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Research for Action

**Aid and Development  
Policy in the 1990s**

Arjun Sengupta

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(UNU/WIDER)

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**UNU World Institute for Development Economics Research (UNU/WIDER)**  
A research and training centre of the United Nations University

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## PREFACE

Aid and development policies have been the subject of a great deal of discussion in recent times. The issues relating to the transfer of resources from rich to poor countries for accelerated and sustainable development and for environmental protection received much attention during the various phases of the deliberations of the United Nations Conference on Environment and Development culminating in the general endorsement of the concept of resource transfers in the Earth Summit in Rio de Janeiro in June 1992. UNU/WIDER studies contributed to this debate in particular by indicating the resource requirements and mechanisms for a global environmental compact for sustainable development.<sup>1</sup> Likewise, the crucial role that aid and development policies have to play in the 'market friendly' adjustment programmes of the IMF adopted by nearly 90 countries has been widely noted. Their success or failure depends to a material extent on the transfer of resources to meet the financing gap associated with implementing the programmes.

The needs and requirements of developing countries for external resources for medium-term structural adjustment on market principles in conformity with the approach advocated by developed countries and for accelerated sustainable development and environmental protection over the longer-term have been well articulated and the magnitudes established. At the same time, the ability of developed countries to provide external resources to developing countries has improved with the end of the Cold War, the reduction of military expenditure and the prospect of the emergence of a substantial 'peace dividend'. It is a paradox, therefore, that when circumstances seem more favourable than ever before for resource transfers from the rich to poor countries there is a waning in practice and in operational terms of the global commitment to aid. Aid flows have stagnated for a decade despite substantial growth of real output in developed countries. Only five OECD countries have achieved the United Nations target of development assistance equivalent to 0.7 per cent of gross domestic product. Cuts in foreign aid budgets in real terms in several countries have become noticeable.

The gap between acceptance of broad principles of a partnership in development at international fora and underfunding of the external resources needs of development programmes must be bridged. There is a need to rekindle the enthusiasm once held for foreign aid based more on reciprocal commitments on the part of rich and poor countries rather than one based on a sense of altruism and charity. The new approaches might involve commitments by developing countries involving acceptable conditionalities to use foreign aid effectively with appropriate 'market friendly' policies

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<sup>1</sup> Lal Jayawardena, *A Global Environmental Compact for Sustainable Development: Resource Requirements and Mechanisms*, Research for Action Series, UNU/WIDER, Helsinki, 1991.

and reciprocal commitments on the part of developed countries to provide the necessary assurance of long-term financial support.

The following paper by Dr. Arjun Sengupta is a contribution towards the development of a framework for cooperation on aid and development policies in the 1990s. He reviews the objectives of aid and development policies and concludes that there is now more than ever before a mutuality of interests between the industrial and developing countries not least because of environmental concerns. In examining the design of aid and development policy he argues the case for conditionality and it being confined to some form of monitoring of the fulfilment of commitments of the beneficiary countries; and for reciprocal commitments on the part of industrial countries to assure assistance required for implementing reform programmes by improving market access and by providing balance of payment finance and social expenditure finance. On the institutionalization of reciprocal commitments he puts forward a variant of the proposal of 'Development Compacts' between a developing country undertaking a programme of adjustment and a group of industrial countries providing the necessary help, which has been elaborated in some detail in the work undertaken in UNU/WIDER mentioned above. Finally, Dr. Sengupta tackles the difficult issue of mobilizing resources for aid. He has put forward some thought-provoking ideas on how industrial countries could incorporate in their direct tax system a new line of tax for supporting foreign aid based on the diminishing utility of income above a certain level.

I am pleased that UNU/WIDER is able to bring the issues discussed in this paper to the attention of policymakers in both developed and developing countries.

Lal Jayawardena  
Director, UNU/WIDER  
February 1993

# I INTRODUCTION

The 1990s will be the first decade after the revolutionary upheavals in the world economic and political system following the collapse of the Soviet Union and the end of the Cold War. Democracy has spread into areas which were earlier citadels of authoritarianism. For the first time 'peace' seems to have a real chance. Nations have not only the opportunity to settle all their disputes through concord rather than conflict, but also a real possibility to build up a cooperative international order, which can extend well beyond the international political and strategic relations.

There has also been a far reaching change in the approach to economic policy after the failure of the command economies. There is now a widespread recognition that market forces should be allowed to operate freely both within and across national boundaries. Governments have realized that the regulation of prices, investment, trade or exchange or the restrictions on the movements of goods and services, or of factors of production usually result in a substantial deadweight loss in welfare, which can rarely be overcome in an actual situation by any other policy. Any gain which might accrue to sectional interests from market regulation would be only temporary and in any case could be improved upon by other policies complementing free market operations. There is also a rethinking, though not yet much of a consensus, about the role of the state in economic activities and ownership of enterprises, about central planning, policy coordination and the state's ability to foresee or to influence the evolution of the economy. Regarding the need to promote the freedom of market forces, however, there seems to be an almost universal agreement.

Most countries are now actively engaged in removing the obstacles to free market operations. The pace of their removal has, however, been affected by the relative strength of the conflicting interest groups. The battle of these interests has been mostly political, with very little economic rationalization for the respective positions. The protectionist forces in the industrial countries are openly arguing in terms of purely sectional interests. Similarly in the developing countries, which had earlier built up a whole edifice of development theory on the basis of protectionism and import substitution, resistance to trade liberalization exists, if at all, not on grounds of economic principles, but in the name of graduation and appropriate sequencing to allow the affected interest groups time to adjust to the changes.

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This paper was presented at a Workshop organized by the Forum on Debt and Development held in The Hague on 9-10 June 1992. An abridged version of the paper was published by FONDAD in November 1992 in a book titled *Fragile Finance: Rethinking the International Monetary System*, edited by Jan Joost Teunissen. The paper reflects the personal views of the author and not the position of his authorities.

As a result of this almost universal change in policy stance towards liberalization, most economies are becoming increasingly globalized. They are being integrated with each other, not only through the interdependence of trade and financial transactions, but also through expanding interlinkages of production and investment as well as marketing and technological tie-ups. This is the way most of the industrial countries recorded steady growth in the last two decades after removing the barriers to trade and competition among themselves. As more economies join the global system in the 1990s, that process of growth would only be further accelerated. For the developing countries, opening up to global competition, and getting integrated into the mainstream of the international economy, and not just operating on the periphery, would place them firmly on a sustained path of growth and development. The pre-condition for that however, would be that they adjust their economies rapidly to the requirements of globalization and that their political structures survive the realignments of sectoral interests.

It would follow from the above that, in the new world of the 1990s, the main objective of aid and development policies should be that of helping the developing countries to integrate into the global mainstream. This would imply assisting them to implement the programmes of economic reforms that they have launched, and to create a trade and investment environment for them so that their development efforts can be sustained through increased resource flows and foreign exchange earnings. At the same time, the aid and development policies will have to continue to serve their traditional objective of supporting long-term development programmes of building infrastructure and financing projects of substantial social benefit such as investment in rural development, health, nutrition, education and poverty alleviation. These would enhance the abilities of the countries to implement the reform programmes and provide safety-nets for the groups adversely affected by the changes resulting from them. In this way, the new aid and development policies would ensure that the political structures of these countries survive in the face of pressures from vulnerable interest groups affected by the reforms, and that support is generated from other groups who gain from the projects of development. In the following sections, we elaborate on these aspects of aid and development policies in the 1990s. First, we relate them to their traditional objectives. Then we spell out the implications of the new objectives for the design of those policies. Finally, we analyse the potential source of resources for the purpose of implementing these aid and development policies in the altered international economy of the 1990s.

## **II THE OBJECTIVES OF AID AND DEVELOPMENT POLICY**

The objectives of aid and development policies of OECD countries have been quite varied, depending upon their historical and contemporary commercial and political ties with specific developing countries. They have also been guided by their perception about the evolving international relations and their own role in shaping those relations. There is substantial literature on the objectives and motivations for aid to developing countries (see, for example, White, 1974, or Maizels and Nissanke, 1984, and the references cited there). In general, however, these can be summarized under three broad headings: (1) military and political considerations; (2) concerns about social justice, poverty alleviation and human development; and (3) mutuality of interests. Most of the OECD countries have channelled their assistance bilaterally as well as multilaterally, in the form of either financial assistance and technical support or trade concessions and market access. The multilateral agencies have also followed the same objectives as of bilateral donors albeit probably with more efficiency and less transparent display of self-interest.

