The Macro Economic Management Challenges of Foreign Aid in Developing Countries

Arabi.U[1] and Nagendra[2]

Introduction

Foreign aid is one of the most powerful weapons in the war against poverty. Many people equate aid with charity as one way act of generosity directed from high income countries to their low income counterparts. Foreign aid is indispensable for the development of less developed countries. It flows in the form of loans, assistance outright grants from various governmental and international organizations. It spreads the benefits of global integration and shared prosperity by enabling poor people and countries to overcome the health, education and economic resources barriers that keep them in poverty. There is an international consensus that human development should be the primary objective. Hence aid budgets are raising despite the several fiscal and public debt problems facing some of the donor countries.

According to Freidman, "Foreign aid consists of grants or loans from one government to another government to enterprises in their countries for specific projects, regarded as contributing to economic development". Broadly, there are two types of foreign aid:

(i) The Tied aid, refers to the aid which the donor (developed countries) ties procurement wise and use wise and it aims at (a) securing interest and (b) protecting industries; thus the tied aid, which is given for a specific project and may be tied by

[1] Dr U Arabi, Reader, Department of Economics, Mangalore University, Mangalagangothri-574199
[2] Mr. Nagendra, Research Scholar, C/o Dr.Arabi.U, Department of Economics, Mangalore University, Mangalagangothri-574199

sources, project and commodities or it may be tied both by project and source and become double tying aid.

(ii) The Untied aid is not related to a specific project. It is a general purpose aid and is also known as program aid or non project aid. Untied aid provides freedom to the recipient countries to purchase machineries, equipments and other material from the cheapest market. It benefits them in meeting their foreign exchange requirement because it can also be utilized for the maintenance of imports. Thus, Foreign aid, the public development assistance include all official grants and concessional loans both in currency and kind aimed at transferring resources from the donor to the recipient less developed country. The assistance may be made on developmental or distributional grounds.

As an instrument of diplomacy, it acquires significance from the point of view of the welfare of the people in underdeveloped countries. It also aims at securing strategic or military advantage in the recipient countries. Establishment of political stability and providing a particular direction to economies of the recipient countries, promotion of the donors own ideology; increasing trade leading to higher exchange earnings mutual economic gains and securing political support on international issues are some of other important goals. Although the role of the Foreign aid attained significance for the recipient countries recently as to revive their economies at a greater degree, at the same time, these countries also experiencing a large number of macro economic challenges in accommodating and utilizing these funds in achieving its goals.

Foreign Aid and Development Endowments

Because of limited endowments of skills, capital, infrastructure, knowledge, and ideas, many poor countries would still not be able to participate in global markets. Action to build endowments is primarily domestic, through private and public investments in infrastructure and other areas. From an equity perspective, thus, the main role of aid is to help countries build the endowments of those who are resource-poor, generally through no fault of their own, and avoid extreme deprivation. The focus on building endowments implies that both the level of aid and its effectiveness matter. Aid effectiveness hinges crucially on aid delivery modalities and on the fairness and transparency of domestic political processes. Birdsall (2004) cites severe "deadly sins": impatience with institution building, failure to exit, failure to evaluate, pretending tat participation equals ownership, failure to celebrate, stingy and unreliable financing, and under funding of regional and global programs-in addition to tying aid to the use of consultants and firms from the donor country and allocating it according to political priorities.

Ensuring that, increased aid promotes growth and reduces poverty is an important task. A few empirical studies by the Centre for Global Development (CGD) and a study by Clemens (2004) suggest a positive relationship with growth and further say that, once one excludes those aid flows aimed at political and humanitarian goals, a positive net effect is observed for the remaining aid focused on economic objectives. But recent IMF work by Raghuram Rajan and Arvind Subramanian (2005) finds no robust evidence of such an effect positive or negative of aid on growth with conclusion holding across time horizons, time periods, types of aid, and types of donors and characteristics of recipient countries. This may be due to aid flows giving rise to real appreciation of the aid recipient currency, a "Dutch disease" effect there by weakening growth.

