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Is tied aid bad for the recipient countries?☆

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ABSTRACT

This paper examines the welfare effects of the exclusivity of foreign aid taking consideration of donor countries' strategic and self-interested economic motivations. Based on an oligopolistic model with strategic interactions between firms and governments providing foreign aid, we demonstrate that a higher exclusivity of foreign aid, taking the form of tied aid, increases the equilibrium amount of aid and the social welfare of the recipient country when the foreign aid policies are decided in a non-cooperative fashion between donor countries. However, when donor countries coordinate aid policies to maximize joint-welfare including recipient country's welfare, the lower exclusivity of foreign aid, taking the form of untied aid, will increase the equilibrium amount of aid and the global social welfare. The results implicate that when a credible enforcement mechanism for the cooperative regime for foreign aid is not available, tied aid is welfare dominant policy for both donor and recipient countries than untied aid.

1. Introduction

Development Assistance Committee (DAC) of OECD has encouraged Official Development Assistance (ODA) to be provided as untied aid with no exclusivity by introducing an explicit guideline for tied and partially tied ODA in April 1987 based on humanitarian motivation.[3] Since then, the share of tied aid has decreased significantly from 48% in 1987 to 15% in 2011 worldwide.[4] Nonetheless, tied aid still plays a big role in many countries including the US that provides 34.5% of the total aid as tied aid, and other OECD countries as Austria, Italy, Portugal, and South Korea.

Untied aid has been widely supported with the belief that tied aid is more likely to be provided with the strategic purpose to support domestic corporate sectors of donor countries. Japan is also often cited as a typical example of the donor country with the strategic purpose to support her own firms with tied aid.[5] In contrast to some critical views on tied aid, Kihara (2012) shows that there is a higher correlation between the per capita GDP growth rate of the recipient countries and the tied aid from Japan than untied aid from other countries. China has also attracted criticism for her huge amount of tied aid in Africa as self-interested efforts to increase the market power of the Chinese firms in Africa notwithstanding possible positive impacts for economic development in the region (Bräutigam, 2011; Sun, 2014).[6]

Although non-exclusivity of aid is emphasized by DAC, one striking finding is that the majority of aid exclusively benefits firms from the donor country in both cases of tied and untied aid. During the 10 years after the Paris Declaration in 2001, contrary to the international community's expectation, two-thirds of formally untied aid has actually benefited corporate sectors of donor countries (Ellmers, 2011).

Confronted with these conflicting features with respect to exclusivity of foreign aid, a more rigorous analysis of the welfare effects of two different types of aid is wanted since many arguments are still raised on the efficiency of the DAC policy guideline to encourage untied aid and to discourage tied aid. Based on these backgrounds, this paper

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[3] OECD defines tied aids as follows: "Tied aid credits are official or officially supported loans, credits or associated financing packages where procurement of the goods or services involved is limited to the donor country." Therefore tied aid provides exclusive benefits only to firms from donor countries since procurement is limited to the donor country. Refer to the OECD Glossary of Statistical Terms at http://stats.oecd.org/glossary/detail.asp?ID=3089.

[4] 'OECD.Stat DAC7b Tying Status of Bilateral ODA' shows that the total bilateral aid in 2011 reached US$ 104.5 bn, while the amount of tied aid was US$ 15.1 bn with partially untied aids at the amount of US$ 4.0 bn.

[5] Due to the high exclusivity of aid, Japan was ranked as the lowest among 22 OECD donor countries, according to the index of donor performance evaluated by the Center for Global Development.

[6] Regarding this region, Hisali and Ddumba-Ssentamu (2013) analyze the aid–tax revenue relationship in Uganda and provides deeper insights into the nature of the relationship.

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aims to determine when DAC's policy for untied aid can be a welfare improving policy and conditions make tied aid welfare dominant.

Among huge literature about the welfare effects of foreign aid, a dominant perspective is to regard the foreign aid as a public good (Dudley, 1979; Kasuga and Morita, 2012; Olson and Zeckhauser, 1966; Raffer, 1999; Reisen et al., 2004; Schweinberger and Lahiri, 2006). In addition to the general welfare analysis of international aid of earlier literature, Kemp and Kojima (1985) study the endogenous price distortion of tied aid that affects welfare of recipient negatively while affecting welfare of donors positively. Reconsidering the transfer paradox, Lahiri and Raimondos (1995) find out the Pareto improving condition that makes both donor and recipient better off. Svensson (2000a,b) shows that tied aid works as welfare-improving policy, resulting in a poverty reduction of the recipient. Abe and Takarada (2005) examine the condition under which the donor suffers from tied aid while the recipient benefits from it.