### **1. Military and Political Considerations**

The military and political considerations were directly related to the bipolar division of the world, when the super powers were trying to build up alliances across their borders with countries in the Third World. Military allies invariably received substantial amounts of aid and development assistance. Even when the quantum of military assistance was not large, the strategic importance of a country due to geographical or commercial reasons would ensure that it received special treatment in the OECD countries' aid and development policy. This practice of alliance formation in the context of the Cold War was very similar to that of building spheres of influence by the colonial powers in the 19th and 20th centuries.

With the end of the Cold War, the motivation for military alliances may have disappeared, but the ramifications of power politics have not, and the promotion of spheres of influence with economic and commercial assistance remains an aim of development policy for many OECD countries. The special relationship that the European Community has with the 'Lome' countries is an example of nurturing a sphere of influence without any military alliance. The continuing relationship between the U.S. and Israel, involving substantial flow of assistance, is a reflection of military interests combined with historical ties of special influence. In addition to these, recently, there has also been a tendency towards forming regional economic blocs, which is motivated partly by the interests of trade and enlarged access to markets, but more so by the political considerations of alliance, ethnic affinity and prevention of a possible flow of unwanted immigrants.

So long as the political considerations of the old or new variety keep influencing the aid and development policies, it may not be possible to achieve the best distribution of aid and the optimal application of development policy, in order to serve the objectives of development and integration of the developing countries, as we have set out above. The effectiveness of aid of a given amount of dollars or of a specific policy of, say, increased market access in a particular sector offered by a donor, may be much higher in a country outside a regional bloc or a sphere of influence. The compulsions of *realpolitik*, however, may force the donor to accept a sub-optimal choice and concentrate on another country that is politically more relevant.

## **2. Social Justice and Human Development**

Concern about social justice, poverty alleviation and human development has traditionally been the most enduring and often the most important motivation of the aid and development policies of the industrial countries. This has been, in most cases, an extension of the domestic policies in these countries providing for the welfare of the poor through social security, public health and redistribution programmes. While there is now growing pressure in all these countries to streamline these programmes, to cut expenses and to let the market forces decide among a number of alternative sources for the delivery of welfare, the principle that the richer sections of the population should take on the burden of meeting a substantial part of the basic requirements of the poor has been almost universally accepted.

The motivation behind this acceptance of domestic responsibility has often been political to neutralize the threat of unrest and insurrection among the deprived community which could disrupt the equilibrium of society. There have been similar attempts to justify an international redistribution of income and programmes for narrowing the disparity in living conditions in different countries of the world, which could otherwise generate serious conflicts in the relationship between the richer North and the poorer South. During the Cold War, the fear was that the poorer countries would be exploited by the rival super powers to expand their spheres of influence and disrupt international equilibrium. After the Cold War, the possible sources of the disruption of the equilibrium, exploiting the fertile fields of conflict between the North and the South, are fundamentalism and terrorism. If that is so, then the motivation for social justice and international equity would be an extension of the political motivation mentioned earlier.

In practice, the policies of assisting the poor, whether at home or abroad, have been inspired in the industrial democracies by a sense of altruism and charity and a respect for the values of justice and equity. Pearson, in his study of the motivation of aid in the 1960s, highlighted this aspect of the sense of charity, justice and fair play as the most important potential source of transfer of resources from the richer developed nations to the poorer underdeveloped countries. (Pearson, 1969) The records of aid and development of the last three decades clearly demonstrate the validity of this point. Large sums of money have been provided by the richer industrial countries, bilaterally and multilaterally, to the poorer underdeveloped countries without any obvious self-interest of the donor countries. Although the general target of transferring 0.7% of the

GNP as official development assistance by the industrial countries has not been formally accepted by all of them, the fact that a number of countries have actually realized that objective and that others are regularly promising to improve their aid performance shows that all donor countries have accepted the principle of resources transfer without any necessary financial *quid pro quo*. There is no doubt that the idea of social justice which is reflected in the domestic redistribution and social welfare programmes of the industrial democracies will continue to be a major source of resource transfer and a principal element of development policy.

The total official development assistance of the OECD countries as a percentage of their GNP has remained fairly static over the last two decades. It was 0.33 in 1970 and only 0.35 in 1990. But the average statistics fail to highlight two facts. First, during these 20 years, the GNP of the OECD countries registered a very substantial growth in real terms, implying that the absolute amount of real resources that were transferred by these countries as official development assistance also registered a very substantial expansion. Secondly, except for the USA and the UK, for whom ODA as a percentage of GNP showed a sharp decline between 1970 and 1990, most other OECD countries, which accounted for large flows of development assistance, registered quite an impressive increase in this ratio during this period. For Japan (providing \$9.05 billion ODA in 1990), it increased from .23 to .31 between 1970 and 1990; for Germany (providing \$6.32 billion ODA in 1990) from .33 to .42; for France (providing \$6.3 billion ODA in 1990) from .46 to .52; for Italy (providing \$3.4 billion ODA in 1990) from .17 to .32; for Netherlands (providing \$2.6 billion ODA in 1990) from .60 to .93; Canada (providing \$2.5 billion ODA in 1990) from .41 to .44; Sweden (providing \$2.0 billion ODA in 1990) from .41 to .90; Norway (providing \$1.2 billion ODA in 1990) from .33 to 1.17; and Denmark (providing \$1.17 billion ODA in 1990) from .40 to .93. These statistics do not show much sign of aid fatigue among the industrial countries.

It is of course true that the aid performance of most OECD countries fell far short of the target of 0.7% of GNP as specified in the United Nations resolution. But this should be seen in the context of the steadily rising public expenditure in most of the OECD countries during the last two decades and the increase in competing claims on public funds from domestic sources. There has also been a substantial rise in these countries in expenditure on public health and education, social security and labour market programmes. This would indicate that the authorities in these countries were mandated by their electorates to expand their support for projects related to domestic social justice and development. Even in the United States, and the United Kingdom, where aid performance as a percentage of GNP was among the lowest — 0.19 for the U.S. and 0.27 for the U.K. in 1990 — the total health expenditure as a percentage of GDP was as high as 11.2% in the United States and 6% in the U.K. by end-1987. The expenditure on labour market programmes alone in the United States and the U.K. was almost five times as high as their expenditure on foreign aid in the last few years.

It would, therefore, be more plausible to explain the shortfall in aid performance not in terms of a general apathy towards social activities or towards social justice and equity, but rather in terms of a failure to persuade the electorate about the effectiveness of foreign aid in promoting social justice across national boundaries. Admittedly, the electorates in these countries would be more included to support social expenditures

targeted towards their own people compared to those for the poor foreigners. But since there is no sign of a strong prevalence of xenophobia, one can only conclude that a country which is willing to spend more than 25% (the OECD average) of its budget on social expenditures at home for the poor and less than 1.3% on foreign aid, is doing so because it is not persuaded about the effectiveness of the foreign aid programmes.

In the 1990s, when most of the developing countries have embarked on major economic reforms, there is a much better possibility of persuading the electorates of the industrial countries about the effective utilization of foreign aid. These reform programmes are expected to bring about strict financial and commercial discipline, stop the waste of resources and implement programmes supporting structural adjustment and social development in a manner that can be demonstrated as improving the effectiveness of foreign aid.

### **3. Mutuality of Interest**

Mutuality of interest as a strong motivation for the aid and development policy of the industrial countries has often been defined in political and non-economic terms, almost as an extension of the military and political considerations discussed above. If countries are accepted as allies in a military sense, they would be more dependable and useful if they were also economically and commercially strong enough to share the burdens of any possible military manoeuvres. With the end of the Cold War, this specific military aspect of mutual interest and strategic alliance would seem to have lost ground.

Of late, environment has come up as another source of mutual interest in the relation between the industrial and the developing countries. We shall not go into this any further in this paper except to point out that the scope of the mutuality of interest in this area is so vast that a large international programme of aid and transfer of resources can be built just upon the possibility of environmental cooperation. We shall limit ourselves to the traditional arguments for mutual interest which were basically related to (a) trade and supply of commodities; (b) expanding market for manufactures; and (c) widening the scope of profitable investments.

Mutuality of interest was in fact put forward as an argument for providing foreign aid in the 1950s and 1960s, quite often referring to the lessons of the Marshall plan on aid in post-war Europe. The Pearson report also highlighted the mutuality of interest between the industrial and developing countries. It was, however, the oil crisis of 1972-73 which brought out the full implications of the mutual dependence between the industrial North and the commodity producing countries of the South. The Brandt Commission Report devoted itself to building up a new paradigm based on mutual interest (The Brandt Commission Report, 1980). In the area of commodities, and not just in the petroleum sector, it came to be recognized that the developing countries which supplied commodities required assistance to withstand the adverse effects of instability in the international commodity markets, and that the industrial countries needed to help them to increase their productivity and to stabilize their export earnings from commodities. To this was added the potential of the developing countries as an

expanding market for the exports of the industrial countries if the developing countries' export earnings were stabilized and if their domestic savings were complemented by foreign aid to raise their capital formation and thereby enhance their rate of growth. It was also pointed out that if foreign aid helped to develop the infrastructures of the Third World countries and promoted reasonable growth of their economies, there would be a demonstrable increase in the marginal productivity of investment in these countries, so that foreign private investments from the industrial countries could be increasingly deployed there with a high rate of return.

