistic purpose, or to advance the national interests of the giving nation. Aid can be between two (bilateral) or many (multilateral) countries/institutions. Bilateral aid is usually tied aid (conditional aid) is when recipients must purchase products/ services from the donor country. Multilateral aid is usually untied aid that can be spent in any sector of the recipient country.

This is a literature review and for that reason no separate literature review is given here. One of the limitations of the study is that it doesn't observe any trends of any particular economic entity on the basis of empirical evidences. More importantly, this analysis is not country specific so it may create ambiguity if someone plans to relate with any particular economic unit. The excuse of those limitations is that this study is not a quantitative analysis rather a general discussion regarding the role foreign aid in economic development.

SHRINKAGE OF FOREIGN AID

Foreign aid is declining day by day. Rich countries have cut aid funds by 8.4%, in consideration of real value and inflation. Last year, the governments of the 22 economies that belong to the OECD donated about EUR 66 billion, which is about 0.28% of the GDP of the 22 donor countries of the organization; it was 0.31% of GDP in 2006 (Missionary International Services News Agency, 2008). After rising steadily through the 1980s and peaking at $60.9 billion in 1992, development-aid flows declined to $59.2 billion by 1994. Members of the Organization for Economic Cooperation and Development (OECD) committed 0.30 percent of their combined GNP to development aid in 1994, the lowest rate in twenty-one years and less than half the international standard of 0.70 percent (Hook, 1996, p.3).

Though the OECD claims that real aid rose by 2.4%, Patrick Bond of the Centre for Civil Society (CCS) based in South Africa and author of *Looting Africa* states:

> *"Rich countries have shrunk aid by 8.4% in 2007 compared to a 6% rise in arms expenditure. World military spending is about 13 times higher than overseas development assistance".* (Cited in Sharife, 2009, p.22)

The reasons for this decline are not hard to find. Critics have long said that foreign assistance was wasted by bloated aid agencies pouring money into the pockets of corrupt third world governments. One of the important reasons behind this declination is the termination of Cold War. Overall international foreign assistance has fallen sharply since the end of the Cold War.

Elisa, *et al*. (2001) in a news release of the World Bank, expressed a different opinion for the declining trend of foreign aid saying:

> *"……according to African Development Indicators 2001, two important sources of finance, Foreign Direct Investment (FDI) and official aid, are also declining in size, and tend to favour those countries with lucrative mining and oil industries in the case of FDI, or countries with sound social and economic policies in the case of aid".*

For inflation and many other economic factors the real value/monetary value of foreign aid also declining gradually. Decline in the share of food aid is also a reason for the reduction in grant flow for many countries. Bi-lateral aid is also declined by the developing partner for alleged corruption in grant utilisation by the government agencies.

FOREIGN AID AND DEVELOPMENT

Foreign aid to developing countries has been an important source of finance to enhance economic growth. However, numerous studies of aid effectiveness have failed to arrive at a consensus. Some studies on aid effectiveness found that foreign aid adversely affected domestic resource mobilisation. While others hold the view that aid has a positive impact on growth. Now the question is how does foreign aid affect the economic growth of developing countries?

Positive Relationship between Foreign Aid & Development

Some researchers suggested that good economic policy is a pre-requisite for the effectiveness of aid. This view has been challenged by many who find that aid is effective even independent of policy. In general, aid is found to have a positive impact on economic growth through several mechanisms (i) aid increases investment (ii) aid increases the capacity to import capital goods or technology (iii) aid does not have an adverse impact on investment and savings (iv) aid increases the capital productivity and promotes endogenous technical change.

Papanek finds a positive relation between aid and growth. Fayissa and El-Kaissy show that aid positively affects economic growth in developing countries. Singh also finds evidence that foreign aid has positive and strong effects on growth when state intervention is not included. Snyder shows a positive relation between aid and growth when taking country size into account. Burnside and Dollar claim that aid works well in the good-policy environment (cited by Minh, 2006). Developing countries with sound policies and high-quality public institutions have grown faster than those without them. The good-management, high-aid groups grew much faster, at 3.7% per capita GDP (Elisa, *et al*., 2001).

Aid has successfully supported poverty reduction and growth promotion in many countries. Consequently, even if aid flows have not stimulated growth under all circumstances, they have had a positive effect on average (UN Issue Paper, 2007, p.1). The most influential study of this movement is that by Burnside and Dollar which focused on the impact of policy on aid effectiveness. The authors used an interaction term between aid and an index of economic policy in order to study the aid- policy- growth relationship. In this study the authors comprising fiscal, monetary and foreign-exchange variables in the recipient country. The results of Burnside and Dollar's analysis suggest that aid promotes growth only in countries with sound economic policy regimes. The authors assume that combine effects among aid and policy are successful because, in good policy environments, either the fraction of invested aid or the resulting increase in productivity is larger.

