Relation of Foreign Aid to Home Investment

The Concept of a Foreign Aid Multiplier

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While in India the import content of the development plan is relatively low, in so far as its economy is more diversified, the scope for the creation of export surplus is also relatively large, particularly when account is taken of the flexibility of the policy of import restrictions.

The object of this paper, however, is mainly to indicate the lines on which the gain from foreign aid is to be investigated. If an underdeveloped country decides to surrender an available foreign aid, it must do so with full atmreness of the inplication of the decision.

FOREIGN aid In the form of equipment and technical personnel facilitates home investment and provides a necessary initial push towards the economic development of an under-developed country. It is of the nature of an under-developed economy that the supply of technical equipment and skill is short relatively to the needs of development, and it is just these deficiencies that is sought to be met by foreign aid. The under-developed economies need this initial impulse, and the advanced countries are becoming increasingly aware of their obligation to supply this impulse. Yet there are people who, while recognising the need for aid, urge caution against its acceptance by under-developed countries on political grounds. Foreign aid, it is feared, tends to carry with it foreign interferences of all kinds against which it is difficult to provide adequate safeguard, This is an understandable caution, considering the fact that most of the under-developed countries, particularly of South-East Asia, have just emerged from a long period of political subjection. In our own country there has been of late a tendency to raise the question from a political to an ethical plane. India must not, it is urged, accept economic aid from the U. S. unless the latter shows the way to stopping A-bomb tests. In view of all this it is Important to conder the nature and extent of loss that surrender of foreign economic aid means for an under-developed country wishing to have a planned course of development.

Transfer Problem

Is the significance of foreign economic aid to be judged simply by the amount of aid or by something more? Can an under-developed economy be self-sufficient in the matter of planned investment for development purposes? If not, what Is the degree of dependence that home investment has on foreign resources, and how far is it possible for the planning country to secure the necessary foreign resources without foreign loans or grants? The matter can conveniently be put in terms of finance. Suppose that the entire finance required for a scheme of public investment is available within the country either by way of internal savings or by way of taxation. Does it necessarily ensure command over the real resources that the scheme involves? If the necessary resources are all available within the country the answer is simple. If, on the other hand, a part of the resources has to be imported, complications crop up, and we have the familiar 'transfer' difficulties. This indeed is one of the things that a purely 'financial' approach to planning seems to ignore. Foreign aid removes these complications by placing foreign resources directly at the disposal of the receiving country. In so far as foreign resources are a necessary complement of domestic resources in a given scheme of economic development, the aggregate home investment that is made possible by foreign aid is a multiple of the amount of the aid. What is the value of this multiplier, and on what does it depend?

Import Content of Development

Assume that the technical coefficient of the planned investment is fixed, so that the ratio between the foreign constituent and the domestic constituent of the investment plan is also fixed. Assume further that the economy where the additional investments are planned for developmental purposes is otherwise in a state of foreign trade equilibrium, and that beyond the point of equilibrium the elasticity of exports is zero. The foreign aid multiplier can then be readily deduced from the import content of the development plan; for it turns out to be the reciprocal of the ratio of the foreign constituent to the aggregate investment planned. If, for example, this ratio is 1:4,—if, in other words, the foreign constituent is 25 p.c. of the planned investment, the foreign aid multiplier is 4. If the ratio is 1 :5, the foreign aid multiplier is 5. And so on, -the value of the multiplier varies inversely with the import content of the investment plan. If, on the other hand, the technical coefficient is freely variable, -if, that is to say, the foreign resources can be freely substituted by internal resources, or alternatively, if the elasticity of exports of the country is infinity, the foreign aid multiplier comes down to unity. In this latter case, the benefit that the country derives from foreign aid is just equal to the amount of the aid; if foreign aid is surrendered, aggregate investment is less by just the amount of the aid.

A numerical example will make the matter clear. Suppose that a country plans an investment of the order of Rs. 1000 crores, of which the foreign constituent in physical terms is worth Rs. 200 crores. The import content is thus 20 p.c. of the planned investment. Now, the planning authority, let us say, collects enough savings to finance the internal share of the investment, i.e. Rs. 800 crores. On our first assumption, a foreign grant or loan of the balance of Rs. 200 crores makes it possible for the country to carry the entire scheme of investment through, while its absence renders the entire scheme abortive. In this case the surrender of foreign aid of the order of Rs. 200 crores results in a loss of investment of the order of Rs. 1000 crores. On our second assumption, on the other hand, there are two possibilities. In so far as the method of production is freely variable, the investment pattern can be so chosen as to be independent of foreign resources. And in so far as exports are perfectly elastic, one-fifth of the internal savings (i.e., Rs. 160 crores) can be used for the purchase of exportable goods within the country against which an equivalent amount of foreign ex-

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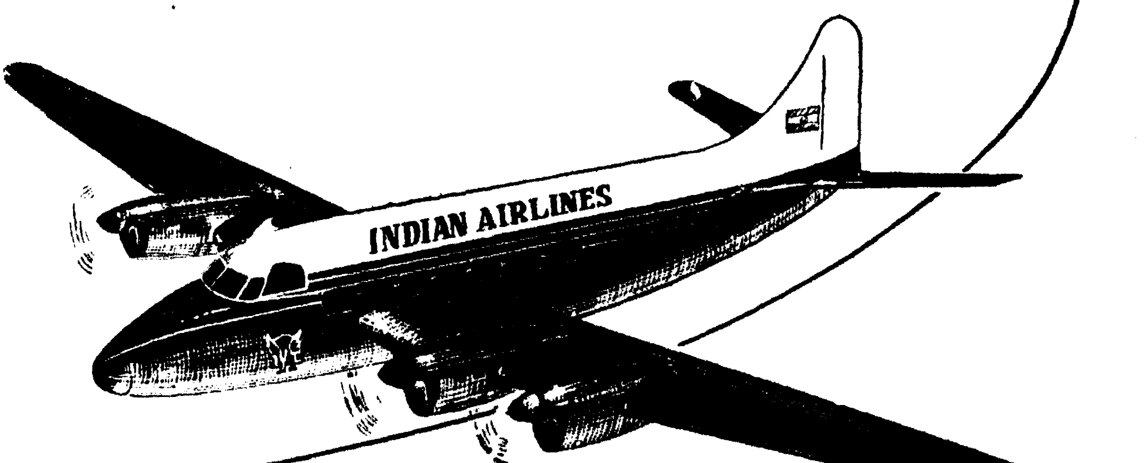