Burnside and Dollar (2000) and Collier and Dollar (2001, 2002) found that aid was more effective in reducing poverty if it was allocated to counties that followed good policies and had good institutions. In fact the aid effectiveness varies across countries as a result of different county circumstances, such as climate, a different aid allocation rule would maximize the poverty impact of foreign aid. Cogneau and Naudet(2004) suggested an alternative rule for aid allocation and showed that gains in poverty reduction similar to those found by Collier and Dollar could be obtained if aid was directed to countries that have greater geographic, historical, or economic structural disadvantages. The resulting allocation would spread the risk of poverty more evenly across the world's population, while reducing global poverty almost as much as the allocation proposed by Collier and Dollar. Hence, this equity perspective suggests that an approach that does not take a country's circumstances into account is likely to ignore important information about need. But an approach that ignores aid effectiveness does not lead to expanded opportunities. To contribute toward an equalization of opportunities across the world's individuals, aid should be targeted where the probability is greatest that it effectively reaches those with the most limited opportunities-the poorest of the poor. That clearly depends on the poverty and deprivation levels in each country and on its government's ability and political commitment to deliver the aid where and how it is intended.

Over the past three decades, three broad views have emerged on the relationship between aid and growth:

Aid has no effect on growth, and many actually undermine growth. It can undermine incentives for private sector production, including by causing the currency to appreciate, which weakens the profitability of tradable goods production an effect known as "Dutch disease". Similarly, food aid, if not managed appropriately, can reduce farm prices and hurt farmer's income. Aid flows potentially can undermine incentives for both private and government saving. They can also sustain bad governments in power, helping to perpetuate poor economic policies and postpone reform. This view has been supported by a range of empirical studies, mostly published from the early 1970s through the mid-1990s. While these studies have been influenced, many are of questionable quality, especially using today's research standards. For example, most assume only a simple linear relationship between aid and growth in which each new dollar of aid has exactly the same impact on growth and ignore possible endogenously in which faster growth might attract higher aid or both might be caused by something else, among other issues.

Aid could support growth by financing investment or by increasing worker productivity. It can bring new technology or knowledge either imbedded in capital goods imports or through technical assistance. Several early studies formed a positive relationship between aid and growth but this stand of the literature took a significant form in the mid 1990's when researchers began to investigate whether aid might spear growth with diminishing returns that is the impact of additional aid would decline as aid amounts grew.

Aid has a conditional relationship with growth, helping accelerate growth only under certain circumstances. The conditional view usually argues that aid effectiveness hinges on either recipient characteristics or donor practices.

Jonathon Isham, Daniel Kaufmann, and Lant Pritchett (1995), found that World Bank projects had higher rates of returns in countries with stronger civil liberties. Craig Burnside and David Dollar (1996) followed with their influential study concluded that, aid simulated growth in countries with good policies, but not otherwise. Others have proposed different characteristics that might affect the aid-growth relationship, including vulnerability to trade shocks, climate institutional quality, political conflict, and geography. Multilateral aid might be more effective than bilateral aid and untied aid is thought to have higher returns than aid tied to purchase in the donor country. Donors with large bureaucracies' heavy reporting requirements or ineffective monitoring and evaluation systems probably undermine the effectiveness of their own programs. Two influential and overlapping views argue that aid is more effective where donors allow for greater country ownership or broader participation in setting priorities and designing programs.

New research has taken a different track by exploring the idea that not all aid is alike in its impact on growth. This view suggests that most research on aid and growth is flawed regarding both substance and timing. On substance, almost all studies look at the relationship between total aid and growth, even though large portions of aid are not primarily directed at growth. For example, food and humanitarian aid are aimed primarily at supporting consumption, not growth, as is the provision of medicines, bed nets, and school books. And aid to support democracy or judicial reforms is not primarily aimed at stimulating growth. These important aid financed activities help improve recipient welfare by supporting basic consumption needs, developing political institutions, and strengthening health and education-but they are likely to affect growth only indirectly, if at all. By contrast, aid to build roads, bridges, or telecommunications facilities or to support agriculture and industry is more directly aimed at production and should be expected to accelerate growth (IMF2005).

