Role of Foreign Capital and Aid in Economic Development of India

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Abstract

Foreign capital can enter a country in the form of private capital and/or public capital. Private foreign capital may take the form of direct and indirect investments. Direct investment means that the concerns of the investing country exercise de facto or de jure control over the assets created in the capital importing country by means of that investment. Direct investments may take many forms: The formation in the capital importing country of a subsidiary of a company of the investing country; the formation of a concern in which a company of the investing country has a majority holding; the formation in the capital importing county of a company financed exclusively by the present concern situated in the investing country; setting up a corporation in the investing country for the specific purpose of operating in the other concerns; or the creation of fixed assets in the other country by the nationals of the investing country. Such companies or concerns are known as transnational corporations (TNCs) or multinational corporations (MNCs).

Introduction

Indirect investment better known as “portfolio” or “rentier” investment consists mainly of the holding of transferable securities (issued or guaranteed by the government of the capital importing country), shares or debentures by the nationals of some other country. Such holdings do not amount to a right to control the company. The shareholders are entitled to the dividend only. In recent years, multilateral indirect investments have been evolved. The nationals of a country purchase the bonds of the World Bank floated for financing a particular project in some LDC. Public foreign capital may consist of: (a) “Bilateral hard loans” i.e., giving loans by the British Government in pounds sterling to the Indian Government; (b) “Bilateral soft loans” i.e. sale of food grains and other farm products to India by the United States under PL 480*; (c) “Multilateral loans” i.e., contributions to the Aid India Club, the Colombo Plan, etc., by the member countries. Under this category are also included loans made available by the various agencies of the United Nations like the IBRD, IFC, IDA, SUNFED, UNDP, etc., (d) Intergovernmental grants. Foreign Aid refers to public foreign capital on hard and soft term, in cash or kind, and intergovernmental grants.

Role of Foreign Aid

Public foreign capital is more important for accelerating economic development than private foreign capital. The financial needs of LDCs are so great that private foreign investment can only partially solve the problem of financing. For one thing, it has nothing to do with social expenditures in such spheres as education, public health, medical programmes, technical training and research, etc. such schemes though indirectly contributing to economic efficiency and productivity of the economy in the long-run yield no direct returns, and could, therefore, be financed with the help of grants received from "advanced" countries. Further, private foreign investment presupposes the existence of basic public services in LDCs. But investment in them requires large sums and risks which private capital is unable to undertake. So investment in low-yielding and slow-yielding projects could be possible only on the basis of foreign aid. Moreover, unlike private foreign investment, aid can be used by the recipient country in accordance with its development programs. Therefore, much cannot be expected of private foreign investment. There is, however, a growing international awareness that "poverty anywhere is a danger to prosperity everywhere and prosperity anywhere must be shared everywhere". Developed countries consider it to be their moral duty to help their less fortunate brethren in underdeveloped countries. But this realization on the part of the developed countries has never been spontaneous. The have always been motivated by international policies in the context of the cold war. Their aim has been to give aid with "strings" attached. "it was only with the entry of the Soviet Union and other communist countries into the field that western countries also began displaying some enthusiasm for offering aid to the "underdeveloped" countries at the governmental level without strings". Foreign aid flows to the LDCs in the form of loans, assistance and outright grants from various governmental and international organizations. It is regarded indispensable for the development of LDCs. But there are some economists who dispute this view and hold that foreign aid is not indispensable for their development rather it obstructs it. We study the case for and against foreign aid.

