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The Efficiency Reducing Effects of Official Development Aid

by Herbert Sperber, Speyer*

Despite considerable disbursements of official development aid the average annual per capita income in developing countries has increased only slightly. The prosperity gap between these countries and the industrialised nations has widened. In many cases the least degree of progress has been made in those countries receiving most support in proportion to their national income. Has the channelling of vast sums of official development aid turned out to be a failure? Or has it indeed hindered the development it set out to achieve?

The officially propagated objective of development policy is to "encourage economic and social development in Third World countries".¹ The total official development aid of all donor countries and institutions covered by OECD statistics during the first two development decades (1960-1980) amounted to more than US \$ 250 billion.² Despite such vast assistance average annual per capita income in the developing countries recorded an increase of only US \$ 125 over the past thirty years, as opposed to a corresponding figure of US \$ 2,950 in the western industrialised countries.³ Corrected for systematic estimation errors the "prosperity gap" between the North and the South thus increased from a ratio of approximately 10:1 in 1950 to one of between 12:1 and 13:1 by the end of the seventies.⁴ It is also conspicuous that some of those very countries which in proportion to their national income had received the greatest amounts of development aid revealed the least developmental progress, whereas other countries receiving hardly any assistance at all managed to substantially improve their position.⁵

Has the channelling of such vast sums of development aid turned out to be a failure? Or does it even hinder development? This article endeavours to provide answers to these questions. The analysis focusses on the specific channels via which the economic growth effects of official development aid can be adversely impaired or "compensated for".

In comparison with other forms of international financial flows, official development aid above all shows the two following characteristics⁶:

(1) On average about three-quarters of official development aid consists of pure, non-repayable grants. The grant element of the remaining development aid *credits* amounts to approximately 60 % of their nominal value. The grant element of total official development aid (i.e. of grants and credits) thus accounts for approx. 90 % of total development aid contributions. This means that on average 90 % of official development aid is not subject to any form of reciprocal payment in the form of interest or redemption obligations on the part of the developing countries. Only about 10 % must be utilised as productively as (commercial) loans at market terms if the income at the

¹ West German Federal Ministry for Economic Cooperation (BMZ): Die entwicklungspolitischen Grundlinien der Bundesregierung, unter Berücksichtigung der Empfehlung der „Unabhängigen Kommission für Internationale Entwicklungsfragen“, adopted on 9 July 1980, Item 6.

² This figure only covers the *net* disbursements received by the developing countries (or, for the period 1960-69, the net bilateral disbursements and those made to multilateral agencies); cf. Organisation for Economic Cooperation and Development (OECD): Development Assistance, 1971 Review, Annex, Tab. 2, p. 165; and OECD: Development Co-operation, 1981 Review, Annex, Tab. A.1, p. 172.

³ Estimates by the United Nations taken from: Birla Institute of Scientific Research: Does Foreign Aid Help?, Economic Research Division, New Delhi 1981, p. 7, Footnote 5.

⁴ Cf. R. J. Langhammer, B. Stecher: Der Nord-Süd-Konflikt, Hintergründe 3, Würzburg 1980, p. 13 ff.; and M. Bohnet: Instrumente der Entwicklungshilfe, IFO-Studien, Vol. 23, 1977, No. 1/2, p. 43 f.

⁵ Cf., e.g., P. T. Bauer: Wirtschaftlicher Fortschritt ohne Auslandshilfe, in: Bergedorfer Gesprächskreis zu Fragen der freien industriellen Gesellschaft, Entwicklungshilfe – Eine Illusion?, Mem. No. 49, 1974, p. 7 f.; P. Mosley: Aid, Savings and Growth Revisited, in: Oxford Bulletin of Economics and Statistics, Vol. 42, No. 2, May 1980, p. 80 ff.

⁶ The following statements relate to the official development aid disbursements made by the industrialised countries belonging to the Development Assistance Committee (DAC), cf. OECD: Development Co-operation, 1981 Review, p. 84 ff. and Statistical Annex, Tab. B.1, B.5, B.6; and OECD: Development Co-operation, 1979 Review, p. 99 ff.

