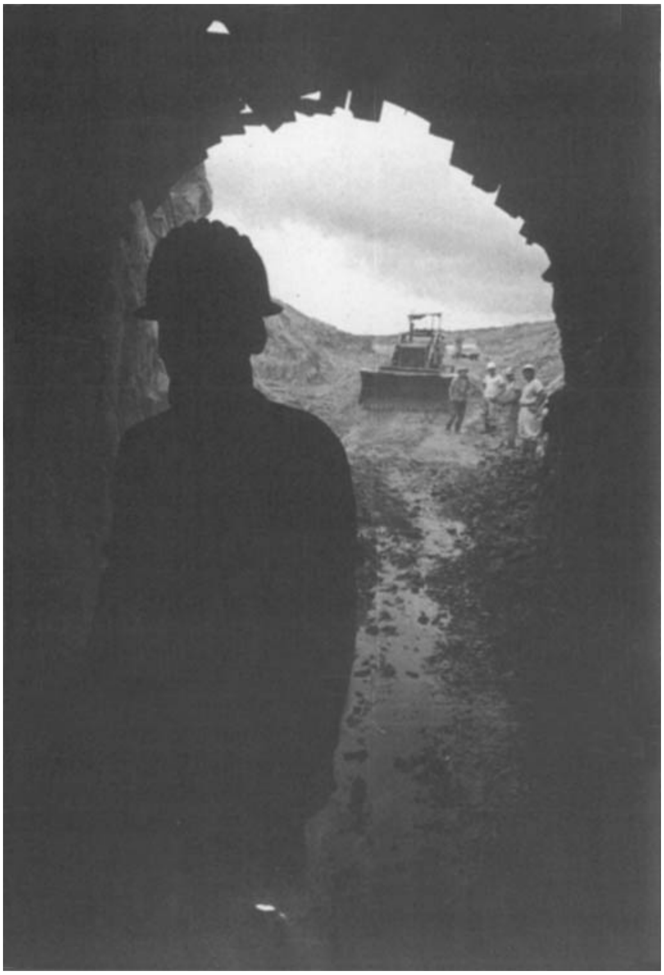
Gains to Donor Countries from Tied Aid

It is well known that aid that is tied to the exports of a particular country is apt to be expensive to the recipient. The economic effects of tied aid on the donor country are less frequently discussed.

Bimal Jalan

ECONOMISTS are not particularly noted for unanimity, but if there is one thing that they all seem to agree on it is that aid that is tied to the exports of the donor countries is more expensive to the developing countries than aid that is not. Estimates of cost difference between tied and untied aid of course vary, but it is generally agreed that the developing countries stand to gain by at least 10 to 15 per cent in aid volume if all the aid that is tied were to be untied, and thus open to international competitive bidding. For individual projects, the tied aid may be twice as costly to the recipient as untied aid.

The reason for the higher cost of tied aid in a number of instances is very simply that the projects or programs for which individual countries provide aid are not necessarily the ones in which they are internationally competitive. For example, country A may be the world leader in electronics and the cheapest producer of electronic equipment, but it may provide aid for the import of steel cables or locomotives, which it may not be able to provide as cheaply. If the recipient country has to import locomotives from country A, then naturally it would have to pay a higher price than if it were free to import from the cheapest source, say, country B. Tied aid becomes even more expensive for the recipient when country B provides tied aid for the import of electronics equipment and country A for the import of locomotives.



A hydroelectric project: electric power equipment is a common type of tied aid.

Why then do the donors tie their aid to their own exports? The primary reason is the desire to avoid the balance of payments impact of the aid transfer—country A ties its aid because if it did not, a part or all of its aid might be used to finance imports from third countries, leading to a deterioration in its balance of payments. The worse a country's over-all balance of payments situation the greater is the desire to avoid the balance of payments consequences of aid transfer.

