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TIED AID FROM THE PERSPECTIVE OF A SMALL DONOR COUNTRY

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1. INTRODUCTION[1]

There is a growing concern in donor countries that scarce budget funds allocated to development assistance are not used as efficiently as possible, neither to promote growth and welfare in poor countries, nor to support sound economic relations between countries. A sense of "aid fatigue" is spreading.

One significant explanation of situation is the persistence of under-development. Although development assistance has been provided for a long period, conditions remain troublesome, or are actually deteriorating, in many countries. Naturally, development takes time, and results cannot be expected immediately. Moreover, massive resource transfers in the form of aid may simply be overshadowed by reversed capital flows in the form of debt repayments and capital flight. In many instances, however, development assistance fails even to pull countries in the right direction. Instead of inducing self-sustained progress, aid funds may support social, political and economic structures that inhibit growth.

At the other end of the discussion of foreign development assistance is weak economic conditions in the donor countries. The duration of the present recession has made even the richest countries experience high unemployment and alarming public deficits. Public activities have to be restrained at a time when investments in education and social services are badly needed. In this situation, it is claimed that the output from foreign development assistance is too meager to justify continuous contributions from tax payments.

The proper role of aid is far from straightforward. On the one hand, aid can be considered a form of international taxation by poorer countries of richer ones.[2] The implication is that

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1 The authors are grateful to Swedish authorities, including the Ministry of Foreign Affairs, SIDA and BITS, and to a number of Swedish private company groups, for providing ample information on activities in developing countries. Special thanks are also directed to public and private organizations in China, Costa Rica, Guatemala, Kenya, Nicaragua, Tanzania, Thailand, Tunisia and Vietnam which have provided in-depth insights on the link between foreign development assistance and commercial trade in these countries.

2 See for example Bhagwati (1985).

once funds have been transferred, it is the responsiblity and right of the recipient country to coordinate and allocate available resources in accordance with its own development strategies. Interventions by donors are viewed as unnecessary and disruptive of the consistency of the recipient's own efforts. On the other hand, the absence of an appropriate institutional framework and administrative resources on the recipient side, or the presence of corruption, may make conditionality and monitoring a prerequisite for efficient aid.

Surely, aid would be unnecessary in a world without market imperfections. Trade and investment patterns would simply reflect differences in competitive advantage. Capital, technology and know-how would be allocated optimally, and private sector initiatives would be sufficient to generate sustained growth. The absence of economic progress in so many poor economies, as well as the apparent shortage of sound commercial links between developed and developing countries, provides in itself overwhelming evidence of distortions. Some are undoubtedly a result of actions in developed countries, e.g. in the form of protectionist measures adopted against producers in the third world. Others are associated with imperfections in capital markets, information deficiencies, and a shortage of human capital in developing countries.

Contrary to some allegations, we claim that foreign development assistance does have an important role to play, not only to address urgent needs but also in order to establish preconditions for commercial relations. This concerns not merely the provision of resources in the form of physical capital, but even more so assistance in the build-up of relevant knowledge and experience. Under what circumstances, and how, aid actually helps to overcome existing distortions, initiate and support those structures that lay the basis for an expansion of viable commercial activities, remains an open question, however.

As a result of aid fatigue, there is now an emphasis on incorporating strong elements of conditionality and reciprocity in development assistance. In particular, this debate brings new attention to the concept of tying. Here, tying referrs to the restriction of aid funds to procurement of goods and services from the donor country. Tying is brought forward as a means of securing an effective use of specific donor country resources in aid. On the other hand, there are strong forces working for untying of aid, in order to increase competition and greater freedom for market forces.

The role of tying is, indeed a controversial matter. Tying is often suggested to be costly for the recipient side. In addition, it is argued to involve a redirection of aid from the poorest and most needy countries to those which are most interesting from a commercial perspective, as well as a distortion of aid away from the design which is appropriate from the perspective of the recipient country to that which fits the interests of donor countries. With a weakening multilateral trade system, there are fears that options to tie aid will transform development assistance into a leverage for managed trade. These threats are all the more realistic as tying on the part of one donor may induce tying by others as well.