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future disposal of the borrowing countries – excluding external financing – is not to be reduced. To put it another way: the productivity required of expenditure financed by development aid is on average 90 % lower than that required of expenditure financed by credits at market terms. However, the fact must be taken into consideration that a substantial part of official development aid – about two-thirds of the total – is carried out in the context of “project aid” and thus tied to the implementation of specific investment projects. The project-linked use of such funds is laid down in bilateral or multilateral agreements and is subject to the permanent control of the donors. Official development aid has, however, yet another outstanding feature.

(2) The largest part of official development aid, again estimated at almost two-thirds, is transferred directly to the governments of the respective developing countries. Most of the remaining funds are channelled directly, or indirectly via the government, into private and public enterprises whose investment financing is at least partly (in the case of public enterprises often wholly) accounted for by governmental budgetary funds.⁷ The influence exerted by official development aid on the overall level of investment in developing countries is thus highly dependent on the budgetary behaviour of the governments of recipient countries and/or such governments’ *fiscal policy reactions* to the inflow of official development aid. Which are the typical features characterising the budgetary situation and behaviour of governments in developing countries? And which (adverse) consequences result for the effects on economic growth of official development aid?

Public Investment Shunting

The inflow of official development aid may well cause some of the financial resources already contained in the recipient country’s government budget to be directed

⁷ For information on the importance of public enterprises and the extent of budgetary ramifications between the state and public enterprises in developing countries cf. A. Premaud: Government and public enterprises – the budget link, in: Finance & Development, Vol. 16, 1979, No. 4, pp. 27-30.

⁸ Cf., e.g., K. Griffin: Foreign Capital, Domestic Savings and Economic Development, in: Bulletin of the Oxford University Institute of Economics and Statistics, Vol. 32, 1970, pp. 103, 106; H. W. Singer: External Aid: For Plans or Projects?, in: Economic Journal, September 1965; furthermore, amongst others, G. Holtham, A. Hazlewood: Aid and Inequality in Kenya, British Development Assistance to Kenya, London 1976, pp. 104, 184 ff.

⁹ Another feasible possibility is the shifting of financial resources for productive investments into the sphere of non-productive investments, the financing of which is usually rejected by the donors of development aid (e.g. presidential palaces, ultramodern capitals, etc.), cf. P. Mosley, op. cit., p. 85.

¹⁰ For details of the problems of lack of coordination and of competition among donors of development aid, cf. G. Holtham, A. Hazlewood, op. cit., pp. 184, 189; furthermore, also OECD, op. cit., 1981 Review, p. 37 ff.

away from those purposes for which official development aid has been granted and used for other purposes.⁸ In the case of investment-tied development aid this means that part of the capital budget planned to go into investment spending can now be “shunted” into the sphere of current (consumption) spending.⁹ The intended investment effect of the official development aid is thus dampened. This can occur irrespective of whether development aid is granted to governments or to the private company sector. The only difference is that in the former case the level of investment in *physical* assets planned before development aid, and in the latter case the level of *financial* investment planned before development aid, are reduced in favour of an extension of current spending.

So-called “basic shunting”, in which the investment project apparently financed via development aid is identical with regard to financial spending to the project which would have been carried out or financed without such aid, is not the most likely course. More probable is a situation in which before development aid the implementation or financing of similar, e.g. cheaper, investments is earmarked in the developing country’s government budget, the granting of investment-linked development aid, however, is tied to the realisation of a financially more extensive project. This is the situation of “partial shunting”, in which the share of investment spending is increased by the granting of official development aid, the budgetary means released corresponding only to a part of the amount of aid.

On the other hand, it is quite possible that the donor of development aid is only willing to finance a project which is less expensive than the one originally planned by the government, so that the spending directed towards the project will be reduced compared to the situation before development aid, i.e. the inflow of official development aid in this case not only leads to a smaller increase but to a *drop* in absolute terms of the investment level of the recipients of development aid. The lack of coordination and indeed competition to be found amongst donors of development aid makes it easier for the governments of developing countries to ensure that those projects are accepted as worth financing which could also have been financed without development aid.¹⁰

There are several indications that governments in developing countries do indeed take advantage of the possibility of using the financial means released by investment-linked development aid for consumption.¹¹ The following observations provide evidence of the “special interest” of governments in developing countries in extending their current spending:

