Why Development Aid? *

It has become common practice for both bilateral donors and multilateral aid agencies to make loans to developing countries below the commercial rate of interest. One obvious reason for this is the competition for exports, which can lead to subsidized credits in the hope that export sales of manufactured products or sales of surplus agricultural commodities are thereby promoted. Such concessional loans which more than compensate for the subsidy element by raising the returns on other transactions (or preventing those returns from falling) are not discussed here. The boundaries become a bit blurred when subsidized loans are given for infrastructure that makes private foreign investment more profitable, or loans to promote benefits from trade in the long-term. But, in principle, under discussion are loans without any clear *commercial qui pro quo*.

At first sight, this appears to be a new departure in international relations. Concessionary terms did not exist before the last World War.. But if account is taken of the much greater prevalence of default in pre-War days, the *ex-post* rate of return, on the average, on loans extended to the then developing countries, was probably quite low, and not so very different from the *ex-ante* terms in an age when default is hardly ever permitted. In this light, concessionary aid without default might be regarded as a substitute for higher rates combined with the risk of default or the costs of gun boat diplomacy. The Paris Club has replaced a cruder kind of club-wielding.

Since pure grants had, of course, been known for a long time, and had been given by voluntary agencies such churches, usually in the form of the services of teachers and doctors, the question may be asked why the principle of the pure grant has not been extended to inter-governmental and international agency transactions. Any concessionary loan has a grant element, which can be calculated as the present value of

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aid disbursements minus the present value of repayments (amortization and interest), discounted at an appropriate rate of interest reflecting the domestic opportunity cost of capital. It would, therefore, be theoretically possible to convert the grant element of a loan into a pure grant, and to let the borrower go to the commercial capital market and subsidize his borrowing there with the grant. In practice this is not done because capital markets are not perfect. The borrower would not be able to raise the loan on commercial terms and then subsidize it with the lump-sum grant. Additional reasons for the preference for a loan over a lump-sum grant may be the desire of the donor to impose the discipline of a loan agreement, and of the recipient to avoid the impression of charity.

There are five sets of arguments for extending loans or credits on concessional terms to low-income countries. First, there are arguments on distributional grounds; second, there are arguments on general cost/benefit grounds; third, there are arguments on grounds of constraints on servicing debts at fully commercial rates; fourth, there are arguments on grounds of time and maturity; and fifth, there are arguments for buying non-commercial advantages by the concessionary element.

The distributional arguments can be justified on a variety of philosophical grounds. Perhaps the most common one is the utilitarian argument that a dollar redistributed from a rich man to a poor man detracts less utility than it adds, and therefore increases the sum total of utility. Even if it were accepted that the sum total of world utility is a meaningful concept, the argument would require further elaboration, for development aid is not aid from rich individuals in rich countries to poor individuals in poor countries, but intergovernmental aid or aid from an agency to a government. It would therefore have to be insured (a) that the aid reaches the poor in the poor countries and (b) that in the absence of tax-financed aid, the tax relief would benefit the poor in the rich countries. If condition (b) is not fulfilled, some redistribution would be justified even if it did not reach the poorest people in the low-income countries.

It is also possible to justify concessional aid on Rawlsian grounds, i.e. the relief of the poorest people in the world community. Such grounds are perhaps more appealing than utilitarian arguments, partly because the relief of absolute poverty is a more widely accepted objective than abstract utilitarianism, and partly because it would justify enriching some rich individuals — almost inevitably the result of aid — if this were a condition for improving the fate of the poorest.

It might also be possible to call upon entitlement theories (in contrast to end-result theories). The justification of the transfer could be regarded as compensation for the violation of rights, such as excluding poor people from entry into the rich countries. Or we might consider concessionary loans as compensation for capital flight or for erecting barriers to imports. Some creditor countries might prefer to give concessionary loans rather than open their markets for the servicing of commercial debt. Or we might regard aid as a compensation for the unequal distribution of the world's natural resources among states, to which all mankind may be thought to have an equal right of access.

