



THE AID DEBATE: PAKISTAN'S PERSPECTIVE

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List of Acronyms

BOP	Balance of Payments
CPI	Corruption Perception Index
FY	Fiscal Year
GCF	Gross Capital Formation
GDP	Gross Domestic Product
GoP	Government of Pakistan
HIV	Human Immunodeficiency Virus
IMF	International Monetary Fund
KSA	Kingdom of Saudi Arabia
MDGs	Millennium Development Goals
ODA	Official Development Assistance
SDGs	Sustainable Development Goals
UK	United Kingdom
US	United States
USA	United States of America
WWII	World War Two

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1. INTRODUCTION

Is foreign aid effective?. This question becomes all the more important if viewed against the backdrop of calls for doubling foreign aid to developing countries. The answer to this enquiry, however, has spawned a debate among mainstream academia with each side postulating viable arguments in their defense. In case of developing countries, the for-aid camp points toward the foreign-exchange bottleneck as well as insufficient savings as the rationale for foreign aid which makes up for such deficiencies. The theoretical foundations for this argument can be traced to the famous Harrod-Domar model which implicates that low saving rate dents the growth process (Harrod, 1939 and Domar, 1946). As of late the case for foreign aid has assumed a humane face by appealing to the stalled social sectors of developing countries. This role of foreign aid was duly formalized by the integration of Official Development Assistance in now defunct Millennium Development Goals (MDGs) and the recently promulgated Sustainable Development Goals (SDGs). Contrarily, not-for-aid camp directs their criticism on foreign aid based on the fact that it rather than helping the poor countries, subverts the growth process by distorting market incentives and highly politicizes the development endeavor beyond bounds. Criticism of foreign aid is also leveled from the political spectrum both from “*the Left*” and “*the Right*” with the latter hinting the potential pauperism that it can ensue while the former points its neo-imperialist connotations. The empirical evidence also paints a contradictory picture of aid effectiveness. There is wide literature which suggests that “by and large” aid has been effectiveness contending that income per capita would have been lower in the recipient countries had there been no aid (McGillivray, 2004 and Sasaki, 2006). One strand of literature asserts that aid affective is contingent on the domestic policies of the recipient countries like Burnside and Dollar; 1997, 2000, 2004; Collier and Dollar, 2001, 2002; Collier and Hoeffler, 2002. In contrast to this, some of the studies found that aid effectiveness is policy-neutral (Amavilah, 1998; Hansen and Trap, 2001; Uttara and Strobl, 2004; and Roodman, 2007). On the other side, Rajan & Subramanian (2008) conclude that there exists no systematic link between growth and aid. Djankov *et al.*, (2008) argues that increases in foreign aid decreases institutional quality while Hansen and Trap (2001) finds that aid has a diminishing returns element to it. Working on non-income indicators, Mishra and Newhouse (2007) finds a small impact of health aid on reducing child immortality.

This inconsistency in literature on aid effectiveness is also visible in Pakistan's perspective. Relying on time series data, Javid and Qayyum (2011) using a data range

of 1960-2008 finds that aid has negative impact on real GDP while aid-policy interactive term has positive impact on real GDP implying that aid effectiveness is contingent on good policies. Mohey-ud-Din (2005) analyzes the effectiveness of foreign aid in closing the savings-gap and exports-gap in case of Pakistan and concludes that aid has been effectiveness in promoting economic development while it also exerts some negative influence by increasing the debt burden. Some of the other studies in case of Pakistan which highlighted the aid effectiveness are Mullick, 2004 and Shahzad *et al.*, 2011. Contrary to this, negative impact of foreign aid on growth is also observed by some studies like Ishfaq, 2004 and Khan & Ahmed, 2007. Evaluating aid effectiveness in terms of non-income indicators, Ullah (2013) finds that USAID funds do not contribute to improvements in the health sector of the province of KPK and Chaudhry *et al* (2010) observes that aid has positively contributed to education sector of the country.

This paper attempts to add to this debate on aid effectiveness by evaluating it in the light of arguments for and against foreign aid from the perspective of Pakistan with especial focus on its political economy. It must be noted here that this research is limited only to aid flows by bilateral and multilateral sources to Pakistan instead of private flows of funds. Furthermore, to the best of our knowledge the paper also assesses arguably for the first time in Pakistan whether foreign aid has become a resource case. Section 1.2 delineates the major concepts of aid economics; section 1.3 takes stock of Pakistan's incessant relationship with foreign aid and section 1.4 gives a bird's eye view of the structure of foreign aid in Pakistan. Furthermore, section 2 and section 3 evaluates the arguments for and against aid respectively in terms of Pakistan while the final section concludes.

1.2 The Aid Economics¹

While the obsession with foreign aid has been relatively new, it has a history that spans well over a millennia and may be even more. During the famous Peloponnesian wars that pitted Athens against Sparta, foreign aid was disbursed regularly to Greek colonies by Athens and Sparta to secure the favors of local populace. About three centuries earlier to this, during the time of the so-called Pax-Assyria the Assyrian Empire doled out funds to its buffers states of the Levant in order to secure their

¹ This section draws heavily from the book "*Dead Aid: Why Aid is not working and how there is a better way for Africa*" by Dambiso Moyo

loyalty in case of any military struggle against its arch-nemesis Egypt. The same policy was also retained by its successor the Neo-Babylonian Empire. Foreign aid's role in one of the game-changing battles of the world – The Battle of Waterloo – that decided the fate of Napoleon Bonaparte was instrumental². Ironically enough Napoleon himself is said to have quoted that “An army crawls on its stomach”. The American Revolution was also fuelled from French coffers. It is noted, however, that most of the aid in antiquity was motivated to gain political advantages as in case of French aid to the Americas which meant to undermine British influence in the region. Nevertheless, moral and religious motivations for foreign aid were also evident (Byusa, 2012).

Paradoxically, the economic case for foreign aid is also rooted in a geo-political event – the infamous WWII. Moyo's history of foreign aid in the post-war period is visualized in the figure 1:

² Chapter 2 On Human Bondage from the “*The Ascent of Money*” by Niall Ferguson.