- The substantial efforts by such governments to finance an increasing level of military expenditure,
- the disproportionately high personnel costs in the public service sector, and, in connection with the often excessive extent of public entrepreneurial activities, the permanent demands made on the current budget to cover the losses of public enterprises, and
- the growing refinancing requirements to cover the debt service on foreign loans at market terms.¹²

Substitution of Loans at Market Terms

The inflow of official development aid may induce the governments in developing countries to reduce borrowing at market terms.¹³ In as far as these loans were intended to finance investment spending, the increase in the extent of public investment spending is less than the amount of development aid. Part of the investment effect of development aid is compensated for by the decrease in the investments financed by loans at commercial terms. The substitution of commercial loans by official development aid is not just limited to government borrowing. The granting of official development aid to private enterprises may well induce the governments to lower their guarantee ceiling for government-backed borrowing. Due to the ensuing worsened conditions of access to private capital markets the investment level of the firms affected remains beneath the level possible if all credit sources otherwise available had been exhausted.¹⁴

Here, we shall concentrate only on the possibility of substituting loans from foreign sources by development aid to governments. The interest of the governments in developing countries becomes clear straight away: as opposed to loans at market terms, official development aid does not limit the future financial scope of recipient governments, or at least to a much lesser extent. The allocation of official development aid is not therefore associated with a marked economic necessity to employ these means in a productive way. What is more, repayment periods of up to 50 years, with 10 years

redemption-free and interest rates of 0.75 %¹⁵, often considerably exceed the political time horizon of the government members. Since project-linking can be avoided via the above-mentioned "shunting" and official development aid is not, as opposed to the adjustment grants of the International Monetary Fund, linked to specific conditions regarding economic policy, other, non-economic restrictions on the use of funds also do not apply. Financial means in the form of official development aid are therefore "freely disposable".

The generally "tougher" terms of commercial loans, on the other hand, make it essential to carry out a profit-oriented selection of the types of spending to be financed (or to put it more precisely: to effect a profit-oriented utilisation of the – thus increased – *total* expenditure). The interest on the loans has the most important "leverage effect". The characteristic feature of commercial private loans is not to be seen merely in the fact that their interest rates are higher than in the case of official lenders but that these are, above all, *variable* ("floating interest rates").¹⁶ The variability of the interest rates means that from time to time (usually every 6 months) the latter are adjusted to certain market interest rates, e.g. LIBOR (= London Inter-Bank Offered Rate), which in their turn are most sensitive to the credit policies of the industrialised countries, i.e. these interest rates largely change in accordance with the inflation rates in the industrialised countries. Given a rising rate of inflation, the associated "anticipation" of inflationary developments leads to abrupt increases in the debt service burdens, thus inducing accelerated repayment of the *real* loans.¹⁷ This "built-in inflation effect" in interest rates increases the pressure on the borrowing government to concentrate its spending on those areas with the most promising profit prospects (in terms of foreign exchange).¹⁸

¹⁵ Terms for financial cooperation between the Fed. Rep. of Germany and those countries most affected by international price increases (MSAC), which do not at the same time belong to the group of least developed countries (LLDC), the latter receiving only non-repayable financial contributions; cf. West German Federal Ministry for Economic Cooperation (BMZ): Vierter Bericht zur Entwicklungspolitik der Bundesregierung, March 1980, p. 24 f.

¹⁶ Cf. on this point G. R. K i n c a i d : Inflation and the external debt of developing countries, in: Finance & Development, Vol. 18, 1981, No. 4, pp. 45-48.

¹⁷ Cf. *ibid.*, esp. p. 47.

¹⁸ If commercial loans are nevertheless used in developing countries to finance consumptive (or non-profitable investive) expenditure, perhaps *due* to the fact that these countries hope to be able to cover the ensuing debt service obligations via official development aid; cf. in this context also P. T. B a u e r : Die Entwicklungsländer in der Weltwirtschaft: Entwicklungshilfe und globale Umverteilung, in: Ludwig-Erhard-Stiftung: Zwischenbilanz der Diskussion über eine neue Weltwirtschaftsordnung, Symposium VII, Bonn 1981, pp. 25-41, esp. p. 30: "Official aid tends to . . . encourage careless financial commitments, since balance-of-payments difficulties are an impressive justification for demands for development aid" (our translation).

