

IMPACT OF FOREIGN AID ON THE ECONOMIC DEVELOPMENT OF THIRD WORLD COUNTRIES A CASE STUDY OF THE US AID TO PAKISTAN

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Abstract

This paper analyses the concept of foreign aid, its definitions, nature and various types. It examines effects of foreign aid and establishes that foreign aid has both beneficial as well as adverse effects on the economy of the recipient states. A case study of the aid provided to Pakistan by the US is carried out in order to study the impact of aid. The history of Pakistan's engagements with the US is discussed, especially with regards to foreign aid. The recommendations given at the end of this study outline the possible ways through which the US aid programmes can be made to result in improvement of bilateral relations.

Key Words: *Foreign aid, Third World, Pakistan, Economic development, Bilateral relations.*

Introduction

Transfer of resources from developed states of the world to the developing or under-developed states is called foreign aid. The Encyclopedia Britannica defines foreign aid as “the international transfer of capital, goods, or services from a country or international organization for the benefit of the recipient country or its population. Aid can be economic, military, or emergency humanitarian (e.g., aid given following natural disasters).”¹

According to Columbia Encyclopedia, foreign aid is “economic, military, technical, and financial assistance given on an international and

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¹ Foreign Aid, from *The Encyclopædia Britannica*, available at: <http://www.britannica.com/EBchecked/topic/213344/foreign-aid>, Internet Accessed: April 1, 2010

usually intergovernmental level.”²

There are two pre-requisites for the flow of resources to qualify as foreign aid, firstly, the motive of the donor for such transfer of resources should be non-commercial and secondly, the transfer of resources should be on concessional terms, i.e. interest rate and re-payment period shall be softer than commercial rate and period.

Foreign aid may be provided by a single country, a group of countries or an International Financial Institution (IFI). Foreign aid that is provided by a single donor country to a recipient country is called bilateral aid, while aid provided by IFIs, donor agencies or group of countries to a country or countries is called multilateral aid.

Types of Foreign Aid

Foreign aid comprises of resource transfer to the recipient state which result in raising the performance of that state above the current level, at least for the short-term. There are various types of foreign aid:

- 1 Financial aid, which is the provision of convertible foreign exchange to the recipient country. Financial aid can either be tied or un-tied. If the financial aid is not tied to any project or nation, it is called un-tied aid.
- 2 Tied aid can either be nation-tied or project-tied or both, called double tied.
- 3 Nation-tied aid is conditional; the aid has to be spent by the recipient country in the donor country.
- 4 On the other hand, project-tied aid is provided for only for certain projects and the money cannot be relocated to any other project or cause.
- 5 Other types of foreign aid include loans and grants. Loan is defined as “An arrangement in which a lender gives money or property to a borrower and the borrower agrees to return the property or repay the money, usually along with interest, at some future point(s) in time”.³ The developing or under-developed country borrows foreign exchange from a developed country in order to finance its short-term and long-term projects. Loans are of two types, hard loans and soft loans. Hard loans are provided are given for a period of five years or less, they have no concessional elements, grace period is very limited and interest rate is higher. While soft loans are given for a longer period of time, their interest rate is lower and grace period is longer. Grant is also a type of foreign aid. It is the most desirable foreign assistance. It does not

² Foreign Aid Columbia *Encyclopædia Britannica*, available at: <http://www.answers.com/topic/foreign-aid>, internet accessed: April 1, 2010

³ Loan, from Investorwords, available at: <http://www.investorwords.com/2858/loan.html>, Internet Accessed: April 3, 2010

involve re-payment of the principal amount or the interest; rather it is a sort of gift from the donor given in times of emergencies or other humanitarian purposes.

- Another kind of foreign aid is Foreign Direct Investment (FDI). It is defined as “direct investments in productive assets by a company incorporated in a foreign country”.⁴ There are two different opinions about FDI. Proponents state that FDI is beneficial for the client state because it does not involve re-payment and it brings technical know-how to the host country. Opponents of FDI state that the outflow of capital, as profit for the foreign companies, exceeds the amount of repayment and the technical know-how can be procured at much lower rates on commercial basis.
- Military Aid is also included in foreign aid. It may not directly affect the economy of a country but it boosts the security of a country that may indirectly influence business activities of a country. Since it does not directly affect the economic activity of the recipient country, it is sometimes ;8excluded from foreign aid.