In this study, we stress that the presence of distortions makes it impossible to conclude à priori whether tying practices are good or bad. Rather, the outcome depends on how and under what circumstances tying is allowed and used. There is a need for guiding principles which prevent mismanagement of aid funds by either donor or recipient countries. Above all, however, it is vital to lat the basis for an expansion of sound commercial exchange between developed and developing countries. Tying does play a role in this context, but it must be balanced by restrictions, and by priorities other than that of maximizing procurement from the donor country.

The issues raised in this paper are not least pivotal to donor countries which are "small" in the sense that they exercise relatively few other instruments, other than that of aid, to stimulate the establishment of commercial relations with developing countries. While the analysis should have a general bearing, the study moves from an overview of general trends and practices towards examining the specific experience of Swedish foreign development assistance. Like the other Nordic countries, Sweden has always been a firm believer in an ambitious as well as generous aid programme. Today, the winds of change are strongly felt in these countries.

The study is organized as follows. Section two surveys definitions of tied aid, presents tying practices and outlines the present structure of aid provided by the major donor countries. Section three elaborates on the challenges of development, investigating why foreign development assistance is difficult in the first place. Advantages as well as disadvantages of tying are discussed. In section four, it is discussed how tying affects exports as well as the cost effectiveness of development assistance. The study is concluded with suggestions regarding circumstances under which tying may be applied.

2 TYING PRACTICES.

The most common way for a donor country to promote its commercial interests in aid, is to tie funds with regard to the procurement of goods and services. Partly due to the existence of many different forms of *tying*, however, the concept is subject to considerable vagueness in theory as well as in practice. It is difficult to distinguish between tied and untied aid in many cases. Let us therefore look at the definition of tying somewat closer .

2.1 Definitions of Tying.

In the DAC creditor reporting system (DAC, 1992), tying refers to the restriction of procurement to the donor country. Official development assistance (ODA) is here divided into three categories according to procurement conditions:

- **Untied aid**, defined as grants or loans which are fully and freely available for world-wide procurement of goods and services. Funds for local cost financing in the recipient country are also included.

- **Tied aid**, defined as grants or loans which are in effect restricted to procurement of goods and services from a limited geographic area, most often the donor country. Aid-in-kind, i e goods purchased in the donor country and delivered ready to use, are also considered to be tied.

- **Partially untied aid**, defined as grants or loans tied to procurement of goods and services from the donor country and a restricted number of countries, including practically all developing countries.

The above definitions indicate an effort to incorporate not only directly and openly tied aid in the concept, but also aid where practices, conditions and forms result in tying. In reality, such distinctions are difficult to make.

In its broadest sense, tying is used as a synonym for conditionality, where the donor in some way or other directs the use of resources transferred to the recipient. Bhagwati (1985) and Hamilton (1976) define three different ways of imposing conditionality in aid:

- **Tying to source**, where the recipient is directly requested to use aid funds for procurement in the donor country or a limited geographic area. There is no conditionality on the end use of funds, only on the origin of purchases. One example would be tied import support, where the donor agrees to finance imports as requested by the recipient, with the restriction that goods should be imported from the donor country.

-**Tying to goods, services or sectors**, where the donor finances procurement of commodities or services as specified by the donor. Aid-in-kind delivered from the donor country, such as food aid, is tied in this sense. Another form is sector support, where the donor seeks to promote specific sectors (agriculture, energy) or issues (gender planning, environment) in the recipient country.

-**Tying to projects or development programmes**, which concern activities such as rehabilitation, construction, feasibility studies, institution reforms, etc.

The above definitions are indeed general, implying that tying includes all forms of aid which represent not entirely unconditional financial transfers from one government to another. Evidently, restrictions are not necessarily imposed on aid funds for the purpose of promoting donor country exports. For example, the last two forms of conditionality do not directly imply procurement from the donor country. They may reflect specific development priorities or an effort to establish closer monitoring of aid.

For the purpose of this study, it is useful to limit the concept of tied aid to funds which are subject to any restrictions in terms of source for procurement. Such source tying is often combined with other restrictions, whereby aid flows are directed to specified activities. Tying would, for example, occur if the donor agrees to support sectors or activities with the open or implicit condition that all projects must be undertaken by donor country nationals. Aid funds can also be subject to indirect tying if they are incorporated in general bilateral trade agreements.