While most of these arguments were correct in principle, their applicability in a specific country was very much dependent upon the economic policies followed by that country. In the absence of such policies and in a situation without any promise for sustained beneficial interaction, the industrial countries generally chose to reduce their dependence on the sourcing of commodities and raw materials in the developing countries and to expand their trading and investment activities within the larger group of industrial countries themselves. The paradigm of mutual interest thus remained an unrealized potential and did not become a driving force behind the aid and development policy of the industrial countries (Sengupta, 1980). This does not, however, mean that mutual interdependence between the industrial countries of the North and the developing countries of the South did not increase in the 1970s and 1980s. The volume of trade between them expanded at a significant rate, though much less than the rate at which trade among the industrial countries themselves was expanding. There was also a substantial increase in the flow of investment from the North to the South. Though there was also an expanding trade in commodities, the terms of trade for most of this period moved against the commodity producing developing countries. Interdependence in the sense of interactions and mutual trade expanded but it failed to provide any leverage of influence to the developing countries which could be used by them to secure increased flow of assistance from the industrial countries or to bring about a change in their trade and development policies.

In the altered context of the 1990s, when the developing countries are pursuing economic reforms and structural adjustment, the argument of mutuality of interest would seem to have gained a new lease of life. For, if the developing countries follow appropriate policies and successfully adjust their economies to achieve a sustained rate of growth, a partnership with them could be highly beneficial to the industrial countries. The commodity supplies could be stabilized through increases in their productivity with the injection of both domestic and foreign investment. With their large population, expanding growth, increased capital formation and an improved functioning of the infrastructure, their potential as markets for exports and profitable outlets for investment from the industrial countries would expand enormously. As these countries develop and build up their industrial complementarities with the countries in the North, they could become extremely effective partners through joint ventures, through subcontracting and through production linkages within the same industry. In other words, the developing countries that had till recently been looked upon only as markets for the exports of the industrial countries, could now be the sources of imports into the industrial countries, thus providing a large scope to the profitable operation of multinational enterprises.

### **III THE DESIGN OF AID AND DEVELOPMENT POLICY**

Given the objectives of aid and development policies in the altered world of the 1990s, their effective implementation would depend very much on their design, and the way they are actually applied in a specific country. The elements of that design would of course have to be flexible and varied to accommodate differences in the objective conditions in the different countries, such as levels of development and the nature of the social, legal and political infrastructure. The relationship between the beneficiary and the donor countries, its history, and the perception about its future would also influence the framing and the application of these development policies. Nevertheless, it should be possible to identify a basic structure of the design of such policies which the different donor countries would like to follow to help the beneficiary countries to implement economic reforms, to get integrated into the mainstream of the world economy and to launch themselves on a sustainable path of development.

#### **1. Conditionality and Reciprocal Commitments**

The most important basis for such a design would have to be a credible commitment by the beneficiary countries to economic reform, to policies of structural adjustment, macroeconomic balance and growth. The credibility of that commitment would invariably involve some conditionality in the sense that the beneficiary countries would have to accept that the assistance they would receive under these policies would depend upon their fulfilling the commitment. Although most of the bilateral assistance for development until now has not been linked to any explicit conditionality, it is high time for the developing countries to realize that without some conditionality they cannot expect any significant flow of assistance any more. There are too many conflicting claims on the limited savings of the industrial countries, and there is very little leverage left with the developing countries for them to extract any development assistance without demonstrating their ability to use that assistance effectively with appropriate policies.

There exists, by now, a vast literature on conditionality and also a long and varied experience of the operation of conditionality by the IMF, the World Bank and the regional development institutions (see, for example, Williamson, 1983 or Avramovic, 1989). We do not need to go into these issues in any great details for our purpose, except pointing out three aspects which are relevant for the formulation of the new development policies. First, the conditionalities should be related to some form of monitoring the fulfilment of the commitments by the beneficiary countries, and not to the actual achievement of the objectives. The relationship between the policy instruments and the objectives is often so tenuous and subject to so many exogenous uncertainties that conditionalities framed on outcomes of policies would rarely be able to monitor the intensity of efforts of the beneficiary countries.

Secondly, the conditionalities cannot be used as a rationing device for development assistance. Harsher conditionalities do not mean greater effectiveness in the use of assistance, and so the quantum of aid allocated to any country cannot be decided by the severity of the conditionalities that the country is willing to accept. The effectiveness of aid would depend upon the economic conditions of the beneficiary country, the level of development of its social and industrial infrastructure, and also the weights attached to the different objectives of aid and development policy. If aid is meant for improving the profitability of private investment or expanding the market of the donor countries' exports, it would probably be more effective in a country which already has a reasonably developed infrastructure or where aid can break the specific bottlenecks preventing the release of the country's growth potential. If, on the other hand, aid is meant to have a large impact on health, literacy or removal of social disparities, it may have to be channelled more to the least developed countries.

Since a typical developing country is a combination of different sectors at different levels of development with different types of problems, and the aid and the development policy has a number of objectives, it is almost impossible to identify, *ex ante*, a set of policies that would be sufficient to ensure the outcome of the desired objectives. Most of the time, the policies would have to be flexibly applied, modified and improvised in the evolving situation of an economy and the best that could be expected from the authorities is that they remain committed to following the right policies and maintain the strict fiscal and financial discipline that is necessary to avoid any waste of resources. Therefore, the best set of conditionalities for a particular country should be centred around a few indicators that would reflect the country's adherence to those disciplines, such as the reduction of fiscal deficits or control of money supply or financial and physical deregulation, in steps which are sufficiently strict to demonstrate the commitment of the authorities but which, at the same time, are reasonably phased out to be implementable without disrupting the political system.

The idea behind using conditionality mainly for monitoring the commitment of the policy making authorities and not necessarily for monitoring the implementation and outcome of an elaborate policy programme is quite simple, though not always generally appreciated. If a country's commitment to economic reforms and policy adjustments remains firm and steady, there is no reason why that country would not implement the policies that would produce the desired results, unless the outcomes of the policies are extremely uncertain or if the policies themselves are not feasible, reflecting in both the cases the inadequacy and imperfect specifications of the policies. It is often forgotten that the implementation of the right policies to achieve the desired objectives is in the interest of the countries themselves and they would usually stick to that if they are perceived as appropriate, even though difficult, because the alternative state of affairs would be much more costly in social and political terms. It may be necessary for a country undertaking reforms to have a programme formulated and changed, as necessary, with the help of external agencies and experts after a full discussion. But it is not necessary to impose the compliance of the country to the programme by monitoring the details. If the commitment of the authorities can be monitored and ensured, the compliance to the best implementation of the programme would also be ensured.

The prospects of compliance to the policy commitments of a developing country would improve enormously if it is assured of all the assistance required for implementing the reform programmes. This is the third aspect of conditionality mentioned above, which has a special relevance for an aid and development policy for the 1990s. Conditionality, especially for the IMF programmes where it has been originally applied, involves a form of reciprocal commitments. If a country undertaking a financial programme fulfils its commitments, the Fund is supposed to automatically disburse the sum it has committed for payment. The Fund's commitments are based on an assessment of the amount of external finance that the country would require, after taking into account all other sources of finance, to implement the programme. This is known as the Fund's providing the financial assurance to a country undertaking a programme, so that if the country fulfils the conditionality, it would be assured of an adequate flow of finance to meet the resource gap during the period of the programme.

With the passage of time and global shortage of transferable resources, especially in the 1980s, this aspect of reciprocal commitments, implied in the conditionality of the Fund programme, has been increasingly diluted. The Fund's own resources have proved to be inadequate and, with growing arrears in its repayments, the Fund has been forced by its major shareholders to limit drastically the access to its resources. A commensurate amount of resources has also not been forthcoming from other bilateral and private sources, in spite of the Fund trying to play a catalytic role. As a result, the Fund's programmes have either remained underfunded with unfulfilled financial assurances or the programmes have had to be unduly tightened with a severe compression of expenditure leading to a contraction of output, employment and living standards.