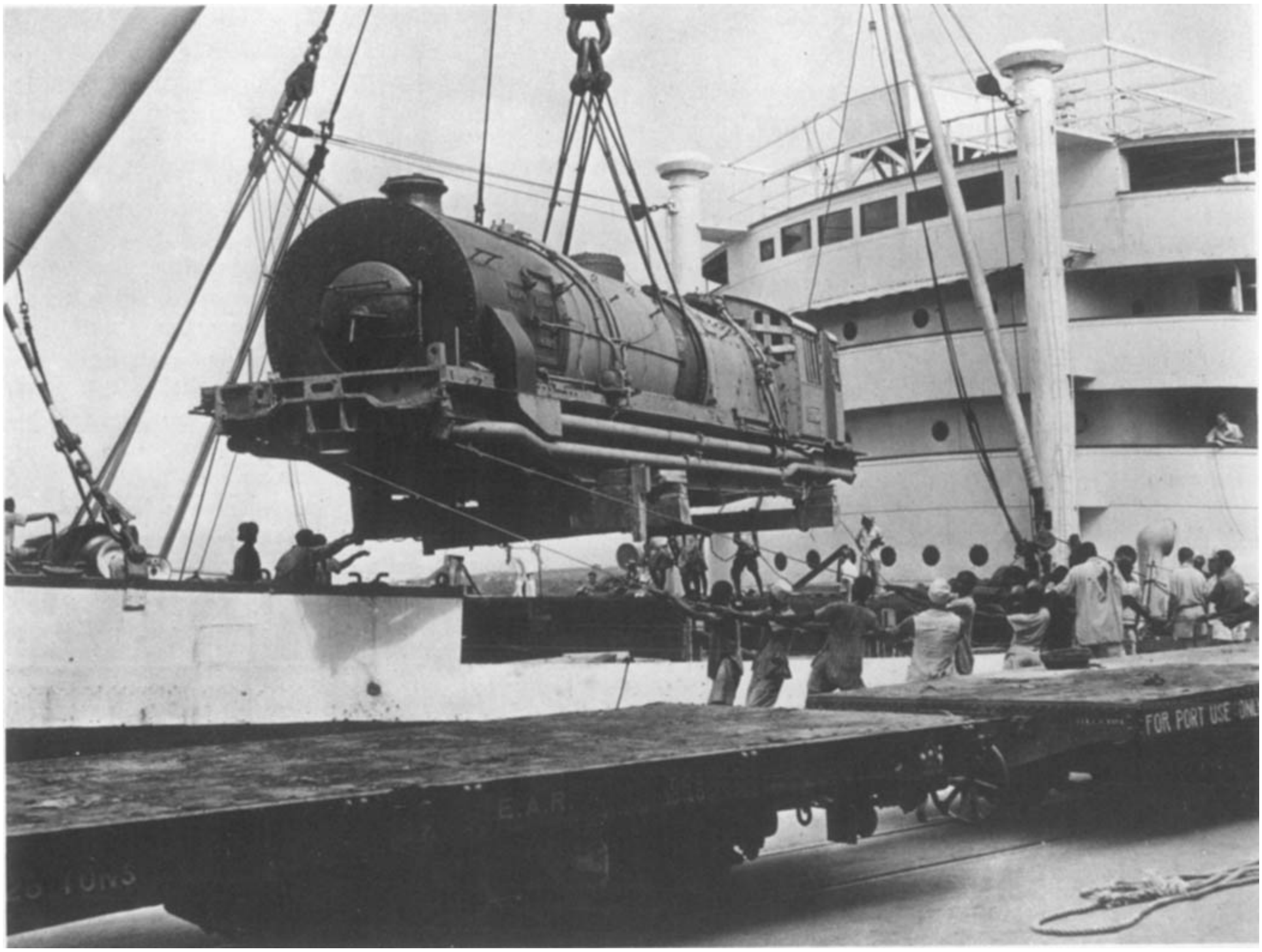
However, the practice of aid-tying is by no means confined to donor countries with balance of payments deficits. In fact, aid-tying has now become a normal feature of the aid program of almost all donor countries, irrespective of whether they are in surplus or deficit. This is so much so that untied aid is now the exception, and one estimate is that more than three fourths of all official bilateral assistance from developed countries is subject to restrictions in one form or another on the source of procurement. Apart from the anxiety to safeguard the balance of payments from the effects of aid, a number of other reasons have contributed to the increasing use of the practice of tying aid—among them are the pressure of domestic industrial and commercial interests for export markets and the desire of donors to be associated with specific projects that can be clearly identified with them. Manufacturers in donor countries prefer tied aid because, as with government procurement limited to national supplies, they may be able to quote higher prices. An equally dominant element in the tying of aid has been competitive—if country A ties its aid that benefits its exporters at the expense of others, why not country B?