Unless combined with source tying, other forms of conditionality are not, in this respect, referred to as tied aid. They may nevertheless be imposed with the purpose of increasing the return of aid flows to the donor country. By restricting the use of untied aid funds to areas (sectoral and/or geographical) where the donor country has competitive advantages in technical competence or commercial linkages, the donor may secure the returns of a larger share of grants as payments for imports.

Another source of difficulties in distinguishing between tied and untied aid is the practice of imposing source-tying not only through formal but also informal restrictions. The former refer to contractual agreements where it is initially stated that procurement must be made from the donor country, the latter to other means through which source tying is secured, such as political pressure, historical ties, traditional links, etc. Whereas formal tying can be quantified, it is difficult to assess the extent of informal tying, since far from all additional reflows from aid are a consequence of tying practices. Some aid-related exports simply reflect competitiveness, information advantages or interlinkages between recipient and donor which also prevail in ordinary commercial relations. The distinction can only be made with respect to intentions, not to actual results.

2.2 The Present Structure of Tied Aid – Some Observations.

In the following, we outline the present structure of tied aid. The data deals exclusively with the performance and policies of members of DAC, which account for some 90% of total ODA.[1] Absolute figures present volumes, main sources and destinations. Furthermore, comparisons between total and tied aid flows indicate whether there exist structural differences between aid policies in general and tying practices. An obvious limitation is that DAC data incorporates only formally tied aid. As pointed out in the previous section, it is difficult to distinguish between tied and untied aid due to informal and indirect practices. This makes it important to go beyond the actual figures, and consider various characteristics of donors' total aid flows. Implicit tying practices can be reflected in geographical destinations and types of projects. For example, an emphasis on bilateral aid and/or richer and commercially interesting recipient countries may suggest a stronger inclination towards reciprocity in development assistance.

1 The figures on ODA flows are based on statistics as reported to DAC by its members and represented in *the Chairman's report 1992*. Important findings on tied aid flows are revealed in a new report, DAC (1993).