Effects of Foreign Aid

Responding to world-wide developmental goals and humanitarian needs through its foreign assistance programmes is an integral part of the foreign policy of developed countries. Through their peculiar aid policy, the developed country/countries develop an association of ‘dependency’ with the client state(s). Dependency is a form of inter-dependence with an extreme form of power imbalance. This imbalance or asymmetry is the prime characteristic of dependency. The asymmetrical relationship between the donor state and the recipient is reflected by the dominance of the former over the latter. Through its foreign aid programme the donor state controls or influences the national policies of the client state by regulating the latter’s socio-political as well as economic affairs. K. J. Holsti is of the opinion that that “Needs that cannot be filled within national frontiers help to create dependencies on other states” and “dependencies are vulnerabilities and leave states open to be influenced by others”.⁵

Foreign aid has both beneficial as well as adverse effects on the economy of the client states. Scholars are divided regarding the implication of foreign aid on the recipient country. The Extensionist School of thought holds that foreign aid is provided to developing countries for their socio-political and economic development. Non-Extensionist School opposes this claim and holds that foreign aid retard growth of a country.

⁴ Foreign Direct Investment, from Investorwords, available at: http://www.investorwords.com/2042/foreign_direct_investment.html, Internet Accessed: April 3, 2010

⁵ Bruce Russett and Harvey Starr, *World Politics: the Menu for Choice*, (San Francisco: W.H. Freeman company, 1981), p. 178.

One of the biggest recipients of foreign aid in South Asian countries is Pakistan. According to a comparative study of South Asian countries' dependence on foreign aid, Pakistan received about Rs. 192.5 billion in the year 2006, while India was least dependent on foreign aid as it received about Rs. 78.98 million in the same year; Bangladesh and Sri Lanka are also "mild recipients of foreign aid as compared to Pakistan".⁶

As far as Foreign Direct Investment is concerned, India takes the lead in South Asia, e.g. in the year 2006, FDI in India was about Rs 6.598 billion, while Pakistan did not have even half of India's FDI.⁷

Moreover, there is an interesting relationship between foreign aid allocation and poverty; only 31% of aid is provided to the ten least developed countries with 66% of the world's poorest people (see Table I):

Table I: Foreign Aid Allocations and the Poor, 1992

10 developing countries with greatest no. Of Poor People	Number of Poor (millions)	Poor as a %age of Total World Poor	Official Development Assistance (ODA) per Poor Person (U.S. \$)	ODA as a %age of Total ODA
India	350.0	26.9	7	5.2
China	105.0	8.1	28	6.5
Bangladesh	93.2	7.2	19	3.8
Brazil	72.4	5.6	3	0.5
Indonesia	47.8	3.7	44	4.6
Nigeria	46.4	3.6	7	0.5
Vietnam	37.6	2.9	16	1.3
Philippines	35.2	2.7	49	3.8
Pakistan	35.0	2.7	49	3.8
Ethiopia	31.9	2.5	41	2.9
Total	854.5	65.9	17	31.7

Source: Akhtar Hussain Shah, (Et. Al), Is foreign aid necessary for the economic development of less developed countries with special reference

⁶ Muhammad Zeeshan, *Foreign aid: a boon or bane?*; available at: www.thefinancialdaily.com; Internet accessed April 10, 2010

⁷ Ibid. (Note: The examples of FDI in Pakistan are Lever Brothers, Reckitt and Colman, Bata and Philips etc.)

to Pakistan? From *IPRI Journal, 2005, p. 11*

There are two main types of foreign aid provided to Pakistan, i.e. project aid and non project aid.⁸ Table II shows the typology of foreign aid provided to Pakistan.

Table II: Typology of foreign aid provided to Pakistan

(1952-2002) in US\$ millions

Plan/Year	Project Aid	Non Project Aid				Total
		Non Food	Food	BOP	Relief	
Pre Plan (1952-55)	170	48	119	-	-	337
1st Plan (1956-60)	406	244	192	-	-	842
2nd Plan (1961-65)	1209	420	765	-	-	2394
3rd Plan (1966-70)	1811	763	469	-	-	3043
4th Plan (1971-78)	2543	1299	785	1090	-	5717
5th Plan (1979-83)	3363	950	36	531	643	5523
6th Plan (1984-88)	4882	791	776	-	734	7183

⁸ Non-project aid is further sub-divided into; food, non-food, BOP and relief aid.