If the objective of the aid and development policy of the 1990s is going to be helping the developing countries to adjust their economies through structural reform and integration into the mainstream of the world economy, the industrial countries must restore this reciprocal element to conditionality. If a developing country launches a programme of its implementation, fulfilling the commitments of maintaining the financial and fiscal disciplines, it should be assured of all the financial, technical and structural assistance as well as market access and developmental support which would be necessary to bring about a successful outcome of those reforms. If these assurances are not forthcoming, the developing country cannot be expected to carry out the reforms and structural adjustment and comply to the stringency of financial discipline except for a limited period. The hope that the success of the reforms would improve the country's credit rating and eventually increase the inflow of private funds is so tenuous and uncertain that unless the reforms produce positive results in a very short period the contractionary effects of an adjustment programme may force the authorities not only to interrupt the reforms, but also to adopt policies of short-term relief that could be highly counterproductive in the long run.

## 2. Market Access

Once a feasible programme of reform has been worked out and a set of minimum conditionality has been accepted by a developing country to demonstrate its commitment to the implementation of the programme, the industrial countries could reciprocate along the lines of new aid and development policies in the following three ways. First, they could ensure free access to the reforming countries' exports in their markets and provide all possible financial, technological or promotional assistance to build up the capability of the developing country for increasing its export supplies. It is important to note that all programmes of structural adjustment and market reforms of a developing country imply a reallocation of resources, facilitating increases in export production; the programmes cannot be successful if at the same time a stable and expanding market for these exports is not created. Furthermore, such markets should be stable with a reasonable certainty of access and potential for growth, so that these sectors can attract increasing amounts of investment from both domestic and foreign private sectors. The size of the market of the industrial countries would be large and growing, and the policy would be beneficial even with a small growth of the GNP of those countries.

The ideal policy would be for the industrial countries to provide completely free access to the exports of the reforming developing countries without any restrictions or sectoral limitations. The welfare of the industrial countries can only increase as a result of granting such freedom of access, even if it is completely unilateral. Their imports will be cheaper, real incomes will be higher and resources released from industries losing out in competition with the developing countries can be absorbed in other more efficient industries, especially with their growing real income. The benefits of course would be larger if the markets for exports of industrial countries also open up. But the interests of labour and capital which would benefit from those newly opened markets would not necessarily be the same as those who would be displaced by competition from the imports from the developing countries. If the authorities of the industrial countries can make the arrangements to accommodate the displaced labour and capital, there is no reason why the authorities should not be able to provide free trade access, unilaterally, to some selected developing countries. In the context of the new aid and development policy for supporting countries going through major economic reform, the case for granting unilateral free trade access is even stronger, because the success of economic reforms in those countries would create the potential of an expanding market for exports of the industrial countries in the immediate future.

Providing some developing countries, as a *quid pro quo* for their economic reforms, a free access of their exports to the markets of industrial countries will not go against the spirit of the GATT. Although initially this would take the form of a preferential trade agreement, these countries would be expected to liberalize their own growing market in pursuance of their programmes of economic reform. The existing GATT provisions allow such asymmetric free trade arrangements which have allowed some members such as the European Community to provide preferential treatment by giving free trade access to some 'associate' countries in return for a promise of opening the markets of these associates, selectively, over a period and differentially among

sectors. Similar provisions can be invoked if industrial countries decide to extend the privileges of associateship to specific developing countries which have undertaken credible programmes of adjustment and reforms.

Alternatively, the industrial countries may adopt the GSP route to provide enlarged access through special preference to developing countries implementing adjustment programmes. One has however to be somewhat more careful in using the GSP route. The spirit of such a generalized system of preferences, even if it is granted unilaterally, is that it should be uniform and that it should be available to all developing countries. In practice, this principle has been flagrantly violated. There should therefore be little objection if without withdrawing GSP to any other developing countries, it is decided by some industrial countries to grant free access to exports, by enlarging GSP, to selected developing countries undergoing adjustment. To make this policy an effective means of supporting the reform efforts without in turn introducing any market distortion, this enlargement of preferential access should be stable, certain and transparent, free from quota restrictions and subject to simple and uniform domestic value addition requirement and should be extended universally to all exports from these countries. It is important to emphasize this point because any attempt to restrict the GSP, either in terms of quotas or sectors of products, would distort the export markets of these developing countries and might give altogether wrong signals to investors in the segmented markets and frustrate the objectives of deregulation in the economic reforms. Similarly, such GSP should be extended also to 'Non-Tariff Barriers', which have turned out to be, in recent times, the most harmful barriers to trade. The Non-Tariff Barriers, because of the uncertainty of the time and the extent of their application, may often prove to be the single most important disincentive for investment in developing countries in their export sector. A GSP for NTBs can go a long way to remove that disincentive for a reforming developing country.

The privilege of 'association' granted by the European Community to a few countries also involves the Community authorities granting special financial, technical and fiscal assistance to those countries to build up their capabilities for becoming effective partners of the members of the Community. The same privileges can be extended to the reforming developing countries in the context of a new aid and development policy. The industrial countries may provide all assistance necessary to build up the productive, technological and marketing capacities in different sectors of those countries which have the potential of operating efficiently in the international market. Concessional tax arrangements can be given on investment incomes, technical fees, or royalties on technologies, which may flow back to the industrial countries from investments in those developing countries. There can also be specific industrial R&D and marketing cooperation between these countries under appropriate fiscal incentives.

### **3. Balance of Payments Finance**

The second element of the reciprocal commitment in the new aid and development policy would be related to providing adequate balance of payments finance to meet the resource gap of a developing country undergoing an adjustment programme, during the period of the programme. These resource gaps are estimated as

a difference between the import and other foreign exchange payment requirements and export and other foreign exchange earnings of the country during this period over and above the regular inflow on capital account. Since the import requirements are projected on the basis of growth of output and consumption as well as the time required for completing the process of adjustment, the quantum of the resource gap becomes dependent upon the targets and the design of the programme. If there is an assurance from the donor countries of adequate financing in addition to the flow of resources from international financial institutions, the programme can be so designed that the consumption standards are not unduly depressed, and that the growth of output and employment is maintained at a satisfactory level without unleashing inflationary pressures. With such a design for adjustment programmes, the prospects of its successful implementation improve by not only facilitating smoother adjustment of economic activities but also increasing the political acceptability of the consequences.

There is another aspect of such an assurance of adequacy of financing which is related to the occurrence of unforeseen contingencies. Quite often changes in exogenous factors, not taken into account at the time of the formulation of the programme, produce such an adverse impact on the economy of the adjusting countries as to disrupt the process of implementation until new arrangements are put in place. If the industrial countries fulfil their assurance of adequate financing and adjust the quantum of assistance to meet the contingencies which are the results of factors beyond the control of the policy making authorities of the reforming countries, reform programmes can remain on track improving the prospects of successful implementation of the programmes.

#### **4. Social Expenditure Finance**

The third element of the new policy would be related to maintaining the flow of external assistance required for carrying out the minimum expenditure on social and developmental infrastructure and providing additional safety-nets for ameliorating the conditions of social groups adversely affected by the adjustment programmes. It is important for the success of any adjustment programme, whether for a sustainable stabilization or for structural reforms, that investments on the maintenance and growth of social and economic infrastructure facilities be maintained at a reasonable level. For most programme countries with an inadequate supply of external resources, these are the areas where the expenditures are usually cut substantially and often in an ad hoc manner. These involve anti-poverty programmes, retraining, maintenance of essential food supplies, etc. An assurance from the donor countries for providing resources to maintain these expenditures would help in avoiding such cut backs. Short run adjustment measures have the maximum chance of success if they complement the long-term measures for development of economic, social and human infrastructure.

#### **5. Development Compacts**

If there is a general agreement among the industrial countries about the elements of the new aid and development policies in the 1990s, as described above, there would

remain a problem of institutionalization of their application. First, there would be the problem of how to design and set up the conditionality in an objective manner, guided by the requirements of the circumstances and not by the political interests or the bargaining strength of the donor and the recipient countries. The simplest solution to this, without creating any additional institutional mechanism, would be to leave it to international financial institutions to discuss and settle with the concerned developing countries. Fortunately for this new approach to aid and development policies, most of the developing countries in the recent period have already entered into negotiations with the IMF and the World Bank and have subjected themselves to their discipline. By 1993, it is estimated that almost 90 countries would have adopted the adjustment programmes of the IMF. Other international agencies have also been active in designing and supporting adjustment programmes for many of these countries. It should, therefore, not be very difficult for the industrial countries to apply their new aid and development policies as an extremely important complement to the adjustment exercise of these international agencies, without trying separately to decide on the design of the programme and the conditionality.

Even after this, however, there would remain a problem of finding a method by which the industrial countries can judge the adequacy of supply of resources and other development policies related to market and technological access for the reforming country. They also have to decide about the burden sharing among themselves of the cost of these aid and development policies. It is in this context that we may like to consider a proposal of 'Development Compact' between a developing country undertaking programmes of adjustment and a group of industrial countries providing necessary assurance to help the implementation of the programme (Sengupta, 1991 and Human Development Report, 1992; also Bacha, 1987 and Report of the IMF's Group of 24 which spell out the logic of reciprocal obligations).