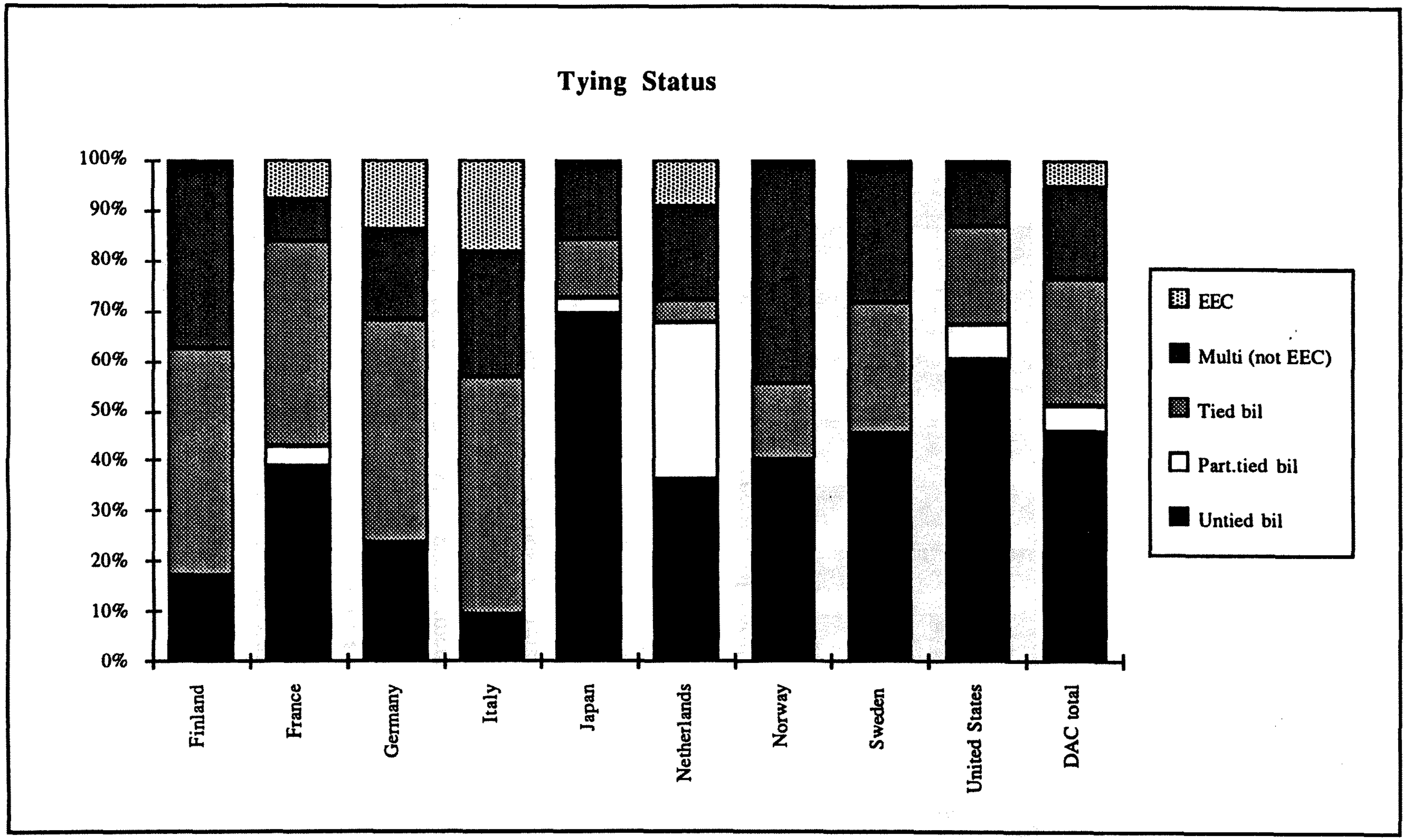


Figure 2.1. The Tying Status of Selected Dac Members, 1990

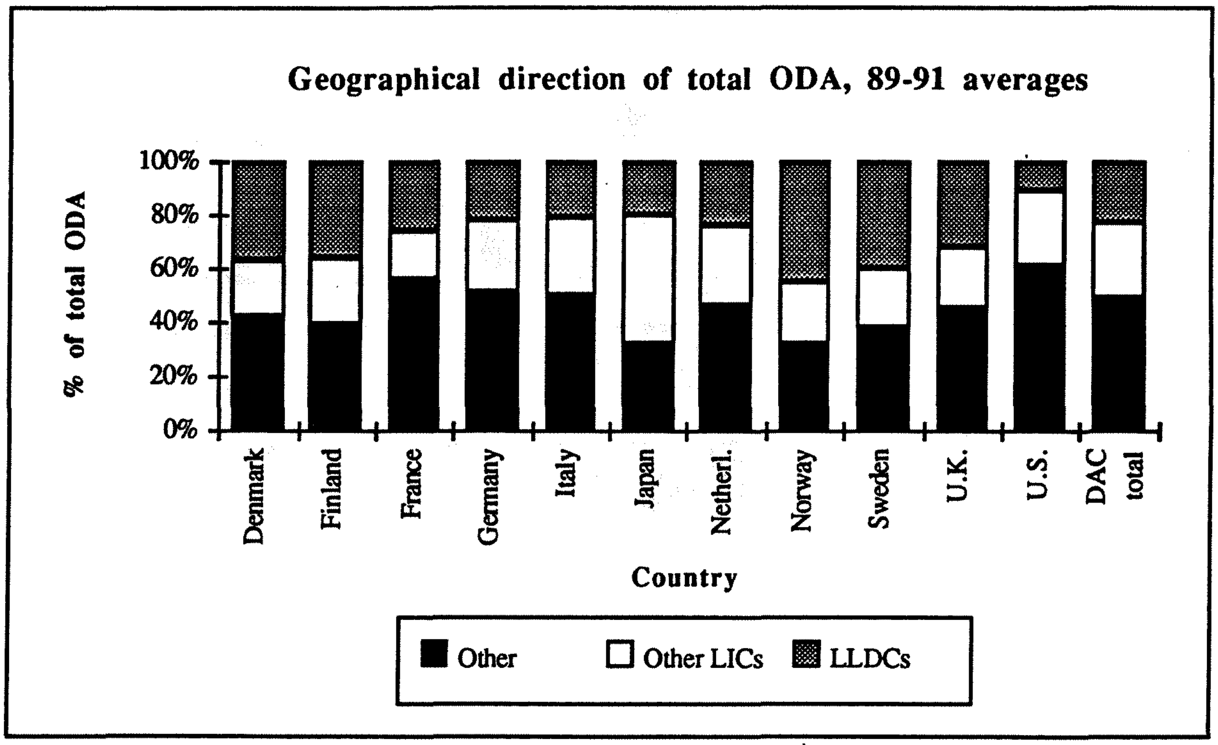
Source: *The Chairman's Report*, DAC 1992