Figure 1: History of Foreign Aid

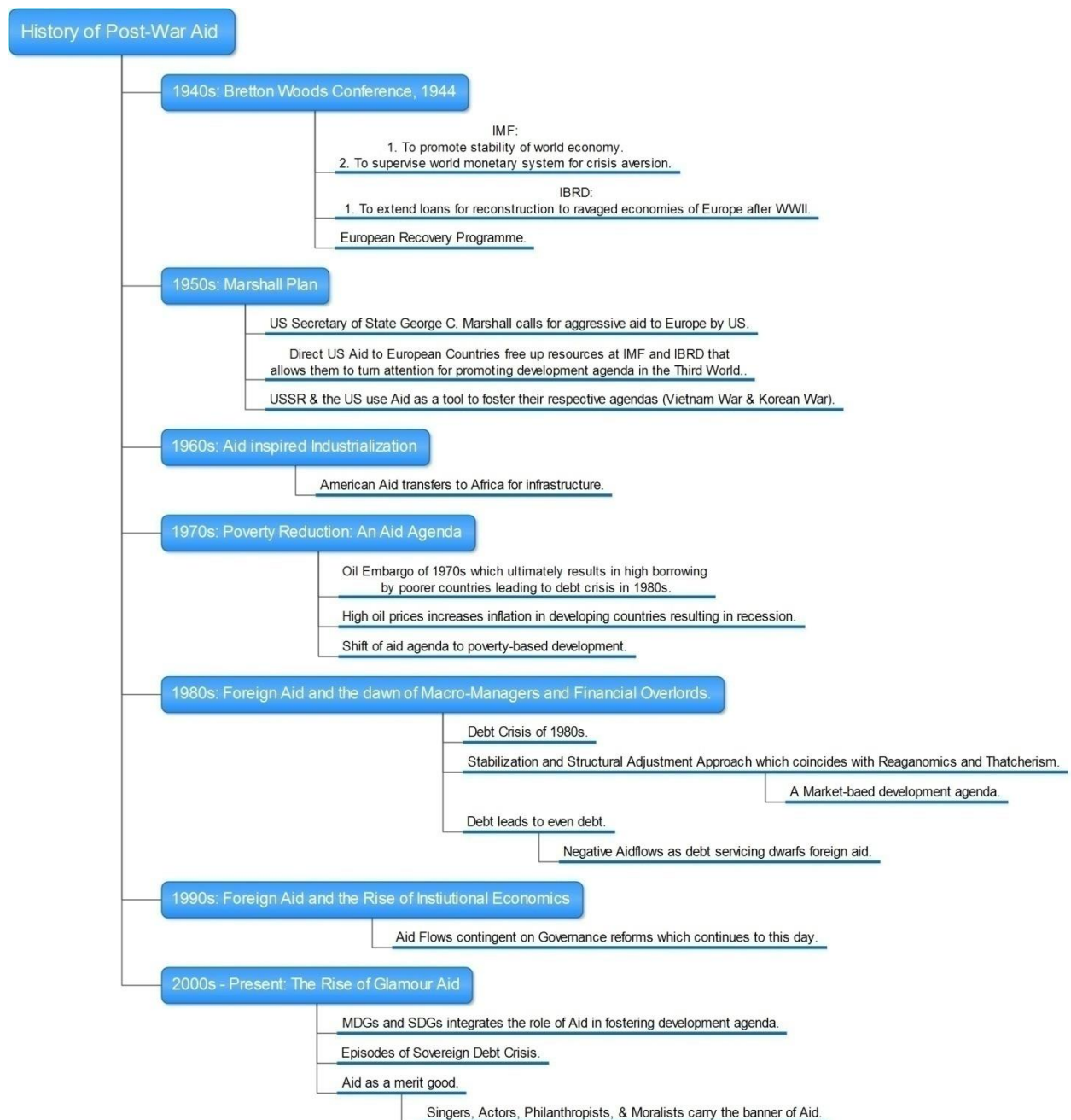
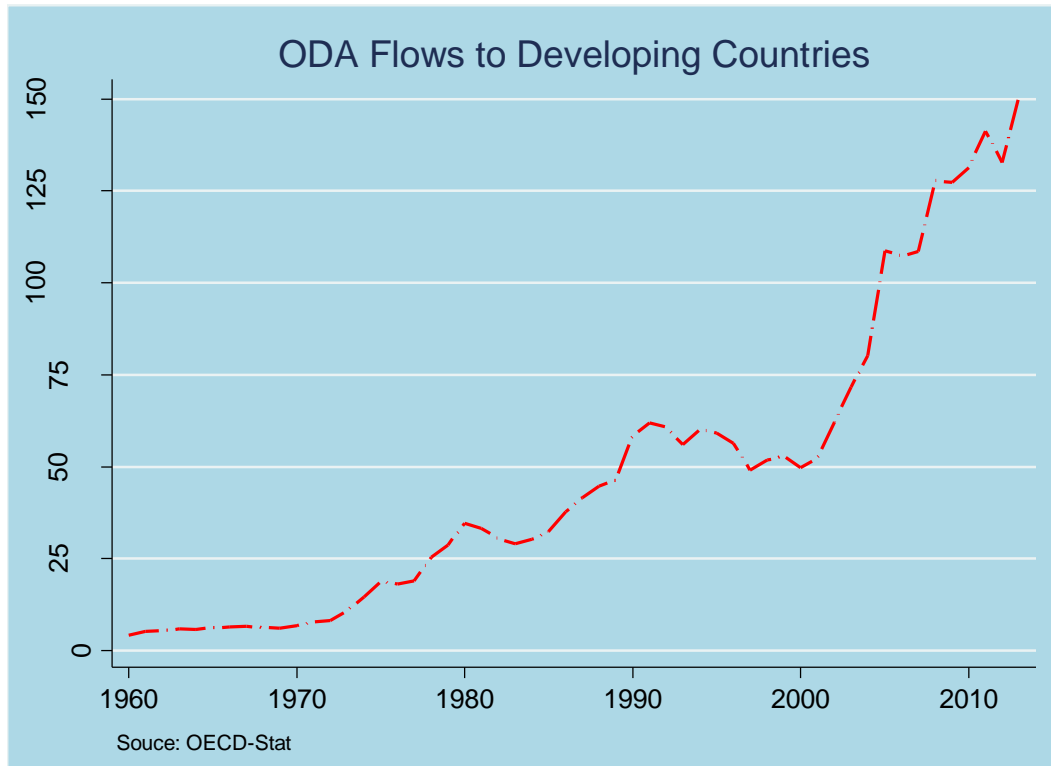


Figure 2: ODA Flows to Developing Countries



As of late the aid critique is being led by American Economist William Easterly and Zambian economist Dambisa Moyo. Most of the arguments raised by Easterly against foreign aid revolve around the fact that foreign aid encourages perverse incentive on part of both donor countries and recipient countries. A large chunk of the foreign aid given is eventually spent on the produce of the donor countries, that is, most of the aid is tied. Younas (2008) states that "aid allocation motivations stems partly from trade benefits that accrue to the donor country ... more aid is disbursed to the country which imports capital goods from the donor country. Easterly (2006) states that 75 of the aid disbursed by the United States is spend on American products. Easterly and Pfutze (2008) further gives evidence in this regard that tied component for bilateral aid is 21 percent which is 4 percent for food aid and 24 for technical assistance. Technical aid is regarded by some as the worst form of aid in which about half of the aid is spent on salaries of experts from donor countries³. Furthermore, it is also criticized that aid process in donor countries is much politicized and aid contracts are heavily vied and lobbied for by donor country's organization. In 2011 when Hillary Clinton was Secretary of State, the healthcare arm of Clinton Foundation

³ Clinton Foundation was to recruit about 100 faculty members from 13 US universities and persuade them to work at a 7 percent low administrative rate and even then it would require \$150 million out of which nearly half was to be spent on salaries of American doctors and nurses. *Rwanda aid shows reach and limits of Clinton funds*. <http://www.nytimes.com/2015/10/19/us/politics/rwanda-bill-hillary-clinton-foundation.html>. Retrieved on 08-11-2015

lobbied for channeling the American aid away from HIV prevention programs to programs for training health professions in Rwanda. This changed did occur and was operated by Clinton Foundation much to the disappointment of aid contractors in US who lost money⁴. The donor authorities are also blamed to decide at average by appropriating aid funds in all sorts of projects and hence under allocating in projects with higher marginal benefits.

On part of the recipient country, it is argued that they deliberately keep the productive capacity down to stay on the aid radar by being relevant. This can also work in the opposite way in which the recipient country will paint a rosy picture just to please the donors for even more aid. Another view is that aid is always meant to fail since it is mostly advanced to countries with weak institutions and corrupt governments. It is off-stated that some of the aid-receiving countries have billionaire leaders. Hence, aid suffers from adverse selection problem. Along with this, it also suffers from moral hazard problems. The recipient country's government spends it in unproductive endeavors and most of it is wasted in the bureaucratic process. This problem becomes even more serious in anticipation of debt forgiveness which ultimately ensues reckless spending. These adverse selection and moral hazard problems are also called Samaritan's Dilemma. The economic environment of the recipient country may not encourage investing which causes aid funds to be consumed rather than invested. Hence, aid fuels a consumption boom (Boone, 1996).

