THE IMPACT OF FOREIGN AIDS AND DEMONSTRATION EFFECTS ON ECONOMIC DEVELOPMENT IN LESS DEVELOPED COUNTRIES

Eggon Henry Ahmed and Ajidani Moses Sabo

Abstract

In this paper, an attempt was made to discuss the impact of foreign aids and demonstration effect on economic development in developing countries-Various literature concerning aids and demonstration effect were reviewed. The paper observed that foreign aids are quite desirable in any economy because they play a major role in easing the constraints of low levels of domestic savings and investment as well as foreign exchange inadequacies. However, it was found that aids remained highly concentrated, going from a few number of developed countries to a few number of developing countries. It was also found that foreign aids have played a positive role in improving Human Development Index (HDI) in Less Developed Countries (LDCS). In view of the above, it was recommended that there should be more outright grants and confessional loans and less tied aids to give greater autonomy and flexibility to (he recipients in terms of their allocation and uses. The paper posits that the LDCS .should look inward us an alternative to foreign aids.

Introduction

Foreign aids are quite desirable in any economy. They have played a major role in the development of the advanced countries. In the developing countries, where domestic resources tend to be in short supply, foreign aids make significant contributions to the host country's economic growth and development through casing of the constraints of low levels of domestic saving and investment as well as foreign exchange inadequacies. They have also helped individual countries to cushion shocks either internal ones such as harvest failures or external ones such as fluctuations in commodity prices or recessions in industrial economics.

At international level, foreign aids promote global economic efficiency and allow countries with balance of payments deficit to strike the right balance between reducing their deficits and financing them. At the international political front, foreign aids enhance friendship and peace among nations.

This paper is divided into four sections, apart from the introduction, section two discusses the theoretical framework. Section three presents trends and direction of foreign aids and economic development in LDCS. Finally, section four presents the conclusion as well as policy recommendations.

The Concepts and Elements of Foreign Aids

It is acknowledged that foreign aids have been defined from various perspectives including social, political and economic dimension.

Anyanwu (1993:355) defines foreign aids as the international transfer of public funds in form of loans or grants either directly from one government to another (bilateral assistance) or indirectly through the vehicle of a multilateral assistance agency like the World Bank. It includes bilateral grants, loans and technical assistance as well as multilateral flows or public development assistance. He further states that aids are broadly classified into two; tied aid and untied aid.

He described tied aid as an aid in the form of bilateral loans or grants which requires the recipient country to use the funds to purchase goods and/or services from the donor country thus the tied aid is said to be tied to purchase from the assisting country". This causes demonstration effect on the recipient nation.

Aid may be tied by source, project or commodities, or it may be tied both by project and source, and becomes double tying aid. Aid tying by source may require the recipient nation to spend the aid on the donor's goods and services or it may be used to finance only those commodities and/or projects where the donor nation possesses a decided advantage in tendering the specified terms.

He Anyanwu argues that aid tying by source pushes up the cost of projects especially where the recipient is forced to get machinery, spare parts, raw materials, etc, from the donor nation. This consequently lowers the real value of the aid while distorting the recipient's allocation of investment resources.

Besides, the development programme becomes biased towards those projects that have a high component of the special import content. It limits the choice of technology used in the investment projects and might force the recipient nation to adopt a highly capital intensive technique which may be inappropriate to a labour surplus nation.

Tied aids have both merits and demerits to both donor nation and recipient country. The merits to donor nation include:

i Better opportunities for publicizing the donor's aid programme.

ii Increased access to information on sectors of the recipient's economy in which projects are financed.

i Incentives for improving the quantity and. quality of projects.

n Increased case of influencing the recipient's policies in those sectors of the recipient's

iv economy for which aid was granted.

The demerits to recipient country include:

i It leads to inter-governmental bureaucratic frictions created by detailed supervision of project formulation and execution;

ii It distorts investment priorities of the recipient country,

iii It causes demonstration effect in the recipient nation;

iv It leads to dislocation between production and consumption;

v It attracts undue loyalty respect for donor.

Untied aid on the other hand, is defined as a general purpose aid. It is the assistance whose disbursement is tied to the recipient's expenditure on wide range of items of the total needs of the recipient's country.

Untied aid has the following merits for the recipient nation:

i The recipient is free to utilize the aid in accordance with her development programmes

ii It reduces the real cost of aid as the recipient can purchase her requirements at competitive rates from the world market;

iii There is absence of bureaucratic frictions.

iv The recipient has opportunity to use an appropriate technology in keeping with its factor endowments and allocate her resources in a much better way (Anyanwu, 1993).

Anyanwu further identifies three reasons for developing countries acceptance of aid, which include:

i Aid is taken as an ingredient in the development process since it supplements scarce domestic resources thereby enhancing self-sustaining economic growth,

ii The political reason is to provide greater political leverage to the existing leadership to suppress opposition and maintain itself in power. This is why sometime aid comes in form of military and internal security reinforcement,

iii The moral reason is that the rich nations have an obligation to support the economic and social development of the LDCS having previously exploited them especially during the colonial era and even through international trade.