¹¹ Cf., e.g., Birla Institute of Scientific Research, op. cit., pp. 30, 37.

¹² Bottlenecks in financing the debt service on commercial credits can in their turn be due to a consumptive or non-productive use of these loans; cf. S. K. M a l i k : Bleak Prospects for Commercial Bank Lending to Developing Countries, in: Aussenwirtschaft, Vol. 35, 1980, No. III, p. 264.

¹³ Cf., e.g., P. T. B a u e r : Auslandshilfe: Ein Instrument für den Fortschritt?, in: Ordo, Vol. XVIII, 1967, pp. 173-205, esp. p. 189 f.

¹⁴ The motive behind narrowing down the guarantee framework for government-backed borrowing at market terms can be the fact that budgetary means, which would otherwise have to be used as "provision against contingencies", can then be used for other, e.g. consumptive purposes.

The inflow of official development aid to the governments of developing countries can also induce the latter to reduce their taxation efforts.¹⁹ Tax revenue primarily serves to finance current spending. A reduction in tax revenue or a reduction in the growth of tax revenue thus tends to lead towards a financing deficit within the current budget, or to a situation in which otherwise possible current budget surpluses fail to materialise and can no longer be used to finance additional investment spending.²⁰

Taxation Policy

Why should the inflow of official development aid favour a reduction of taxation efforts? And what would suggest that the associated easing of fiscal pressure on private households and companies will not lead to

corresponding positive growth effects? The analysis of the special "taxation conditions" in developing countries provides a few pointers. The first noticeable characteristic feature is the considerable share of (indirect) taxation of goods and services, in particular the excessive taxation of imports.²¹ On the one hand, this reflects the lack of availability of other taxable areas in comparison to industrialised countries. Above all, the extensive "subsistence economy" existing in many developing countries largely escapes taxation. On the other hand, the situation is characterised by the inadequate ability of the tax authorities to make full use of the potential presented by the more complicated forms of taxation.

Furthermore, import taxes usually have the function of protecting domestic producers. However, due to the strong dependence of developing countries on imports the retention of a generally high level of import taxation is hard to push through politically. Many governments in developing countries found themselves increasingly

¹⁹ Cf., e.g., K. B. Griffin, op. cit., p. 106; K. B. Griffin, J. L. Enos: Foreign Assistance: Objectives and Consequences, in: *Economic Development and Cultural Change*, Vol. 18, 1970, No. 3, p. 321; furthermore L. Landau: Saving Functions for Latin America, in: H. B. Chenery (ed.): *Studies in Development Planning*, Cambridge/Mass. 1971, p. 321.

²⁰ The possible release of own resources for the financing of domestic investments is often viewed as a positive "external" effect of the granting of "programme aid" (for consumptive purposes).

²¹ Cf. International Monetary Fund: *Taxation in Sub-Saharan Africa*, Occasional Paper 8, Washington DC 1981.

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V E R L A G W E L T A R C H I V G M B H – H A M B U R G

faced with this problem in the years since 1973, in which prices for crude oil imports shot up whilst at the same time the export possibilities for processed industrial products deteriorated as a result of the recession and protectionist trends in the industrialised countries, and prices for primary goods exports were subject to heavy fluctuations.²² Taxation policy in developing countries is characterised by the existence, against the backdrop described above, of a large number of tax exemptions and tax reductions for certain import goods and certain importers. The number of such special regulations increases the pressure on the government to grant even more individual tax reliefs. The inflow of financial resources in the form of official development aid may be welcomed as an opportunity to maintain current spending and at the same time reduce tax revenue.

