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**“ROLE OF FOREIGN ASSISTANCE IN ECONOMIC
DEVELOPMENT OF PAKISTAN”**

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ABSTRACT

This study evaluates the effectiveness of external development assistance provided to Pakistan. First the study critically goes through the foreign debt and aid profile in Pakistan. It has been established that Pakistan since its inception has received a large amount of foreign assistance for its development projects. But after 1980s Pakistan accumulated a huge amount of foreign debt, which is adversely affecting its growth performance. Second, the aid effectiveness issue is also evaluated in the context of Paris Declaration (2005). It becomes clear that both government of Pakistan and donors are jointly responsible to fulfill the declaration agenda. For that purpose several policy recommendations have been suggested both for the government of Pakistan and the donor countries and organizations. By overcoming the previous mistakes and following these suggestions the effectiveness of aid can be increased in the recipient countries.

EXECUTIVE SUMMARY

This study evaluates current position of Pakistan's external debt and aid with special references to the effectiveness of external development assistance to Pakistan. This study is accomplished in the light of Paris Declaration (2005), which seeks to address ways through which the effectiveness of external aid can be enhanced by overcoming the deficiencies of both donors and recipient countries.

There is no tension between Government of Pakistan and its donors in terms of aid relations. With some suspicions, donor countries and organizations state satisfaction with Pakistan as a partner country and with the outcomes of their own projects and programs. Opinions on the government side are somewhat mixed but no-one talks in terms of a crisis. On the other hand, displeasure is also uttered. However, such types of unhappiness have been expressed against other developing also. There has been reasonable progress in harmonization and alignment in recent years but few thought adequate progress had been made. There have been few discernible changes by either donors or government of Pakistan as a result of commitments entered into in Paris Declaration (2005).

There are not well-established dialogues between government of Pakistan and donor countries and organizations except then the annual Pakistan Development Forum (PDF) meetings, the nature of which is not conducive to decision-taking or genuine dialogue.

Some groups argue that the Paris agenda is not applicable to Pakistan. It is noted, from an examination of the Declaration, that much of it is relevant to Pakistan and disagree with the claims that irrelevance is a justification for inaction. It has been mentioned, however, that many of the limitations on aid effectiveness in Pakistan are the same as those in other developing countries. The study identifies specific fundamentals, which particularly stand in need of implementation locally, particularly in the areas of ownership, weak government of Pakistan capacities, limited alignment of donors with government systems, deficient mechanisms for dialogue and mutual accountability, and limited joint working by donors. Responsibility for these is shared between government of Pakistan and donors.

This study provides the ways and means to strengthen the aid effectiveness in Pakistan. For that purpose different recommendations have suggested that should be taken

both by government of Pakistan and donors as the responsibility to meet the Paris Declaration lies on the shoulders of both government of Pakistan and donors.

Recommendations for government of Pakistan include among others:

- ∞ To improve its governance and capacity of public sector administration and planning for the implementation of Paris Declaration reforms
- ∞ A more holistic approach that captures synergies across sectors, agencies and programs tends to enhance aid effectiveness.
- ∞ To develop a statement of aid policy
- ∞ To improve public services
- ∞ Government of Pakistan should improve its coordination with donors.
- ∞ Government should integrate capacity strengthening objectives through a country-led capacity development strategy. Special attention should be paid to strengthening public financial management capacity.
- ∞ For better reporting government should strengthen the links between its development strategies and budget processes. Also to establish results-oriented reporting and assessment frameworks.
- ∞ Pakistan must maintain the sustainability of its reforms.
- ∞ Government should increase absorptive capacity in the country

The following recommendations are suggested for the donors among others.

- ∞ Donor countries should form an aid effectiveness group. The existing informal Poverty Reduction Working Group appears an appropriate existing institution to be developed in this way.
- ∞ Financial assistance by the donor countries needs better targeting towards least developed countries, and towards other low-income countries.
- ∞ Institution of joint monitoring and evaluation arrangements and discussions among sets of donors for the institution of joint monitoring and evaluation are required.
- ∞ To review their conditionalities imposed on recipient countries.
- ∞ Intensified efforts at the sectoral level to establish the conditions necessary for the development of sector-wide approaches (SWAs)
- ∞ Coordination among all relevant stakeholders is essential

- ∞ Following the lead of a recent initiative by the Asian Development Bank, consideration of other ways of simplifying donor procedures and reducing the government of Pakistan's transactions costs.
- ∞ Donors to implement common arrangements for planning, funding, disbursement, monitoring, evaluation and reporting. They should commit to work together to reduce the number of separate missions and diagnostic reviews.
- ∞ Donors should provide timely, transparent and comprehensive information on aid flows. Donors and governments to move towards joint assessments of their respective performances through country-level mechanisms.
- ∞ Development of a collective position on what remains to be done in order to foster greater donor alignment with Government of Pakistan financial reporting and procurement procedures.

ROLE OF FOREIGN ASSISTANCE IN ECONOMIC DEVELOPMENT OF PAKISTAN

1. INTRODUCTION

After the end of the Second World War many countries especially under developed countries highly appreciated the external assistance to boost investment and output growth. Domestic savings, government revenues and foreign direct investment are considered primary means for financing development. Since developing countries face financial constrains, therefore, these countries heavily depend upon external assistance. Foreign aid is useful for growth if it is not substitute of domestic savings. The underlying theory is that initially developing countries has to imports intermediate capital goods for rapid industrialization. These countries face foreign exchange shortages for imports. Therefore, they rely on external sources to finance their imports. In future their exports increases and they become able to forego their debt obligations. If aid is used effectively and in accompanied with complementary reforms, it can in fact leverage the development of a country. Moreover, sustainability of growth will be achieved if aid projects are focused on creating and transmitting knowledge and capacity. In earlier periods, many developing countries remained successful in achieving their targets as they observed high level of growth by getting high level of external assistance. However, in the last two decades empirical research did not find a robust positive impact of foreign aid on economic development (Boone, 1996).¹ This observation leads to some natural questions as why did even substantial aid flows frequently fail to push recipient countries on a steeper growth path and did not generate the desired results. Answering such questions will be crucial to the success of future aid efforts, as without a better knowledge of why aid did not work in the past, ambitious development targets such as the Millennium Development Goals (MDG) cannot be reached.

