Foreign Aid and Assistance

Case Study: Kosovo

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ABSTRACT

In Kosovo case, foreign aid provided significant results that effected economic growth in the first years after the war. The following years showed a slight downturn in the economy which recorded some negative social and economic consequences. In this regard, foreign aid decreased and changed donor support for Kosovo from what was initially called 'humanitarian aid' into development aid towards concentrating more on infrastructure and reconstruction. A great success during the first two years was evident in the infrastructure sector: primarily in road reconstruction with more than 60 per cent repaired by grants and other foreign assistance, healthcare and education was also available to more people in need, while on the other hand small and medium enterprises started to emerge.

Keyword: *Foreign Aid, Assistance, Kosovo, Economic Growth, Poverty Reduction*

1.0 INTRODUCTION

After the war in Kosovo in 1999 there was an urgent need for international assistance presence and financial aid for the country to recover. Since 1999 until 2005 more than €3billion has flown in Kosovo in international assistance from many donors like: United Nations (UN), Organization for Security and Cooperation in Europe (OSCE), World Food Program (WFO) and European Agency for Reconstruction (EAR). There was an immediate need for these non-governmental organizations (NGO's) to stop a humanitarian catastrophe in the post-war initial years, primarily focusing in delivering emergency aid in food, shelter and hygiene (CDA, 2007). Kosovo's economy in last decade has been solid, yet, with a gross domestic product (GDP) of €1,750 it remains the poorest country in Europe. After the war in 1999 the economy started to grow rapidly with more than 10 per cent in 2000 driven by foreign aid allocation in reconstruction. From 2003 and onwards the economy started to shrink as many donor agencies withdrew their missions from Kosovo and left for high priority missions in Iraq and Afghanistan. Since 2005, annual growth decelerated below 5 per cent, whereas regional countries were growing faster, therefore the income gap has widened heavily. In order for Kosovo's economy to stay in track with other countries it needs to double its growth rate annually over the next decade to reach Albania's income level (if the Albanian growth rate remains the same with an average growth of 5 per cent), or to reach Montenegro it would need 12 per cent annual growth if the Montenegro's economy growth remains on average 6 per cent (World Bank, 2010). On the other hand even though a massive amount of foreign aid was distributed to Kosovo, by 2004, more than 44 per cent of population were on poverty, while 14 per cent in extreme poverty. At the Millennium Summit held in 2000, where 189 countries adopted UN Millennium Declaration, 8 goals were set to be achieved by 2015. One of the goals is poverty reduction (Demukaj et al, 2008). Kosovo's target by 2015 in regard of poverty reduction is to halve the proportion of people who lives in poverty.

2.0 FOREIGN AID AND GROWTH AN OVERVIEW

Foreign aid or official development aid is usually transferred from rich and wealthy nations to poor nations through non-government agencies that cover those areas. According to (Chatterjee and Turnovsky, 2006) the magnitude of foreign aid transfer to these undeveloped nations has increased significantly in the last decades from $6 million in 1965 to more than $59 billion in 2002. Most of these flows came from members of OECD and OPEC (Organization of Petroleum Exporting Countries) as development aid to help undeveloped countries in economic growth. The effectiveness of foreign aid in economic growth depends on the implementation of good government policies (Moreira and Bayraktar, 2007). They point out that these policies to be reinforced depend heavily on aid and the effect of aid relies on the degree of economic vulnerability and domestic instability. According to (McGillivray, 2003a, 2003b) countries in the past after the cold war did not pay any good attention to the effectiveness of foreign aid in economic growth. Nowadays, it seems that aid has significant effects in growth if donors put more attention into development criteria, design and implementation of aid activities. Another good reason why foreign aid has significant effect in growth is because of the new technology involved in collection and assessing data and testing hypothesis for a possible impact. On the other hand (Burnside and Dollar, 1997, Collier and Dollar, 2001) argue that foreign aid has positive effects on growth depending on the policy implications of recipient countries, therefore, if foreign aid works in all countries it is evidently shown that results were flawless in countries with better policy regimes. Foreign direct investment is also believed to be a great source of economic growth through technology, productivity and efficient technology in terms of technical assistance. Basically it is a channel of transformation and adaptation of technology and management practices from developed countries to developing countries that strive to compete in international market and increase their performance and market share in domestic and international market (Todaro and Smith, 2003). With better technology usage the increase of trade is affected significantly and as trade is also the engine of growth countries can benefit enormously thanks to their specialization products and comparative advantage, while at the same time providing products at the economies of scale. While, trade is expected to increase economic growth in the long run, in terms of technology import and human capacity professionalism, on the other hand developing countries face many problems in entering new markets, especially in developed countries where they try to protect domestic companies by imposing new barriers towards these countries. Good government policies and allocation of foreign aid leads also to better investment in human resources as a source of economic growth. It is a great input for research and development of new ideas and products that would generate high income in the long run, therefore, developing countries that have high level of educated human resources strive for a faster growth (Barro, 1991).