But the entitlement arguments would point to a distribution towards countries from which most people or goods are excluded. We do not observe this in the actual country distribution of concessionary loans. Since such aid is normally given to low income countries, it is more consistent with utilitarian or Rawlsian arguments than with entitlement arguments, although two propositions would have to be established. First, that the obligation of the rich to assist the poor applies to the world community, and second, that the governments see to it that the redistribution is in fact one from rich to poor individuals or at least families.

Arguments could be made on the ground of the interdependence of utility functions, though again they might lead to a very different distribution of aid from the one we observe. Interdependence of utility functions is likely to be stronger with professionals across national boundaries, say professors or doctors or airline pilots, and would lead to aid that would aggravate the inequality of income distribution by making the professional reference groups better off.

The removal of some forms of deprivation, such as starvation of children or disease, may be regarded as in the nature of public goods. Even non-egalitarians and non-utilitarians may wish malnutrition of children to be removed. Aid for basic needs has therefore a stronger public appeal than greater international equality.

The second set of arguments compares costs and benefits to both borrower and lender. Even a pure grant is not costless to the borrower. If it is for a project, proposals have to be prepared, projects designed, feasibility studies conducted, project appraisal carried out. The aid-financed project may inflict maintenance and recurrent costs on the recipient, diverting resources from other uses. There is therefore some trade-off between the terms of project aid, confined to capital expenditure, and programme aid in the form of pure foreign exchange. For the

same amount, harder terms may be appropriate for the latter than for the former.

Another line of the cost-benefit argument would be to show that at a small cost to the donor a great benefit can be bestowed on the recipient. This would be the case if substantial externalities and multiplier effects were to spring from the aid-financed project, or if the aid given takes the form of deliveries from industries or firms in which excess capacity is above the average in the economy as a whole and therefore imposes small burden on the donor. An analogy would be the provision of a link in a bicycle chain to someone needing desperately a bicycle. Without the link, the bicycle does not run. The benefit is vast. But the link imposes only a very small sacrifice upon the donor. It may even be beneficial to the donor, by stimulating domestic activity. Somewhere between to low (or negative) cost to the donor and the high benefit to the recipient lies the appropriate interest rate. But this type of argument presupposes some moral principle of distributive justice. For otherwise, however low the cost to the donor, there is no reason why he should not maximize rents on his resources.

The third set of arguments relates to differences in servicing domestic loans and international loans. Critics of concessionary aid have argued that international loans should be made only on commercial terms. If the rate of return on borrowed money exceeds to commercial interest rate, the project should be carried out and will pay the interest; if not, it should not be carried out. The interest rate also imposes the discipline that is needed in project selection. It creates the correct incentives and signals in economizing in the use of capital. Concessionary aid will encourage wasteful use of the capital, and foreign exchange, underutilisation of capital, and excessively capital-intensive techniques and higher unemployment. The Bank has argued strongly for cost recovery. Why not apply the same doctrine to its own transactions?

To this, there are four replies. First, many projects are in fact subjected to the discipline of interest rates. This is the case whenever IDA money is given to development banks or other credit institutions in developing countries, which then on-lend it at commercial rates to domestic borrowers. It is only at the inter-governmental or inter-institutional level that the discipline is removed. But, second, it is extremely unlikely that the obligation to pay commercial interest would make a difference to borrowers, especially governments, in deciding on the use of the money. This is particularly since, third, as will be seen when the fifth set of arguments is discussed, soft loans give the donor the right to exercise leverage over the use of the money, so that it is likely to be used *more* efficiently than hard loans.

Fourth, somewhat different considerations apply to IDA lending from those that would apply to domestic lending. First, a project may not itself yield a commercial return but it may give rise to higher returns in other lines of activity. For example, an agricultural nucleus estate that processes and markets the produce of smallholders and that provides extension services and credit to them, may raise the incomes of many poor farmers, without itself being able to recoup fully commercial returns. What economists call "externalities" may be important. On the other hand, while loans and credits normally supplement investment and other development resources and contribute to accelerated capital formation and growth, this growth may, in some conditions, be less than the effective cost of the loan if allowance is made for tying by bilateral donors, for the costs of project preparation, for repayment in convertible currencies specified by the lender, the value of which may have risen, and for the secondary effects of servicing the loan on the terms of trade.