Pakistan like many other developing countries of the world also received a high level of foreign aid to strength its growth performance. Since Pakistan remained a capital deficient country, therefore, it has been relying on external assistance to finance its saving-investment and balance of payment gaps. Low level of saving in Pakistan forced successive Pakistani

¹ See Rajan and Subramanian (2005) for a comprehensive empirical evaluation of the aid-growth relationship. See also Kraay (2006) for an assessment of the relative importance of international aid in growth regressions.

governments to look for foreign aid to undertake development programs. Moreover, the need of foreign aid became important also due to transfer of technology, capacity building and import financing. High level of foreign debt and aid did not enhance the growth performance of Pakistan. Rather, high level of this accumulation of external debt among other factors is being now considered one reason of hindrance to output growth. Thus, there is a need to improve the effectiveness of foreign aid in Pakistan as without enhancing aid effectiveness, both the short-term (i.e. debt rescheduling) and long-term (i.e. enhancing saving-investment ratio) solutions would fail.

Donors generally express satisfaction with Pakistan as a partner country and with the outcomes of their own projects and programs. However, dissatisfaction is also expressed. Criticism of aid ineffectiveness in Pakistan is similar to complaints in other developing countries about ways in which donor policies and practices reduce the effectiveness of the assistance provided. It was such complaints, which led to the adoption of Paris Declaration (March, 2005) and, before that, of the Monterrey (2002), the Rome Declaration (February, 2003) and the Marrakech (2004). This paper examines the effectiveness of external (development) assistance in Pakistan. This is undertaken in the light of Paris Declaration, which seeks to address ways through which the effectiveness of foreign aid can be reduced that has resulted in the past by shortcomings on the part of both donors and recipient governments.

The rest of the paper is organized as follows. Section 2 discusses about debt. Section 3 provides critical review of debt position in Pakistan. Remedies to combat debt burden in Pakistan are elucidated in Section 4. Section 5 provides the relevance of external aid effectiveness with economic growth. Section 6 highlights the problems of aid effectiveness. Section 7 delineates the ways and means to improve effective of external aid in Pakistan. Final section concludes the discussions and provides some policy recommendations.

2. WHAT IS DEBT

When a government spends more than its revenue it collects, it borrows from various sources to finance the budget deficit. The accumulation of past borrowing from domestic sources is the domestic or public debt. Public debt has two components, (a) rupee component and, (b) dollar component. Similarly, when a country imports more goods and services than it

borrowed from various sources to finance current deficit. It also borrows externally for debt repayment and to maintain a certain level of foreign exchange reserves. The accumulation of all such past borrowing is the external debt.² Generally, both types of debt, that is public debt and external debt, are examined separately because factors responsible for growth of the two types of debt are different and their consequences for the economy are also different. Public debt poses difficulties for the budget while external debt poses difficulties for the balance of payments. Less developed countries (LDCs) accept external debt due to following reasons;

- ∞ Because aid is essential ingredient in the development process
- ∞ Due to political and moral motivations
- ∞ Because it is remedy for saving and small capital stock
- ∞ Remedy for technical backwardness
- ∞ Provision of overhead capital and building of basic infrastructure
- ∞ Establishment of basic heavy industries
- ∞ Establishment of risky venture
- ∞ Increase in employment opportunities
- ∞ Increase in productivity and wages of labor and consumption of consumers
- ∞ Help in controlling inflationary pressures
- ∞ Overcoming the balance of payments difficulties

On the other hand, critics consider debt accumulation bad for the economy due to following reasons;

- ∞ Because short-term borrowing for longer-term projects can lead to serious cash flow problems
- ∞ Because borrowed funds are directed towards wasteful or low economic return projects.
- ∞ Because external financing may reduce investment
- ∞ It may lower the productivity of capital

² Sometimes a country also obtains grants from foreign countries. Grants are basically unilateral transfers from government of one country to government of another country with no obligations.

- ∞ It may fail to improve income-earning capacity
- ∞ It fails to overcome balance of payments and inflationary difficulties
- ∞ It fails to increase food, raw materials and import substitutes
- ∞ It creates social and political tensions
- ∞ It leads to too much dependence on aid
- ∞ It reduces the level of domestic savings

Proponents say that borrowing domestically or abroad is a normal part of economic activity. As long as the borrowers can earn a higher economic/social rate of return than the cost of invested funds, creation of debt is not a burden. Debt-servicing problems arise when the debt carrying capacity of the country does not increase commensurate with the increase in its debt servicing liabilities.³

There are different kinds of foreign aid;

Project aid: This aid is provided in foreign exchange terms to complete particular projects, like dams, roads, rule development projects, etc.

Program aid: In contrast to project aid program aid is provide to complete project at aggregate level like overcome balance if payment difficulties, etc.

Non-project aid: An aid that is not linked with any special project is called non-project aid. This aid is provided in the forms of, (a) non-food commodity aid, (b) food aid, (c) P.L. 480 programs, (d) relief aid, and (e) technical assistance.

Pakistan obtains aid from various donors, which includes Consortium Countries and Organizations, Non-Consortium Countries and Organizations, and Islamic Countries. Most of the aid provided to Pakistan comes from Consortium Countries and Organizations. Consortium Countries and Organizations include Japan, the United States, the United Kingdom, Germany, Canada, Belgium, France, Italy, Holland, Norway, Sweden, World Bank (WB), Asian Development Bank (ADB), International Development Association (IDA) and International Financial Corporation (IFC). Non-Consortium Countries and Organizations

³ The debt carrying capacity is defined as the ability of a country to service its external liabilities within an orderly and stable macroeconomic framework.

include Australia, Austria, China, Denmark, Finland, Romania, Switzerland, Former Soviet Union, Czechoslovak and Korea. And Islamic Countries include Abu Dhabi, Kuwait, Saudi Arabia, Qatar, Libya, Malaysia, Islamic Development Bank and Organization of Petroleum Exporting Countries (OPEC).