Aid that comes as cash such as budget or balance of payments support could be spent on a wide variety of activities. Low income countries face many sources of instability. Their economies one equally dependent as a single vulnerable to climate or trade related shocks and their political systems are prove to destabilizing regime changes and even though low-income countries have dew source of instability in middle income countries. They are still vulnerable to the consequence of volatile financial flows in the form of aid like private capital flows fluctuation in aid can occur because to perceived domestic changes. The donors are now shifting away from project aid to program aid and countries will be seeking to under aid. Their shift will help to reduce transaction cost and drains on limited capacity caused by the need to implement a large number of projects. But program aid flows tend to be more volatile than project aid which is equally committed up front and disbursed on a multi year basis. Thus, the development community runs the risk of slipping into a low level equilibrium that is countries that budget prudently over the medium term would discount pledge of assistance; donors would then the fewer funding gaps in turn causing aid commitments to fall behind intended increase or even in absolute terms.

In recent years the development community has begun to shift away from emphasizing on the aid recipients to develop their own policies. As rich countries ratchet up aid flows they need to ratchet down the transaction costs that reduce aid effectiveness that does not mean compromising on fiduciary responsibility to tax payers. But it does mean ending tied aid reducing the volatility and unpredictability of aid flows and rethinking the scope of conditionality. More aid will produce better results only if it is delivered through streamlined management structures that are more accountable to developing country governments and their citizens. Yet policy environment has improved dramatically as have the human development returns to aid. The balance of responsibility and obligation between aid recipient and aid donors also needed.

Developing countries wanting aid have set target and linked to the MGDs, undergone budget monitoring by the International Monetary Funds (IMF) and comply with extensive conditions. The donors and aid recipients have to agree on a financial needs assessment that identifies the aid requirements for achieving the MDGs. In short, for the global community aid represents mechanism for expressing human solidarity and for extending opportunity. Whether motivated by human rights, religious values or wider ethical poverty, hunger and avoidable child deaths is a moral imperative enlightened self interest underlies of the security rationale for aid.

Challenging Factors of Aid Flows utilization

Aid in the past was often guided by geopolitical considerations linked to the interests of donor countries rather than by development objectives. The harmonization and alignment of aid under the 2005 Paris Declaration on Aid Effectiveness, as well as the trend toward improved aid allocation selectivity on the basis of need and policy quality, provide evidence of this. This "new aid architecture" is aligning aid with country-owned poverty reduction strategies to finance priority social and infrastructural investments, conditional on delivering measurable results.

a) Conditions for effective aid

For a county to be able to effectively absorb and utilize aid, a few conditions have to be met like, a clear national development vision upon which donor support can be anchored coupled with an appropriate medium term strategy for achieving it, strong government leadership and national ownership of the development process and sustained reforms including in aid delivery. It is also essential that certain other critical conditions like sound public expenditure and financial management systems, trust between the government and overseas development partners and promotion of democracy and good governance are equally desirable. Besides these, the focus of the poverty reduction strategy has to be on poverty, improved quality of life and social well being and good governance and accountability. In many of the recipient countries aid management is part and parcel of ongoing economic reform program. Hence development partners must focus on six principle challenges:

1) Ensuring that larger aid flows promote growth and reduce poverty.
2) Increasing substantially the delivery of government service and investment in infrastructure, and managing spending decisions when a larger proportion of financing is outside the governments control and uncertain in duration

3) Dealing with the possibility that higher aid flows might cause an appreciation of an aid recipient's currency, or domestic inflation, with adverse effects on the country's international competitiveness.
4) Handling the increased complexity of managing monetary, fiscal and exchange rate policies when higher aid is subject to uncertainty in terms of its magnitude, timing and likely economic effects.
5) Recognizing that substantial aid in the form of even concessional loans could result in debt problems in the future and
6) Managing the potentially adverse effect of growing aid dependency.