Those who claim that aid works, point mostly to the fact that health indicators of the developing countries have improved markedly – and they have.⁵ Some of other evidence supporting the aid effectiveness argument states that top ten of Americas' trading partners today were once recipient of aid from it.⁶ In his book "The End of Poverty", Sachs asserts that one of the reasons for poverty is the so-called poverty trap which deprives poor countries from capital building investment. Hence, foreign aid is imperative to make such investment for them. However, it is also accepted by aid exponents that foreign aid works only if it is properly designed, delivered, and managed. Sachs (2014) writes that "it works best in conjunction with sound economic policies, transparency, good governance, and the effective deployment of new

⁴ *Rwanda aid shows reach and limits of Clinton funds*

<http://www.nytimes.com/2015/10/19/us/politics/rwanda-bill-hillary-clinton-foundation.html>.

Retrieved on 08-11-2015

⁵ Aid Works by Jeffrey D. Sachs. <http://www.project-syndicate.org/commentary/aid-works> Retrieved on 08-11-2015.

⁶ Foreign aid works. Here's proof. <http://www.usglc.org/2014/01/23/foreign-aid-works-heres-proof/> Retrieved on 08-11-2015.

technologies". Paul Collier (2007) substantiating this view states in his book the Bottom Billion that "Aid has tended to be more effective where governance and policies are already reasonable."

1.3 Pakistan's Wedlock with Foreign Aid⁷

Pakistan's relationship with foreign aid started just three years after its inception in 1950. Initially aid numbers were small as during five eight years of Pakistan from 1947 to 1955 a sum of \$372 million in foreign assistance was given to Pakistan. During the first three five-year plans of Pakistan; a total of \$993 million was disbursed for first five year plan (1955-1960) which increased to \$2.365 billion for the second five-year plan (1960-1965) and \$2.701 billion for third five year plan (1965-1970). The aid numbers plummeted thereon during the civil war in Pakistan that led to the secession of East Pakistan. Qureshi (1978) gives the numbers of aid flows that amounted to \$7.2 billion from 1950 to December, 1971 – the same month in which Pakistan was dismembered – out of which 75 percent of the funds were loans while the grants component totaled to about 25 percent.⁸ Pakistan paid about \$0.8 billion of the disbursed loan component of \$4.4 billion and left behind a debt legacy which started at \$3.6 billion. A legacy that stays with the country to this day as the total debt outstanding increased 13 times to \$46 billion⁹ in 2011-12 from 1971-72 (Qureshi, 1978 and PBS, 2014). Following the separation of East Pakistan in early 1970s, aid did increase during mid-1970s but this trend was not sustained as aid did not increase further up until early 1980s as Pakistan became the frontline state against America's campaign to dislodge Soviet design of regional hegemony when it invaded Afghanistan in 1979. In mid-1960s, Pakistan signed a six-year agreement with US which was to provide \$4.02 billion, 57 percent of which was to be economic aid while the rest military aid (Arshad and Ahmed, 2007). The aid flows took a bum in early 1990s onwards mainly as a result of Pressler amendment in the US which stopped aid flows to Pakistan from US during to its nuclear programs. In what could be described as herd behaviour, aid flows to Pakistan from other sources also declined.

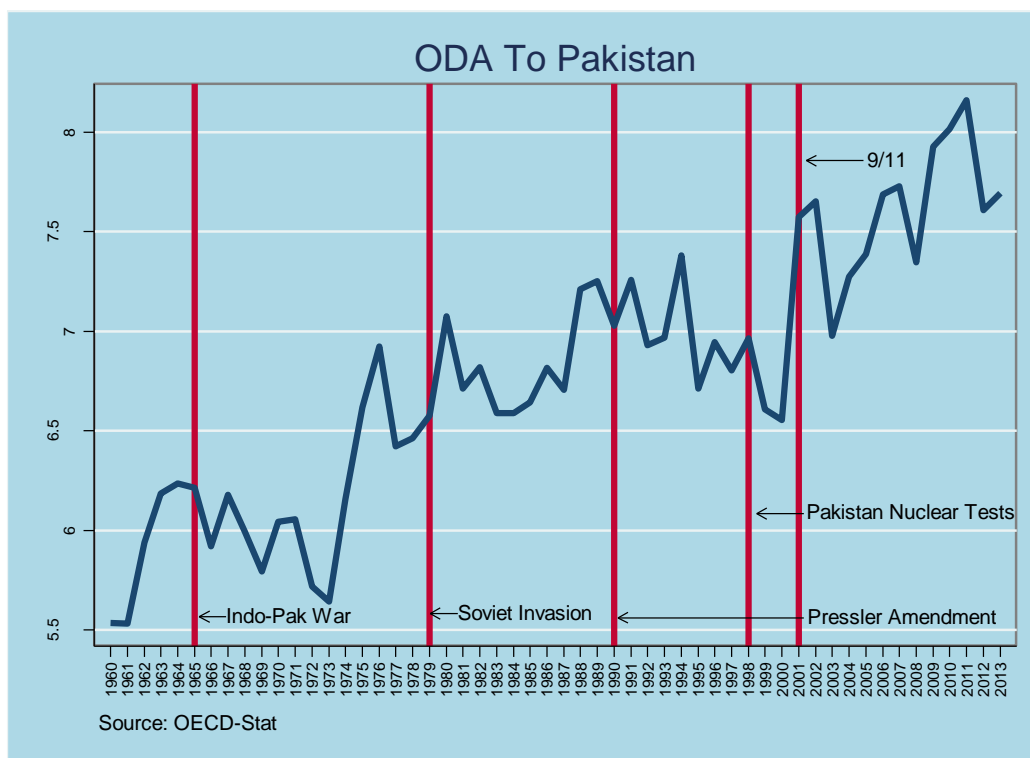
⁷ For a more detailed history of foreign aid to Pakistan see *Foreign aid – blessing or curse: Evidence from Pakistan*. <http://www.pide.org.pk/pdf/PDR/2007/Volume3/215-240.pdf>. Retrieved on 09-11-2015.

⁸ The standard definition of foreign assistance requires that at least 25 percent of the funds must be grant or grant-type assistance.

⁹ Total debt outstanding in 2011-12 excludes debt outstanding to IMF.

The change of events in the geopolitical spectrum pushed Pakistan again in the mainstream of foreign aid. The 9/11 terrorist attacks and Pakistan's subsequent accession to become an ally of the Western powers in War against Terrorism resulted in massive flows of aid to Pakistan. Figure 3 shows the Official Development Assistance aid flows to Pakistan in log scales with reference lines for major political events. It can be seen that even Official Development Assistance exhibit the impression of political implications. ODA aid growth increased in 1979 up until the passage of Pressler amendment in 1990. Growth in aid flows decreased following 1965 War and after Pakistan's successful testing of its nuclear bombs in 1998. Yet again, ODA growth jumped up after 9/11 terrorist attacks. It is reiterated here that aid flows to Pakistan exhibit some sort of a herd behaviour in which ODA flows follow US aid flows. This also implies that in case of Pakistan, donor sources have a leader-follower relationship with the United States of America.