7th Plan (1989-93)	7643	1922	1558	413	545	12081
8th Plan (1994-98)	9564	61	1923	1139	61	12748
9th Plan (1999-03)	4991	-	502	8307	35	13835
Total	36582	6498	7125	11480	2018	63703

Source: Economic Survey of Pakistan (2002 -03); see: Ghulam Mohey-ud- Din, Impact of Foreign Aid on Economic Development in Pakistan (1960-2002), June 2005, MPRA; available at: <http://mpr.aub.uni-muenchen.de/1211/>; Internet accessed April 12, 2010

A Case Study of US Aid Provided to Pakistan

Background

Pakistan is at the forefront of the American-led War on Terror since 2001. The U.S.-Pakistan partnership is not a new phenomenon; it dates back to 1950s. Pakistan has remained a close American ally since its formative years. It will not be exaggeration to suggest that the United States owe its Cold War victory to the efforts of Pakistan.

After maintaining a few years of relative neutrality during its initial years of independence, Pakistan joined the American camp, by entering into US-led alliances against the Communist USSR. Notable anti-Communist Pacts, of which Pakistan was a member, were the South East Asian Treaty Organisation (SEATO) and Central Treaty Organisation (CENTO). Pakistan joined the Capitalist bloc due to a number of reasons.

The foremost reason was that Pakistan faced numerous economic and financial problems, to overcome which, it needed foreign aid. United States provided aid in cash, which could fuel the weak Pakistani economy. The other dilemma for the foreign policy formulators of Pakistan was security, especially from its hostile neighbour, India. For that matter, Pakistan wanted weapons and by joining the U.S. led alliances, Pakistan could get the American weapons. However, the United States did not guarantee Pakistan's security vis-à-vis India and made it clear that the defence pacts of SEATO and CENTO are Communism-specific. Still the idea lurked in the minds Pakistan's policy makers that being in alliance with the United States will protect Pakistan against any possible Indian aggression.

In 1960s, Pakistan was called the 'Most Allied Ally' of the United States. However, Pak-US relations deteriorated in the mid-1960s and US imposed an embargo on military aid to Pakistan in 1965. In 1970s, sanctions were imposed by the Carter Administration on Pakistan which resulted in curtailment of foreign aid.

Pakistan became a 'front line state' in the aftermath of the Soviet invasion of Afghanistan in 1979. Pakistan was again getting foreign aid and assistance from the United States. However, after the Soviet withdrawal, sanctions were imposed against Pakistan under the Pressler Amendment in October 1990 due to Pakistan's nuclear programme. US suspended all military and economic assistance which dropped from US \$574 million planned for fiscal year 1991 to none.

Terrorist attacks on the US soil in September 11, 2001 dramatically changed relationship between Pakistan and the United States. Interestingly, the most-sanctioned ally of United States became a 'major non-NATO ally' in the "War against Terrorism". Pakistan became one of the world's leading recipients of US aid. Pakistan's weak economy was revitalized after its alliance with the US; so far it has received around \$8.66 billion in military and economic aid.

The most recent instance of US aid to Pakistan is through the Kerry Lugar Bill, which was passed by the US congress in 2009, according to which Pakistan will receive \$1.5 billion a year for five years to improve its social and economic structures. The Bill also includes military aid of \$400 million annually for 2010-2013 with a condition that Pakistan's commitment to combat terrorism is certified.

Thus, Pakistan remains one of the biggest recipients of the US aid. The relationship between Pakistan and United States can be best understood under the structural parameters of "dependencia".

The following two tables (III and IV), depicts the foreign aid provided by US to Pakistan:

Table-III: Foreign Aid to Pakistan
(Comparison of 1970 & 1991)

Donors	(Million Dollars)	
	30 June 70	30 June 91
US Govt. and Agencies	1212.5	2974.9
US AID	1087.1	1499.3
US EXIM Bank and Others	67.7	409.6
PL 480	57.5	1066.0

Source: Mehrunnisa Ali (Ed.), *Reading in Pakistan Foreign Policy: 1971-1998*, (Karachi: Oxford University Press, 2001), p. 371.

Table IV: Direct Overt U.S. Aid and Military Reimbursements to Pakistan, FY2002-Y2009 (millions of dollars)

Program or Account	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008 (est.)	Program or Account Total	FY 2009 (req.)
Section 1206	—	—	—	—	23	14	57	94	
Counternarcotics Funds	—	—	—	8	29	39	55	131	
Coalition Support Funds	1,1691	1,247	705	964	862	731	255	5,934	200
Pakistan Frontier Corp train & equip	—	—	—	—	—	—	75	75	
Foreign Military Financing	75	225	75	299	297	297	298	1,566	300
International Military Education	1	1	1	2	2	2	2	11	2

and Training									
International Narcotics Control and Law Enforcement	91	31	32	32	38	21	22	267	32
Non-proliferation, Anti-Terrorism, Demining, and Related	10	1	5	8	9	10	10	53	11
Total Security-Related	1,346	1,505	818	1,313	1,260	1,115	774	8,131	545
Child Survival and Health	14	16	26	21	28	22	30	157	28
Development Assistance	10	35	49	29	38	95	30	286	—
Economic Support Fund	615	188	200	298	337	389	347	2,374	603
Food Aid	5	28	13	32	55	—	42	175	37
Human Rights and Democracy Funding	1	—	2	2	1	11	—	17	—
Migration and Refugee Assistance	9	7	6	6	10	4	—	42	—
Total Economic-Related	654	274	296	388	539	521	449	3,121	668
Grand Total	2,000	1,779	1,114	1,701	1,799	1,636	1,223	11,252	1,213