b) Aggregate budget sustainability

The prospect of a significant increase in aid will force recipient governments to consider how to weigh these "aid uncertainties" in deciding how much to expand service delivery. Budget need to be considered in a medium to long term context with a number of questions needing to be addressed should program be scaled up on the assumption that higher aid inflows will be sustained even when few donors can commit themselves to providing aid beyond a few years. Most government lacks the capacity for any significant substitution of domestic tax resources in the event of such shortfalls, and there are inevitably macro economic limits on the potential for domestic bank borrowing.

c) Sectoral sustainability

Much of the additional aid will not come on the form of general budget support available to the government for spending for any purposes. In addition to specific projects, most donors still earmark program aid for sectoral spending while the ministry of finance has to judge the aggregate sustainability of a budget financial by uncertain higher aid flows, each ministry must consider the sustainability of aid flows dedicated to its specific sector. The impact of higher flows certain sectors may be substantial. I health or education, increased aid may facilitate a doubling or more of a governments spending. In fiscal year 2005 aid for HIV/AIDS spending could potentially increase public health spending by 40-50 percent in Ethiopia, Guyana, Kenya and Zambia and even more in Rwabada.

d) Public financial management

The effectiveness of aid in improving productivity, incomes and welfare will depend on how governments manage their resources. A recent World Bank -IMF Study highlighted the weakness of public financial management systems, commitment controls, cash management, budget reporting audit and regulatory capacity. Ironically higher aid flows may exacerbate this weakness, intensifying the need to strengthen the capacity of budget managers -independent of whether services are to be directly provided by the government or contracted out to the private sector.

e) Organizational Challenges

Organizations that function effectively on the scale may be much less successful when expanded to substantially larger scale. One of the toughest issues for governments facing an increase in aid flows is a possible Dutch decease effect. Inflows of foreign currency should boost demand both for tradable and non-tradable and also possibly for money itself. Greater demand for tradable goods could be satisfied by more imports. But higher demand for non tradable could encounter production bottlenecks and pressure for higher wages that would result in a rise in their price relative to tradable. Thus pushing up the real exchange rate for the currency will hurt the international competitiveness of a country's tradable goods industries, weakening the potential gains from international trade and the county's capacity to attract investment and grow itself out of poverty and aid dependency. If the external assistance promotes the achievements of the MGDs and confronts key infrastructural and human resource bottlenecks, it may not only rise current welfare levels but also create a future economic environment that has potential to increase productivity and competitiveness. The competitiveness of the tradable goods sector have been weakening increasingly a country's vulnerability to aid shocks without clear guarantees there may thus be a case for limiting the scale of aid dependency but the optimal level will be shaped by how successfully a country can confront and resolve the policy issues.

f) Donors and Service Reforms

In many developing countries external donors support service reforms. In middle income or large low-income countries they mostly pilot innovations or implement demonstration projects. The international community has comes a long way in understanding what makes aid more effective focusing on the selection of recipient countries.

1. Donors need to pay more attention in the problems in influencing service reform in recipient's countries.

2. They should strengthen the critical relationship among policy makers' providers and clients.
3. Donors should support recipient institution by evaluating innovations systematically by harmonizing and realigning their financial assistance and knowledge transfers with the receipt service delivery and by focusing on outcomes and results.
4. In good country environment where there are genuine reformers, donors should also integrate their support in the recipient development strategy, budget and service delivery system.
5. In low income countries coming out of conflict with weak institutions, donors should support urgent social and other services, while identify mechanisms that build transparent public institutions in the longer term.

g) Aid and Accountabilities

Aid differs in important ways from domestically financed services. The beneficiaries and finances are not distinct. They line in different countries with different political constituencies. This geographical and political separation between beneficiaries in the recipient country and taxpayers in the donors' country breaks the normal performance feedback loop in service delivery. For example beneficiaries in a recipient country may be able to observe the performance of aid agencies. But they cannot reward or punish the policy makers responsible for this performance in donor countries. The broken feed back loop induces greater incentive bias in aid than in domestic programs. So aid effectiveness is determined not only the incentives embedded in the institutional environment of aid agencies.

h) The cost of aid fragmentation

The problem with aid fragmentation is that there are too many projects for any to work efficiency. When projects for fixed costs are high and there are returns to scale fragmentized aid can be wasteful. Fragmentation also imposes high transaction costs on recipients with large amount of officials' time taken up by the donor requirement. High fragmentation indices could also reflect donor specialization in different sectors. High fragmentation may have an even stronger impact in low income countries with weak policies and institutional environments. This is because the domestic capacity the implement reforms are typically highly constrained both the political capital of reformers and the technical capacity of the administration. Fragmented donor intervention creates pressure on capacity by demanding both political and administrative efforts to implement change across a wide variety of areas at some time.