While on the other hand for foreign aid to be successful (Radelet, 2006) states that foreign aid should meet at least one of the four objectives of development: 1) to stimulate growth in infrastructure by supporting also agriculture and bringing new technology into use and new creative ideas, 2) strengthen education system by bringing new reforms, health care, environmental and political system, 3) support of food and other commodities and 4) stabilizing economy after financial crises. Despite these economic growth objectives there was always an assumption that more foreign aid leads to faster growth. However, the relationship between foreign aid and growth varies in different countries. Some countries that were beneficiaries of large foreign aid achieved great economic growth results at a fast pace, while on the other hand there were countries that achieved a small proportion of growth, while other countries even negative economic growth, or in other cases countries that benefited small amount of aid their economic growth was outstanding. According to (Radelet, 2006) lack of a strong relationship between foreign aid and growth is associated by other factors also. Countries that received large foreign aid probably faced ‘endemic disease or poor geography’, or they had a civil conflict and they just came out of it in which case foreign aid had positive effect of growth, but not at the overall growth performance in the country. In other countries foreign aid could show significant signs of growth under certain circumstances in which cases government introduces good economic policies, but fails in others where the corruption is high and economy is mismanaged badly.

While foreign aid has positive effects on economic growth, on the other hand it can also be subject of diminishing returns. Based on a number of studies that tested for nonlinearity in the relationship of foreign aid growth, where aid can positively affect growth up to a certain level based on GDP it is important to mention that it is negatively related later or has negative effects (Hansen and Tarp, 2001; Dalgaard and Hansen, 2001). According to these studies the negative relationship is introduced when the country's GDP is affected by too much aid inflow, respectively, when GDP reaches between 15 and 45 per cent. Basically, it means that beneficiary countries have limited resources or capacities to use this amount of aid effectively. Foreign aid depending on the recipient country can also hinder economic growth. According to (Svensson, 1998) countries that have weak institutions and lack monetary policies foreign aid could be fungible into financing government expenses rather than having aid invested effectively. Lack of savings, dependency of the recipient country on foreign aid is also an indicator for bad performance and slow economic growth in general. Bad government policies, lack of rule of law and high corruption is another factor that foreign aid is misplaced or badly invested. These negative relations between foreign aid and growth resulted in forcing many international agencies and donors that provide aid to revise their policies and performance to think more carefully to improve the effectiveness of foreign aid and tighten the recipients' conditions in the distribution and allocation of aid (World Bank, 1998).

2.1 Aid and Economic Growth Relationship

The relationship between aid and growth has been debated for a long time as a lack of a clear theoretical model by which aid would have effect on growth. For many years the only model used to explain relationship between aid and growth was the 'two gap' model from (Chenery and Strout, 1966). The first gap in this model is the amount of investment needed to achieve certain level of growth and investment saving availability, whereas the second gap is the difference between import requirements for a certain level of production to achieve and earnings from the foreign exchange. In their model they explain that economic growth depends on investment as a share of GDP, by using measurements to reveal whether that investment was of high or low quality. The model equation is the following:

$$G = (I / Y) / \mu$$
$$I / Y = A / Y + S / Y$$

In this equation G is the target of the GDP growth, I is the investment required, Y the output, μ is the incremental capital output ratio (ICOR), A is aid and S domestic saving. To measure the level quality of investment ICOR ranges between 2 and 5. The higher the ICOR the lower is the quality of investment measured. In this sense ICOR provides the required amount of units of additional output to produce an additional unit output. To have the investment ratio of GDP and the growth rate it is required that both additional capital units and additional output units to be divided by initial output. (Easterly, 2003). This calculation is measured if the investment rate is 24 per cent, while on the other hand ICOR is 4, the result of economic growth would be 6 per cent. If a country uses its capital more efficiently and the ICOR of this specific economy is 3, in order for the country to achieve 6 per cent growth it would require investment of 18 per cent. The financing gap model of (Easterly, 2001) where he tested the model regarding whether aid improves growth and investment shows that for aid to increase investment, and investment to increase economic growth, 88 aid recipient countries were used in the sample data from the period of 1965 and 1995. Out of 88 countries only 6 pass the test due to large amount of aid received in the period of 30 years with Hong Kong (0.7 per cent of GDP aid), China (0.2 per cent of GDP), with the inclusion of other four countries with less than 0.2 per cent of GDP like: Morocco, Tunisia, Malta and Sri Lanka. According to (Easterly, 2003) although financing gap model has dubious theoretical foundations and plenty empirical failures regarding that aid increases investment and this outcome results in economic growth it is very useful from many institutions and continues to be used by world Bank, International Monetary Fund and many other institutions.

The two gap model was criticized by (Colman and Nixson, 1994) as it is more useful and applicable for developed countries, rather than for developing countries. The two gap model assumptions of being independent on each other and that there is no link between investment and saving is unreal. In regard of saving (Cairncross, 1962) argues that the amount of saving it should not be an important factor limiting investments, however, it should basically be proportional with the amount of investment generated in order to profit in less developed countries. Savings rate affects positively growth, while on the other hand population growth rate may have negative effects on growth argues (Todaro and Smith, 2003). Usually savings increases capital and positively affects social life and boosts infrastructure growth; however, higher population leads to higher social and economic problems that may have impact in economic growth. In other words, developing countries that tend to have higher savings rates grow faster, while countries with higher population trends tend to have slower economic growth.

2.2 Assessing the benefits of aid

Analyses regarding the effectiveness of aid were less important in the 1940's and up until the 1960's when countries started to provide grants to developing countries with the purpose of increasing growth and poverty reduction (Chenery, 1965). The benefits of foreign aid have always been a controversy in terms of economic development and policy reforms. Rich countries in the 1950's and 1960's used foreign aid to fill the gaps in resource constrained economies, rebuilding and redevelopment of developing countries by encouraging them through central government planning. However, recent studies of the benefits of aid came with mix conclusions according to (Bone, 1996). They found out that foreign aid does not have effect on investment and growth and therefore the marginal propensity to consume from aid is insignificant, while marginal propensity to invest was zero. In addition to that (Easterly, 2001) while doing cross data analysis found out that there is no empirical relationship between growth and foreign aid or between investment and aid therefore, he concluded that, based on the finance gap aid did not deliver the expected results therefore it may provide wrong economic impression. However, foreign aid can benefit enormously if there are good and sound government policies argue (Burnside and Dollar, 2000). If the government manages to design and implement good monetary policies, fiscal and trade policies the effect on growth in such countries is always positive in contrast with countries with weak policy or poor regimes. Whereas, on the other hand (Hansen and Tarp, 2001) argue that foreign aid does not entirely depend on good government policies, it actually increases growth through capital accumulation. Regarding the 'Assessing Aid' study done by the World Bank in November 1998, two authors that did the research (Dollar and Lant, 1998) found out that foreign aid works perfectly well when it basically supports local governments that implement and manage good social, economic and political institutions. Their study concludes that foreign aid should be a mix of ideas and financial assistance or money in this case to produce better results and achieve certain goals in terms of development. However, historically, foreign aid programs produced from successful to disastrous failures. Successful aid generated great efforts in humanitarian relief, provided child care, reduced and provided care for many diseases that poor countries came across, supported programs in agriculture and farming that fed millions of people around the world, improved infrastructure and reconstruction of destructed schools for many children to attend school, improved sanitation and access to clean water and provided on certain occasions even health clinics. On the other hand, it failed to produce good results in different situations argues (Hancock, 1989). In 1987 in Somalia foreign aid agencies neglected to respond towards drought conditions despite government calls for assistance resulted in human casualties. In other situations foreign aid allocation repeatedly to African countries like: Tanzania, Congo, Zambia and Malawi did not make any significant impact in the life and perspective of these nations. Furthermore, (Hancock, 1989) and (Maren, 1997) point out that World Bank, International Monetary Fund (IMF) and other financial institutions were heavily criticized of how they approached and dealt with aid in the last decade. Corruption within the central and local level of the recipient government countries in one hand, while lack of basic expertise, communication skills, project management and cultural understanding from donor agencies on the other hand is what makes foreign aid fail most of the time.