3. FOREIGN DEBT AND AID IN PAKISTAN: A BRIEF HISTORY

Pakistan in its present geographical form emerged as separate political entity after 1971, and most of the meaningful analysis will therefore have its focus on the period covering the last two decades. But it is useful to provide a historical context by looking at the external capital inflows of the 1950s and 1960s. Since its independence Pakistan heavily relied on external assistance. A number of factors and variables are considered for this great dependence of Pakistan on foreign resources. Domestic savings and investment rates were low due to the very low levels of per capita income, the pressing need to assist the millions of people displaced by partition, and the imperative of creating the basic administrative apparatus and institutions required to run a new country. Pakistan observed persistently large fiscal and current account deficits for a very long period of time as Figures 1 and 2 indicates. Fiscal deficit averaged 7 per cent of GDP during last two decades (1980s and 1990s), while current account deficit averaged 5 per cent of GDP in the 1990s. These deficits were financed mostly by creating external inflows. Table 1 and Figure 3 indicates the pattern of external assistance of Pakistan in terms of both foreign debt and aid. The heyday of Pakistan's economy remains the decade of the 1960s when the GDP growth rate averaged 6.8 per cent annually. The investment rates reached a peak of 23 per cent in 1964-65 and foreign saving financed almost half of this investment. The 1965 war with India led to a setback, and the level of aid declined. The higher incomes generated during this period boosted the domestic savings rate, which reached almost 12 per cent. The separation of East Pakistan, the two oil shocks, and a fundamental change in the economic philosophy of Pakistan accentuated pressures on the external finances of the country in the 1970s. The Afghan war brought an unexpected windfall in the form of increased assistance from the United States. This allowed the government to avoid the need to restructure the economy and eliminate the imbalances on fiscal and external account. The accumulation of the foreign debt increased after 1980s, which created the serious problem of debt servicing in the country and Pakistan severely

faced budget balance problems (see Table 2). All these years Pakistan's tax to GDP ratio did not increase, making dependence on foreign aid a permanent feature of Pakistan's economy. Pakistan's debt situation continued to deteriorate in the 1990s. By the mid 1990s debt servicing was consuming more than half of the country's annual revenues, leaving little space for social and development expenditures. The twin problems of high fiscal deficits and high current account deficits became more problematic in the 1990s than in previous decades. These led Pakistan into greater dependence on foreign capital to finance the difference. The 1990s have been characterized by a series of important shifts in the nature of capital flows to the Pakistani economy; the implications of these changes for the country's debt profile are equally important. With the passage of time the debt burden of Pakistan continued to grow. Presently Pakistan has \$ 36.5 billions external debt, which is 28.3 per cent of its GDP, 127.6 per cent of foreign exchange earnings and approximately three times of its foreign exchange reserves.⁴ Figure 4 shows the patterns of GDP growth (fc) and the shares of foreign debt and aid in GDP. It is evident that after 1990s growth performance of Pakistan weakened while the accumulation of foreign debt and aid increased.

Figure 1: Fiscal Deficit of Pakistan (% of GDP)

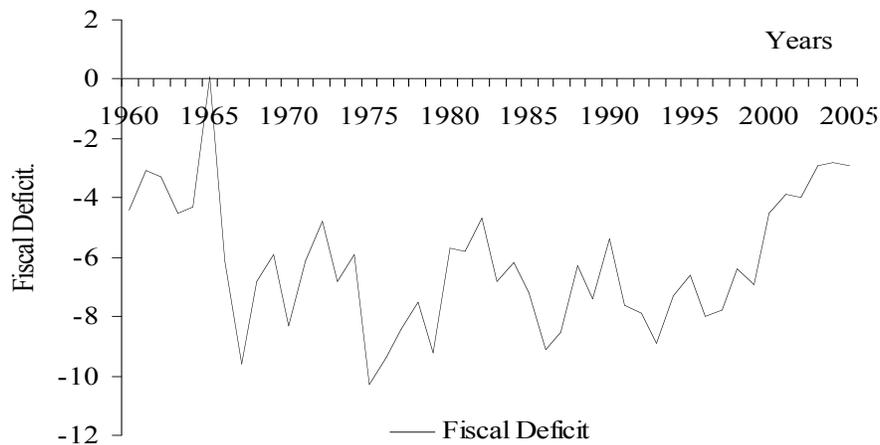


Figure 2: Current Account Deficit of Pakistan (% of GDP)

⁴ Economic Survey, Government of Pakistan, (issue, 2005-06).

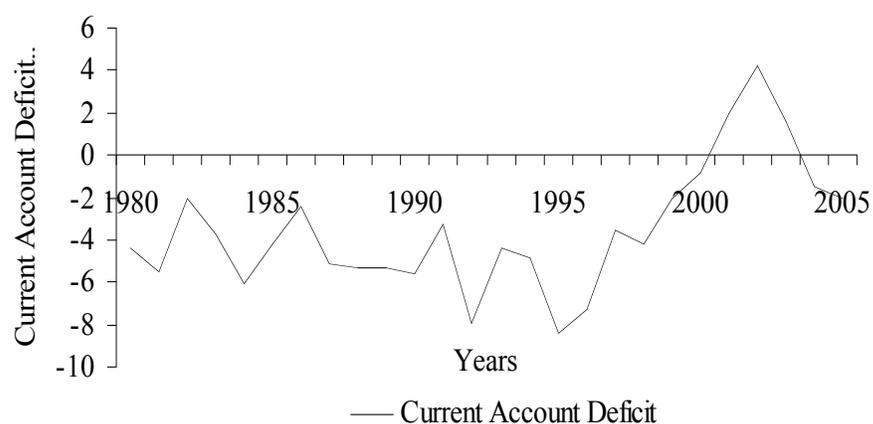


Table 1: Foreign Debt and Aid Position of Pakistan

Years	GDP Growth (%)	External Debt	Debt as % of GDP	Millions (US \$)	
				External Aid	Aid % of GDP
1960-61	4.9	171	0.2	342	0.4
1961-62	6.0	225	0.2	304	0.3
1962-63	7.2	408	0.4	501	0.5
1963-64	6.5	661	0.6	541	0.5
1964-65	9.4	1021	0.9	706	0.6
1965-66	7.6	1325	1.0	533	0.4
1966-67	3.1	1696	1.3	623	0.5
1967-68	6.8	2099	1.5	729	0.5
1968-69	6.5	2532	1.7	594	0.4
1969-70	9.8	2959	1.8	564	0.3
1970-71	1.2	3425	2.1	612	0.4
1971-72	2.3	3766	2.2	409	0.2
1972-73	6.8	4022	5.1	355	0.5
1973-74	7.5	4427	4.7	498	0.5
1974-75	3.9	6650	6.8	976	1.0
1975-76	3.3	7566	7.5	1051	1.0
1976-77	2.8	8255	8.0	960	0.9
1977-78	7.7	9230	8.3	856	0.8
1978-79	5.5	10306	8.8	948	0.8
1979-80	7.3	11244	8.9	1470	1.2
1980-81	6.4	11344	8.5	972	0.7
1981-82	7.2	11720	8.1	1102	0.8
1982-83	6.7	12399	10.5	1301	1.1
1983-84	4.8	12905	10.9	1176	1.0
1984-85	9.2	14053	12.4	1257	1.1
1985-86	7.0	16350	14.1	1528	1.3
1986-87	5.8	18136	15.9	1398	1.2
1987-88	6.4	19983	16.7	1824	1.5
1988-89	4.8	21562	18.3	2619	2.2
1989-90	4.6	23009	21.5	2342	2.2
1990-91	5.6	24703	22.3	2156	1.9