Figure 3: ODA to Pakistan



1.4 Composition of Foreign Aid to Pakistan

Pakistan's composition of foreign aid has been changing ever since it started way back in 1950. As in case of any other country, the major sources of aid to Pakistan are

bilateral sources and multilateral sources. As of late the bilateral sources have been dwarfed by the multilateral source which is shown in figure 4. From 2006-07 to 2014-15, the share of bilateral sources averaged 35 percent while the multilateral aid sources accounted for 65 percent of the total foreign aid disbursed to Pakistan. In bilateral aid, the five major donor countries to Pakistan are USA, UK, China, KSA, and Japan as average share of aid from these countries in total bilateral aid to Pakistan is 92 percent from 2006-2007 to 2013-14. Another important change in bilateral aid flows is the share of aid from China and USA. In 2006-07, China's share in total bilateral aid was 14.5 percent which stayed at that level the following year 2007-08. However, it was 41 percent in 2008-09, 19 percent in 2009-10, 27 percent in 2010-11, 60 percent in 2011-12, 57 percent in 2012-13, 45 percent in 2013-14, and now stands at 67 percent. Contrarily, aid funds from USA accounted for 48 percent of total bilateral aid in 2006-07, 11 percent in 2007-08, 21 percent 2008-09, 28 percent in 2009-10, 35 percent in 2010-11, 7.1 percent in 2011-12, 6.9 percent in 2012-13, 9.7 percent in 2013-14, and 5.4 in 2014-15. This gives evidence to the fact that China's role in Pakistan has now markedly increased relative to that of the US as China's share in total bilateral aid outpaced that of US's share six times (2007-08, 2008-09, 2011-12, 2012-13, 2013-14, 2014-15) out of the 9 data periods. China has been the largest single donor country during the last four consecutive years.

Breaking down aid flows still further with respect to type of aid, the results show that aid has more of a loan component in it now. Though it must be noted that loan component has always been higher than grant component historically but recently the bend towards loan component has become stronger. As already stated above in the previous section, from 1950 to 1971-72 grant component was 25 percent in the total committed aid of \$7.2 billion which now clocks in at 16 percent well below the 25 percent grant requirement in foreign aid.

The grant component in bilateral aid, however, has been well above 25 percent – it averages 50 percent from 2006-07 to 2014-15 while the same for multilateral aid averages at a meager 2 percent only. Figure 5 shows the graphical view in this regard. Furthermore, it is also observed that project aid component of aid is also on the decline as shown in table 1. Apart from two years i.e. 2011-12 and 2012-13 non-project aid has been greater than project aid. Since project aid increases the productive capacity of the country it is also important to study its major heads which is done in figure 6. It is observed from figure 6 that areas such as power and transport and communication account for the major share of project aid – the two heads together has an average share of 57 percent in the total project aid. Some of the acutely under allocated heads

are agriculture, health, rural development and poverty reduction, physical planning and housing, water and education.

Finally, one of the striking characteristics of foreign aid to Pakistan is the fact that recently a better share of it has been used up as a BOP cushion as figure 7 below suggests. The average share of BOP/Cash is about \$1.655 billion almost equal to that of development aid's share during 2007-2014.