Source: U.S. Departments of State, Defence, and Agriculture; U.S. Agency for International Development

Impact of Foreign Aid on Pakistan's Economy

Regarding the impact of foreign aid on the economy of Pakistan, economists such as Hollis Chenery and Arthur MacEwan “express the need for foreign assistance to Pakistan for accelerated growth”⁹ Economists such as A. R. Kamal, Parvez Hasan, Pervez Tahir and Rehana Siddiqui highlighted “non-optimal utilization of foreign assistance for Pakistan and interpreted it as a sustainable and prospective factor for

⁹ Akhtar Hussain Shah, (Et. al.), Is foreign aid necessary for the economic development of less developed countries with special reference to Pakistan? *IPRI Journal*, (Summer, 2005), V:2, pp. 1-28.

higher growth, if macro and micro level efforts are made for optimal utilization of foreign assistance".¹⁰

On the other hand, Non-Extensionist School comprising Griffen and Enos, Weisskopf, Ridell, White and Pakistani economist Shahrukh Rafi Khan points towards "the existence of a negative relationship between assistance and growth".¹¹ Shahrukh Rafi Khan (1997) says that the harsher terms on which Pakistan gets aid, makes the debt trap more formidable as does the economics of aid growth nexus.¹² In order to analyze the effect of foreign aid on Pakistan's economy, examining the following Table is pertinent. The Table V shows the net resource flows and net transfers to Pakistan from all donors, including the United ;2States:

Table V: Net Resource Flows and Net Transfers to Pakistan (US\$ Million)

	1970	1980	1990	1999	2001	2002	2003
Net Flows	433	1,021	1,228	1,071	1,622	1,066	1,247
Net Transfers	369	819	778	263	525	511	596
National Income	4.3	4.0	2.9	1.5	1.7	1.5	1.5
Net Transfers	3.6	3.2	1.9	0.4	0.8	0.7	0.7

Source: World Bank. Ishrat Husain, National Economy and Impact of Foreign Aid, p. 9.

One finds out from Table V that net flows as percentage of gross national income have gradually declined from 4.3% in 1970 to 1.5% in 2003 and net transfers from 3.6% to 0.7%, which means that dependence of Pakistan on foreign assistance, as Ishrat Hussain, the former Governor State Bank of Pakistan, puts it: "is so low and insignificant that it won't make much of a difference to our national economy".¹³ Dr. Ishrat Hussain thus concludes that net flows and net transfers for 2002 and 2003 have declined as proportion of national income compared to 1999 and hence the popular assertion that the economic turnaround in Pakistan can be attributed to September 11, 2001 is a myth.

Moreover, it not only increases the debt of Pakistan but also exhausts a major chunk of Pakistan's budget in debt-servicing. US-aid also results in dependence of Pakistan on the US bail-outs, which decreases the incentive for major economic reforms and an indigenous economic development model in the country. In addition, the aid always has strings attached to it, due to which Pakistan is not able to pursue an independent economic and foreign policy, resulting in forestation among the policy-makers and the public. The US Congress reiterates that the US tax-payers'

¹⁰ Ibid., p. 15

¹¹ Ibid., p. 1

¹² Ibid., p. 19

¹³ Ibid. Ishrat Husain, p. 6.

money cannot be doled out without expecting “tangible” results. However, the wish-list or conditionality of the aid providers is unrealistically huge and outmatches the meager amount of the aid-given to comply with such “wishes”.

The US aid is also not sustainable; it depends upon the whims of the US Congress, and Pakistan usually struggles in getting aid that is pledged by the US Administration. This makes the US-aid un-reliable.

One can conclude that although the US aid may have benefitted Pakistan in the short-term, but it has failed to produce the desired effects on Pakistan’s economy in the long-term. The recommendations given at the end of this study outlines the possible ways through which the US aid programmes can be made more desirable for Pakistan and thus can result in improvement of bilateral relations.