1991-92	7.7	26822	25.4	2471	2.3
1992-93	1.5	28222	27.4	2493	2.4
1993-94	4.4	29336	31.9	2549	2.8
1994-95	5.1	31923	33.8	2600	2.8
1995-96	6.6	30053	33.2	2565	2.8
1996-97	1.7	31092	39.6	2233	2.8
1997-98	3.5	29008	39.2	2801	3.8
1998-99	4.2	30185	40.8	2442	3.3
1999-00	3.9	29674	43.5	1428	2.1
2000-01	1.8	28625	46.2	1599	2.6
2001-02	3.1	31089	51.1	2316	3.8
2002-03	4.8	32640	49.2	1550	2.3
2003-04	6.4	33887	46.9	1242	1.7
2004-05	8.4	35031	46.2	1286	1.7
2005-06	6.6	36213	44.8	1332	1.6

Source: Economic Survey, Government of Pakistan, various issues.

Figure 3: Foreign Debt and Foreign Aid of Pakistan (US \$ Millions)

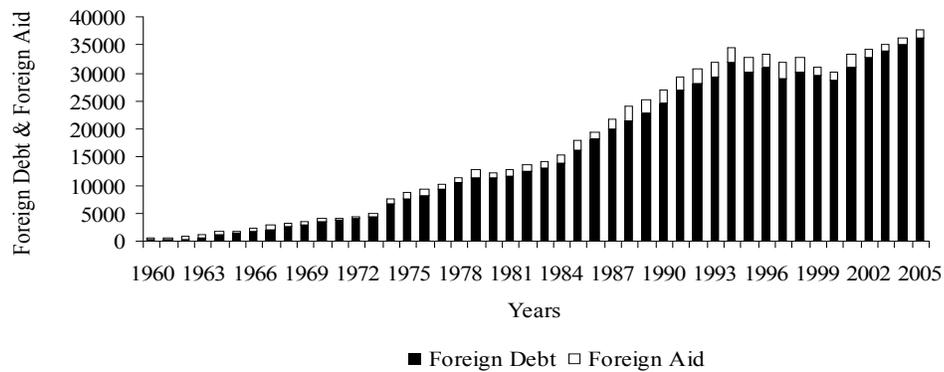


Figure 4: GDP Growth and Foreign Debt and Foreign Aid to GDP Ratio (percentage)

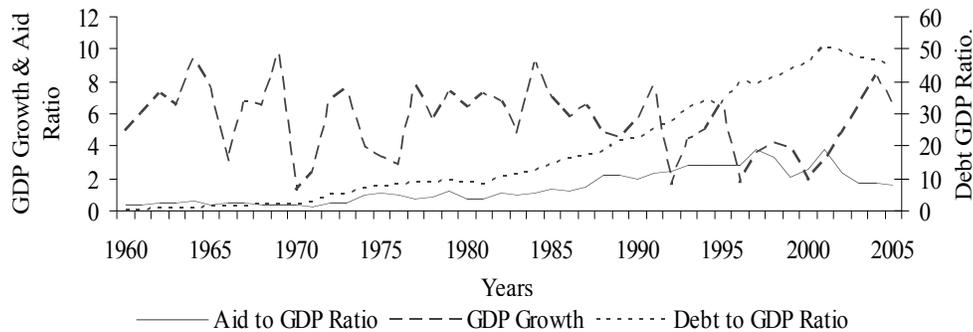


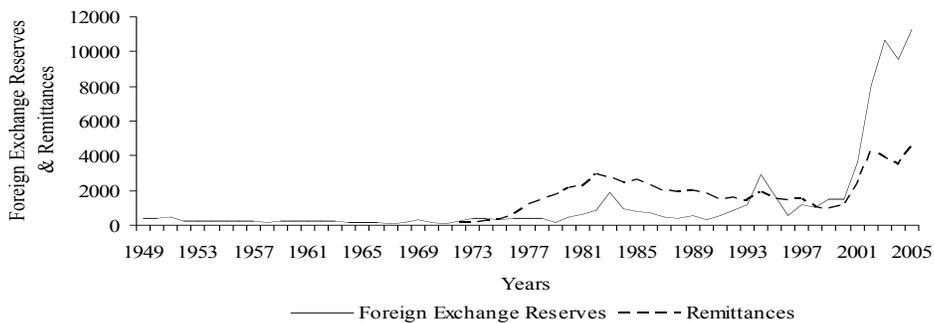
Table 2: Debt Servicing Position of Pakistan

Years	External Debt Servicing as a % of		
	Export Receipts	Foreign Exchange Earnings	GDP
1960-61	14.9	-	0.4
1961-62	27.2	-	0.7
1962-63	22.4	-	1
1963-64	27.4	-	1.2
1964-65	25.9	-	1.1
1965-66	29.2	-	1.1
1966-67	35.2	-	1.3
1967-68	31.2	-	1.3
1968-69	44.3	-	1.8
1969-70	52.1	-	1.8
1970-71	43.3	-	1.7
1971-72	20.6	-	1.3
1972-73	23.6	18.1	3
1973-74	19.2	14.2	2.2
1974-75	23.9	16.3	2.2
1975-76	21.9	13.7	1.9
1976-77	27.3	15.3	2.1
1977-78	24.9	11.2	1.8
1978-79	25.6	12.0	2.2
1979-80	24.7	11.9	2.5
1980-81	20.4	10.6	2.1
1981-82	19.9	8.8	1.6
1982-83	23.5	9.6	2.2
1983-84	26.3	10.9	2.3
1984-85	31.6	12.9	2.5
1985-86	29.5	13.5	2.8
1986-87	29.9	15.6	3.3
1987-88	25.1	14.7	2.9
1988-89	24.1	14.4	2.8
1989-90	24.9	14.4	3.1
1990-91	21.5	13.7	2.9
1991-92	21.9	13.2	3.1
1992-93	24.2	15.3	3.2
1993-94	25.7	16.2	3.4
1994-95	25.1	16.5	3.4
1995-96	24.5	16.7	3.4
1996-97	27.2	17.6	3.6
1997-98	27.3	17.6	3.8
1998-99	19.7	13.6	2.6
1999-00	17.6	11.9	2.1
2000-01	21.3	13.7	2.8
2001-02	13.1	7.8	1.7
2002-03	9.3	5.3	1.3
2003-04	24.3	14.0	3.2