Secondly, where the service payments on the loan have to be collected by the government, the fiscal capacity in many developing countries may be inadequate for raising the revenue. In addition to the project hurdle and the fiscal hurdle, there is, thirdly, the foreign exchange hurdle. The loan service has to be conducted across the foreign exchanges, in freely convertible currency, whereas the IDA credit is tied to specific projects. To overcome this hurdle, it is necessary not only that the project be viable, but also that enough exports are generated, or imports are saved, to yield the foreign exchange for the debt service. This so-called "transfer burden" of the debt service, fully discussed in the context of post World War I reparations, may be (theoretically) positive or negative, depending, among other things, upon the trade policies pursued by the remitting and receiving countries. To give only one illustration of a negative burden, if the borrower pays interest and principal by raising the prices of his export commodities in the face of an inelastic foreign demand, he will be able to purchase the same volume of foreign exchange for fewer exports. But normally the burden will be positive and can be substantial. For development consists in bringing about structural changes in the economy, which usually require foreign exchange outlays without simultaneously generating enough foreign exchange to pay for these requirements.

The secondary transfer burden depends on a whole range of macroeconomic policies with respect to export incentives, exchange rates, tariffs, etc., as well as on factors entirely outside the control of the borrowing country, such as the level of protection and trade policies in the creditor countries.

It might also be argued that any given interest rate burden is substantially heavier for an international debt than for a domestic private debt. For domestic interest payments can be deducted from taxable income before tax assessment, but not international interest payments. If it were replied that absence of relief from an absent burden is not itself a burden, it should be borne in mind that (a) tax payers receive benefits from the taxes they pay and (b) domestic income taxes are often passed on to the buyer of the oligopolistic firm's products, when administered pricing prevails. A full analysis of this line of argument would have to compare the incidence of a commercial loan with a tax on the domestic borrower in the donor country with the incidence of the loan on the recipient foreign government.

The fourth set of arguments derives from the fact that development is a long, slow process, in which poor countries with large populations, low productivity as a result of low level of education and skills and weak or absent physical infrastructure have to prepare the "runway" for future "take-off". Benefits often accrue only in the distant future. It might be said that this does not constitute an argument for soft loans, but for longer maturities, and the stretching out of interest payment, without any relief. For time has its costs, and unless the projects can eventually pay compound postponed interest, they should not have been undertaken. But such stretching of maturities enormously reduces the resources transferred and carries with it risks. Soft terms will speed up the development process, graduation will occur sooner, and donors will have to furnish less total aid in order to achieve development objectives than if terms had been harder. If the terms were not soft, we would see either a still poor country transferring resources to richer countries, or, as is in the nature of compound interest, a rapidly mounting debt burden mortgaging the future. If the donor's objective is maximum development impact, combined with the desire to wind up aid, soft terms are the appropriate instrument.

The situation is aggravated when aid is given for projects. Gross aid has to exceed net aid (i.e. aid after the deduction of repayment and interest) for a positive transfer of foreign exchange to occur. In low income countries project aid may run into limits of absorptive capacity.

When these limits are reached, we would be faced with a situation in which a poor recipient country has to transfer resources to rich countries (or, perhaps, choose to default). To avoid this, soft terms may be adopted.

The fifth set of argument states that the grant component is intended to buy benefits other than commercial returns. Bilateral donors may attempt to buy friends or votes in the UN, or democracy, or peace, or stability or strategic advantages. The lines between these advantages and commercial advantages become blurred if the purpose of concessionary aid is to provide the infrastructure and political conditions for trade and private foreign investment from the donor country to flourish. It can be argued that soft loans are more likely to be used efficiently than hard loans, reversing the arguments of those who say that soft loans weaken the incentive to make good use. The greater the grant element, the greater the right of the donor to exercise control. The objective of efficient use of funds is therefore an argument for soft loans. The notion that the donor "buys" efficient economic development with the grant element in the loan is suspect for governmental donors, because they may smuggle political or commercial or strategic interests into the bargain. Only an international agency such as IDA can conduct such a bargain without acrimony. A difficulty with this argument is that, since the private international capital market is not perfect, even commercial banks can impose conditions on their loans. The implication that there is a concessionary element even in commercial loans is probably correct. But the degree of conditionality can clearly be greater, the greater the concessionary element.

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