Negative Relationship between Foreign Aid & Development

By contrast, foreign aid is found to be significantly and negatively correlated with growth. There are a number of underlying causes, such as aid dependency, bad economic management of the recipient countries, corruption and poor coordination and cooperation among aid agencies etc.

Many researchers find that foreign aid has negative impact on growth. "Knack argues that high level of aid erodes institutional quality, increases rent-seeking and corruption; therefore, negatively affects growth. Easterly, Levine and Roodman, using a larger sample size to re-examine the works of Burnside and Dollar, find that the results are not as robust as before. Gong and Zou show a negative relation between aid and growth" (cited by Minh, 2006).

Firstly, due to the volatile nature of aid, the government of the recipient country is sometimes unable to mobilise the volume of aid on time and fails to persuade donors that remaining funds will be spent efficiently. Thus, disbursement of aid may be further delayed; hampering the government's spending ability. Conditionality is another problem related to foreign aid which constraints the economic development of the recipient countries. Moss, a former consultant for the World Bank, said that tied aid is "highly inefficient since it restricts the market and thus costs the donor more money for the same benefit" (cited by Djankov, *et al*., 2006, p. 24).

Secondly, we think capacity has been a major constraint. Traditionally, the donor-recipient relationship has been an asymmetric one involving a strong and a weak party, where political and economic structures of domination and exploitation provided little space for the latter to choose. If the aid is tied one then at the time of negotiation, the donors bargain with their high capacity.

Sometimes foreign aid makes a nation aid dependent rather than making economically independent. Food aid injected in Somalia bring food deficit to the country. Somalia had become alarmingly dependent on imported food (Mathew, 2009 on the *Daily Gambia Echo*).

Since most foreign aid is government to government, it is ruler's discretion how they allocate foreign aid resources- whether in productive or unproductive sectors. More recently some authors have argued that the effectiveness of foreign aid may depend on the way in which aid is disbursed. If foreign aid contributes to any productive consumption, such as enhancing education, building rural and urban infrastructure, protecting private property, and reducing trade risks, it results in a net benefit to economic performance, and countries that receive more aid should expect increase in their well-being. But ruler does not want to invest the aid resources in the above sectors, because they would be failed to return the loan money and become the victim of the loan trap. Ultimately it can not bring the proper economic growth of the country.

Actually foreign aid has generally benefited the ruling elite and top management of the NGOs. So the ultimate goal of foreign aid can not be obtained. One study revels that rather than create wealth, prosperity and economic development, most Africans have over the past few decades realized a net decline in their standards of living. On the contrary, the ruling elite became richer. According to Mathew, 2009, on the *Daily Gambia Echo*, "…. over the period that foreign aid was being pumped into Africa, the per capita GDP declined by an averaged of 0.59 percent annually between 1975 and 2000. Foreign aid has been found to do more harm to Africa leading to a situation where Africans have failed to set their own pace and direction of development free of external interference".

Lack of commitment and accountability of the aid-recipient country is also a reason for which economic growth is being hampered. Powerful rulers have discretion over how foreign aid is used and/or distributed. Since they do not have to be accountable to any one sometimes they exploit their power to grab the aid resources. Sometimes they give emphasis on short-term political interests and time preferences, for the foreign aid resources. Ali, and Isse (2006, p.244) said, "Since no one expects to reap the future profitability of aid, in such settings, rulers might adopt policies that benefit them in the short term but hurt the nation in the long run".

Finally, the relation between aid and growth varies across the regions. Sub-Sahara is the region with largest amount of aid provided by donors but the economic performance remains fairly poor. This may be due to lack of the appropriately designed programs, timely and sufficient disbursement, corruption of the high officials and strict penalty upon deviation or violation etc. Foreign aid contributed to relaxing government budget constraints and thus increasing government consumption.

CONCLUSION

Despite the large literature on aid and growth, the debate about aid effectiveness is one where little is settled. Aid effectiveness is not isolated from development effectiveness. In order to achieve the goal of aid effectiveness it is required to improve the capacity of the poorer countries and to include all stakeholders for a good deal of political interests and commitment at the highest level. The recipient countries should give proper importance not only to their policies but also the way how aid resources will be prioritised, channelled and processed.

Notwithstanding increased activities with the participation of several donors, aid has largely remained unsuccessful in terms of achieving its major goal. Lack of predictability of aid flows, increased conditionality, absence of accountability etc. have been identified as being responsible for such the performance of aid in the recipient countries. So the time comes to shift the focus of aid from merely aid management and delivery to broader issues of effectiveness in achieving clear results.

The government should divert a larger portion of aid to investment in the desired sector of an economy. The decisions should be taken by the recipient country to ensure the priority. For instance, in an agro-based economy where the economy of recipient country absolutely depends on agriculture, the investment in agriculture sector should get the top priority. Aid donors may provide a framework for the implementation aid funds. Well- targeted aid may increase the ability of the poorer country to maximise the benefits of trade liberalisation, improve the environment for investment and ensure that the poor have the ability to contribute in achieving growth.

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