Source: Statistical Supplement Economic Survey 2003-04

The major change in Pakistan’s debt profile has been a sharp change in the composition of external financing-away from bilateral grants and concessional lending towards multilateral and non-concessional flows. A second key shift has been in the composition of the debt stock. Among bilateral donors, Japan remained as Pakistan’s largest bilateral aid donor, supplanting the United States. The World Bank classifies Pakistan as a moderately indebted country, but the vulnerability coefficients are all moving in the wrong directions. Almost all debt indicators show a worsening situation. Debt-GDP and aid-GDP have both worsened despite the high growth of GDP. Similarly debt servicing as a percentage of export receipts, foreign exchange earnings and GDP has increased over time (Table 2). These indicators are alarming and the long-term trends based on existing flows are not very encouraging. The main source of official grants have been US and Japan, but technical assistance grants, which do not directly help the balance of payments position, form a significant proportion. On a more optimistic note, there has been an increase in private capital inflows as both foreign direct investment and portfolio equity flows are moving into Pakistan to replace the traditional sources of official capital. Workers remittances are also increasing in the country, which are also supposed to increase foreign exchange reserve position of Pakistan (see Figure 5). As financial and economic integration is occurring globally, Pakistan is starting to benefit from international capital movements.

Figure 5: Foreign Exchange Reserves and Workers Remittances (US \$ Millions)



4. SOLUTION TO DEBT DIFFICULTIES

Debt is like a cancer, once it gets a grip on a country it is very hard to eradicate, and may envelope every other brogan of life, unless the rest of the economy can be reinforced to overcome it. Unsustainable debt position has severe macroeconomic consequences. It results cut in development spending, decline in investment rate, rise in poverty and thereby slowing the pace of economic growth. Furthermore, a prolonged dependency on foreign debt affects the financial sovereignty of a country. Since Pakistan became the prolonged user of International Monetary Fund (IMF) and other International Financial Institutions (IFIs). Therefore, Pakistan's economic policy making circled around IMF/IFIs programs. As a result, influence of IMF and IFIs in Pakistan's policy making increased substantially.

Some researchers have analyzed this debt burden issue from different perspectives. Claessens and Diwan (1989a, 1989b) argue that the burden of foreign capital inflow can depress investment below its optimal level and thus slow economic growth became ultimate fate of the recipients. This can occur through two channels, (a) inability to get desired foreign borrowing, a liquidity constraint, and debt overhang which is strong enough, (b) expected future loss of output to foreign creditors. From the debtor country's perspective, the financing costs of voluntary debt reductions and transformations are likely to exceed the benefits. Thus, that Pareto-improving schemes are difficult to find in practice-unless the debtor uses funds donated for this purpose, or that it gains in exchange some concession from creditor's group. Therefore, conventional debt rescheduling cannot efficiently reconstruct under a situation of debt overhang.

The debt-servicing problem might result either from liquidity problems or due to solvency reasons. A liquidity problem would arise if the borrower fails in obtaining the foreign exchange to make the debt service on schedule. The solvency problem, on the other hand, would arise if the real interest rate on marginal external loan exceeds the addition to national income made by loan. Pakistan has not trapped in liquidity problem yet. The solvency problem is of long-term in nature and may arise if external resources are consumed rather than invested. It may also arise if the recipient country's investments projects yield marginal return less than the marginal cost of borrowing. Debt reduction is a structuring of

outstanding debt in a way that reduces the expected present discounted value of the contractual obligations of the debtor (Sachs, 1988).

Pakistan is one of the groups of the developing countries, which have relied heavily on external sources of financing for their development. This strategy has helped Pakistan to achieve reasonable growth in per capita incomes and consumption. A combination of propitious factors has enabled Pakistan to attract a relatively high level of external resources in the past (more than 10 per cent of GDP), but it is becoming clear that this level is untenable over the long run. The costs of this heavy dependence on external resource flows have started manifesting themselves in various forms, and questions are being asked as to whether it is in the collective national interest to continue this strategy unabated.

There appears to be an emerging consensus that the country would be better served by reducing this heavy dependence. This is a welcome development, which deserves serious consideration. Since external debt affects the macroeconomic position of Pakistan. The option for Pakistan in eschewing large capital flows and maintaining reasonable growth in per capita income can be realized only if domestic saving rates are at least doubled from their present level. This goal is not all unrealistic as almost all the countries in Asia, with very few exceptions, have saving rates around 25 per cent. In Pakistan's case this can be attained if there is willing, political commitment, and tenacity in taking some hard decisions which may not be popular in the short-run. Pakistan should follow a debt reduction strategy to get rid from IMF and other IFIs' trap. This debt reduction strategy should include;

- ∞ Reduction in 'twin deficits'
- ∞ Reduction in cost of borrowing
- ∞ Raising economic growth
- ∞ Raising fiscal revenue
- ∞ Paris club debt restructuring
- ∞ Borrowing only at concessional terms
- ∞ Improving maturity profile of debt
- ∞ Tapping resources from international capital and equity markets
- ∞ Fiscal responsibility and debt limitation law
- ∞ Increase the privatization process

- ∞ Attract foreign direct investment
- ∞ Increase the saving rates

The implications of these options and particularly the trade-offs involved have to be examined. It must be recognized, for example that it is not feasible to cut external resource flows while maintaining the present level of consumption and imports. The above-mentioned policies are long-run policies. There are some piecemeal ways in which the present debt burden of Pakistan can be ameliorated in the short-run. These short-term polices include;

- ∞ Debt rescheduling
- ∞ Debt service capping
- ∞ Debt buy-backs and debt swaps
- ∞ Repayment of loans in local currency
- ∞ Debt forgiveness

However, for a developing country like Pakistan external borrowing is necessary to fund its development project. Pakistan needs to develop an effective borrowing strategy that is consistent with its development priorities. An appropriate borrowing strategy consistent with macroeconomic framework must include:

- ∞ Currency mix
- ∞ Terms and conditions
- ∞ Parameters of borrowings
 - Current account deficit
 - Amortization payments
 - Reserves target
 - Medium-term development priorities

Furthermore, to combat the problem of sustainable debt Pakistan should maintain stability in the exchange rate, keep inflation as low as possible, reduce interest rate, attract foreign investment, and move from donor driven to need-based borrowing and continued to

maintain high level of growth. Moreover, Pakistan must maintain macroeconomic stability and continue to follow the path of structural reforms. Political stability is also vital. Historical experience suggests that it is only the countries, which have been able to raise and maintain high rates of domestic saving that have achieved impressive growth rates on a sustainable basis. The recent phenomenon to pile up foreign exchange and to part with external debt is to attract foreign direct investment (FDI). The opening up of the stock markets to foreign investors and the launching of the Pakistan Fund has already produced very positive results. Pakistan is starting from a low base and has certain advantages of location, labor costs, and raw materials to offer. But there are perpetuates which are missing. Studies of determinants of FDI have shown that a stable political and economic environment, enforcement of laws and contracts, a trained, skilled and disciplined labor force, critical support services, and availability of the quality infrastructure are the key factors for potential investors in making investment choices. Tax holidays, fiscal concessions, subsidies, and import tariff protection are the wrong means to promote investment if the goal is to develop competitive and efficient industries. As a matter of fact, FDI should not be encouraged in countries where effective rates of protection are high. Pakistan will not be able to maximize social benefits from FDI unless the present high tariff structure is dismantled.

Foreign direct investment is expected to possess four advantages over borrowing. First, equity financing requires payment only when the investment earns a profit, while debt requires repayments regardless of whether an economic return was earned or not. Second, payments on foreign direct investment can be regulated by the host country, while debt repayments are outside its control and are affected by interest rates set in the international markets. Third, because much of the foreign direct investment consists of reinvested earnings, only a portion of the returns on investment is repatriated, as opposed to the need to repay interest and principle on loans. Fourth, foreign direct investment permits a closer match between the maturity structures of their earnings from an investment and that of the required payments to the capital used to finance it.

East Asian countries were able to avoid crisis in the 1980s, despite their heavy debt burden, because they made productive use of borrowed external funds that eased infrastructural bottlenecks, focused investment on human resource development, expanded the productivity base, and did not allow public enterprises to run up massive financial

deficits. External flows were diversified over time, with export earnings and foreign direct investment being the main vehicles for raising external finance. East Asian countries not only invested the borrowed resources productively, but also had a balanced portfolio of capital flows. Finally, stronger and persistent efforts in increasing domestic savings rates were the driving force in East Asia and financed a large proportion of their overall investment. Empirical work on the sources of growth corroborates this evidence on efficient use of resources, both domestic and foreign, in these countries.

The main thrust of the East Asian experience is that foreign aid, of the right type and form, is highly efficient in stimulating growth and equitable income distribution when it accompanied by appropriate economic policies. Asian countries made greater use of IMF facilities in the 1970s than did the Latin American nations. The recent positive developments in Mexico, Chile, and Venezuela tend to confirm that the policies pursued by East Asia in the 1980s are equally valid in their case. In short, countries which help themselves emerge as winners in the long term. Recent empirical research amply shows that foreign aid of the right type and quality can have a positive impact only if the macroeconomic policies are right, macroeconomic incentives are not distorted, and the supporting institutions are in place. In the absence of these preconditions, foreign aid only helps countries to postpone the tough decisions required for prudent economic management. Under those circumstances, foreign aid is a curse, which should be avoided.

5. AID EFFECTIVENESS AND GROWTH

The effectiveness of foreign aid remained a controversial issue in development economics. After the end of the World War-II particularly during 1960s and 1970s, foreign aid in huge amount was transferred to developing countries in the form of project aid to improve their growth performance. As it is well established in literature, that foreign aid enhances output growth if it is utilized in investment and other productive projects (Hansen and Tarp, 2000). However, during 1980s and particularly in 1990s it was established that the development strategies of the previous decades in developing countries that were initiated due to transfer of foreign aid to these countries were no longer sustainable. One reason for the failure of foreign aid in strengthening the economies of the recipient countries is the establishment of weak policies in these countries. Both in theoretical and empirical literature

it is well established that aid works only in countries with good macroeconomic policies environment (Burnside and Dollar, 1997, 2000; Roodman, 2003). This is acknowledged even in publications of the World Bank (World Bank, 1998). Therefore, researchers have suggested that aid should be channeled to good policy countries to improve its impact on growth and particularly to alleviate poverty from these countries (Collier and Dollar, 2001, 2002). Subsequent researchers in part also justify that inability of foreign aid can be reduced via ineffective policy changes.

This influential message led the world to focus more on the effectiveness of the foreign aid and formulate policies so that foreign aid may become a driving force for the recipient countries. The question therefore arises how aid can be restructured in such a way as to be more effective in promoting growth and reducing poverty. As the international community has formally engaged itself to reduce poverty by half until 2015, the challenge to enhance aid effectiveness becomes even more pressing. In order to meet this challenge, the International Financial Institutions (IFIs) have recently shifted their focus towards increased ownership and broad based support for policy measures in developing countries. In particular, there is now a strong emphasis on participatory processes, which have become a formal requirement for the elaboration of developing countries' Poverty-Reduction Strategy Papers (PRSP).

6. THE PROBLEM OF AID EFFECTIVENESS

Aid effectiveness means meeting program and project development objectives. As such, it is a multidimensional concept that encompasses capacity building, poverty reduction and sustainable growth. Developing countries obtain aid from different sources and each source has its own ways of working. These often conform to national administrative standards and requirements of the aid-giving country. However, the diversity of approaches to the design, commissioning, implementation, reporting, review, monitoring and evaluation of projects/programs under different aid agencies create a massive workload for the recipient countries and wastes scarce human and financial resources to comply with these requirements.

Experience of recipient countries has identified some main problems that these countries are facing. These include:

- ∞ Difficulties with donor procedures
- ∞ Lack of information
- ∞ Uncoordinated donor practices
- ∞ Excessive demands on time
- ∞ Donor driven priorities and systems
- ∞ Delays in disbursement
- ∞ Demand beyond national capacity

This in turn results in a lack of a sense of ownership of aid in recipient countries. It reduces their effectiveness, over-stretches their administrations and reduces aid effectiveness.