In addition, Burnside and Dollar (2010) argued that foreign aid raises growth only in a good policy environment of recipient countries driving attention to the soundness of the recipient country's economic policies. However, Easterley et al. (2003) argue through extended studies with updated data that there is no strong correlation between the soundness of the recipient country's policies and the effectiveness of aid in promoting growth of recipient countries. In the spirit of Easterley et al. (2003), instead of focusing on the soundness and goodness of recipient countries' policies, we focus on the effects of different types of motivation of donor countries and the different types of the aid regime such as the cooperative regime and non-cooperative regime.

Knack and Eubank (2009) shows that the harmonization among donor countries and alignment with the major development issues of recipient countries are the key factors to determine the efficiency of aid. Using an endogenous growth model incorporating leisure choice of individual, Liu et al. (2014) show that a foreign aid can lower growth and the welfare by providing to individuals less incentive for working and more incentive for playing.

The major difference between earlier studies and this paper lies in that this paper examines the equilibrium aid strategies considering strategic and self-interested economic motivation lying behind international aid. To the best of our knowledge, this study is the first work to provide a theoretical framework to understand the welfare effects of varying levels of the exclusivity in both tied and untied aid. Based on a spatial oligopoly model with strategic interactions between firms and governments providing aid, we demonstrate that the higher exclusivity of aid, taking the form of tied aid, increases the equilibrium amount of aid and the social welfare of the recipient country when the ODA policies are made in a non-cooperative fashion between donor countries. However, when donor countries can coordinate aid policies for joint-welfare maximization including the recipient country's welfare, the lower exclusivity of aid, taking the form of untied aid, will increase the equilibrium amount of aid and the global social welfare. These results implicate that the policy recommendation of OECD DAC for untied aid can be a welfare improving approach only when the international coordination mechanism for cooperative aid works effectively.

Section 2 explains the basic model setting where representative firms from two donor countries compete in a recipient country's market while governments of donor countries have varying levels of self-interested motivations of aid provision. Section 3 discusses the equilibrium when aid is provided in a non-cooperative fashion between donor countries, while Section 4 determines the equilibrium under a cooperative regime of aid provision. Section 5 examines the conditions for the cooperative regime of aid provision to be sustainable, and Section 6 discusses the policy implications and concludes.

2. Stylized features of tied and untied aid

We examine how tied aid differs from untied aid in terms of the contexts the aid is provided in reality and the effects caused by the two different types of aid based on available data in the following.

First, the difference between the tied and untied aid is defined as follows: According to the definition of the Development Aid Committee of OECD, “tied aid describes official grants or loans that limit procurement to companies in the donor country or in a small group of countries. Tied aid therefore often prevents recipient countries from receiving good value for money for services, goods, or works.

Untying aid – removing the legal and regulatory barriers to open competition for aid funded procurement – generally increases aid effectiveness by reducing transaction costs and improving the ability of recipient countries to set their own course. It also allows donors to take greater care in aligning their aid programs with the objectives and financial management systems of recipient countries.”[7]

The backgrounds for the strong supports and recommendation for untying aid are as follows[8]:

i) Tied aid decreases value for money provided by the aid. DAC recommendation on untying ODA to the least developed countries (LDCs) showed that tied aid increases costs of supplies by 15% to 40% mainly due to limited competition and resulted monopoly prices with higher transport costs compared to the local purchases.
ii) Tied aid undermines the recipient country's ownership of the development process. Tied aid is criticized as preventing developing countries from taking full responsibility of their own development in utilizing the aid. Tied aid puts purchasing decisions in donors' hands resulting in the purchase of inadequate purchasing mainly benefiting firms from donor countries.
iii) Tied aid is criticized as undermining the right to development. That is, tied aid deprives developing countries from full potentials of the long-term sustainable development that untied aid might have provided with local procurement products and services from the developing recipient country.

Based on the above arguments, DAC of OECD has adopted a strong policy drive to untie aid, especially recommending untied aid for least developed countries since 2001. Thereafter, there has been a rapid growth of the share of the untied aid as shown in the following table.

[7] The definition of the tied and untied aid is quoted from OECD official site, http://www.oecd.org/development/untyingaidtherighttochoose.htm.
[8] Refer Ellmers (2011) for the details of the discussions about the shortcomings of tied aid.