Figure 4: Source of Aid

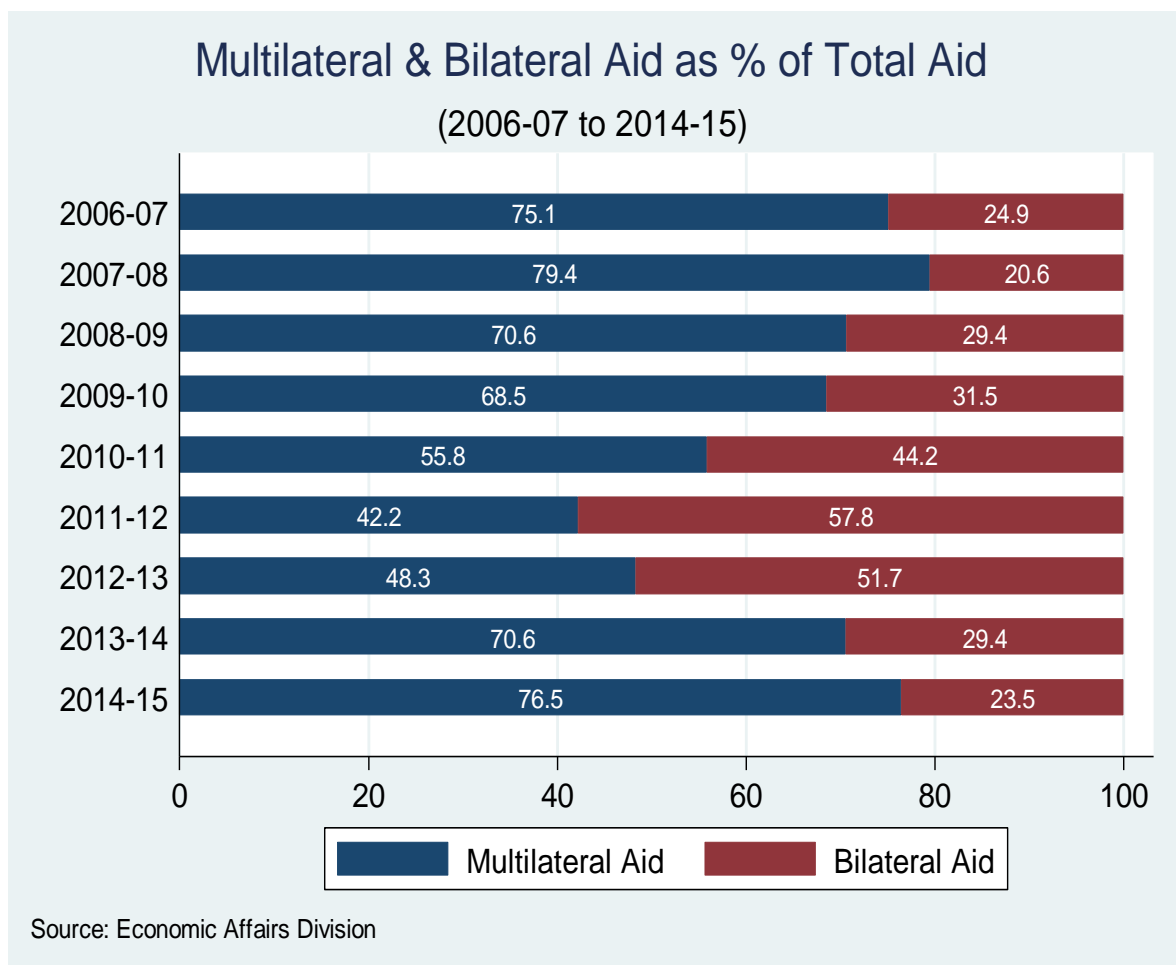


Figure 5: Aid-type for Multilateral and Bilateral Aid

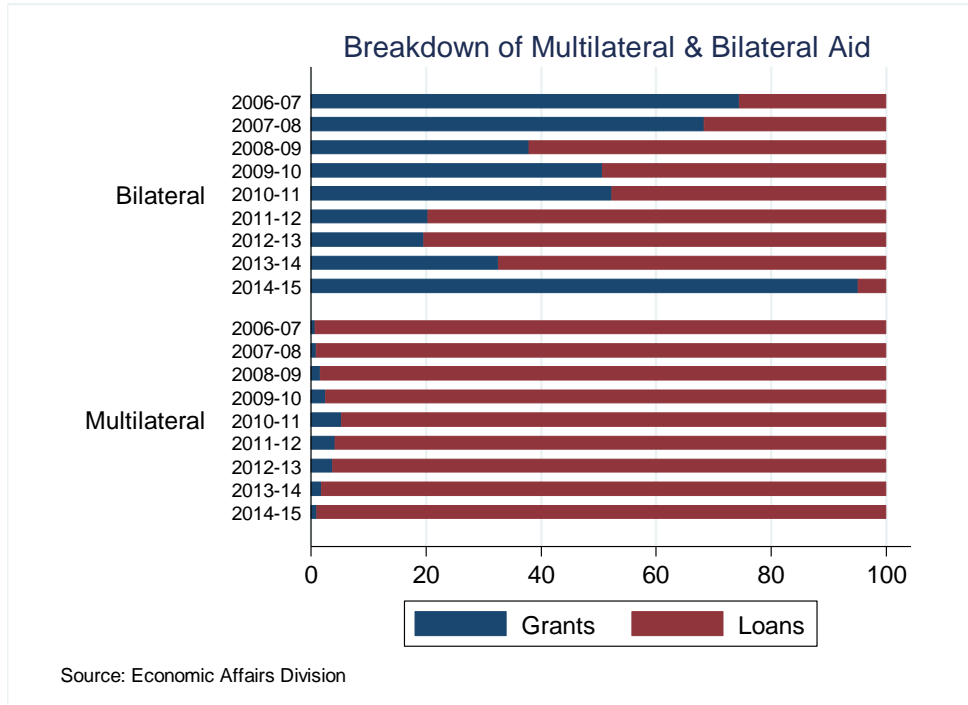


Figure 6: Major Heads of Project Aid

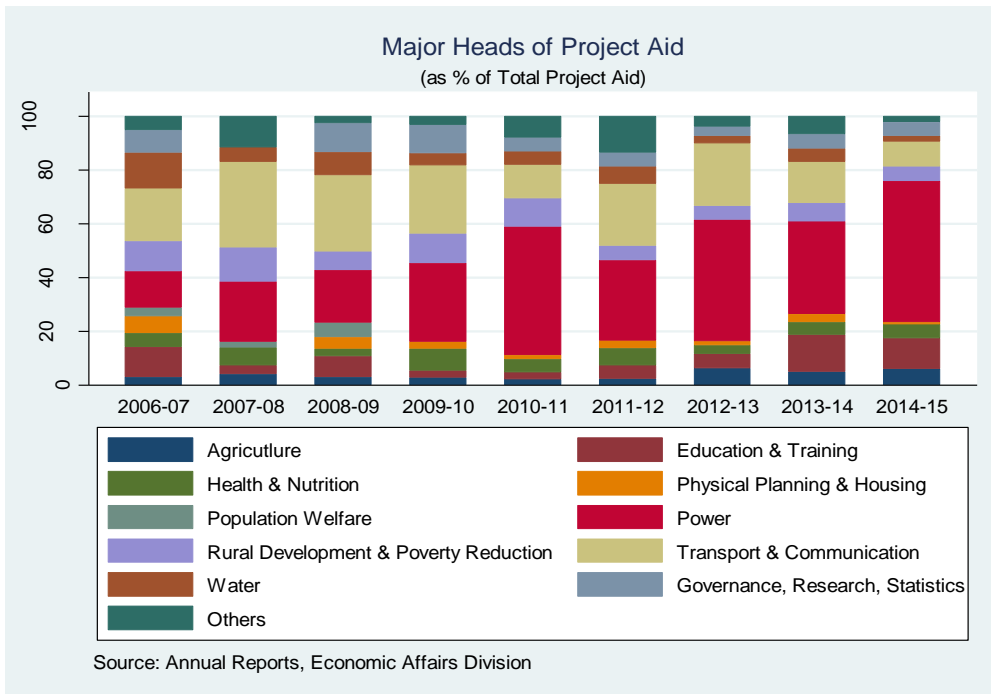
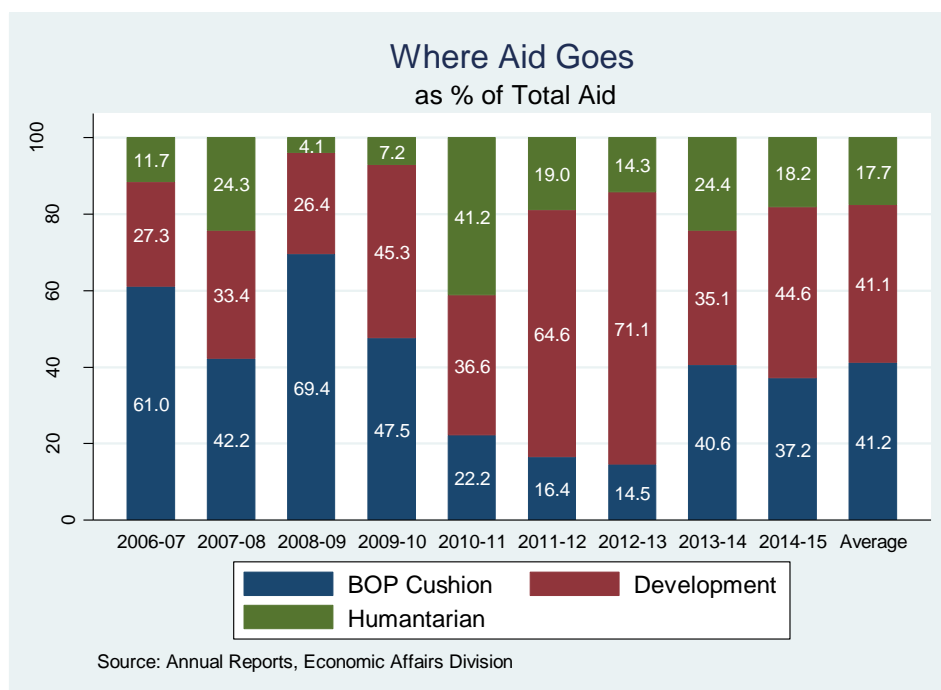


Table 1: Project Aid vs. Non-Project Aid

Project & Non-Project Aid* (in Million \$)			
Year	Project Aid	Non-Project	Total
2006-07	864.619 (26.23)	2431.963 (73.77)	3296.582 (100)
2007-08	697.44 (19.48)	2883.07 (80.52)	3580.51 (100)
2008-09	1057.27 (22.67)	3606.17 (77.33)	4663.44 (100)
2009-10	995.05 (27.17)	2667.91 (72.83)	3662.96 (100)
2010-11	931.87 (36.57)	1616.01 (63.43)	2547.88 (100)
2011-12	1965.75 (64.61)	1076.68 (35.39)	3042.43 (100)
2012-13	2031.23 (71.14)	824.05 (28.86)	2855.28 (100)
2013-14	2282.16 (33.57)	4515.99 (66.43)	6798.15 (100)
2014-15	2871.73 (49.53)	2926.37 (50.47)	5798.1 (100)
Average	1521.90 (39.00)	2505.357 (61.00)	4027.26 (100)

*Shares out of Total Aid in parenthesis

Figure 7: Where Aid goes

2. ARGUMENTS IN FAVOR OF FOREIGN AID AND PAKISTAN

This section evaluates the arguments in favor of foreign aid with respect to Pakistan. Section 2.1 assess if foreign aid helped increase investment, exports, and growth in Pakistan during 1990-2010 period. The last sub-section 2.2 evaluates Pakistan's social sector performance.