7. STRENGTHENING AID EFFECTIVENESS IN PAKISTAN

This section identifies a number of possible recommendations that are supposed to be followed both by government of Pakistan and the donor countries to improve aid effectiveness in Pakistan. It requires joint working by government of Pakistan and donor countries in terms of both coordination and mutual accountability. Thus, any responsibility of ineffectiveness of foreign assistance should be shared between Government of Pakistan and the donors.

The key issues that need to be addressed in order to increase aid effectiveness in Pakistan are, (a) relevance and incentives, (b) leadership, (c) coherence, (d) institution, and (e) capacity. Relevance and incentives refers to the doubts about the relevance of the Paris Declaration (2005) and the weak incentives for improvement that appear to exist on the donor side. Leadership is related to governance. Coherence refers to absence of direction on how foreign assistance can best be utilized to further the objectives of the PRSP/MTDF and the need for clarification of roles at different levels of government. Institutional issue refers to the desirability of strengthening mechanisms for regular and structured collective dialogue between the government of Pakistan and its development partners. Such mechanisms could be used to monitor progress on implementation of Paris Declaration and to deal with the government of Pakistan donor issues, which inevitably arise from time to time. Moreover, adequate capacity level also matters for aid effectiveness.

Increased aid effectiveness should be pursued through four interlinked strategies, (a) strengthening the performance orientation of the aid program, (b) combating corruption, (c)

integrating and broadening Pakistan's engagement with the region, and (d) working with partners. To single out the commitments of, (a) ownership, (b) alignment, (c) harmonization, (d) managing for results, and (e) mutual accountability as identified in Paris Declaration, different policies should be pursued by the government of Pakistan in collaboration with donors.

Government of Pakistan should take into account the following factors for the implementation of the Paris Declaration goals regarding external assistance effectiveness:

- ∞ Government of Pakistan should improve its governance and capacity of public sector administration and planning for the implementation of Paris Declaration reforms e.g. in aid co-ordination, in consultation with donors and others. Improvements in governance and institutions can upgrade service delivery systems and contribute to aid effectiveness.
- ∞ A more holistic approach that captures synergies across sectors, agencies and programs tends to enhance aid effectiveness.
- ∞ Government of Pakistan should develop a statement of aid policy,⁵ as is increasingly happening in other developing countries e.g. Afghanistan, Rwanda, Tanzania, Vietnam, etc. Such a statement of policy should be built around the Paris Declaration but would not necessarily be confined to the scope of that.
- ∞ An active civil society improves public services. In sectors such as natural resource management, primary education, rural water supply and urban sanitation, a participatory approach to project design and service delivery, in contrast to top-down technocratic approaches, could yield significant improvements.
- ∞ Pakistan faces the problem of multiple donors, resulting in fragmented initiatives that do not make up a coherent strategy. Government of Pakistan should take this issue seriously.
- ∞ Donor countries pursue their own priorities rather than those of the government of Pakistan, thereby eroding national planning efforts of Pakistan and jeopardizing the

⁵ This system generates an annual assessment of donor progress towards good aid practice, based on indicators of (a) ownership and its inputs (including policy dialogue and internal reporting mechanisms), (b) transactions costs, (c) accountability, (d) capacity-building, and (e) flexibility. The system also assesses the recipient's progress in improving the policy and institutional environment.

sustainability of the initiatives in question. Government of Pakistan should coordinate with donor countries to overcome this problem.

- ∞ Donors use country's own systems, e.g. for financial management, accounting and audit, procurement, monitoring. Specifically, donors rely progressively on strengthened country procurement systems. Government should integrate capacity strengthening objectives through a country-led capacity development strategy. Special attention should be paid to strengthening public financial management capacity.
- ∞ There is a poor reporting of aid disbursements, as well as of results and impacts, in Pakistan, thereby government of Pakistan has little idea of what is actually being spent and done, and what effects it might be having on performance indicators. This particularly related to grant aid from bilateral donors being channeled through NGOs. To manage the results government should strengthen the links between its development strategies and budget processes. Also to establish results-oriented reporting and assessment frameworks.
- ∞ Effective aid complements private investment. In countries committed to reform, aid enhances private sector confidence and better supports public services, while, in severely distorted markets and environments, aid acts as a substitute for autonomous private investment, often explaining the marginal impact of aid in such cases. Pakistan must maintain the sustainability of its reforms.
- ∞ Increased aid will only be effective if there is adequate absorptive capacity or if such capacity can be developed in tandem with higher aid flows. Thus, there is a need for capacity building in Pakistan.
- ∞ More importantly, government of Pakistan should create mechanisms of regular collective dialogue with donors to drive forward progress on the Paris principles. PRSP II and the MTFDF can be adapted for aid mobilization and coordination purposes.

From the point of view of donors, discussions on aid effectiveness have led to recommendations for, (a) improved conditionality, (b) greater selectivity, (c) the provision of

technical assistance and dialogue (ideas before financing) to countries with weak policy environments, and (d) a shift from project-based support to general budget or sector support.

Donors can ‘override’ or ‘undercut’ recipients in the aid process. Overriding occurs if donors define what recipients should be doing and, at the same time, provide instructions, incentives or conditionalities that push recipients in the right direction. Undercutting, on the other hand, occurs if donors, in extending aid, create the conditions for the long-term dependency of the recipients, or supply the motivation for the doer to be in or remain in a condition to receive help (Ellerman, 2001). While we have emphasized the central importance of action and leadership on the part of the government of Pakistan, this does not mean that there is nothing that donors can do now. A list of possible donor actions could include the following factors.

- ∞ Donor countries should form an aid effectiveness group. The existing informal Poverty Reduction Working Group appears an appropriate existing institution to be developed in this way.
- ∞ Financial assistance by the donor countries needs better targeting towards least developed countries, and towards other low-income countries. Much aid continues to go to middle-income countries where the ability to tap private financial flows has been increasing.
- ∞ Institution of joint monitoring and evaluation arrangements and discussions among sets of donors for the institution of joint monitoring and evaluation are required.
- ∞ Policy-based aid helps to enhance policy reform in the case of credible reformers. In contrast, donor financing with strong conditionalities, but without strong domestic leadership and political support, has generally failed to produce lasting changes. A demonstrable commitment based either on a strong track record or on credible intent to initiate well-sequenced reform efforts, is conducive to aid effectiveness.
- ∞ Intensified efforts at the sectoral level to establish the conditions necessary for the development of sector-wide approaches (SWAs)
- ∞ Coordination among all relevant stakeholders is essential so as to avoid duplication, inconsistencies and inefficiency in project and program design and implementation.