Case for Foreign Aid

LDCs are characterized as "capital-poor" or "low-saving and low-investing" economies. There is not only an extremely small capital stock but current rate of capital formation is also very low. On an average, gross investment is only 5% to 6% of gross national income in these economies, whereas in advanced countries it is about 15% to 20%. Such a low rate of saving is hardly enough to provide for a rapidly growing population at the rate of 2% to 2.5% per annum, let alone invest in new capital projects. In fact, at the existing rate of saving, they can hardly cover depreciation of capital and even replace existing capital equipment. Efforts to mobilize domestic savings through taxation and public borrowing are barely sufficient to raise the current rate of capital formation via investment. Rather, these measures lead to reduction in consumption standards, and unbearable hardships on the people. The importation of foreign capital helps reduce the shortage of domestic savings through the inflow of capital equipment and raw materials thereby raising the marginal rate of capital formation. Besides, low-saving and low-investment imply capital deficiency, and along with it LDCs suffer from technological backwardness. Technological backwardness is reflected in high average cost of production and low productivity of labor and capital due to unskilled labor and obsolete capital equipment. Above all, it is reflected in high capital output ratio. Foreign capital overcomes not only capital deficiency but also technological backwardness. It brings sufficient physical and financial capital along with technical know-how, skilled personnel, organizational experience, market information, advanced production techniques, innovation in products, etc. it also trains local labor in new skills. All this accelerates economic developmental woefully lack in economic overhead capital which directly facilitates more investment. The rails, roads, canals, and power projects provide the necessary infrastructure for development. But since they require very large capital investment and have long gestation periods, such countries are unable to undertake them without foreign aid. Similarly, LDCs are not in a position to start basic and key industries by themselves. It is again through foreign capital that they can establish steel, machine tools, heavy electrical, and chemical plants, etc. moreover, the use of foreign capital in one industry may encourage local enterprise by reducing costs in other industries which may lead to chain expansion of other related industries. Thus, foreign capital helps in industrializing the economy. Further, private enterprise in

LDCs is reluctant to undertake risky ventures, like the exploitation of untapped natural resources and the exploitation of new areas. Foreign aid assumes all risks and losses that go with the pioneering stage. Thus, it opens up inaccessible areas, taps new resources, and helps in augmenting the natural resources of the country, and removing regional imbalances.

Inflationary Pressures in Developing Countries

The appearance of inflationary pressures is inevitable in a developing country because of the existence of the disequilibrium between demand and supply of domestic products, following the initiation of a large public investment programme. The latter has the impact of rapidly increasing the demand for goods and services relative to their supplies. This leads to inflationary pressures which become strong due to the existence of structural rigidities that inhibit the expansion of food and other consumer goods. Foreign aid helps minimize such inflationary pressures when food and other essential consumer goods through foreign aid raise the levels of consumption which, in turn, enhance the productive efficiency of the community.

Foreign Aid Overcomes the Balance of Payments Difficulties

Foreign aid overcomes the balance of payments difficulties experienced by an LDC in the process of development. To accelerate the rate of development it needs to import capital goods, components, raw materials, technical know-how, etc. Besides, its import requirements of food grains increase rapidly with population pressures. But its exports to developed countries are either stagnant or have a tendency to decline. The gap between imports and exports leads to the balance of payments difficulties. It is through foreign capital that an underdeveloped country can meet all its import requirements, and at the same time, avoid the balance of payments difficulties. Further, there is the need for additional foreign exchange for servicing external debt. This accentuates the balance of payments problems which can again be remedied by importing capital.

Factors Determining the Amount of Foreign Aid for Economic Development

The amount of foreign aid flowing to LDCs, however, depends upon a number of factors. The first is the availability of funds. Developed countries should have enough surplus capital to export. There does not appear to be a plethora of surplus in such countries. With the exception of the United States, there are very few countries that can spare so much capital as to bring it up to 10-15 million dollars annually, required by LDCs. Some of the developed countries like Canada and Australia themselves borrow from the United States and Great Britain to finance their development projects. However, a genuine effort on the part of rich countries to mop up surplus capital can meet the requirements of LDCs. The second factor is the absorptive capacity of the recipient country. LDCs should get as much as hey could usefully invest. Absorptive capacity covers all the ways in which the ability to plan and execute development projects, to change the structure of the economy, and to reallocate resources is circumscribed by the lack of crucial factors, by institutional problems or by unsuitable organization. The structure of the economy along with the utilization of its existing capacity will have an important bearing on a county's absorptive capacity. The amount of capital that can be utilized by an LDC is determined by the availability of complementary resources. It will remain unutilized if complementary resources are not available. Inadequacy of overhead facilities like power, transport, etc., in LDCs keeps the capacity to absorb foreign aid low. The other factor which keeps the absorptive capacity for productive investment low are the lack of efficient entrepreneurship, administrative and institutional bottle-necks, the lack of trained personnel, the lack of geographic and occupational mobility, and the small size of the domestic market.

