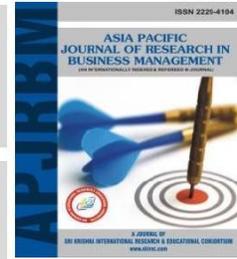




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**AN ECONOMIC ASSESSMENT OF FOREIGN AID AND ECONOMIC GROWTH: A CASE STUDY OF
AFGHANISTAN**

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ABSTRACT

The economy of Afghanistan is passed through thick and thin of economic problems. The devastating situation of Russian war during 1970's was the major hindrance in the political and economic situation of the country. The economy after 2001, the re-structuring and economic reforms agenda of US-led government is the last resort of Afghan nation. Since then major foreign donor agencies led the government towards a strong footing for economic and political stability. Result shows that major economic indicators such as: employment, poverty alleviation, economic growth and other structural reforms have a positive tendency in Afghanistan as a result of foreign aid. It is further recommended that the economy must find its indigenous resources for sustainability and long term economic growth and development.

KEY WORDS: Foreign Aid, Economic Growth, Economic Development

Introduction

The economy of Afghanistan is considered one of the poorest countries of the World as a result of political instability and many decades of war. The country seen a widespread destruction due to Russian war. The administrative units, economic/ financial institutions and formal social institutions have badly affected during the last few decades. The freedom fighters and Taliban was the major stakeholder of a huge blow to the economy. The key areas of the economy was badly suffered during 1970's and 1990's move of Russia and Taliban led government respectively (Franck, 2008).

The major shift in the economy was seen after September 11, 2001. The attack of US on Afghanistan have been transformed the economy in various dimensions. The Taliban led government was removed and interim government was established in the country. The interim government led by Mr. Hamid Karzai a reconstruction and rehabilitation conference was arranged in Tokyo, Japan in 2002 to attract foreign donor agencies and developed countries to support Afghanistan in economic and institutional challenges. The conference was successful in term of financial and leadership support of donor countries (Franck, 2008).

Afghanistan being a least developed country is trapped in vicious circle of poverty. It happened as a result of low incomes followed by low saving and investment. Furthermore, the taxable capacity is also lower in the economy and earnings of government also have the same position. As a consequence the country is facing deficit in both investment and saving and also in balance of payments. To fill the export-import gap and saving-investment gap, the economy will rely on Foreign Capital Inflows (FCI) as a last resort. FCIs are of various forms such as: Foreign Direct Investment, Export Credit, Technical assistance, Emergency relief, grants and loans etc. Although developing countries need FCIs but its form is different from country to country depends upon the nature and structure of the developing economy. Among others, the economic circumstances and size of the economy are the major determinants in attracting FCIs. For example, the developing countries in East –Asia are relying on Foreign Direct Investment (FDI) and underdeveloped countries in Africa have dependency on foreign aid. The structure of Afghanistan is much closer to that of developing countries in Africa and still it depends upon foreign aid (Asiedu, 2001).

The economy of Afghanistan FCI is justified on the following grounds. Firstly, The Two-Gap model, a major argument that is deficit in saving and deficit in Balance of Payment needs to be rectified with the support of foreign debt. On the other hand, The FCI will also accelerate and facilitate the indigenous capacity of the country and will enhance production which in turn will enhance the national income and saving. The foreign aid is also justified on the ground that it will also hamper the technical capacity of local workers in the form of updated machineries and transfer of skills from the donor countries (Collier, 2002).

Foreign aid has positive impact on economic growth through several ways. (i) It increases investment opportunities in the recipient countries (ii) It also the mode of maximizing the capacity to import technology or capital goods (iii) It also increases endogenous technical change and promotes capital productivity in recipient countries (Kosack, 2006).

(Kimur, 2010) studies the relationship between foreign investment, foreign aid treaties, domestic saving and economic development in 34 countries during 1951-1969. Results showed that the flow of foreign aid has a sustainable impact on economic growth compared to other variables. They have suggested that it is foreign aid which can bridge the exchange rate gap compared to domestic saving in under developed countries. More importantly, FCI is useful to come up with a solid solution to constraint in balance of payments position of recipient's countries. They also resulted a negative correlation between domestic saving and foreign aid which was considered a serious issue in growth performance.