2.1 Two-Gap Model

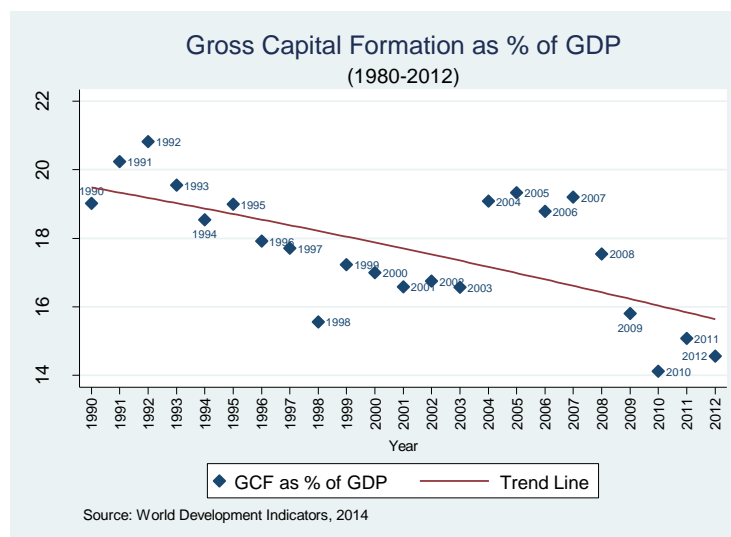
Foreign aid is theorized to increase growth in developing countries by increasing investment since stock of saving falls well short of the required amount of investment in such countries. In the context of the study, this argument is assessed for Pakistan during 1990-2012 data period and using gross capital formation as percent of GDP as a proxy of investment and net Official Development Assistance as percent of GDP as measure of aid. Effectiveness of aid in increasing its growth is also assessed using real GDP for the same reference time (1990-2012). The results as depicted in the first and second panel of figure 9 for investment and growth respectively shows that increases in ODA does not bring any sort of increase in either investment or GDP growth. The flat shape of the trend line between GCF and ODA shows that investment is aid-

neutral and so is growth as its trend line with ODA is also flat. Consequently, there does not appear to be any consistent pattern between each of the variables and ODA.

In nutshell, this section shows that swings and movements in macroeconomic variables like investment and growth are independent of aid in Pakistan. Investment which is the main channel through which aid is expected to bear any meaningful positive relationship with growth increases through private decision of investors. The fact that Pakistan received less aid during 1990s and higher aid during 2000s would have implied that trend line for investment against time would have been a straight positively sloped linear line but as shown in figure 8 the case for investment has been opposite. Investment ratio was higher in 1990s than 2000s.

In case of Pakistan, it has been often observed that instead of foreign aid, growth inducing increases in investment is an outcome of diverse factors like a stable political outlook and secure supply of energy to the manufacturing units. Another factor which this study likes to highlight is financial democratization or financial inclusion. This has been rather elusive for Pakistani investors due to lack of awareness for financial products and financial institutions¹⁰. This may explain Pakistan's low saving rate which hovers around 8 percent of GDP (Abbasi, 2015). This implies that low savings rate in Pakistan is not an outcome of it being poor as is the rationale behind big push policy of foreign aid but rather lack of financial knowledge on part of the investors in Pakistan.

Figure 8: Downward Trend for Investment



¹⁰ According to a World Bank report, only 14 percent of Pakistanis use financial products from financial institutions. <http://tribune.com.pk/story/987583/investment-is-a-mindset/>. Retrieved on 09-11-2015

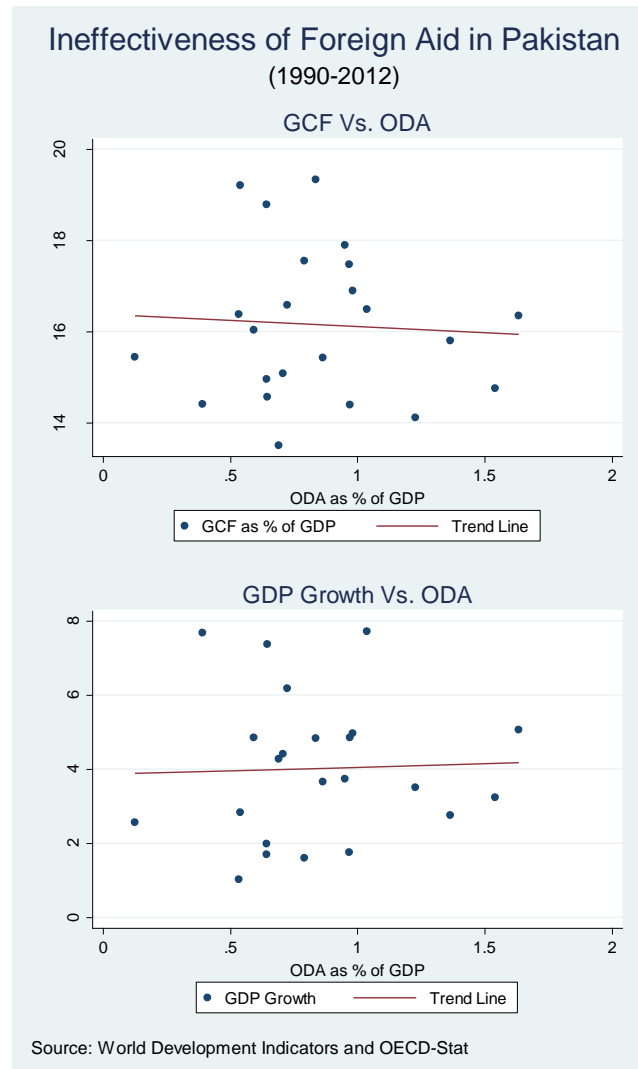
2.2 Social Sector Performance of Pakistan

The social sector achievement of the country has been rather dismal despite massive foreign aid to Pakistan during the last 15 years. Nevertheless, significant improvement is also evident in Pakistan's social sectors. Focusing on health sector and comparing the performance of Pakistan with global trends shows stark reality. The infant mortality rate in 2015 stands at 66 per 1000 while the global infant mortality rate is 32 per 1000. The same pattern is also observed when attention is turned to under-5 mortality which is 86 per 1000 and 43 per 1000 for Pakistan and the world respectively in 2015. Another indicator in which such deviation can be seen is deaths due to communicable diseases which were 38 percent of total deaths in 2012 and the world share for the same year was 23 percent. One of the most disturbing statistics is the percentage of children under age five that are stunted as almost 45 percent of the children in Pakistan were reported to be stunted in 2012. The underweight children turned out to be 32 percent in 2012. Both of these figures were well above the world rate. Furthermore, per capita health expenditure is \$36 in Pakistan and the global average health expenditure per capita is \$1042.

The performance of the education sector is far better than that of health sector but downward deviation from global standings is also observed. The completion rate for primary schooling was 72 percent in 2013 while the global rate for the same year was 92 percent. As for secondary schooling, the completion rate was 38 percent against the global rate of 75 percent in 2013. The literacy rate of the country stood at 55.4 percent but the world literacy rate was 85 percent in 2010. In 2013, for every one teacher in primary schools there were 43 students while at global level every one teacher had 24 students.

This study is of the opinion that there exists no conclusive evidence suggesting that despite stark deviation the improvements in the social sectors of the country are due to foreign aid. Instead the study argues that any such improvements in Pakistan's health and education sector is an outcome of private decisions of individuals responding to high premium that labor markets have placed on high education and better health in the face of historic urbanization process witnessed in the country.