This notion of Development Compact is much more modest than other proposals of 'Development Contracts' made by the Norwegian Minister, Mr. Stoltenberg (Stoltenberg, 1989). The Development Contracts are supposed to be comprehensive long-term commitments by the industrial countries not only for stabilization and adjustment, but also long-term development with a provision of international assistance to help the implementation of broad development plans of the Third World countries. Stoltenberg did not specify the details of his proposal for Development Contract, which have been, in some sense, provided by Gerard Adams when he talks about a continued dialogue 'in the framework of a new institution, a Development Commission which will deal with the specifics of the policy, monitor performance and supervise the required revisions' (Adam, 1991). Our notion of a Development Compact is much looser than a formal agreement but based on an understanding between the adjusting countries, the international financial institution, like the Fund and the Bank and a group of industrial countries. It would be associated with an ongoing Fund-Bank programme with their stipulated methods of monitoring, supervision and revision. In a sense, these Development Compacts can be considered as an extension of the experiment of the Support Group exercises that were conducted by the Fund and the Bank, to help some of the highly indebted developing countries who fell into arrears with these institutions. These countries, in order to get out of the arrears problems, were persuaded to adopt extremely stringent structural adjustment programmes. Since the Bank or the Fund

could not provide these countries with any resources until their arrears were cleared, as per their Articles of Agreement, they organized Support Groups of donor countries who pledged to provide the necessary assistance to these countries for implementing their programmes. The Support Groups met frequently to examine the reports of the Bank and the Fund about the state of implementation of the programmes, deliberated on adequacy of the programme design, the targets and the conditionality, as well as the success or failure of the arrears countries in meeting the performance criteria. On the basis of these deliberations, they decided upon the amount of finance that should be provided to the country under programme and also the method of sharing the burden among themselves.

The Support Group exercise was performed in an ad hoc manner and there was no systematic approach to an aid and development policy, as elaborated above, in place at that time. If, however, there is now a general agreement about the tenets of the new approach which we have elaborated, it should not be difficult to institutionalize the Support Group mechanism in the form of a Development Compact as we have suggested for a reforming developing country. It would not require the creation of a new institution, because for most of the developing countries there is already a mechanism of consortium of aid groups, from which a number of industrial countries may be selected to form a Support Group when the country concerned agrees to adopt major adjustment and reform programmes. It would not take much time for this mechanism to come into full operation because it can always use the experience of the operation of the Support Groups.

#### IV RESOURCES FOR AID

The aid and development policy for the 1990s, as discussed above, would entail some realignment of production activities in the industrial countries. But more than that, it would require adequate financial support to the developing countries to meet the resource cost of such realignment and adjustment of their production structures. The success of the policy would thus very much depend upon the amount of resources the industrial countries would be willing to transfer to the developing countries.

Even though the development policy, related to trade and market access, may not immediately involve any net resource transfer to the developing countries, eventually some funding would be necessary to build up the capabilities of these countries to participate in the enlarged market. If the capital and skill formation implied in building up such capabilities are financed by grants, it would obviously imply a net resource transfer. If they are financed by private foreign investment or commercial and official credit, there would be an immediate resource transfer followed by future outflows of dividends, interest and amortization whose present value would generally exceed the amount of the immediate resource transfer. In many cases, these flows of investments and credits may have to be accompanied by tax exemptions and holidays or concessional interest, implying further net resource transfer. To this, one should add the possible use of structural assistance given by the authorities in the industrial countries to their domestic industries facing competition from the developing countries once the latter are granted free market access in accordance with the new development policy. Although such assistance will flow to the domestic units of the industrial countries, it may be reckoned as a necessary resource cost of following the new policy.

The aid policy, as described in this paper, would of course imply a substantial additional resource transfer. To the traditional use of development aid, we have added the financial flows for meeting the resource gap in an adjustment programme, together with the amounts needed to meet the unforeseen contingencies, and for providing the safety-net to the vulnerable groups affected by the programmes. This might require a substantial amount of resource transfer, depending upon the number of countries covered by this policy and the length of the programme period during which export earnings and normal capital flows are unable to meet the demand for resources. If we are pleading for a new aid and development policy in the 1990s, we should try to identify the potential sources of these additional transfers.

An immediate consequence of the end of the Cold War is the possibility of an all round reduction in military expenditure, and the likely emergence of the 'peace dividend'. The Human Development Report of 1992 has identified the possibility of raising US\$ 1500 billion by the year 2000 AD if military expenditures are reduced by 3% a year during the 1990s. US\$ 1200 billion out of this would come from the industrial countries and other US\$ 279 billion would come from the developing countries. These amounts are enormous, and resources of this order, in addition to the

existing flow of savings, could provide substantial opportunities to expand the transfer of resources from the industrial to the developing countries.

Even if such peace dividends of this magnitude do not materialize, at least to this extent, it would still be possible to generate a surplus of resources in the industrial countries by a small increase in their rates of savings, which could be quite large compared to the amounts recently transferred to the developing countries. The Human Development Report has presented the statistics about global economic disparities which show that the countries accounting for the poorest 60% of the world population had a total domestic investment of less than US\$ 300 billion in 1989. This was equal to 8 or 9% of the total domestic savings of countries with the richest 20% of the world population. Assuming that these rich countries have a rate of savings of 22% of GNP, which is the OECD average, a 1% increase in their savings transferred to the poorest countries could increase the latter's rates of investment by more than 50%.

These arithmetics can be presented in different ways to indicate the relative insignificance of the magnitude of aid compared to the total claim on resources of the industrial countries. The combined GNP of the countries with the richest 20% of the world population in 1990 was more than US\$ 17,000 billion. The official development assistance received by all developing countries in 1990 was roughly US\$ 44 billion. An additional saving of a little more than a quarter of one per cent of the GNP in the richest countries, if transferred to the developing countries, would more than double the aid flows to these countries. This would not seem to be at all non-feasible. Even if these rich countries have a very moderate growth of 2.5% a year, they would have to save only around 10% of their incremental output to achieve this result. The higher the actual growth rates in these countries, the lower would be the proportion of the incremental output that they would need to save to more than double their aid flows to all the developing countries.

## **1. The Cost of Resource Transfer**

Any assessment of the cost of such resource transfer should be reckoned not by the nominal value of the resources, but in terms of the utility or welfare sacrificed by the industrial countries in effecting that resource transfer. It would of course be difficult to arrive at a universally agreed numerical estimate of such cost because of the inherent problems of specifying a utility or welfare function for all countries. But the analytical issues involved in such assessments would be brought out clearly, if the arguments are related to the utility or welfare value of the resources. For instance, let us assume that the welfare functions with respect to the per capita incomes of the industrial countries are similar to the well-behaved utility functions of individual incomes; then, one can say that the marginal utility or welfare of an industrial country diminishes as the country's income per capita increases. This would mean that the welfare value of the resources of a country will be falling short of the nominal value of those resources as the per capita income of the countries increases, and that the cost of resource transfer, in terms of sacrifice of welfare for the country, will decline as it becomes richer in terms of money income. Furthermore, if the characteristics of the welfare function are similar for all industrial countries, it would also mean that the richer a country, the lower will

be the welfare cost of transferring a given amount of resources as foreign aid from that country.

The Human Development Report of 1992 has used this principle for adjusting the per capita GDP of richer countries in terms of their contribution to human development. Assuming that the utility of income reflects the well-being of the people defined as human development, a diminishing marginal utility of income for a country with increasing income per capita has been described as the 'diminishing returns for human development'. Any additional income may of course have many alternative uses, but it would contribute less and less to human development in that country as income per capita rises. The value of its GDP measured in terms of contribution to human development would then fall short of the value of GDP measured in constant-price dollar, as the country becomes richer with increase in per capita income.