(Knack, 2001) examined the impact of tied loans on economic growth in 77 developing countries on annual data from 1971-1990 using regression techniques. They analysed the modern economic growth theories while keeping foreign aid, human capital and domestic saving as explanatory variables. Results showed that foreign aid has a positive correlation with economic growth, while domestic saving has negative correlation with economic growth. It is consistent with the foreign aid theory which assumed that foreign assistance accelerated economic growth through domestic capital formation in developing countries.

(Karakaplan, 2005) resulted a significant relationship between foreign aid and economic growth in selected lagging economies. He further proclaimed that previous result showed larger countries with more foreign aid have recorded low economic growth. Similarly, they resulted that small countries recorded faster economic growth as a result of foreign aid. Donors also prefer to extend financial support to many small countries compared to few large countries based on aforementioned facts. There is another controversy from donors in term of foreign aid. The reason for such controversy tends to receive less aid than they expected to complete their long term projects. Moreover, giving decisions of donor countries depends upon the relationship between the two countries. Some of the recipient countries also remained colonies of donor countries which also helpful in decision regarding the volume and size of foreign aid. Another finding of the study was trade is relatively a larger fraction of GDP in small countries and gained more weight in assessment of donors for aid giving undertakings.

(Karras, 2006) while using cross-country analysis indicated that one of the major source of quality of government index erode as a result of foreign aid. The major factors were corruption, rule of law and bureaucracy. He argued that dependence on aid can potentially underestimate institutional quality, rent seeking behavior, alleviating pressures to reform inefficient institutions and polices. Larger amount of aid inflows have no significant correlation with general welfare of the communities and economic growth and it reduced expected public goods quality and increased rents in the recipient country. Any

permanent increase in foreign aid reduces capital accumulation, long-run labour supply and rising long-run consumption and surprisingly having negligible impact on foreign borrowing.

Kuziemko (2006) used the optimal growth model with foreign borrowing, domestic saving, and investment, foreign aid and consumption-leisure choices. They resulted that foreign aid has negative effect on domestic saving and the income received are mostly spent on consumption oriented activities and having no impact on growth and investment in under developed economies.

(Smith, 2009) examined the connection between aid and economic growth in Afghanistan. While using game theory, he argued that the major problems in aid utilization for economic growth exist in built-in-incentive of the aid utilization system itself. They found that developing countries deviates from their commitment after receiving foreign aid. The main reason for low speed of economic growth in developing countries is that they rely solely on foreign aid and lacking management skills to utilize their endogenous resources which in turn hamper their growth rate.

Various studies found the positive effect of foreign aid on economic growth while keeping certain factors in loop. Among those factors strong monetary and fiscal policies mechanism to utilize foreign aid effectively were prominent and countries having weak mechanism of these policies showed that foreign aid is less effective for economic growth. Dollar (1997) used the data for 56 developing countries during 1970-1993 and analysed growth convergence model. While analyzing the relation among Aid, Growth and Economic policies found that foreign aid significantly effected economic growth in those least developing countries which have a strong fiscal mechanism. They further found that the role of economic policies seemed more important for aid effectiveness in in lower income countries. They also found that aid follows the trend of diminishing returns to scale. The tendency for bilateral aid or total aid favours effective utilization of policies.

A realistic approach to receive foreign aid from donor countries depends upon effective environment for aid utilization did not considered practically. The proper design of aid plans, strengthen institutions, transfer of technology and skills were the major factors in aid utilization process. In least developing countries aid management plan is more important than money aid. It implies that investment channel is more appropriate in middle developing countries and they are getting benefits from aid up to a reasonable extent and led to raise the tempo of growth. They further suggest that reforms through knowledge, transfer technology and policy makers training were the major determinants of trade utilization. Aid utilization is more effective when the plan for such funds is planned by local authorities and hence more effective when it is backed by enough reforms by local authorities (Boone, 1994).

(Burnside, 1997) studied the relationship between foreign aid and economic growth in under developed countries during 1960-1980 while removing government intervention from analysis. An interesting point was foreign aid was significant in case of economic growth when government intervention variable was ignored. When government intervention variable was included in the list of explanatory variables such relation was statistically very weak which shows that government intervention was significant variable in case of economic growth in this case. Furthermore, foreign aid affected negatively indigenous saving while exports, per capita income and country's size affect economic growth positively.