Questionable Reduction of Import Prices

The economically meaningful use of the instruments of import taxation policy is, as is its adequate assessment, an extremely difficult business. On the growth policy problem of a *more differentiated* application of tax concessions only the following will be remarked here: tax concessions for certain kinds of imports, i.e. for crude oil, discriminate against those domestic producers who, while their own imports are not subject to tax concessions, are competing against the producers affected by these concessions. As soon as the granting of tax reliefs leads to a situation in which import goods which are cheaper before taxation are more expensive after taxation than the goods subject to tax relief, this implies a loss of possible foreign exchange savings, since the possible substitution of expensive imports by cheaper ones is delayed. At the same time domestic production is cut back, since those producers are adversely affected whose production methods require the (pre-taxation) cheaper imports. In addition, the removal or reduction of taxation for individual imports goods harbours the danger that the supply of those domestic goods will also be pushed back which could be produced at the same quality using only, or primarily, domestic inputs if the (protective) taxation were maintained. The relative reduction of imports prices can play a role here in causing the

domestic supply even of those goods for which domestic suppliers have comparative advantages (e.g. agricultural products) to be rationed and substituted by imports, whereas the domestic product of excessively taxed luxury import articles (e.g. cosmetics) is encouraged.

Follow-up Costs Ignored

The above deliberations concentrated on the effects of official development aid on the overall level of investments in developing countries. The main assertion was that the level of investment which would otherwise, i.e. without development aid, have been achieved, can be reduced by the inflow of official development aid. Of course, there are also a number of categories of consumer expenditures of considerable importance to growth.²³ In this connection we shall deal briefly with the role of "follow-up expenditure" or "current expenditure on follow-up costs". The concept of "follow-up expenditure" covers current expenditure on personnel and materials which occurs following investment spending and is essential for making an investment project operational and maintaining operationability.²⁴

Within the government budget in developing countries follow-up expenditure is charged to the budget of current (consumption) expenditure. However, both the donors and recipients of development aid tend to regard current budget spending as being non-productive, whereas they often sweepingly regard the expenditure covered by the capital budget (the "development" budget) as conducive to development and growth.²⁵ This results in psychological pressure, both domestic and foreign, to reduce current spending so as to create a surplus in the current budget to finance additional capital expenditure.²⁶ If at the same time within the current budget there is a tendency towards extending certain expenditure items (of the type mentioned above) this can result in a "two-pronged" pressure on the extent of the budgetary means available for follow-up expenditure, leading to losses of capital stock productivity in the case of "underfinancing".²⁷

The effect of neglecting current follow-up expenditure is enhanced by a development aid policy in which the donor countries compete for the financing of "good"

²² Cf. P. Nunnenkamp: Ausmaß, Ursachen und Lösungsansätze der internationalen Verschuldungssituation von Entwicklungsländern, in: Konjunkturpolitik, Vol. 26, 1980, pp. 372, 375.

²³ Cf. on this point, A. M. Kamarck: "Capital" and "Investment" in Developing Countries, in: Finance & Development, Vol. 8, 1971, No. 2, pp. 2-9.

²⁴ Cf. E. Lang, R. Lenk: Folgekosten öffentlicher Investitionen, Überlegungen zur öffentlichen Leistungserstellung mit Investitionen, from the series: Der Finanzminister informiert, published by the North-Rhine Westphalian Ministry of Finance, No. 12, Düsseldorf, May 1980.

²⁵ Cf. P. Heller: The underfinancing of recurrent development costs, in: Finance & Development, Vol. 16, 1979, No. 1, pp. 38-41.

²⁶ This corresponds to the demand that the developing countries have to make own efforts.

²⁷ Cf. on this point also P. Heller: Public Investment in LDCs with Recurrent Cost Constraint: The Kenyan Case, in: Quarterly Journal of Economics, Vol. 88, May 1974, pp. 251-277.

investment projects characterised by a high foreign policy prestige value and speedy transfer of aid funds and very often offer more development aid for these than can be meaningfully used by the recipient countries²⁸, whereas, on the other hand, only in exceptional cases is development aid provided for financing the running costs of investment projects. The governments in recipient countries are thus encouraged to take advantage of the political competition between the donors of development aid and by adapting their projects to the type preferred by foreign institutions to create demand for as much of the "cheap" investment finance as possible. Apart from the possible resultant adverse structural effects, there is an increased danger of investments being raised to such a level that the associated follow-up costs exceed the increase in current revenue. The "closing down" of operational investment projects is then seen as the most effective counter-measure by governments in developing countries to obtain an ex-post minimisation of the follow-up costs. The same effect can be brought about if the project is not even put into operation following its completion. It is a well-known fact that there are many examples of such "misinvestments".²⁹