An aid transfer is a transfer of real income and real resources for the use of others, and it is interesting to examine what effects tied aid, as contrasted with untied aid, has on the economy of the donor countries. These effects may be discussed under two heads—effects on domestic economy and effects on balance of payments. For simplicity it may also be assumed that tied aid leads to a higher level of exports than untied aid, and that the amount of aid provided remains the same whether aid is tied or untied. Given various motivations for aid-tying on the part of donor countries, it is quite possible that a donor country would be willing to provide a higher volume of tied aid than of untied aid.

Effects on Domestic Economy

It is easy to see that for any one country an increase in exports, insofar as it leads to an increase in aggregate demand, is equivalent to an increase in domestic investment, and should normally lead to an increase in employment in export industries. The expansion of employment also means an increase in the income of people engaged in producing export commodities, and insofar as this additional income is spent on domestically produced goods, it leads to a further secondary increase in employment. It follows, therefore, that, given the level of domestic investment, a donor country with unemployed resources would be better off with more exports than less, and as a logical corollary, with tied aid than with untied aid.

However, it is only in a very few donor countries that unemployment is a serious problem today—in fact only two or three industrialized countries have had rates of unemployment exceeding 4 per cent in recent years. Many industrial countries, on the other hand, are going through a period of full employment of their resources or even overemployment in the sense that there are more jobs than there are people to fill them. Under these circumstances, if aid is tied it would result in a higher level of exports, and, unless domestic investment or consumption can be reduced and imports and capital outflow be encouraged, it is likely to lead to inflationary price increases. Competition between export and domestic industries would lead to a rise in wages and prices without any corresponding gain in real income. If, however, aid is untied, at least some of its impact would be absorbed by a decrease or slower growth in reserves—in the extreme case when procure-



"There are a number of factors which complicate the arithmetic of balance of payments gain from tied aid."

ment outside the donor country is 100 per cent of the aid given, aid is reflected in a loss of reserves and nothing else.

It should be emphasized that the expansionary effect of tied or untied aid on a country's domestic economy would depend on whether there is a net increase in the total demand resulting from an increase in exports. If tied aid is financed in such a way that it leads to an equivalent decrease in domestic investment or consumption, there is no net expansionary effect and it does not matter whether a country has full employment or underemployment. A fully employed country, that wishes to tie its aid can avoid the inflationary consequences of tied aid by financing such aid out of the proceeds of a tax which decreases domestic consumption or investment by an equivalent amount. However, in the short run, where resources are not fully mobile between domestic and export industries, tied aid may still result in some inflationary pressure.