Bruno (1998) studied the various dimensions of foreign aid from 1975-99 in panels under developed countries. He categorized foreign aid into food aid, project aid, programme aid and technical assistance aid. Using Autoregressive model they found that as a result of project aid public savings reduced while, the impact of programme aid in this case was normal. On the other hand, food aid and technical assistance were having positive impact on public saving. Programme aid and to a lower extent technical assistance reduced the dependence on international trade.

(Kilic, 1991) applied granger causality test between foreign aid and economic growth in case of Cameroon, while applied other diagnostic tests found causal relationship between foreign aid and economic growth but not foreign grants. The impact of domestic resources on economic growth was significant on economic growth in case of Bangladesh from 1972 to 1988. Nevertheless, when foreign resources were classified into different groups and resulted that foreign loans were more effective than grants and project aid were more effective than food aid.

The effect of foreign aid were different in different under developed countries. While using data from 1960-79 in ten developing countries showed that the impact of foreign technical assistance on official development assistance was significant. In countries like South Korea, Taiwan, Kenya Thailand and Kenya foreign assistance accelerated economic growth while in Tunisia, Ghana, Sri Lanka and Chile the impact was negligible on economic growth. The growth factors in post-aid scenario was higher either or lower depends upon three points. (i) Poverty level of country before aid. (ii) Rise in government consumption in percentage of aid received. (iii) The terms of aid. The government replaces portion of saving on aid that freed money to other programmes which are indispensable (Isham, 1997).

The present study is designed to identify the effects of FCI on economic growth in Afghanistan. Furthermore, it analyses the effectiveness of foreign aid on economic stability of the country and also examine the role of foreign aid on GDP growth in Afghanistan.

RESEARCH METHODOLOGY

The present study used the primary data collected through structure questionnaire and interview method. Different heads of government ministries including ministry of finance, ministry of health, ministry of education and ministry of rural rehabilitation and development, Da Afghanistan Bank and other financial institutions and local NGOs were contacted for collection of data.

RESULTS AND DISCUSSION

The Tendency of foreign aid exists since ancient past. Since 19th century private aid flowed from western countries to under developed countries. They also contributed in the form of missionary schools in under developed countries. The mode of aid was very simple till recent past. Following the World war two decolonization, European reconstruction, and the rivalry between developed countries badly suffered the under developed countries. During that time aid to poor countries was given in the form of expertise, skilled labour and materials. Recently, in Afghanistan foreign aid received of various dimensions but the respondents have the opinion that aid received in various forms are not according to the planned presented by Afghan government. The donors have imposed certain conditionalities which are not according to indigenous demand of Afghan community. The foreign aid in Afghanistan created temporary boom in the economy which is another reason for inflation in the economy and that's why the Afghan economy is called bubble economy. The respondents from financial institutions proclaimed that the situation in Afghanistan will be worse than before when all such funds are stopped in the country.

The donors have spent USD 36 billion from 2002-2010 on various projects and programme in Afghanistan, out of which 12 billion was received in untitled loans and grants. These aids are mostly spent on infrastructure development, capacity building programmes and reconstruction of Afghanistan. The major donor agencies in the country were CIDA, JICA, DFID, USAID and other leading monetary institutions like World Bank and IMF. USA is the single largest donor to the country in last eight years (2002-2010) and has provided almost USD 20 billion to Afghans.

The foreign aid spent in Afghanistan during 2002-2010 was USD 1241 per capita which is relatively less than such aid received in Bosnia and Iraq, while Afghanistan needs more aid than mentioned countries because Afghanistan is least in poverty indicators. A major share of donations has spent on military related projects where the donor countries are snatching the money back in form of consultancy services to various departments. The respondents were of the opinion that as a result of such funds consultants are taking almost 30 percent of allocated funds provided by donor agencies to Afghan

economy. Another important point to be mentioned here is 50 percent of the foreign aid is spent by donor agencies directly in the country which also created gap in disbursement and management of projects.