There can be several functional forms of the relation between utility or well-being and per capita income reflecting such diminishing marginal utility. The Human Development Report chose a form following Atkinson's formulation which gives:

$$W = \frac{1}{1-e} \times y^{1-e}$$

where  $W$  is the index of well-being and  $e$  is the elasticity of the marginal utility of income, which can vary between 0 and 1. When  $e = 0$ ,  $W = y$  or the index of well-being is equal to the per capita income. When  $e$  approaches 1,  $W$  becomes  $\log y$ . Within this range, the Report attached discrete values to  $e$  according to a step function related to a threshold level of income,  $y^*$  which it described as the poverty line, signifying the minimum acceptable level of human development. When  $y$  is less than  $y^*$ ,  $e$  is set equal to zero. When  $y$  is greater than  $y^*$  but less than  $2y^*$ ,  $e$  is equal to  $1/2$ . When  $y$  is greater than  $2y^*$  but less than  $3y^*$ ,  $e$  is equal to  $1/3$ , and so on. Accordingly, the Report estimated different values of  $W$  for countries with different levels of per capita income, given as:

$$\begin{aligned} W &= y \text{ for } 0 < y \leq y^* \\ &= y^* + 2(y - y^*)^{1/2} \text{ for } y^* \leq y \leq 2y^* \\ &= y^* + 2(y^*)^{1/2} + 3(y - 2y^*)^{1/3} \text{ for } 2y^* \leq y \leq 3y^* \\ &\text{and so on.} \end{aligned}$$

The Report has specified a minimum level of per capita GDP, US\$ 4829 in terms of the purchasing power parity dollar of 1989, as the threshold income up to which there is no difference between the (constant) dollar value of income and the value in terms of well-being or contribution to human development. The per capita GDP could then be taken as an index of well-being for all countries below that level of income. This took care of most of the countries of the world for which no adjustment was made in their per capita GDP to reflect its net contribution to well-being or human development. But for the richer countries, major adjustments were made according to the step formula mentioned above. The result of this exercise, as given in column 6 of the Appendix Table 1, derived from the Human Development Report of 1991, reveals a

very substantial adjustment in the per capita real GDP for the richest (ODA) countries, needed to reflect their contribution to well-being in terms of human development in these countries. For example for the USA, the adjusted real GDP was only about 25% of the actual (PPP \$ of 1989) real GDP; for Canada it was 27%; for Japan it was 35%; for Switzerland it was 27%; for France it was 35%; for U.K. it was 36%; for Italy it was 37%.

This method of adjustment of the real per capita GDP of a number of the countries implies that 60 to 70% of their incomes have negligible marginal utility, meaning that they make very little contribution to the well-being of their own people. The extent of this adjustment appears to be somewhat large, reflecting basically the value of the parameters of the transformation function, chosen rather arbitrarily. However, it brings out the essential logic of this approach which seems to be quite plausible as well as reasonable. The level of per capita GDP of \$ 4829, chosen as the threshold, is derived from a Luxembourg study of the levels of poverty in eleven industrial countries, indicating some sort of a poverty line in these countries, below which the marginal utility of income cannot be falling. If this threshold amount is enough to meet all the basic requirements of living, health, nutrition, shelter and education, an income level exceeding this amount could add to the total well-being of the population, or the utility of income, only by a diminishing amount. There may be several alternative formulations of the relationship. The rate of decline of utility may increase as the average per capita GDP increases by multiples of the threshold amount. It may be a discrete or a continuous function of the rise of income. The extent of the decline may be less in the beginning and may accelerate later with the distance between the actual and threshold level of income growing. But so long as there is a diminishing marginal utility of income, there would always be a portion of the total income, at some level of income above the threshold level, which could be given away by these countries at a relatively low cost of utility or well-being.

If the logic of this argument is accepted, it should not be very difficult to divert a fraction of the amount, which yields negligible additional utility in the rich countries as aid to developing countries. Even if that amount with negligible utility is only 10% of the incomes of the richest countries, far less than the 60 to 70% of their incomes as implied in the adjustment functions used by the Human Development Report, it could be as high as \$ 1700 billion, assuming their combined GNP is \$ 17 trillion. If only 10% of that amount of negligible utility is transferred to developing countries as aid, it would generate \$ 170 billion or about four times the present level of ODA. Whatever may be the actual values of the parameters of the function, so long as there is a functional relation between the welfare or utility and the per capita income of a country with a negative second derivative signifying diminishing marginal utility, it would not appear at all implausible that at least 1% of their income could in principle be transferable as aid to the developing countries without great cost to these rich countries.

## **2. Resistance to Aid**

The fact is, however, that there is a lot of resistance in the industrial countries today to any move for increasing foreign aid to the developing countries. This would seem to contradict the spirit of the argument presented above and it would be necessary to examine the basis of this resistance in order to neutralize it, if we wish to generate a large increase in the flow of aid. The postulation of a diminishing marginal utility function for rising levels of income of the richer countries, especially after a threshold of income that meets all the basic requirements of living in an industrial country, would be intuitively acceptable to most in these countries. In spite of that there may be at least three reasons why there would still be such a resistance to increasing the flow of aid to the developing countries. We take them up one by one.

The first reason may be related to the problem of perception of well-being. The people in the richer countries may be persuaded to accept that beyond the threshold level of income as defined above, additional income makes only diminishing contributions to their own well-being. That does not necessarily mean that a transfer of a part of that income to the developing countries would make any difference to their perceived well-being, unless such aid can affect some variables in their own well-being function.

It can of course be argued that the well-being of a modern people is related not only to their own physical and cultural values, but also to a spirit of altruism, or charity, a feeling of satisfaction when there is improvement in other people's welfare. To this may be added the perception of mutual interest, which would relate an improvement in the economic and commercial conditions as well as in the political and cultural environment of the developing countries to the improvement of the welfare of the people in the richer countries. We have talked about this earlier in terms of the objectives of aid policy. If the people in the richer countries share these objectives, there would be some case for transferring resources to the developing countries.

The problem is that most aid programmes are not designed to highlight the elements that appeal to the people's sense of charity and perception of mutual interest, nor do they convincingly demonstrate the effectiveness of that aid to contribute to human development in the recipient countries. If foreign aid could be seen as contributing to poverty alleviation and development of the weaker sections on that ground, as well as to the expansion of market and investment opportunities, then a strong support could possibly be built up in the richer countries for foreign aid. Indeed, the Human Development Report contains indices that can be used to design such an aid programme in a transparent-enough fashion to convince the donor countries about the desirability of aid.

The second reason for resistance to foreign aid in the richer countries may be related not just to the design of the aid programme but to the confidence of the aid givers about the ability of the receiving countries to use that aid efficiently. A micro-level effectiveness related to the ability at the ground level to execute the programme is not a sufficient condition for the full and efficient utilization of aid. It very much

depends upon the overall macro-policy framework of a country: whether the production possibilities are created in a stable environment of growth, without any open or repressed inflationary pressure. If the donor countries do not have any confidence about the economic policies of the aid receiving countries, it would be difficult to generate much public support for any noticeable increase in foreign aid.

Both these reasons for the resistance to foreign aid can be effectively answered if the new aid and development policies for the 1990s, as spelt out in this paper, are adopted. It may require some shift of emphasis on one or another of the elements of the policy to meet the reservations of any particular country. But the specifications of those policies are flexible enough to demonstrate that the economic policies in the developing countries which the donor countries would support are capable of improving the well-being of their people efficiently and effectively.

### **3. Mobilizing Aid Funds**

The third reason for resistance to aid is more basic and requires special treatment. Even if it is accepted, in terms of a diminishing marginal utility of income, that there is a reasonable fraction of the total income in the rich countries which could be transferred to the developing countries at an insignificant cost to the total well-being of those countries, there may not be any mechanism to withdraw those amounts from exactly those sections of the population in these rich countries for whom the marginal utility of income is negligible. This is a problem related to the distribution of income in the rich countries, where people have different levels of income and also possibly different utility functions of income. If this implication of distributional difference could be ignored, the governments of these countries could possibly finance the aid flows through a uniform indirect tax, such as a tax on gasoline or hydrocarbon fuel, that may also have a pronounced beneficial effect on the welfare of everybody in those countries.

A marginal increase in the progressive income tax, however, could produce the desirable effect. There is now a general antipathy against raising of or operating with income tax in most of these countries. Still, if the taxpayers could be persuaded about the logic of diminishing marginal utility of income, and if the threshold per capita income can be seen as adequate for meeting most of the basic biological and cultural needs of the population, then a marginal tax progressing with the multiples of that threshold income may find sufficient acceptance to generate a substantial amount to be dispensed as aid. Thus, the industrial countries could incorporate in their direct tax system, a new line of income tax for supporting foreign aid so that every unit, whose income exceeds the minimum per capita income that is needed for a decent standard of living, would be liable to pay a marginal tax that would progressively rise with the difference between its actual income and the minimum threshold income. For example, if the threshold income is \$ 5,000 per capita and the tax unit is a family of four persons, it would pay no such tax up to an income of \$ 20,000, and would pay, say, 1/2 % on income between \$ 20,000 and \$ 40,000, 1% on income between \$ 40,000 and \$ 60,000 and so on. The exact rates and slabs of the tax would depend upon the size of the units, types of exemption and the nature of assessing the tax liabilities in the different

countries. But the principle should be a transparent linkage between the actual income of the taxpayer and the threshold income of basic needs, on the assumption that the marginal utility of income rapidly diminishes as income exceeds that threshold level.