Needless to say that for the donors as a group, so far as resource diversion is concerned, it will not matter whether aid is tied or untied, since in ether case they have to divert enough resources from their domestic investment or domestic consumption to provide additional exports to the developing countries, unless of course there is sufficient unused capacity in the export industries and/or a part of the aid-financed procurement is from within the developing countries themselves. However, even for donors as a group in full-employment conditions, untied aid has an advantage over tied aid in that such aid makes a greater use of the equilibratory forces of international trade. Even when all economies may be said to be fully employed, they are in reality only more or less so relative to each other. Countries which have less pressure on their resources are also the ones which are likely to have lower prices. When developing countries use their multilateral funds to buy goods in the cheapest markets, they tend to place their orders in countries with lower prices or in countries that have some unused capacity. Untied aid thus introduces a mechanism for allocating the required level of export demand resulting from aid according to the degree of full employment in these countries. Tied aid, on the other hand, tends to divert resources from each donor country without regard to the relative pressure on its domestic resources.

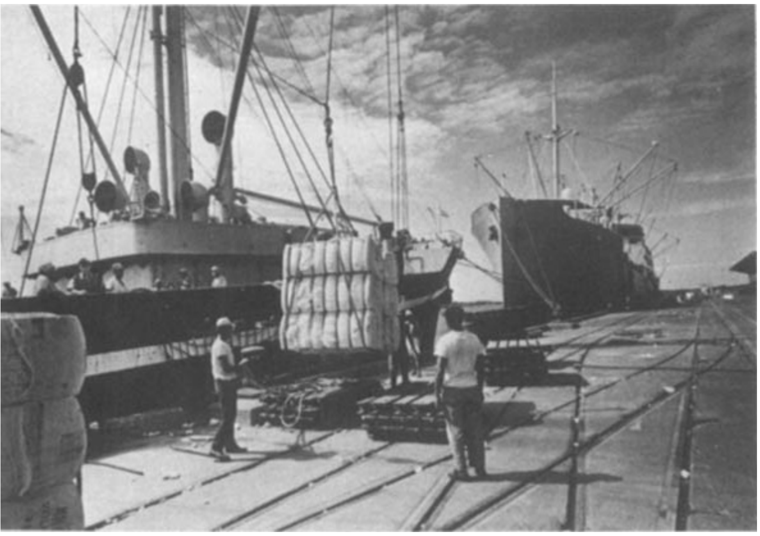
Effects on Balance of Payments

Tied aid, by definition, represents an equivalent amount of exports, and at first sight, it would seem that the balance of payments gain from tying of aid would be equal to the value of aid. This, however, is not necessarily so. The balance of payments gain from tying of aid is much less than the face value of aid, because even if aid were untied and open to international bidding, it is likely that the particular donor country would have won at least a few orders. The true balance of payments gain to the donor country is, therefore, the difference between the value of tied aid (or exports resulting from tied aid) and exports attributable to an equivalent amount of untied aid. The extent of the balance of payments gain on account of tied aid is thus likely to vary widely among donor countries depending on the international competitiveness of their exports.

Nor is this all. There are a number of other factors which further complicate the arithmetic of balance of payments gain from tied aid. First, there is the possibility that additional exports resulting from tying of aid may only be substituting for the commercial exports of the donor country. Outside of aid, there also exists a normal trading relationship between industrial countries and the developing countries—in fact most of the normal imports of the latter come from the more developed countries—so that what may happen is that the recipient country may merely switch some of its normal imports to the tied-aid account. For example, suppose that a less developed country imports $100 million worth of goods out of its own export earnings from the donor country A. Country A then decides to provide it with another $50 million of tied aid. It is clear that the balance of payments gain to country A from tying of aid would be reduced to the extent that the recipient country is successful in switching part of its normal import requirement of $100 million to the aid account. Thus, in the new situation, it may, for example, import (from country A) only $75 million worth of goods out of its own export earnings (rather than $100 million, as previously) and shift the remaining $25 million to the tied-aid account. The total balance of payments gain to the donor under these circumstances is only $25 million, rather than the face value of tied aid, which is $50 million. In fact it is not inconceivable that, compared with the situation when aid is untied, there would be a net loss to the balance of payments of the donor country. This will happen if one can assume that under untied aid the donor country would have won more than $25 million of export orders. In the latter case, the total exports of the donor country would have amounted to more than $125 million (including $100 million of normal imports). The success of the recipient country in switching would, of course, vary from country to country depending on the extent and composition of a country's commercial trade with the donor country, as well as whether tied aid is for the financing of a specific project or for the financing of a general development program. A recipient country is likely to have greater success in switching its export-financed import requirements to aid account when aid is for general development purposes (i.e., program aid) than when aid is tied to imports of specified items for a specific project. The desire to prevent the possibility of "switching" has led to the adoption of rather complicated procurement procedures by donor countries which are designed to ensure that exports under tied aid are in fact additional to the recipient country's normal imports. These have not been entirely successful.