- Coordination should be promoted at the local, provincial and national levels, ensuring benefits from synergies and the promotion of externalities
- ∞ Development of a joint donor response to PRSP-II / MTRF setting out how best external assistance could contribute to realizing its objectives.
 - ∞ Development of co-operative arrangements among groups of donors with a view to agreeing on such measures as joint missions and evaluations, basket funding and lead donor arrangements.
 - ∞ Following the lead of a recent initiative by the Asian Development Bank, consideration of other ways of simplifying donor procedures and reducing the government of Pakistan's transactions costs.
 - ∞ Development of a collective position on what remains to be done in order to foster greater donor alignment with government of Pakistan financial reporting and procurement procedures.
 - ∞ Donors to implement common arrangements for planning, funding, disbursement, monitoring, evaluation and reporting. They should commit to work together to reduce the number of separate missions and diagnostic reviews.
 - ∞ Donors should provide timely, transparent and comprehensive information on aid flows. Donors and governments to move towards joint assessments of their respective performances through country-level mechanisms.

Donors are divided among themselves, by scale of program, in their levels of local enthusiasm for the Paris Declaration agenda, and by the extent to which authority has been decentralized to local representatives. The first two of these factors tend to combine, so that not all the larger donors appear inclined to pursue the Paris agenda with vigor, resulting in a lack of leadership. A further problem is that donor agencies do not necessarily perceive strong incentives to pursue the Paris agenda.

A complete range of services is provided to help aid agencies to become more effective agents of development and social change. These services include:

- ∞ Results-based Program Design-ensures projects and country programs have clear, realistic, and measurable development outcomes.

- ∞ Performance Monitoring Systems-design and implementation of program monitoring and evaluation systems for improved performance, learning, and accountability.
- ∞ Participatory Development-program planning and management with diverse groups to build ownership and program sustainability.
- ∞ Donor Coordination-strengthening donor collaboration in evaluations, strategy development, and country program design.
- ∞ Organizational Development-aligning people, organizational structures, and procedures to deliver development outcomes.

Keeping in view a variety of issues, it is important to promote the enhancement of aid effectiveness by using a multi-dimensional but well-coordinated approach. This allows each player to push forward the issue deemed most appropriate (cost-effective) and rewarding (with a high likelihood of success). The necessity to pay attention to the transaction cost of harmonization is also pointed out. Thus the required level of harmonization and its institutionalization needs to be well taken into consideration. Decentralized (provincial-level) harmonization can reduce the transaction costs of harmonization and reduce the strain on limited available national capacities

8. CONCLUSIONS AND POLICY RECOMMENDATIONS

Pakistan has achieved relatively high growth rates in income and consumption since independence. Foreign aid and external borrowing made it easier to avoid hard policy choices and trade-offs. As a result Pakistan has lied beyond its mean for the last two decades, and has been fortunate in bridging the gap between domestic savings and investment through heavy reliance on foreign savings and current income transfers from abroad. The external financing strategy pursued so far has placed a greater emphasis on foreign aid, external borrowing, and workers remittances.

Pakistan would be better served by increasing those sources of external financing that are stable, have positive effects on growth, and are largely within the policy control of the Pakistani authorities, rather than contributing to depend on the traditional; sources, which have been found volatile, less stable, overly dependent on the whims and caprices of external policy makers and make a questionable contribution to growth performance. These desirable

sources are: export of goods and non-factor services, foreign direct investment and portfolio investment, and foreign assets of Pakistanis and non-resident Pakistanis in the former category: while foreign aid, external borrowing, and worker's remittances are in the category of less stable sources. The external economic environment does influence the demand for exports, supply of FDI, and foreign assets of Pakistanis. But it has been found that, in general despite their short-term fluctuations, these sources of finance are influenced relatively more by domestic policy variables and hence can be relied upon to a much greater extent for long-term development financing than worker's remittances, official aid, or external borrowing. At a latter stage of development, when the credit worthiness of a country is well established on the financial markets, commercial borrowing assumes a more stable role. Pakistan however, has yet to reach that stage.

The main purpose of aid is to eradicate extreme poverty, promote gender equality, investing in health and education and achieving environmental sustainability. Over the decades, improving aid effectiveness has been one of the main concerns of the development community. Recently, the donor community has been concerned with growing evidence that a number of donor requirements and processes for aid delivery have been generating unnecessary transaction costs as well as hindering the development of the already limited capacity of partner countries. Partner countries have also expressed their concern that donor practices are not always well suited to national development priorities and systems.

As a corollary of the adjustment program in many developing countries, the use of a wider variety of analytical tools in aid impact assessment has become common. Pakistan being the signatory of the Paris Declaration is also taking suitable measures to improve the aid effectiveness. Aid effectiveness can be achieved if there is a good and stable policy environment in recipient countries and coordinated actions among all the relevant international and domestic stakeholders, in the context of an effective partnership for development. For aid programs to be effective, they need to be integrated into country driven, long-term strategies for sustainable economic development, with a focus on results and a framework for mutual accountability.

On the side of donors there is a need for improved coordination, less competition, improved impact assessment, and more patience. Evidence suggests that aid effectiveness is jointly determined by (a) the quality of the recipient's policy environment and (b) the quality,

timeliness and appropriateness of donor assistance. The effectiveness of each dollar of aid can and must be enhanced through the joint efforts of donors and recipients. Intensified partnership between donors and partner countries are required in order to ensure better matching of supply and demand. The active participation of recipients in the design and management of aid programs through effective partnerships with donor countries is an important tool in increasing their capacity to participate as equal partners in the global knowledge society. This would help create an environment, which will enhance the effectiveness of foreign aid. Capacity building for ODA management and Harmonization and simplification of donor procedures will also increase aid effectiveness. In countries where both macroeconomic policy and institutional capacity are strong, aid should be channeled more liberally in the form of budgetary support, which could reduce cost overheads and simplify administration. Aid effectiveness also requires objective and rigorous evaluation of outcomes, the dissemination of information for purposes of institutional learning and mechanisms for the resolution of conflict.

However, one nearly universal complaint is that there have been few discernible changes by donors as a result of commitments entered into in the Paris Declaration. Formulation of Poverty Reduction Strategies and the use of participatory approaches in formulating them, formulation of medium term expenditure frameworks and alignment of aid policies and programs with national priorities, all these measures are also recommended for aid effectiveness.

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