Empirical Analyses

The number of empirical investigations attempting to prove and quantify the existence and the relevance to growth policy of the effects of public development aid discussed above has as yet remained limited. The most interesting work in this direction up to now is that of P. S. Heller.³⁰ Assuming that public authorities set out to maximise their benefits, Heller analyses the budgetary behaviour of eleven African developing countries in a cross-section analysis. With regard to the anglophone group of countries Heller obtains the result that the granting of bilateral development aid led to a reduction of tax revenue equivalent to 26 % of the development aid contribution and to a decrease in (domestic)

borrowing by the governments of the recipient countries equivalent to 55 % of the development aid contribution. Altogether, Heller shows that the inflow of foreign finance resulted in a shift (shunting) of the budgetary structure towards investment spending, whereas the primary effect of the allocation of funds on a purely grant basis was to raise public consumption spending for primarily political purposes.

Another attempt to ascertain the relevance to growth of the afore-mentioned "shunting effect" of public development aid was carried out by P. Mosley.³¹ Mosley assumes that the increased availability of budgetary resources for current spending brought about by shunting would induce the governments in recipient countries to effect tax reductions. On the other hand, if the inflow of public development aid were not to lead to the release of budgetary resources for current spending, the level of tax income would have to be maintained or, if increased spending is planned, raised. Mosley subsequently tests the hypothesis that the growth effect of official development aid is positively correlated with the change in "taxation efforts" by recipient governments. The chi-square test used by Mosley on the whole confirms this hypothesis. Furthermore, a regression analysis carried out by Mosley reveals a significant positive correlation between the extent of taxation efforts and economic growth in the developing countries under review.

It must be pointed out that most empirical investigations of this kind are forced to operate within the realm of speculation. An adequate assessment of the budgetary reaction induced by development aid requires exact knowledge of the situation which would have emerged without the inflow of development aid. Only the governments in the developing countries could possess such information, and probably not even they. "Controlled experiments designed to show what would have happened with aid on the one hand or without on the other, cannot be constructed. Careful assembly and analysis of data, and a proper understanding of the power and limits of both can, however, lead us far along the road to truth."³²

²⁸ Cf. G. Holtham, A. Hazlewood, op. cit., p. 200; furthermore: A. S. Koch, E. Lang: Die Finanzierung von Folgekosten als Instrument der Entwicklungshilfepolitik, in: Zeitschrift für Wirtschafts- und Sozialwissenschaften, Vol. 101, 1981, No. 3, p. 328 ff.

²⁹ Cf. on this point also: Amtsblatt der Europäischen Gemeinschaften, C 344, Rechnungshof, Jahresbericht zum Haushaltsjahr 1980 zusammen mit den Antworten der Organe, Teil II: „Die Europäischen Entwicklungsfonds“ (Official Gazette of the European Communities C 344, Commissioner of Audits, Annual Report of the Financial Year 1980 together with the Replies of the Organs, Part II: "The European Development Fund"), December 1981, p. 147 ff.

³⁰ P. S. Heller: A Model of Public Fiscal Behavior in Developing Countries: Aid, Investment, and Taxation, in: American Economic Review, Vol. 65, 1975, pp. 429-445, esp. p. 439 ff.; and by the same author: An Econometric Analysis of the Fiscal Behavior of the Public Sector in Developing Countries: Aid, Investment, and Taxation, Center for Research on Economic Development, The University of Michigan, Discussion Paper No. 30, October 1973, esp. pp. 30 ff.

³¹ P. Mosley, op. cit., p. 86 ff.

³² R. N. Wood, Director of the Overseas Development Institute, in the preface to K. Morton: Aid and Dependence, British Aid to Malawi, London 1977. As part of a project being carried out by the author at the Research Institute of the Hochschule für Verwaltungswissenschaften (University of Administrative Sciences) in Speyer entitled "Success Monitoring of Public Development Aid", an extensive time-series/cross-section analysis is currently being conducted which sets out to quantify the influence of budgetary reactions induced by development aid on the efficiency regarding growth policy of official development aid. With this as a basis, a "catalogue" of specific measures is being compiled, the political realization of which holds promise of a considerable improvement of the efficiency regarding growth policy of official development aid.