Notes: Tied bil = Tied bilateral aid
Part.tied= Partially tied bilateral aid

In the following, the term "tied aid" is used in accordance with DAC definitions, i.e. grants, loans or associated financing[2] that are **not** fully and freely available for procurement from substantially any country. Hence, partially untied aid is considered tied. It should be noted that whereas ODA/GNP ratios are calculated on the basis of the grant element of ODA exclusively, the figures below incorporate all aid-related flows, including the total value of loans (not only the grant equivalent). This consequently illustrates the conditionality of total resource transfers. As the leverage effects are included, however, this may in some respects give a skewed representation of the total amount of tied aid provided by a certain country.

Figure 2.1 shows the tying status of total ODA commitments, tied and untied, by selected DAC members. It is worth noting that the most important donors in absolute terms, the US, Japan, France, Germany and Italy, do not provide most aid relative to the size of their economies. Figure 2.2 and 2.3 show the geographical distribution of total ODA and tied aid respectively.

Figure 2.2.



Notes: 1) The figures include imputed multilateral aid (for EEC members, also EEC funds)
2) Other LICs refers to low income countries other than LLDCs

Source: *Recent trends in tied aid*, DAC 1993

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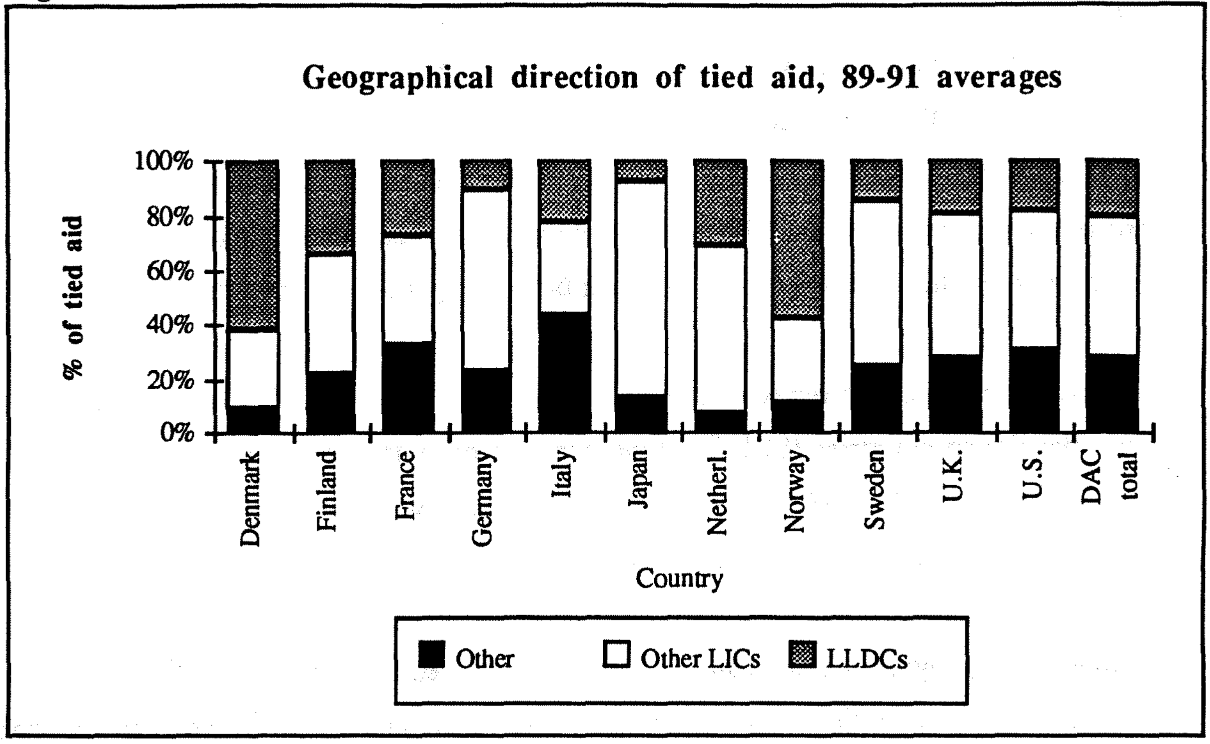
2 Associated financing refers to financial arrangements combining ODA elements and commercial export credits. These financial packages can be premixed, with the grant element included as a subsidy on the interest rate, or a two component model where a grant is combined with commercial export credits.

