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Jagdish Bhagwati on Foreign Aid*

By

Sajal Lahiri

Department of Economics
Southern Illinois University Carbondale
Carbondale, Il. 62901-4515, U.S.A.

(E-mail: lahiri@siu.edu)

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1 Introduction

The analysis of foreign aid is fraught with controversies and paradoxes. This applies to both the theoretical and the empirical literature. There are two broad strands in the literature. First, in international trade theory, researchers have examined the welfare effects of foreign aid and, in particular, if aid can be donor-enriching and recipient-immiserizing – the so-called Transfer Paradox (TP) (See Bhagwati *et al.* (1984) for an early survey of this literature).[1] The main mechanism here is via changes in the international terms of trade. The primary benefit (loss) to the recipient (donor) can be offset by a secondary loss (gain) because of a deterioration (improvement) in the international terms of trade.[2]

The second strand in the literature comes from development economics, and the issue here is the effectiveness, or the lack of it, of foreign aid via mechanisms such as domestic savings and investment, foreign exchange, absorptive capacities, corruption, etc. (see Bhagwati and Eckaus (1970) for a collection classic articles on the subject, and Cassen (1988) for an extensive survey of the literature).[3] Some of the important questions asked in this strand of the literature are:

- What is foreign aid?
- What are the magnitudes of foreign aid?
- Why is aid often so ineffective?
- What factors determine the volume and the allocation of aid?
- Is the burden of development assistance shared fairly by the donor community?

In both strands of the literature Jagdish Bhagwati has made highly original and extremely important contributions. In the following sections, I shall describe some of these contributions and also note how my own work on foreign aid has been influenced by his

[1] Perhaps, this paradox had its inception in a debate between John Maynard Keynes and Bertil Ohlin in 1929 on the possibility of paradoxical effects of German reparations (see Keynes (1929) and Ohlin (1929)).

[2] There are studies that examine the effect of a transfer on inter-temporal terms of trade. See, for example, Djajić *et al.* (1998, 2004).

[3] Djajić *et al.* (1999) develops a theoretical model which incorporates important mechanisms from both strands of the literature, *viz.*, international terms-of-trade effect and savings and investment effects.

writings.

2 The Transfer Paradox

About seventy years ago, Leontief (1936) showed that in a two-country model of international trade with no distortions, *untied* foreign aid can be donor-enriching and recipient-immiserizing. Subsequently, Samuelson (1947) proved that Leontief's result is not possible if the world markets for goods are Walrasian stable. The issue looked settled and nothing much was written on the welfare analysis of foreign aid during the next thirty years or so. However, a classic paper by Bhagwati appeared in 1958 in which he showed that a costless technological progress in a distorted economy can be immisererizing (see Bhagwati (1958)).[4] The intuition is that the primary gain from growth can be outweighed by a loss from the accentuation of the distortion that growth may entail. A question then some started asking if TP is possible in a distorted economy. The literature then moved in a number of directions.

First, in the traditional two-good, two-country framework, Hatta (1973a) and Diamond (1978) showed that in an *exogenously* price-distorted world, TP is indeed possible under Walrasian stability. Bhagwati *et al.* (1985) then had the last word so far by making very important contributions. First of all, in a two-country model with different types of exogenous price distortion, they derived *necessary* conditions under which TP is possible. The necessary condition turns out to be that one of the goods is inferior. Thus, they showed that when all goods are normal TP is not possible even in a price-distorted, Walrasian-stable economy. This important paper did not end there; it then went on to consider the very realistic case where foreign aid introduces distortion endogenously. In doing so they built upon another one of Bhagwati's original contributions on political economy of policy making, *viz.*, a class of Directly Unproductive Profit-seeking (DUP) activities (see Bhagwati (1982)). In this case, TP is possible even when all good are normal. In a recent contribution, Lahiri and Raimondos–Møller (2004) introduced lobbying-induced inefficiency in the recipient country

[4]This seminal paper which will celebrate its 50th anniversary in few years' time was first written when Bhagwati was in his early twenties and an undergraduate student at the University of Cambridge.

in the political-economic framework *a la* Dixit *et al.* (1997) and examined how the donor country can act strategically by its commitment strategy and by its choice of the level of aid to reduce the inefficiency.