It is also possible to work out a new system of international obligation for the richer countries to provide development assistance in accordance with the logic of this argument, and which can replace the so-called uniform target of 0.7% of income for aid applicable to all countries. In fact, if there is an agreement in favour of such an international liability for providing foreign aid, it can operate effectively in practice as an international tax, by specifying the liability for each country and leaving it to the authorities of the country to amend their own fiscal systems suitably to generate that amount of revenue. Otherwise, the specific obligations of the different countries can remain as commitments or targets, as they are now, with possibly an increased chance of persuading the countries to meet these obligations, because they would be demonstrably related to these countries' ability to pay.

In the Appendix Table I, we have given the results of such an illustrative exercise applying it to the ODA countries which are a subset of the countries identified in the Human Development Report as accounting for the highest 20% of world income. The exercise has been done for 1989, because it has used the Luxembourg figure of US\$ 4,829 per capita in terms of purchasing power parity as the threshold income of basic needs or poverty line in the industrial countries. It can obviously be repeated for any other year with any other figure for threshold income, around which there can be an agreement. The total aid obligation or international tax liability for each of the countries has been calculated with the following slab rates:

- When the per capita real GDP  $\leq y^*$ , at 0% obligation on total income;
- When the per capita real GDP  $> y^*$  and  $\leq 2y^*$ , at 1% on the income slab;
- When the per capita real GDP  $> 2y^*$  and  $\leq 3y^*$ , at 2% on the income slab;
- When the per capita real GDP  $> 3y^*$  and  $\leq 4y^*$ , at 3% on the income slab

and so on. The total aid obligation or tax liability is taken as the sum of obligations or taxes for each slab, and  $y^*$  has been taken as \$ 4,829.

The exercise has been repeated, in columns 11, 12, 13, and 14, with obligation rates 0%, 1/2 %, 1% and 2% for the different slabs.

Columns 9 and 13 would give the new targets of aid to GNP ratio for each country for the two different obligation or tax ratio vectors (0%, 1%, 2%, 3%) and (0%, 0.5%, 1%, 2%), which can be compared to the current target of 0.7% for all countries, and the actual achievements in 1990.

The exercise shows how a substantial amount of aid resources can be generated, with a moderate liability, from incomes above the poverty line or basic needs in those countries.

Table 2 makes an attempt to extend this exercise to calculate the possible tax liability or aid obligation of all countries with per capita income exceeding the threshold income so that the scheme can be seen as truly universal. However, the revenues that can be realized from the non-ODA countries, excluding the former Soviet Union, even when they are subjected to the higher obligation-ratio vector (0%, 1%, 2%, 3%), are rather small, yielding only an additional \$ 2.312 billion in 1989. It would seem therefore that unless the universality of the scheme becomes an essential pre-condition for adopting it for generating such aid revenues, it may not be worthwhile to expand its scope beyond the ODA countries.

The feasibility of a scheme for generating revenues or savings through such a tax-system does not mean that it will be achieved easily in practice. The problems of channelling the savings as aid would remain critical in the industrial countries even if the utility cost of these amounts to the tax-payers is negligible, because most of these countries are running high fiscal deficits with supply-side policies very much geared to reducing the level of taxes. Whenever a pool of resources can be released, there would be a demand to use it for reducing the levels of the deficits.

This would remain the case even when resources are released by a reduction of current expenditure, such as military expenditures. If the government does not pass on these savings or the so-called peace dividend to the public at large by reducing taxes, there would be a reduction in the fiscal deficits. The effect of that reduction on a country's level of income and the amount of revenues that could be available with its government for possible transfer to the developing countries as aid would depend upon how the fiscal deficits were financed and how the economy adjusted to the reduction of these deficits. If these deficits were financed mainly through domestic borrowing, a reduction in their level would increase the availability of loanable funds with the private sector, and lower the domestic rates of interest. Whether that would lead to a rise in investment and domestic expenditure would depend upon the phase of the business cycle – if the recession is almost petering out, such a reduction in the interest rates may trigger off an upswing in income and employment. If, on the other hand, these deficits were financed through foreign borrowing, a reduction in their levels would tend to reduce the international interest rates, which may not have much effect on the country's own level of income, except for the usual contractionary effect of expenditure reduction, unless the authorities reduce the domestic interest rates and allow the exchange rate to depreciate stimulating a growth in net exports and the level of income. Alternatively, the government may pass on the savings in expenditure to the public by reducing taxes. If the absolute amount of deficits does not change much, its effects on foreign borrowing requirements and the international interest rates will not be significant. However, lowered taxes would increase the disposable income of the consumers leading to increased expenditure and a rise in the level of income.

It would appear, therefore, that if a reduction in expenditure can be brought about in countries with fiscal deficits, the authorities could adjust to the situation without much difficulty leading to an expansion of the level of income. If a country's income expands, it would allow the country to have the flexibility to raise some extra revenue that could be used as a source of additional aid-funds. This could be done if all expenditure reduction such as the one in the military budget is not passed on to the tax-

payers, and a portion of it is diverted to a pool for the purpose of aid or if a fraction of the extra revenue yielded from the increase in income without a change in the tax-rates is kept aside. However, it would be much better to be transparent about the whole effort, and to raise the extra revenue for the purpose of aid through a marginal increase in income tax related to the multiples of the threshold income as suggested above. Even if the entire peace dividend is passed on to the public, the possible expansion of the level of income would lighten the burden of this extra tax.

## V CONCLUSION

To sum up, and if the above line of arguments is accepted, the following conclusions can be reached about aid and development policy in the 1990s. First, the case for aid, even of the traditional form for poverty alleviation, human development and the building of infrastructure, will be stronger if it can be linked to improving the political and economic feasibility of implementing the programmes of reform that most developing countries have adopted in the recent period. These programmes aim at integrating the developing countries into the mainstream of the world economy, and accelerating the growth of world output, employment and value of trade. Second, the confidence of the aid donors in the ability of the aid receiving countries to make the most effective use of the funds received by them would be increased if these programmes are implemented within a framework of the discipline of international agencies such as the IMF, the World Bank and other regional development banks. Such increased confidence or credibility of the efforts of the developing countries should facilitate an increase in the flow of funds to these countries, especially when these funds are seen as necessary for financing the requirements of these programmes. Third, the developing countries which accept the rigours of the discipline of these programmes, related to appropriate conditionalities, would find it less difficult to do so if they are assured of the necessary support of the donors in implementing those programmes. Accordingly, in order to provide such assurance, the industrial countries must accept the reciprocal obligation of helping these developing countries through aid and balance of payments finance as well as improved market access and flows of investment and technology.

The case for such reciprocal obligation has to be argued and campaigned for, and although it is rational in terms of increasing global welfare, one cannot hope that it will be accepted easily by all countries. For this, it will be necessary, first, to work out a mechanism, such as a Development Compact, to give a concrete share to the principle of reciprocal obligation. Second, it should be possible, in principle, to identify potential savings in the richer countries which can be diverted to the developing countries as foreign aid and support for development at a relatively negligible cost, reckoned in terms of the well-being of the richer countries. Appropriate fiscal methods for mobilizing such resources can be worked out provided that the authorities in the richer countries follow complementary policies. It should also be transparent that these aid funds are used in areas that contribute to poverty alleviation and human development or in areas with potential for promoting mutual interest. The public at large in these countries has to be convinced that these aid funds would help the developing countries implement their programmes with credibility and efficiency.

The exercise on resources in the last section of the paper should be seen as an illustration to identify potential savings in the richer countries. It is no more unrealistic than any attempt to set up a target of aid contribution for the ODA countries. If there is an amount of per capita income of the richer countries which can be regarded as

sufficient to meet all the basic needs of food, shelter, clothing, health and education, then it is plausible to assume that when the per capita income of an ODA country exceeds that amount, its marginal contribution to that country's well-being or utility would decline. Obviously, the amount by which the nominal value would exceed the utility value of income would depend upon the form of the utility function that has been assumed. According to the form given in the Human Development Report, this amount exceeds 60% for most ODA countries. Even if the amount were only 10%, it would yield a large sum of money that the rich of the richer countries could spare without much loss in their well-being. If only 10% of that sum is transferred as aid to developing countries and 90% is used for social expenditure in industrial countries themselves, the aid amount can go up to four-times the current level. It is of course possible to reject the logic of this exercise by suggesting that the welfare functions of the ODA countries are such that the marginal contribution to welfare of per capita income does not diminish at all except at a very high level so that there is very little difference between their nominal income and its contribution to welfare. In other words, they would have very little to spare for the developing countries without hurting themselves. Since nobody knows the actual form of welfare functions it is not possible to counter this argument definitely. However, looking at the numbers it would be quite legitimate to assure that the ODA countries should be able to increase their aid without sacrificing much of their welfare. At least they should not reject the reciprocal obligation of the Development Compacts proposed in this paper on grounds of the paucity of resources.