He also identifies the determinants of the amount of foreign aid for economic development to include: availability of funds in donor nations; absorptive capacity of recipients (including power, transport, etc) size of domestic markets, trained personnel, etc, adequate human and natural resources, attitude and thinking in the donor countries, etc.

Foreign Aids and Economic Development: A Theoretical Perspective

The traditional economic thinking is that aid helps to promote growth and structural transformation in recipient countries. This may be so particularly if such aids are in the form of outright grants. But then, outright grants may turn out to cause inflation and hence impact negatively on the economy of the recipient nation.

Two analogous arguments emerged concerning the impact of aid on economic growth. The traditionalists argue that aids have indeed helped to promote growth and structural transformation in many LDCS. They explained that foreign aid could play a critical role in supplementing inadequate domestic resources in order to relieve savings or foreign exchange bottlenecks. This is the familiar "Two-gap" analysis of foreign aid.

The basic argument of the two-gap model is that most developing countries are faced either with inadequate domestic savings to match investment opportunities or a shortage of foreign exchange to finance needed imports capital and intermediate goods. Most two-gap models assume that the savings and foreign exchange gaps are unequal in value and they are mutually independent, i.e. there is no substitutability between savings and foreign exchange.

Todaro (1989:487) argues that one of the two-gaps will be "binding" or "dominant" for any LDC at a given point in time. He explained that if the saving gap is dominant, this would indicate that . the country is operating at full employment and is not using all of its foreign exchange earning. This means that it has enough foreign exchange to purchase additional capital goods from abroad, but there is not enough domestic labour or other productive resources to carry out additional investment projects.

As a result excess foreign exchange (including foreign aid) might be spent out on importation of luxury consumption goods. Some good examples of "Savings-gap" nations would be the Arab oil nations during the 1970s, savings gap countries do not need foreign aid.

On the other hand, in the situation where foreign-exchange gap is binding (i.e. countries have enough productive resources (savings) but inadequate foreign exchange, they would need foreign aid to enable them undertake new investment projects. Foreign aid can, therefore, play a critical role in overcoming the foreign-exchange constraint and raising the real rate of economic growth.

The country school held that aid does not promote faster growth but might retard it by substituting for, rather than supplementing, domestic savings and investment and by compounding LDC balance of payment deficits as a result of rising debt repayment obligations (in the case of loans), and tying aid to donor nation's exports.

It has been argued in Anyanwu (1993) and Obadan (1999) that aid stimulates the growth of the modern sector, thereby increasing the gap in living standards between the rich and the poor in LDCS. They regarded aid as a positive force for anti development once it retards growth and worsens income inequalities through reduced savings. In other words, aid creates modern sector-traditional sector or rural-urban gaps.

From the foregoing arguments and counter-arguments, it may be stated that aid can increase the amount of resources devoted to capital formation over and above what the recipient country can provide. In this respect, it supplements domestic savings.

In addition, aid also increases the recipient's ability to import the goods it wants. In this way, it provides foreign exchange and helps correct the balance of payments deficit. In view of the above, Meier (1975) concluded that aid clearly acts as a substitute for domestic savings. If savings could be increased, aid could be reduced, or vice versa. However, in a foreign exchange constraint situation, aid is not a substitute for domestic savings. Aid is necessary to increase investment.

Demonstration Effect and Economic Development

Demonstration effects is defined by Todaro (1989) as "the effects of transfers of alien ways of life upon nationals of a country. Such effects are mainly cultural and attitudinal in nature, e.g. consumption habits, modes of dressing, pattern of education, leisure and recreation". As earlier mentioned, tied aid in the form of" bilateral loans or grants can cause demonstration on the recipient country since the recipient country is required to purchase goods and/or services from the donor country, e.g. machinery and spare parts which may not be appropriate for the recipient's environment.

Besides, it limits the choice of technology and forces the recipient nation to adopt the donor's technology, which may be inappropriate in the former's economy.

Besides, a tied aid by source which requires the recipient nation to spend the aid on the donor's goods and services or to finance projects where the donor nation has advantage in tendering the specified terms, will end up in channeling the greater value of the aid to the donor nation. The obvious implication of the above is that the recipient country has no power to allocate the aid to desired sectors.

These consequently not only lower the real value of the aid but also distort the recipient's allocation of investment resources, in the light of the above, it may be stated that tied aids which has demonstration effects on the recipient's economy has negative impact on it.

Trends in Foreign Aids and Economic Development in LDCS

Foreign aids across boundaries have growth both in absolute and relative values over the years, in several ways including official development finance and foreign direct investment.

Obadan (1999:23) reports that Official Development Finance (ODF) rose from $7.5 billion in 1970 to $57.9 billion in 1990. ODF to developing countries peaked in 1991 at $65.5 billion. Thereafter, it declined to $48.6 billion in 1994. Mirroring this pattern is the Official Development Assistance (ODA) mainly received by low income countries. It declined from $53.7 billion in 1991 to $45.2 billion in 1995 and $44.4 billion in 1996.