Ghulam Mohey-ud-Din in his research work “Impact of Foreign Aid on Economic Development in Pakistan (1960-2002)” is of the opinion that there are both positive and negative effects on the economic development. As far as the positive impacts of foreign aid on economy of Pakistan is concerned, it has “helped in boosting the GDP Growth through structural transformation of the economy, laid foundations of the industrial and agricultural sectors, provided technical assistance, policy advice and modern technology, assisted in overcoming the budget deficits and the BOP deficits and has also funded the projects for the social sector development projects”.¹⁵ On the negative side, foreign aid has substituted for domestic savings and increased debt burden.

Recommendations

Following are a few steps that need to be taken by both the US and Pakistan to get better results from the F\foreign aid.

- Pakistan is being given 1.5 billion dollars as a coalition support fund as mentioned earlier in the paper. Pakistan in actual is suffering much more than it is being supported. The best way would be to assess the losses that Pakistan has incurred in the wake of support for US in the war against terrorism. This can be done through a team of experts which should include experts from both the US and Pakistan in order to assess the losses in a better way. Then after the assessment of losses, US would be in a better position to understand Pakistan’s needs and opposition from within US against any increased compensatory aid would be much less as it would be based on more objective criterion;
- There is mistrust about the proper utilization of aid between both the parties. That mistrust can be addressed if periodic auditing is

¹⁵ *Economic Survey of Pakistan (2002-03)*; see: Ghulam Mohey-ud-Din, *Impact of Foreign Aid on Economic Development in Pakistan (1960-2002)*, June 2005, MPRA; available at: <http://mpra.ub.uni-muenchen.de/1211/>; Internet accessed April 12, 2010, p. 13

done and issues and progress of utilization is reviewed by an independent auditing firm which is acceptable to both the parties. There is usually a mechanism of auditing when aid is given to a country but the auditors come from the donor country which is not very unreasonable either. But keeping in view the subtle nature of the ties between Pakistan and US, a third party auditing would be more helpful.

- Moreover, the conditionalities of the aid should be made realistic and the expected results should be achievable, given the ground realities. For this purpose representatives of Pakistan's MoFA should be invited to give their opinion during the formulation of aid conditionalities in the Congress committee that is responsible for chalking out the details of aid bill.
- Pakistan's industry is not functioning well because of severe energy crisis. US should help Pakistan through transfer of technology in the field of sustainable energy. This should be negotiated between US and Pakistan. It would only be a short-term relief which is needed by Pakistan at the moment but the only permanent solution is a vibrant and resilient Pakistani economy which would be self sufficient. A stable Pakistan is vital for regional and global peace and that can only be ensured if Pakistan's economy is put back on track.
- Another important factor that frustrates the relationship and also makes US aid appear vicious, is the scepticism on Pakistani side that lots of strings are attached with the foreign aid, Such scepticism is not beneficial for the bilateral relationship. This can be addressed by negotiating with the US and highlighting the losses incurred by Pakistan and by proposing to the US to give support fund on more liberal and flexible terms.
- The priority list, according to which the projects would be undertaken through the aid received, should come from Pakistani side and MoFA needs to negotiate this with US. That is very important because what US thinks important and urgent for Pakistan might not actually be true as Pakistan's perspective would be more reliable in this regard.
- Giving Pakistan a greater access to the US markets would also boost Pakistan's economy. This can be achieved in phases through bilateral negotiations and ultimately, the aid may be replaced by market access.

Conclusion

Foreign aid can bear positive results in the economy of a third world country like Pakistan in a number of ways. It can help to develop over-head capital and basic infrastructure, like roads, highways, canals,

railways, power stations, which in turn can lead to economic growth of the country. There have been a number of overhead capital and basic infrastructures built in Pakistan through foreign investment, that have ultimately resulted in trickling down positive impacts of the country's economy; a typical example is that of Islamabad-Lahore Motorway. Foreign aid can also help in economic growth by exploitation of untapped resources of the country. Chinese investment in Saindak and Gawadar Deep Sea Port projects are good examples of foreign assistance. Moreover, Pakistan is in need of huge investment in the industrial sector through foreign aid, because the country has not enough resources to establish heavy industries.

However, the governments of third world countries should adopt such policies that in no case can foreign aid hamper development of the country. One of the fallouts of foreign aid is the burden of debt servicing for developmental loans. Another drawback of foreign aid is the string attached to it, especially a conditionality that the given loan has to be invested in the donor country in a particular sector.

One can conclude that policy of a country is very important with regard to foreign aid. In the presence of good monetary, fiscal and trade policies, foreign aid has positive effects on growth of the country.