Second, once again within the two-country framework, Brecher and Bhagwati (1982) examined the welfare effects of *tied aid*. This paper is novel for at least two reasons. First, it is the first paper to analyze the implications of tied aid theoretically. Second, the particular way of modeling tied aid allowed them to consider a distortion that is endogenous. In particular, they consider, *inter alia*, aid that can be tied to increased imports from the donor. Many including myself have been motivated by this contribution to further analyze the welfare effects of tied aid. For example, Lahiri and Raimondos–Møller (1995, 1997) examines the case where aid is tied to *reducing* trade distortions in the recipient country. We show that in this case aid can be strictly Pareto-improving. Lahiri *et al.* (2002) show that when the donor can tie aid to a reduction in the recipient's tariff, the optimal aid level is always positive and the world can always achieve a Pareto-efficient equilibrium.[5]

Finally, a number of authors have examined the welfare effect of aid in the presence of what Bhagwati (1971) called a 'foreign' distortion, *viz.*, the presence of a third country which trades with the two countries, but does not take part in transfers. Gale (1974) showed the possibility of Transfer Paradox in a stable exchange economy. Brecher and Bhagwati (1981) was the first to consider the issue in a trade-theoretic framework with explicit production decisions. In their model, the recipient country is sub-divided into 'national' and 'foreign' owners of factors, and immiserization of the owners of national factors are possible with a transfer.[6] Bhagwati *et al.* (1983) consider an explicit three-country model with endogenous production and consumption. In this general framework, they show the possibility of TP. But, the most important contribution of this paper is to integrate this three-country TP literature with another literature with Bhagwati himself developed earlier, *viz.*, the general-

[5] The optimal level of aid is typically zero in the the type of trade models that we are discussing here. Lahiri and Raimondos–Møller (1998) obtain non-zero optimal aid by modeling altruism on the part of the donor.

[6] Dixit (1983) and Yano (1983) are two other contributions in this area.

ized theory of distortion and welfare (see Bhagwati (1968, 1971)). They showed that if the donor country and the recipient country impose uniformly an optimal tariff against the third country, then TP cannot occur. This has been so far the last word in this literature.[7,8]

3 Development Assistance

There are numerous conceptual, methodological and empirical issues that make applied work on foreign aid extremely difficult. What is foreign aid? Should figures on foreign aid provided by the OECD and other international institutions be taken at their face value? How much aid should be provided by rich countries to poor countries? Should it be supply determined such as the 0.7%-of-GDP rule or should it be demand determenined based on the *needs* of poor countries? What are real costs of aid to donor countries? What are the real worth of aid to recipients? How is the burden of foreign aid distributed among donor countries? How is aid distributed among recipients? These are some of the important questions that one must have answers to before embarking on practical and effective aid policies. Jagdish Bhagwati made a number of very important contributions in finding answers to the above and many more questions (see Bhagwati (1967, 1970, 1972)). These studies have had a profound effect on the second strand of the literature on foreign aid mentioned in the introduction.

The repository of official information on aid is the Development Assistance Committee (DAC) of the OECD. DAC has two lists of countries. Members of list I are grouped into least developed countries (LLDCs), other low income countries (other LICs), low middle income countries (LMICs), upper middle income countries (UMICs) and high income countries (HICs). List II consists of countries who are in transition or reasonably advanced in the development process. These lists and classifications are updated on a regular basis.

[7] Apart from welfare analysis, the effect of foreign aid on other variables have also been analyzed in the trade-theoretic literature. For example, Gaytan-Fregoso and Lahiri (2000) examine the effect of aid on illegal immigration and Becsi and Lahiri (2005) analyze the role of aid in conflict resolution in a three-country trade model with border conflict between the two recipient countries.

[8] A three-country framework in a somewhat different form has been used to analyze issues related to the allocation of foreign aid among recipient countries. For example, Lahiri and Raimondos–Møller (1996) develop a one-donor, two-recipient model and show that competition among recipients for foreign aid can lead to a less restricted trade-policy regime in recipient countries. Lahiri and Raimondos–Møller (2000) analyze lobbying by ethnic groups in a donor country and its effect on the allocation of foreign aid.

Aid given to members on list I is called official development assistance (ODA) and that to members of list II official aid (OA). ODA is further classified into bilateral (given directly by a donor country) and multilateral (given to international institutions like the World Bank for distribution). In most studies on aid, it is bilateral ODA that is examined. For aid to qualify as ODA, it has to satisfy three criteria:[9] (i) it has to be undertaken by official agencies; (ii) it has to have the promotion of economic development as the main objective; and (iii) it has to have a grant element of 25% or more.[10] There are two main points to be noted. First, private aid given via voluntary agencies like the OXFAM are not counted as ODA.[11] Second, military aid is also not part of ODA.