The invasion of USSR in Afghanistan in 1979 and followed by civil war in 1980's destroyed the limited infrastructure, SMEs and other economic and financial institutions. The trend in Afghanistan moved to planned economy from traditional economy in 2002 led by US based policies. The domestic trade and GDP of the country has decreased enormously since 1980 and needed a big push since 1980s. The economy moved to a reasonable extent in 2010 as a result of multi billion dollars received in various forms of foreign aid. The GDP growth rate was 22.5 percent in 2010 which was highest in last few decades but again policy makers proclaimed that it happened as a result of easy money (foreign aid).

The respondents from Ministry of Rural Rehabilitation and Development (MRRD) were much optimism about the future of Afghanistan. They were of the opinion that the multi-million projects and programme started by the ministry will have a long term sustainable impact on the economy. As a result of private-public sector programme initiated recently by the ministry will stand still after the donor countries stop its funds. The reason for such opinion was that MRRD is working on such projects which will remain for years because these programmes can generate revenue by its own, once it was launched successfully.

One of the fundamental areas of aid utilization was natural resources. The respondents from Ministry of Finance were of the opinion that donors are showing little interest to provide support for investing in such resources. Although the Government of Afghanistan had successful enough by launching International conferences to attract donors for providing support in investment in natural resources but the result of these investments is very limited. This sector need to be explored in real form because the previous experiments showed that Afghanistan is one of the rich resources country in the region and if this sector is explored it can change the destiny of the country.

The World Bank officials responded that challenges faced by Afghan communities are of two folds. One section is understating of the constraints in form of foreign aid complexities and another section in form of growth driven policies. The annual reports of world Bank in 2009 addressed that development partners and Government ministries is facing problems in medium term and long term strategies envisaged for sustainable development. The current set up of government is based on external sources for fiscal operations and it will face serious repercussions if they did not found alternate to foreign aid. The government needs a strong base of taxes which can alter the situation but it needs a sacrifice form

the people of least developed countries where major segment of population are living below the poverty line.

CONCLUSION

The foreign aid received so far in Afghanistan have both the positive and negative effects. On the positive side, foreign aid is the significant factor in rising per capita GDP, structural transformation of the economy, technical assistance, modern technology, assisting in balance of trade and providing enough foods and consumption oriented businesses in the country. The projects for the construction of roads, bridges, electricity and laid foundation for the military forces of the country are also the attractive side of foreign aid. On the negative side, foreign aid substituted domestic savings, rise in burden of public debt and strong dependence of foreign aid trapped the economy in to vicious circle of debt. The burden of foreign debt have been raised in Afghanistan over the last decade and the country will face serious issues of debt servicing if the management of macro economy, aid coordination policies, domestic saving polices and polices of international trade and Regional trade did not planned and managed properly.

The economic policies of all types are very vital for the effective utilization of foreign aid. In Afghanistan the new trend of market economy started after 2001 have a serious issue with metropolitans. As the new ministries formed after 2001 have a shape and designed which is not according to the traditional setup of the country. If these ministries and NGOs are working with donor interests then this country will not experience the permanent income stability and will be relying on foreign debt for ever. The polices of foreign aid which are for long term sustainability need to be framed on practical bases and need a strong mechanism of monitoring and evaluation of donor countries and Afghan government jointly. One can easily conclude that if proper monitoring of the programme and projects of foreign aid is ensured it can change the destiny of Afghanistan.

The dream of achieving long term economic growth in Afghanistan is a dream for Afghan in real sense based on its current scenario. The donors are giving foreign aid on their own disposals and the sustainability of the economy needs coherent polices to the indigenous requirement of Afghan communities. The strategic plan for medium and long term development is another milestone in this regard.

The economy of Afghanistan can achieve the dream of long term sustainable growth when the security situation becomes favourable and market distortions are managed effectively. One can provide a real solution to the dilemma prevailing in Afghanistan when providing enough campaigns and awareness

seminars to provide stability in Afghanistan. The economic stability cannot be achieved without political stability and vice versa. The donor countries needs to sustain the aid for coming few decades but needs to provide a legal cover in form of investing in sustainable projects which may be linked with livelihood projects and investing in natural resources.

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