In real terms, aids have also, declined significantly by nearly 17 percent since the mid-1980s. Net ODA flows (including technical cooperation's grants) fell to 0.29 percent of GNP of the OECD countries in 1994- 1995, the lowest level since 1973.

At the same time, the composition of aids has shifted in the 1990s as bigger share of ODA is diverted to disaster relief and peace-keeping operations translating to less support for long-term development.

Also, non-concessional official aids traditionally dominated by net flows from multilateral development institutions and export credit agencies have been declining. However, non-concessional (long-term lending) from multilateral sources were increased in 1995.

This point was corroborated by Ojo (2003:11) when he reported that foreign aids from industrialized countries to developing countries accelerated in the 1980s and triple between 1990 and 1996.

Foreign aids have been shifted from the primary to manufacturing and to the service sector, . and there have been increasing aids to agro-business. However, such aids remained highly concentrated, going from a small number of industrialized countries to a small number of developing countries.

Foreign aids to developing countries as a whole rose by 15 percent from $172.17 billion in 1998 to $198 billion in 1999. Latin America attracted $97 billion, one third of which went to Brazil, while $91 billion went to Asia, $40 billion of which went to China, the largest developing country recipient of foreign aids. Africa received between $10 and $11 billion, with Nigeria accounting for $2 billion (Oxfam, 2000).

One notable implication of the foreign aids is that the poorest countries (with Nigeria being 19) are not being protected from the declines in foreign aids. The declines are particularly worrisome in this globalization era when many low-income countries still lack access to private capital markets, and need assistance to better integrated their economies into the world economy. Even though many of the low-income countries are pursuing (or are likely to pursue) reform programmes to reduce poverty and restore economic growth, they need substantial external assistance to finance economic recovery and reduce their debt over-hang.

Given the reports above, one may ask the question., "is there any relationship between foreign aids and economic development, particularly in developing countries?

It is expected that foreign aids would improve welfare across the globe in view of the traditionalist argument. To ascertain the extent of the effect of aids on economic development in LDCS, the Human Development Index (HDI), which measures the quality of life is analyzed. A change in the HDI that correlates with the movement in aids flows could imply positive impact of aid.

The HDI for developing countries as a group during 1990 - 1996 period declined marginally from 0.655 to 0.647, while the index for OECD countries fall from 0.906 to 0.900.

The HDI for the least developing countries as a group during the period declined from 0.448 to 0.442, the index for the East Asia and Pacific countries during the period rose from 0.7(9 to 0.722, Similarly, the HDI for sub-Saharan Africa rose from 0.467 to 0.468.

However, a critical analysis of some components of the HDI reveals that there appears to be some level of relationship between the extent and benefit derived from foreign aids. For example, per-capita income for developing countries rose from $3,530 in 1990 to $3,850 in 1996 for developing countries as a group compared to $20,020 in 1990 and $23,363 in 1996 for the OECD. East Asia and the Pacific per capita income rose from $3,950 in 1990 to $4,233 in 1996. Sub-Saharan Africa recorded the lowest per capita of $1.,640 in 1990 and $1,831 in 1996.

The conclusion drawn- from this data is that there is probably a correlation between the volume of aid a country or region received and the level of development it enjoys. This seemingly supports the proposition that economic growth, and by extension development, is driven partly by the quality of aids.

Recommendations

In this paper, an attempt was made to discuss the impact of foreign aids and demonstration effects on economic development In Less Developed Countries. Foreign aids has, for a Song time, been cherished as something desirable because of its potentials to bring foreign exchange into the recipient country, augment domestic savings and raise the level of domestic investment and, hence, economic growth.

In view of the above, the following recommendations become appropriate: i There should be more grants and concessional loans .and less tied aids to give greater autonomy and flexibility to the recipient in terms of their allocation and uses, ii There is need for macro-economic stability, in terms of policy making. iii Adequate prudential supervision and regulation of domestic financial institutions and markets should be encouraged, iv The management of aids should be included as ;m integral part of macro-economic management.

v More aids should be channeled through multilateral assistance agencies like regional development banks whose political motives are presumably less narrowly defined compared with those of individual donor nations.

vi Poverty and inequality reductions should be taken as self-interest by developed nations since in the long-run there would be one future for mankind.

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Conclusion

This paper has demonstrated that foreign, aids play crucial role in economic growth in less developed countries. It was found that foreign aids to less developed nations have tended to follow a boom-and-burst pattern, surging and then declining in the mid-1990s.

The distribution of foreign aids has however, been very skewed with East Asia and followed by Latin America and the Caribbean, dominating the in-flows. Sub-Saharan Africa, the Middle East and North Africa, have had very little in-flows.

The patterns of foreign aids showed that, the poorest countries are not being protected from the declines in concessional flows. It is therefore, reasonable to argue for a determined effort on the part of the donors to reverse declining aids trends, replenish the concessional arms of the multilateral institutions and direct resources to reforming low-income countries who should accelerate their reform efforts and improve aid effectiveness by reaching the poor and improving their quality of life.

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