The above definitions point to the fact that foreign aid consists of a number heterogeneous components. To start with, it consists of soft loan with varying degrees of softness and outright grant. Furthermore, aid can be tied by source (which restrict a recipient country's choice of import source) and by end-use (imposition of commodities or projects). Tying by source, in turn, can take various forms (i) formal restrictions, (ii) informal restrictions, (iii) indirect restrictions, (iv) export and import credits, and (v) direct aid in the form of goods and service. There is also the question of verifiability of the restrictions, and the degree of fungibility can vary significantly from one type of tied aid to another. For all these and many other reasons discussed extensively in Bhagwati (1967, 197, 1972), 'it is meaningless to add together, in dollar values,' various components of aid (Bhagwati (1972, p. 78)). The 'cost' to a donor and 'worth' to a recipient can be very different from their nominal values, and the difference between 'nominal' and 'adjusted' values can vary between different components of aid. Finally, there are many conceptual and methodological issues that need sorting before adjustments are made.

In the three substantial studies mentioned in this section, Jagdish Bhagwati not only

[9] see Cassen (1986) and OECD (1999).

[10] More often than not, aid is simply a softer loan, rather than an outright grant. According to OECD convention, if the interest charged is more than 10%, the grant element is taken to be 0%, and the grant element is 100% for outright grants.

[11] Official transfers are about 90% of total transfer.

developed methodologies to address the issues properly and logically, he reestimated the nominal aid flows using his methodologies after going meticulously through a massive data set. His results showed the fruitfulness of the work: the cost of aid, for example, is overestimated in the nominal figures to the tune of 30-40%! These methodological studies by Jagdish Bhagwati, as mentioned before, have had a profound and lasting effect on research on development aid.

4 How to Make Aid More Effective

On the question of how much aid is required, Jagdish Bhagwati, as mentioned above, distinguished between supply-determined and demand-determined aid requirements. In a recent op-ed he made a very interesting point that the question of aid requirement is very much related to the mode of delivering aid (Bhagwati (2005)), and he strongly advocated a complete rethink of the way development assistance is provided. One of the reasons why a serious rethink is necessary is the low 'absorptive capacity' in many of the desperately poor countries, an idea on which he has written at length in his 1972 article. Low absorptive capacity is not simply a matter of bad governance or lack of democracy. He wrote: 'Purely from a physical point of view, there is no reason why we cannot contemplate significantly increased flow of capital and technical assistance ... which would build overheads and factories, enable the transformation of agriculture via irrigation, new seeds and fertilizers... It is of course true that the rate at which *aid flows can be accelerated* will be constrained by ... the rate at which technical training can be imparted to residents in LDCs ...' (emphasis added) (Bhagwati (1972, p. 163)). Back in 1972 he had thus very specific suggestions on how absorptive capacity can be improved. In his 2005 article, he talks about ' the development of vaccines and cures yellow fever, malaria and other diseases. ... Innovative research for African crops could be financed on a ample scale, with the same result as the Normal Borlaug-inspired Green Revolution ... in the 1960s.' (Bhagwati (2005)). His idea of aid flow being accelerated as absorptive capacity improves is very different from recent advocacy by important aid enthusiasts like the British Prime Minster Tony Blair of sudden and sharp increase in aid flows to a number of Sub-Saharan countries.

He is skeptical of the current efforts as they have no plans for a serious rethink on the modality. In fact, Mr. Blair's African Commission (with Sir Bob Geldoff as a member) proposes funds to be spent in Africa with a conditionality of good governance. More and more aid of the same type as before could actually increase corruption in recipient countries as theoretical studies by Bhagwati *et al.* (1985) and Lahiri and Raimondos–Møller (2004) have shown. Jagdish Bhagwati makes the important distinction between funds spent *in* Africa and that spend *for* Africa. While the problem of absorptive capacity put a ceiling on what can be spent in Africa, according to him, the ability to spend money outside for Africa is far greater. Research on disease control and high quality crops mentioned above are some of the examples he provides for money spent for Africa but outside Africa. If the idea is to spend development assistance funds in Africa, he believes that the supply-determined target of 0.7% of GDP which the aid enthusiasts want is overambitious. If there is a rethink on the mode of delivering development assistance and the idea is to to spend aid funds outside Africa but for Africa, he thinks the target of 0.7% of GDP is not ambitious enought; he wants the target to be raised to 1% of GDP.

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