Figure 9: Aid Ineffectiveness in Pakistan



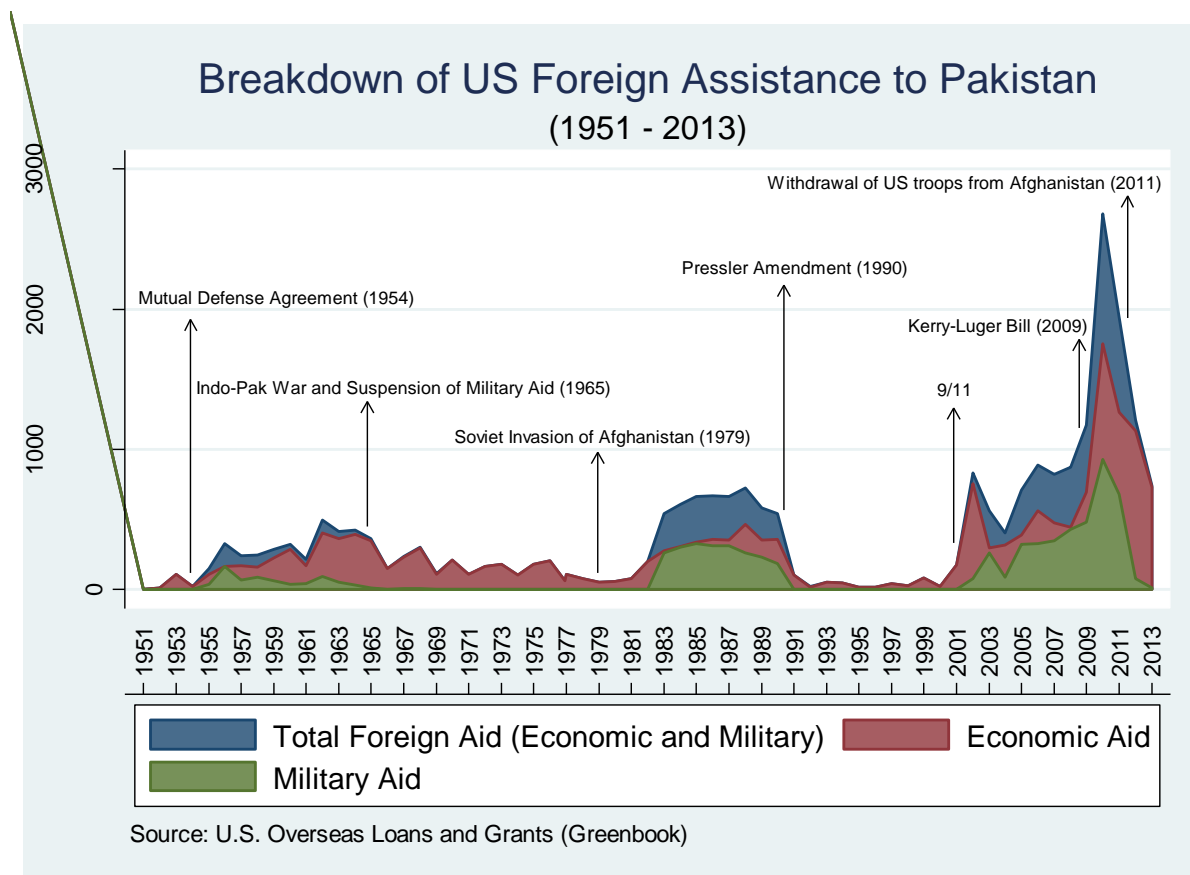
3. ARGUMENTS AGAINST FOREIGN AID AND PAKISTAN

The arguments against effectiveness of foreign aid are dealt with in this section. Section 3.1 covers whether foreign aid decisions to Pakistan are based on political consideration. Similarly, section 3.2 addresses inherent inefficiencies in the aid composition to Pakistan; section 3.3 attempts to establish if foreign aid in Pakistan has assumed characteristics of a resource curse. In the end, section 3.4 gives a brief overview of how foreign aid has shown signs of being a Dutch Disease in case of Pakistan and section 3.5 points towards the vicious cycle of foreign aid.

3.1 Political Economy of Foreign Aid

As already stated in section 1.2, foreign aid is criticized on grounds that aid is given to gain political expediency or enhance political leverage of the donor country over the recipient country. The study postulates that foreign aid advances to Pakistan in a historical context has been a heavily politicized business and there is even evidence that lends credence to this believe and some of which is already provided in explaining swings in figure 3 in section 1.3. However, political implication of foreign aid to Pakistan cannot be observed any better than in figure 10 below which shows breakdown of American aid to Pakistan.

Figure 10: US Aid to Pakistan



The two “bulges or spikes” in this figure, first from 1981 to 1991 and the second from 2001 to 2010 coincides with Soviet Invasion of Afghanistan and the War on terror respectively. Pakistan’s geographical proximity to the region of conflict in both of these wars was the prime reason for a generous US policy towards it. Another

significant feature of note in the figure is extremely low levels of American Aid during 1990s following the passage of Pressler Amendment which required a stoppage of American aid to Pakistan in case President Bush Sr. could not verify Pakistan's nuclear designs. A closer look of the figure also reveals that American aid since the last few years has started declining to Pakistan. This, however, is not hard to understand if viewed against the backdrop of American withdrawal from Afghanistan which started in 2011.

Another feature of Foreign aid by the US is the high share of military aid which is depicted vividly in figure 10. This pattern particularly for Pakistan is also taken to task by one of the leading exponents of foreign aid – Jeffery Sachs¹¹. Consequently, it is observed that America has used foreign aid as a bargaining chip against Pakistan. In conjunction with figure 3, it can be deduced that even growth in ODA flows shows a pattern almost closer to that of American aid implying that non-US donors have a leader-follower relationship with the USA. Hence, it can be safely concluded that aid disbursements to Pakistan has not been apolitical.

3.2 Inherent Inefficiencies in Aid Composition of Pakistan

Pakistan aid structure is highly inefficient. This view is substantiated by the fact that grant component has been lower than the required limit for foreign assistance – the grant or grant-type component currently averages 16 percent from 2006-07 to 2014-15. This implies that foreign aid is adding to our debt stocks unsustainably¹². The potential for debt repayment is further dented by the fact that most of our aid isn't spent on what Dr. Ishrat Hussain refers to as internal-capacity-building in his book *Globalization, Governance, and Growth*. The assertion can be verified by examining figure 6 which shows small shares of development enhancing heads of project aid i.e. poverty reduction and rural development, health, and education. This becomes even more serious when table 1 is observed that highlights lower share of project aid in total aid which is crucial component of aid flows for promoting development. Along with this, the high non-project aid component which is mostly advanced for budgetary support averages 61 percent from 2006-07 to 2014-15 (table 1) and coupled with the fact that aid flows meant as a BOP cushion averages 41.2 percent (figure 7)

¹¹ 75 percent of the total American Aid of \$10 billion to Pakistan since 2001 has gone to Pakistan Military. *American failed militarized foreign aid*. http://www.todayszaman.com/op-ed_americas-failed-militarized-foreign-policy-by-jeffrey-sachs-128276.html. Retrieved on 09-11-2015.

¹² Average external debt as percent of total aid disbursed from 2000 to 2014 is 48 percent. Average external debt is a third of GDP for same reference period.

for the same reference period allows one to state that Pakistan is mortgaging its spending not development. All these facts imply that Pakistan aid flows are bound to add to our debt burden.

3.3 Foreign Aid as a Resource Curse In Pakistan

The study of why some countries grow slowly has led to new concept of resource curse. The phenomenon of resource curse means that a country rich in any natural resource tend to growth slowly than countries not endowed with any such resource. Example of resource curse includes diamonds in Angola, oil in Republica Bolivariana de Venezuela, and coltan in Democratic Republic of Congo. Studies point to three major reasons for resource curse and one of them is the adverse effect of an abundant resource on institutional quality of a country (Harford, 2003; Sala-Martrin and Subramanian, 2003; Djankov *et al.*, 2005). Dominant view among researchers is that in some countries particularly in Africa foreign aid is the only resource. Resultantly, the concept is also being applied to foreign aid as well stating that foreign aid also suffers from the same resource curse problem through its harmful effects on institutional quality of the recipient countries. Empirical evidence also suggests this negative relationship between aid and institutional quality (Knack, 2000; Sala-Martrin and Subramanian, 2003; Brautigam & Knack, 2004 and Djankov *et al.*, 2008).