In terms of macroeconomic effect (White, 1998) provided an illustrative table with three types of aid that are rationale, beneficial and with possible macroeconomic consequences.

Table. 1. Macroeconomic effects of different types of aid.

Type of aid	Rationale	Macroeconomic Benefits	Possible adverse macroeconomic consequences
Project Aid	Investment or rehabilitation	Higher output and improved social indicators	While elephant projects: distort spending patterns; and tie up recurrent resources
Programme Aid			
A) Imports support	Raise capacity utilization	Higher output and increased availability of goods	Easily fungible to non-priority imports
B) Debt relief	Relax foreign exchange constraint and remove debt overhang	Increased imports and investment	Policy disincentive effects, highly fungible
C) Budget Aid	Relax government recurrent constraint	Higher public spending and lower inflation	Distort government spending
D) Counterpart funds	Relax budget constraint	Reduce the need for deficit financing, redirect government spending to priority sectors	inflation
Food Aid	Food security and support to agriculture development	Increased agriculture output and labour efficiency	Disincentive effects
Technical assistance	Filling skills gap and human capital development	Greater efficiency in service delivery and increased human capital productivity	Labour market distortions: encourage brain drain and hinder human capital development.

Source: (White, 1998)

Although there are many arguments for and against aid (Chenery, 1965) points out that in order for recipient countries of aid to achieve better results and distribute foreign aid more efficiently it is necessary to support financial aid with technical assistance in order to support it with highly professional and experienced staff and make sure that aid generates economic growth and social wellbeing towards the benefiting country.

CONCLUSION

The study provides useful evidence on the impact of aid on economic growth and poverty reduction

From 1999 – 2005 from the overall €3.1 billion, around €1.3 billion were allocated towards capital investments, comprising 44 per cent in allocation aid and around 48 per cent of aid spent. On the other hand, technical assistance during that period accounted for around €1.1 billion with 37 per cent of allocated aid and around 30 per cent of aid spent. In addition to that in a period from 1999-2005 donor designated grants accounted for 7.7 per cent as official development aid in which case many projects were supported in sectors like:

culture, democratization, education and science, local administration, public services and trade and finance management. According to the same source justice and home affairs were the highest receivers of aid with 27 per cent of total aid (around 70 per cent of which went to Kosovo Police), public utilities were second with 20 per cent which included water, energy and waste. Other sectors with high receiving aid were also civil society, democracy and human rights with 11.3 per cent, trade and industry around 10 per cent, public administration 9.1 per cent with other remaining sectors in total of around 23 per cent. All these accomplishments were not be making significant impacts on growth and poverty reduction if it wasn't for donor agencies providing foreign aid and assistance.

Nonetheless, negligence from the donor assistance was evident as well, particularly in coordinating their activities. Donor agencies sometimes due to inappropriate coordination resulted in overlapping projects by having different donor agencies officials involved in the same project that supposed to be other way around. Donor agencies also failed to tackle the issue of economic development more strictly and job creation for the high unemployment rate in Kosovo. The overall performance of the donor assistance in Kosovo could be marked as satisfactory and this effort should be credited not only to the donor agencies, but also to the people of Kosovo for cooperation and efforts made in the recovery process.

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