Figure 2.3.



Source: *Recent trends in tied aid,* DAC 1993

The Nordic countries have remarkably similar profiles in their overall ODA flows, although Finland displays some special features. They all have ODA/GNP ratios significantly above the DAC average of 0,35 %, ranging from 0,91% (Sweden) to 1,15% (Norway). Moreover, multilateral commitments account for a relatively large share of the total ODA budget, with some 50% and 40% for Denmark and Norway respectively. Another salient feature is the pronounced poverty orientation – between 35% to 45% of total aid is directed to LLDCs[3] in Sub-Saharan Africa and Asia, the corresponding average figure for DAC being 23%.[4]

The absolute differences between the Nordic countries and the largest donors suggest stronger demands for reciprocity in the ODA policies of the latter. For example, the US, Japan and France have relatively more bilateral aid, with only about one fifth of their respective aid funds channeled through the multilateral system (including EEC for France). These three donors provide relatively little to LLDCs, ranging from 10% for the US to 20% for Japan and 27% for

3 Lower Income Countries (LICs) have a GNP/capita below USD 610 (1990 level). Of these, 47 countries are at present defined as Least Developed Countries (LLDCs), see list of abbreviations.

4 Includes imputed multilateral allocations.

France. Their respective geographical orientation and concentration is also noteworthy. Of total ODA from the US, about 60% is allocated to the Middle East and North Africa. The main recipients for Japanese ODA are countries in Asia, accounting for almost 60%, and more than half of French ODA is directed to Sub-Saharan Africa. Whereas US aid shows little sectoral concentration, French as well as Japanese flows tend to concentrate on social, administrative and economic infrastructure. This is in part connected to the different modes of financing: US aid consists exclusively of grants, while over 60% of Japanese aid consists of ODA loans.

The bulk of tied aid is directed to those lower income countries (LICs) which do not count as least developed countries (LLDCs). One explanation is that loans to LLDCs, according to agreements within the OECD must have a grant element which exceeds 50%, thus limiting the leverage effect of the grant on donor exports.

Although the geographical allocation of total flows of tied aid from DAC is approximately the same as that of overall ODA flows, there is substantial variation between the individual donors. In relative terms, Denmark and Norway allocate a great deal of their tied aid to LLDCs. The direction of tied aid from Japan, Sweden and Germany differs significantly from their respective total ODA flows. In the case of these donors, tied aid is to a large extent concentrated in LICs other than LLDCs. Most of tied grants go to LLDCs, whereas tied loans (including associated financing) are extended to other low income countries. These differences among donors in the direction of tied aid reflect what form of tying is predominant in their respective strategies. On the other hand, donors' tying practices are also a function of varying objectives in aid policy.

The major donors, i.e. the US, Japan, France, Germany and Italy, are the dominating sources of tied aid in absolute terms as well. In relative terms, France, Germany and Italy tie to a large extent, whereas Japan and the US[5] report the highest share of untied aid among the DAC members. As can be seen from table 2.1, the forms of tying differ considerably, however. France, UK, and, notably, Sweden, tend to tie aid in the form of loans on rather hard financial terms, with a grant element of less than 50%. Japan's tied aid almost exclusively takes the form

5 The share of untied aid in US total aid has risen markedly in recent years. The explanation is that large amounts of debt relief, primarily given to Israel and Latin America as budget support, is included in the figures for untied aid.