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change can be secured. In either case the loss of investment due to the surrender of foreign aid turns out to toe just Rs, 200 crores, the volume of Investment being reduced from Rs, 1000 crores to Rs. 800 crores.

Multiplier Inverse to Import Content

The conclusion that is deduced from our first assumption is somewhat of a paradox. The value of the foreign aid multiplier is high if the share of the foreign constituent in a piece of investment is relatively low, and vice versa. It thus looks as if the less dependent an under-developed country is on foreign resources for the implementation of its plan, the greater is the significance of foreign aid. But the paradox is more apparent than real. It is true that the conclusion is unavoidable if we follow our assumption strictly; even a small link, if it is weak, mars the strength of an otherwise stout chain. However, the tyranny of complementarity revealed here is tempered by the possibilities of export surplus envisaged in our second set of assumptions; a country can within limits secure command over foreign resources through internal measures. And here obviously the smaller the share of foreign resources in a given plan of investment the greater is the ease with which the necessary export surplus can be created. The point may be illustrated with reference to a few hypothetical cases.

Case A Import Content 20%

		Rs. (Crores)
(1)	Foreign aid available	200
	Internally available finance	800
	Total investment	1,000
(2)	Foreign aid available	Nil
	Export surplus created (1|5th of the internally available finance)	160
	Total investment	800
	Loss of investment due to the surrender of foreign aid	200
	Foreign Aid Multiplier	1
(3)	Foreign aid available	Nil
	Export surplus created (1|8th of the internally available finance)	100
	Total investment	500
	Loss of investment due to the surrender of foreign aid	500
	Foreign Aid Multiplier	2.5

Case B : Import Content 40%

		Rs. (Crores)
(1)	Foreign aid available	400
	Internally available finance	600
	Total investment	1,000
(2)	Foreign aid available	Nil
	Export surplus created (115th of the internally available finance)	120
	Total investment	300
	Loss of investment due to the surrender of foreign aid	700
	Foreign Aid Multiplier	1.75
(3)	Foreign aid available	Nil
	Export surplus created (l/8th of the internally available finance)	75
	Total investment	187.5
	Loss of investment due to the surrender of foreign aid	812,5
	Foreign Aid Multiplier	2.03

The general assumption in all these cases is one of fixed technical coeflacient, i.e. to say, a fixed ratio of foreign exchange requirement to the total investment plan. In case A the ratio is 1:5, and in case B the ratio is 1:2.5. And yet, in so far as there are possibilities of the creation of export surplus, the multiplier is so damped down that under certain conditions its value becomes less in case A than in case B. In Case A (2) for example, the foreign aid surrendered is Rs. 200 crores and the consequent loss of investment is also Rs. 200 crores, so that the foreign aid multiplier is unity. In the corresponding case under B, the foreign aid surrendered is Rs. 400 crores, and the loss of investment is Rs. 700 crores, so that the foreign aid multiplier comes up to 1.75. Cases A (3), B(2) and B(3) are specially interesting. They bring out one significant feature of an under-developed economy, namely that the total realised investment may often fall below the internally available finance. The bottleneck In these economies is not always finance. Even if adequate finance is available, investment may often lag behind schedule on account of the non-availability of necessary technical resources for which these economies have to depend on foreign sources.

Import Content of Development

The degree of complementarity of various types of technical resources in any investment plan is a function of the period within which the plan is sought to be realised. The shorter the period the greater is the technical rigidity of the investment components. In the context of rapid economic development which happens to be the aim of the under-developed countries, the proportion of the foreign exchange requirement to an investment plan is likely to be more or less fixed. In the case of India it is supposed to be around 20%, while in the case of the comparatively less developed economies, it would perhaps be between 35 and 40%. The International Bank, for example, puts the figure at 33.5% for Columbia and at 36% for Ceylon, while Ceylon's own Colombo Plan estimates a figure of 35 to 40%. The conditions in other under-developed economies would not surely warrant a substantially smaller figure. While, however, in India the import content of the development plan is relatively low, in so far as its economy Is more diversified, the scope for the creation of export surplus is also relatively large, particularly when account is taken of the flexibility of the policy of import restrictions. The cases considered above, even though hypothetical in character, may therefore serve as a basis for the measure of the foreign aid multiplier in these countries. If Case A approximates to the conditions of India and Case B approximates to the conditions of the relatively less developed economies, then, considering their respective scope for the creation of export surplus, the value of the foreign aid multiplier in these countries would in all probability lie between 1.5 and 2. This is just a guess and should be taken at what a guess is worth. The object of this paper is mainly to indicate the lines on which the gain from foreign aid is to be investigated. A closer inspection of the value of the foreign aid multiplier is necessary. For if an under-developed country decides to surrender an available foreign aid, it must do so with full awareness of the implications of the decision.

***Changes, if any, in the barter terms of trade are also ignored.**

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