## **APPENDIX**

**Table 1 - Possible Contribution to the Aid Fund: 1989 (ODA Countries Only)**

**Table 2 - Possible Contribution to the Aid Fund: 1989 (Non-ODA Countries)**

APPENDIX TABLE 1

## POSSIBLE CONTRIBUTION TO THE AID FUND: 1989 (ODA COUNTRIES ONLY)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
	GNP per capita [US \$] 1989	Popula- tion [million] 1989	Total GNP [US \$ billion] 1989 [1]*[2]	Real GDP per cap. [PPP \$] 1989	Total GDP [PPP\$ billion] 1989 [4]*[2]	Adjusted real GDP [PPP \$] 1989	Tax on a GDP per capita basis [PPP \$]	Tax on a total GDP basis [PPP\$ million] [7]*[2]	Percentage of taxes to total GDP [8]/[5]	Tax on a total GNP basis [US\$ million] [9]*[3]	Tax on a GDP per cap. basis [PPP\$]	Tax on a total GDP basis [PPP\$ million] [11]*[2]	Percent- age of taxes to total GDP [12]/[5]	Tax on a total GNP basis [US\$ million] [13]*[3]
Switzerland	29,880	6.5	194.5	18,590	121.0	5,051	268.0	1,744.6	1.4 (.31)	2,804.1	134.0	872.3	0.7	1,402.0
Japan	23,810	122.9	2,926.6	14,311	1,759.1	5,018	141.4	17,374.2	1.0 (.31)	28,906.5	70.7	8,687.1	0.5	14,453.2
Norway	22,290	4.2	93.6	16,838	70.7	5,047	215.4	904.7	1.3 (1.17)	1,197.6	107.7	452.3	0.6	598.8
Finland	22,120	5.0	109.7	14,598	72.4	5,032	148.2	735.1	1.0 (.64)	1,113.9	74.1	367.6	0.5	557.0
Sweden	21,570	8.3	179.9	14,817	123.6	5,036	154.8	1,291.0	1.0 (.90)	1,879.4	77.4	645.5	0.5	939.7
USA	20,910	247.2	5,169.9	20,998	5,191.6	5,074	289.7	71,636.7	1.4 (.19)	71,336.5	144.9	35,818.3	0.7	35,668.2
Denmark	20,450	5.1	104.7	13,751	70.4	5,016	130.2	666.4	0.9 (.93)	991.1	65.1	333.2	0.5	495.5
Germany	20,440	77.3	1,579.7	14,507	1,121.2	5,027	145.5	11,242.5	1.0 (.42)	15,840.5	72.7	5,621.3	0.5	7,920.2
Canada	19,030	26.3	500.4	18,635	490.0	5,051	269.3	7,081.8	1.4 (.44)	7,231.9	134.7	3,540.9	0.7	3,615.9
France	17,820	56.0	997.4	14,164	792.8	5,018	138.4	7,747.2	1.0 (.52)	9,746.9	69.2	3,873.6	0.5	4,873.4
Austria	17,300	7.5	129.6	13,063	97.9	5,013	116.4	872.2	0.9 (.25)	1,155.2	58.2	436.1	0.4	577.6
Belgium	16,220	9.9	161.1	13,313	132.2	5,014	121.4	1,205.6	0.9 (.45)	1,468.8	60.7	602.8	0.5	734.4
Netherlands	15,920	14.7	234.0	13,351	196.2	5,014	122.2	1,795.4	0.9 (.93)	2,140.9	61.1	897.7	0.5	1,070.4
Italy	15,120	57.3	866.1	13,608	779.5	5,015	127.3	7,291.5	0.9 (.32)	8,101.7	63.6	3,645.8	0.5	4,050.8
U.K.	14,610	56.9	830.8	13,732	780.9	5,016	129.8	7,379.3	0.9 (.27)	7,851.1	64.9	3,689.7	0.5	3,925.6
Australia	14,360	16.5	237.6	15,266	252.6	5,040	168.2	2,784.1	1.1 (.34)	2,618.8	84.1	1,392.0	0.6	1,309.4
New Zealand	12,070	3.4	40.5	11,155	37.4	5,002	78.2	262.2	0.7 (.22)	283.8	39.1	131.1	0.4	141.9
Ireland	8,710	3.7	32.1	7,481	27.6	4,932	26.5	97.8	0.4 (.16)	113.8	13.3	48.9	0.2	56.9
			14,388.2						1.19 (.35)	164,782.3			0.57	82,391.1

Notes: Threshold income for basic needs in these countries,  $y^*$ , assumed to be \$4,829 (PPP\$).

Column 10, gives the total liability for foreign aid of the countries, at a tax rate of 0%, for per capita income  $y \leq y^*$ ; at 1% for  $y > y^*$ , but  $\leq 2y^*$ ; at 2% for  $y > 2y^*$  but  $\leq 3y^*$ , and so on.

Column 14, gives the total liability for foreign aid of the countries at a tax rate of 0% for  $y \leq y^*$ , at 0.5% for  $y > y^*$  but  $\leq 2y^*$ , at 1% for  $y > 2y^*$ , but  $\leq 3y^*$  and so on.

Bracketed figures under column 9 show the 1990 ratios of ODA to GNP for each country.

APPENDIX TABLE 2

## POSSIBLE CONTRIBUTION TO THE AID FUND: 1989 (NON-ODA COUNTRIES)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
	GNP per capita [US \$] 1989	Popula- tion [million] 1989	Total GNP [US \$ billion] 1989 [ 1 ] * [ 2 ]	Real GDP per capita [PPP \$] 1989	Total GDP [PPP\$ billion] 1989 [ 4 ] * [ 2 ]	Adjusted real GDP [PPP \$] 1989	Tax on a GDP per capita basis [PPP \$]	Tax on a total GDP basis [PPP\$ million] [ 7 ] * [ 2 ]	Percentage of taxes to total GDP [ 8 ] / [ 5 ]	Tax on a total GNP basis [US\$ million] [ 9 ] * [ 3 ]
Luxembourg	24,980	0.4	9.2	16,537	6.1	5,046	103.2	37.9	0.6	57.3
Iceland	21,070	0.3	5.3	14,210	3.6	5,018	69.7	17.5	0.5	25.9
U.A. Emirates	18,430	1.5	28.4	23,798	36.7	5,079	144.9	223.2	0.6	172.8
Kuwait	16,150	2.0	32.5	15,984	32.2	5,044	94.9	191.1	0.6	193.1
Qatar	15,500	0.4	5.5	11,800	4.2	5,007	45.6	16.1	0.4	21.2
Brunei Darussalam	15,390	--	--	14,590	--	5,031	74.0	--	--	--
Bahamas	11,320	--	--	11,293	--	5,003	40.5	--	--	--
Singapore	10,450	2.7	27.9	15,108	40.4	5,039	81.8	218.5	0.5	151.2
Hong Kong	10,350	5.8	59.7	15,180	87.5	5,039	82.8	477.4	0.5	325.5
Israel	9,790	4.5	44.2	10,448	47.1	4,996	32.0	144.6	0.3	135.5
Spain	9,330	39.2	365.6	8,723	341.8	4,954	19.5	763.0	0.2	816.1
Cyprus	7,040	0.7	4.9	9,368	6.5	4,964	22.7	15.7	0.2	11.8
Barbados	6,350	0.3	1.6	8,351	2.2	4,948	17.6	4.6	0.2	3.5
Bahrain	6,340	0.5	3.2	10,804	5.4	4,999	35.6	17.7	0.3	10.4
Saudi Arabia	6,020	13.6	82.0	10,330	140.7	4,994	30.9	420.5	0.3	245.1
Malta	5,830	0.4	2.0	8,231	2.9	4,946	17.0	6.0	0.2	4.2
Greece	5,350	10.0	53.6	6,764	67.8	4,917	9.7	97.0	0.1	76.7
Libyan Arab Jamahiriya	5,310	4.4	23.3	7,250	31.8	4,927	12.1	53.2	0.2	38.9
Oman	5,220	1.4	7.4	10,573	15.0	4,997	33.3	47.4	0.3	23.4
Total	210,220	88.1	756.3	229,342	871.9	94,948	967.8	2,751.4	0.31	2,312.6

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**UNU World Institute for  
Development Economics Research  
(UNU/WIDER)  
Annankatu 42 C  
00100 Helsinki, Finland**

**Telephone (358) 0-693841  
Telex 123455 UNUEI SF  
Facsimile (358) 0-6938548**