So has foreign aid become a resource curse even in Pakistan? Does evidence support its negative implication on institutional quality of Pakistan be it political institutions, legal or economic? One way to check it is by comparing total aid received by Pakistan with indicators of institutional quality. One of such indicators is Corruption Perception Index (CPI) compiled by Transparency International since 1995 but Pakistan's coverage starts from 2000 onwards to 2014. A higher score of CPI means improvements and otherwise if the score decreases. Table 2 below shows the average score for CPI and average ODA as percent of GDP received during each period. The result of the table shows that average aid flows as percent of GDP is negatively related to average CPI score. This relationship is proved robust even when different indicators of institutional quality are used. Aid does reduce institutional quality in Pakistan. Backing this evidence, Anatol Lieven writes the following in his book *Pakistan – A Hard Country*:

“In fact, very often to make a fortune in Pakistan means finding some way to milk the state – including of course international aid flowing to the state, which is one of the principal ways in which the Pakistani elites make money from the West”.

Table 2: Aid - A Resource Curse?

	Average ODA as % of GDP	Average CPI	Average score economic institutions*	Average score legal institutions*	Average score political institutions*
2001-2005	1.95	2.3	0.4	0.3	0.2
2006-2010	1.43	2.4	0.5	0.4	0.3
2010-2014	1.05	2.7	-	-	-

* Institutional quality indicators compiled by Kuncic, 2014.

3.4 Foreign Aid in Pakistan and Dutch Disease

Another phenomenon closely related to resource curse is that of Dutch Disease. The term was coined by the Economist in 1977 to describe the decline of the manufacturing sector in Netherlands after discovery of large gas reservoirs in 1959. The concept involves the process through which one industry of the manufacturing sector increases its exports and hence increasing the real exchange rate which ultimately depresses the exports from all other industries of the manufactured sector. As in case of resource curse, the concept has also been used to describe the decline in manufacturing exports due to foreign aid as foreign assistance meant to increase foreign exchange reserves have an equivalent impact on increasing real exchange rates¹³. Rajan and Subramanian (2008) gives empirical support to the prevalence of Dutch Disease in aid receiving countries.

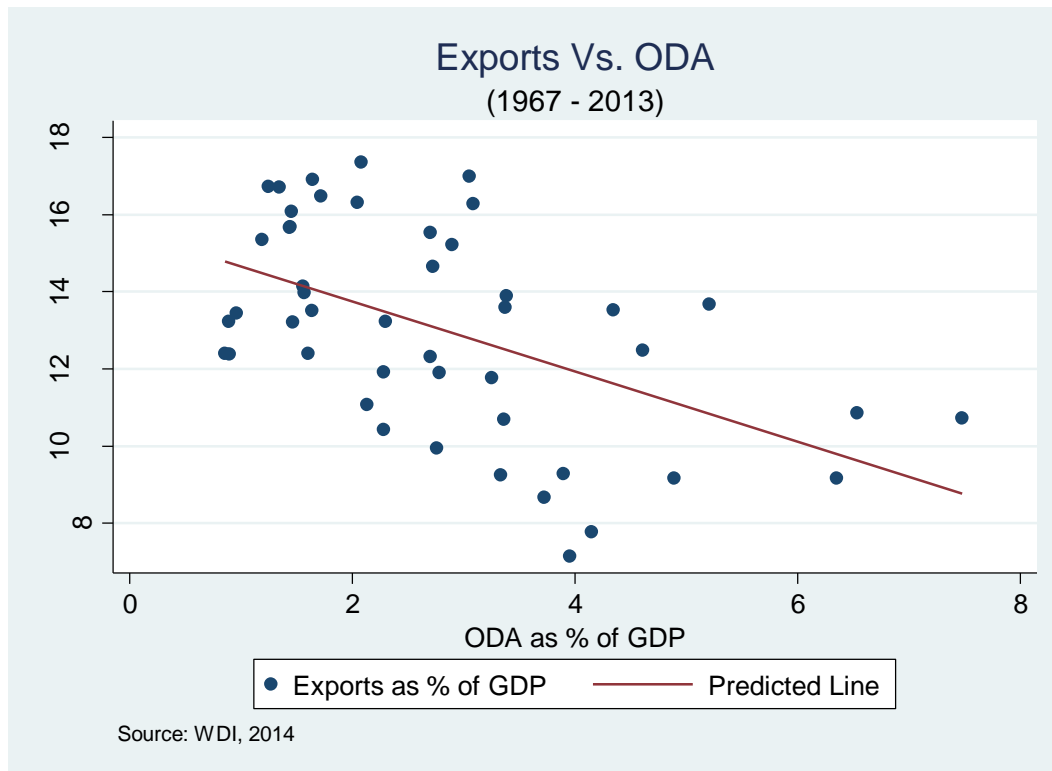
The figure 11 plots exports as percent of GDP and ODA as percent of GDP. It can be seen that rise in ODA is consistent with lower exports-to-GDP ratio implying the prevalence of Dutch Disease in Pakistan. Evidence in support of this hypothesis can be traced from recent headlines as well. Exports of Pakistan have declined by 14 % in the first three months of FY15-16¹⁴. One theory for such decline is anti-liberal trade regime operative in Pakistan. However, there is another bit to the story that can

¹³ Dutch Disease: Too much wealth managed unwisely. <http://www.webcitation.org/mainframe.php> Retrieved on 09-11-2015.

¹⁴ Pakistan has shut market access routes for itself. <http://tribune.com.pk/story/987561/fare-badly-pakistan-has-shut-market-access-routes-for-itself/> Retrieved on 9-11-2015.

explain decline in exports and that is an over-valued currency as a result of record high reserves¹⁵. This increase in reserves was due to the \$6.4 billion amount of foreign assistance in loan that GoP secured in 2013 from the IMF.

Figure 11: Exports and ODA



3.5 Vicious Cycle of Foreign aid In Pakistan

Using all the information in the study it is observed that there exists a vicious cycle of foreign aid in the country. Given that Pakistan's potential to earn foreign exchange is on the decline due to a downward trend of exports and the fact that investment flows also exhibit the downward trend the repayment potential of foreign assistance received is seriously impaired. As a result, Pakistan has to frequently resort to the IMF to get more loans to honor its payments and IMF in turn imposes stringent adjustment policies of fiscal austerity that compromises spending on social sectors¹⁶. In a developing country like Pakistan where a large chunk of the population is reliant on government transfers this causes an even more poor achievements of the country in

¹⁵ IMF says that rupee is currently over-valued by 20 percent.

<http://www.bloomberg.com/news/articles/2015-11-06/imf-says-pakistan-rupee-needs-5-20-drop-to-align-with-reality>. Retrieved on 9-11-2015.

¹⁶ The same conditionalities were also imposed on Greece by ECB and IMF and it was noted that life expectancy started declining in Athens. *Debtocracy*

health and education that ultimately makes us still more eligible for foreign aid. *And the cycle continues.*

Figure 12: Vicious Cycle of Foreign Aid



CONCLUSION

This study documents how and why foreign aid has failed to promote growth and eventually reduce poverty in the country. It has harmed more than helped the cause of economic development in Pakistan. Nevertheless, the study, by no means, suggests that aid should be stopped. Contrarily, it is contended that the path to sustained growth adventure lies not in foreign aid flows but in foreign private flows directed towards private sector that already constitutes 80 percent of the economy. It is this private sector that puts goods on the shelves, generates employment opportunities and allows for economic mobility in the society. It is this private sector which is the commanding heights of modern economy.

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