"The balance of payments gain from the tying of aid is much less than the face value of aid. . . ."

Another factor that may overstate the balance of payments gain from tied aid is the fact that even if aid were untied and spent on imports from a third country, it could have nonetheless led to an indirect demand for the donor country's exports. Increased exports of locomotives from a third country B may result in an increase in imports of country B from country A, which had provided the untied aid in the first place. Finally, there is an indirect positive effect that has to be taken into account. This is the observed tendency on the part of suppliers of equipment in donor countries to quote a higher price for tied-aid procurement than when they are bidding for orders in the open international market. To the extent that this is so, it is a positive element in the balance of payments of the donor country. In this case tied aid also transfers fewer goods than the same amount of untied aid and, therefore, puts less pressure on domestic resources.



"Countries whose share in world trade is much less than their share in total aid are likely to lose in terms of exports and balance of payments."

It is thus easy to see why it is so difficult to make an estimate of the balance of payments gain from the tying of aid. It, however, seems reasonable to assume that these gains, though positive and in some instances substantial, are likely to be much less than the face value of tied aid. Estimates that have been made indicate that, if all the secondary and indirect elements are taken into account, the balance of payments gain from tied aid may correspond to only about one third of the value of such aid.[1]

The above discussion has been concerned with the gain to each individual donor country taken separately. For the donor countries as a group, the gain from tied aid is likely to be much less—it would depend on the extent to which trade has been diverted from the developing or recipient countries as a result of tying. Since the share of the developing countries in aid-financed exports is not very large, trade diversion from them due to tying is likely to be small. With regard to donors as a group, there is another point that may be mentioned. If all the donor countries were to untie their aid simultaneously the loss to various donor countries would be vastly different—in fact some might even register a net gain. This is so because some countries generally do better in exports than others—and if all aid were to be untied, these countries are likely to get a larger share of aid-financed trade than the value of their own aid. Those countries, on the other hand, whose share in world trade is much less than their share in total aid are likely to lose in terms of exports and balance of payments.

Conclusion

What conclusions may be drawn from this brief look at the implications of tied aid for donor countries? Three, I think, may be suggested.

- Countries that are suffering from both a balance of payments deficit and a significant degree of domestic unemployment stand to gain the most from tied aid. In order to gain in terms of employment, tied aid has to be financed in such a way that it leads to an increase in aggregate demand.
- Countries with full employment and a balance of payments surplus would gain the least from tying of aid—in fact they may lose in terms of increased pressure on domestic wages and prices. These adverse effects can be avoided by (a) encouraging imports of goods and outflow of short-term and long-term capital, and (b) by reducing domestic consumption or domestic investment.
- Countries that are suffering from *either* unemployment at home *or* a balance of payments deficit are also likely to gain from tying of aid but not as much as countries which suffer from both unemployment and balance of payments deficits.

[1] See Jagdish Bhagwati, "Tying of Aid" in *Report of the United Nations Conference on Trade and Development*, Second Session, New Delhi, India (Volume IV), 1968.

Bimal Jalan, an Indian citizen, is currently with the Commission on International Development in Washington. Educated at Calcutta, Cambridge, and Oxford Universities, he has previously worked as an economist with both the Fund and the Bank. The views expressed in this article are his own and not those of the Commission.