Lastly, perhaps the most important factor is the will and the effort on the part of the recipient country to develop. Capital received from abroad does not fructify, unless it is desired and paralleled by an effort on the part of the recipient country. As Nurkse aptly said, “Capital is made at home.” The role of foreign capital is to act as an effective agent for the mobilization of a country’s willed.

Need of Trade, Not of Foreign Financial Assistance

Of late, the idea has been gaining ground among the LDCs that trade and not aid is essential for their rapid development. It is contended that the developed countries have failed to meet the aid requirements of the developing economies during the development decades of the 1970s and 1980s. A UNCTAD resolution adopted by a large majority of the developed countries had, in a way, made it obligatory on them to annually contribute to LDCs at least 1% of their national income net after deducting withdrawals of external capital including amortization and repayment. But they failed to contribute even 0.5% of their national income. This has been especially disheartening when the capacity to absorb more aid has been expanding on the part of the developing nations and their economic performance through aid has also improved much. Gerald M. Meier has aptly observed that “the flow of foreign capital from developed countries to LDCs has leveled off, and external debt servicing problem has intensified; the import surplus supported by foreign capital has, therefore, fallen markedly in recent years, and the net transfer of resources beyond imports based on exports has become relatively insignificant for the majority of LDCs. To the extend this foreign exchange constraint is not removed, an LDC cannot fulfill the import requirements of its development programme. The LDC must then undertake policies that will done or a combination of the following: reduce the country’s rate of development, replace imports, expand exports, improve the country’s terms of trade, and induce a larger inflow of foreign aid.”

A larger inflow of foreign aid is neither feasible nor desirable for the LDCs. Foreign aid has undoubtedly provided crucial support to the development plans of such countries, but the developed countries are not prepared to supply aid to the extent required by the less developed. On the other hand, the LDCs are not anxious to have tied aid at the strict conditions laid down by the donors. Prior to the meeting of UNCTAD I in 1964, the policy of import substitution was much favored by the LDCs but it failed to solve their problems. Since then, the various UNCTAD conferences have stressed the outward-looking policies of export promotion and improvement in the terms of trade for the LDCs. The UNCTAD has been pleading for preferential tariffs for the manufactured and semi-manufactured exports of the LDCs and UNCTAD III succeeded in evolving the Generalized Systems of Preferences (GSP) whereby concessions have been extended to the products of the 88 LDCs to penetrate the markets of the OECD (Organization for Economic Cooperation and Development) nations. Therefore, India and other developing countries should make tremendous efforts to boost their exports so that in a decade or so they have a trade surplus. Expansion of exports is also essential to pay for the increasing imports. Larger exports are further needed for debt service payments. This projected level of growth could only be achieved by “vigorous policies”. This is expected to increase the country’s share in world trade from 0.5% to 1% by 1990-91. However, a policy that favors trade end not aid can be successful only if there is an increase in domestic savings equal to the rise in export earnings. Trade will substitute for aid when larger export earnings raise national income and this leads to increased savings. In fact, greater trade opportunities are like greater aid flows. Trade helps in transferring real resources for investment when the LDCs are able to charge higher prices for their exports from the developed countries under preferential trading agreements. Developing countries at a higher level of development like India, Brazil, etc., are able to utilize their export earning for further capital formation but no developed country would be prepared to buy at prices higher than the world market. Subsequently, the need is to stabilize the price level on developing economies and then trade can substitute aid admirably.

Conclusion

To conclude, the inflow of foreign capital is indispensable for accelerating economic development. It helps in industrialization, in building up economic overhead capital, and in creating larger employment opportunities. Foreign aid not only brings money and machines but also technical know-how. It opens up inaccessible areas and exploits untapped and new resources. Risks and losses in the pioneering stage also go with foreign capital. Further, it encourages local enterprise to collaborate with foreign enterprise. It obviates the balance of payments problem and minimizes the inflationary pressures. Foreign air helps in modernizing society and strengths both the private and public sectors. Foreign aid is thus indispensable for the economic development of LDCs. The countries that are in the early phase of development should not think of substituting trade for aid because they can only develop their trade through aid over the long run. Although greater trade possibilities for such countries have some resource element in them, they are more complementary to aid flows than substitutable for them. Development requires both trade and aid.

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