Conclusion

In view of increase in Aid inflows and emerging managing and policy challenges among the aid recipient countries, the complexity of measuring performance results in a focus on inputs in aid agencies. The budgets contracts and expenditures on projects are easier to monitor and design, than the outputs and impacts that the aid projects produce. In addition bureaucracies tend to develop their own procedure which increases the complexity. In this sense aid agencies are like any other large public organizations. Extensive consultations with non-governmental organizations differs the risk of political pressure in donor countries and complex tender and contract procedures defuse criticism by aid service suppliers with such an incentive structure aid agencies allocate comparatively few resources to verify the results of aid projects or to main stream rigorous impact evaluation. If evaluations are a small part of those consults foreign aid market, they also tend toward input bias and may avoid reveling results that can affect their main market. However, three principles can be considered here:

1. Evaluate intervention and aid projects for impact

2. To reduce the costs if aid fragmentation and build capacity work with other donors to harmonies and align policies. This is crucial for aid effectiveness in low income countries that require substantial parts of their public resources as foreign aid.

3. Harmonization and realignment are but done at the country level and by strengthening the recipients existence institutions. In countries with fairly good expenditure management and genuine service reforms-where donors and recipients trust each other-budget support should be considered a viable tool.

The following points to be considered to make Aid more fruitful and useful;

i)To make aid more effective and efficient all donors need to recast their approaches to aid,

ii) To make the most of its values as a keystone in the permanent architecture for achieving social justice

iii) To recognize the half measure and incremental change will not overcome the scale and depth of global poverty.

iv) To shed functional orthodoxies and procedures

There is a window of opportunity to put in place the reform needed to fulfill the potential of aid as a mechanism for achieving the MDGs. Thus, the important issues to be kept in mind by the policy makers may include: a) set a schedule and keep to it, b) back MDG and wider human development plans with real money, c) focus on additionality, d) end tied aid, e) link aid to need, f)resolves the debt problem, g) tackle inequality, h) improve aid quality.

To conclude, in view of increase in aid flows to the recipient developing countries, and need for its scaling-up, the following issues have to be carefully emphasized.

a).To off set a large real exchange rate appreciation and loss of competitiveness, they can use aid to improve productivity. Hence, policy makers must be alert to this phenomenon and they have to make use of aids to build up reserves when ever it warrants.

b). Managing scaled-up will requires effective coordination between different parts of Governments especially central banks and finance markets. Here we have to appreciate how often the policy makers over come their challenge in determining appropriate trade-off between the exchange rate appreciation and the interest rate increases.

c). Recently a consensus has arrived on the importance of increasing the supply response to aid inflows. A strong response is felt which has called for the need to improve the productivity and higher employment a solution to mitigate Dutch Disease. Mean it is equally important that the recipient countries need to create a favourable business environment and the investment climate to attract both foreign and the domestic investment and address bottlenecks, such as underdeveloped infrastructure and agriculture. Thus, they must strike a balance between aid resources on social and productive sectors.

Since the open trade regime can enhance both domestic competition and alleviate the exchange rate pressures stemming from an increased aid emphasis has to be on the importance of strengthening institutions and governance to mange scaled-up aid and improve the investment climate for the private sector. To use aid effectively, countries need to strengthen government's capacity to manage aid flows and the private sector's capacity to operate in an open, competitive environment. In this regard aid recipients should also need to plan to depend less on aid over time. Therefore they have to increase their revenue before aid tapers off by broadening the tax base and eliminating exemptions rather than by raising tax rates. If it is done, the scaling -up scenarios would help countries and donors identify key issues and help countries adopt policies to absorb higher aid flows in future.

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