Total aid commitments by grant element (%)

89-91 averages

Country	<50%	50-80%	80-100%	100%
Denmark	-	-	-	100
Finland	5	25	5	65
France	62	17	-	21
Germany	42	33	14	11
Italy	31	37	-	32
Japan	1	93	-	6
Netherlands	21	18	-	61
Norway	18	10	-	72
Sweden	65	4	-	34
United Kingdom	47	4	-	49
United States	-	-	-	100
DAC total	**27**	**27**	**2**	**44**

Table 2.1.
Sources: *Recent Trends in Tied Aid*, DAC 1993; *The Chairman's Report*, DAC 1992

of loans on rather soft terms, i e with a concessionality level of 50-80%. In contrast, all US tied aid is provided as grants.

Perhaps not surprisingly, tied aid appears to be concentrated to large infrastructural projects, as is shown in table 2.2. One third of the total value of tied ODA commitments is provided for large projects, defined as projects with a value exceeding $50 million. Almost 45% of tied aid flows are destined for energy and transports. Large projects are dominated by Japan (energy and transports), Italy (energy and industry) and Germany (energy and transports). Other countries with a strong sectoral concentration in tied aid are Finland (energy and industry/mining/construction) and Sweden (energy and telecommunications).

It is worth re-emphasizing that the figures for tied aid refer only to formal tying, and that informal or indirect tying practices as indicated by overall aid policy cannot be explicitly incorporated. As pointed out in the previous section, the actual "return of resources" to the donor countries generally exceeds tying volumes. Like the choice of recipients or the sectoral composition of aid, the actual return flow is partly a natural consequence of traditions, competitiveness, etc. In many cases, it is impossible to separate the influence of these different determinants.

The sectoral allocation of tied aid as % of total tied aid, 89-91 averages

Sector / Country	Energy	Transport	Telecomm.	Ind/Mining Construction	Multi-Sector	Other	% of tot tied aid
Denmark	8,7	9,2	3,5	11,4	17,5	49,8	1,6
Finland	20,9	11	1,6	19,5	5,9	40,9	2,6
France	23,7	12,3	11,6	7,6	16,5	28,2	4,4
Germany	32,5	34,7	5,3	7,7	10,1	9,6	2,6
Italy	30,2	9,4	2,3	15,9	9,3	32,9	12,3
Japan	23,9	38,7	9,9	7	0	20,6	15,4
Netherlands	2,5	24,5	1,4	4,1	38	29,2	2,5
Norway	35	17,5	14,7	9,8	2,1	21,7	1
Sweden	39,1	1,9	19,5	7,9	10,9	20,7	3,3
United Kingdom	30	22,3	2,9	5,6	13	26,2	4,8
United States	6,8	4,5	0,04	0,04	5,3	83,4	19,5
DAC total	**20,5**	**17,5**	**5,7**	**7,6**	**10,6**	**38,2**	
Excl US	23,8	20,6	7,1	9,4	11,8	27,2	

Table 2.2.
Source: *Recent Trends in Tied Aid*, DAC 1993

To provide a few examples, France is widely viewed as tying aid to a large extent, not only formally, but also informally and indirectly. As noted above, French aid is largely directed to former colonies in Western, Central and Northern Africa, with which France historically has strong political and commercial ties. The monetary cooperation with some former colonies in Africa clearly favours French imports and increases the political interdependence. Additional flows arising from these interlinkages are, however, difficult to classify – to which extent are they results of deliberate tying, or a natural consequence of existing links?

Japan, on the other hand, has the lowest degree of formal tying. The focus on Asian recipients may in part reflect a wish to assist in an area where Japan has relevant experience and competence. However, in part it also reflects an attempt to secure and expand commercial relations in markets where Japan has strong political and commercial interests. Although 90% of all ODA loans from the OECF[6] were untied in 1991, Japanese companies accounted for more than 30% of the contractual value of these loans, compared to 20% for all other developed countries together (Japanese Ministry of Finance, 1991). Japan is also known for the strong

6. The Overseas Economic Development Fund is the core financial institution for Japanese ODA.

connection between its technical cooperation and project-aid. It has been argued that Japanese consultants design feasibility studies with the explicit purpose of making projects fit the special competence of Japanese enterprises. If this is the case, the general Japanese aid practices substitute for formal tying.

2.3. Recent Developments - Bilateral Donors and International Forums.

Bilateral aid policies are undergoing major revisions. There are many indications of a major reorganization of aid flows towards activities which are of greater commercial value to the donor countries. This is due to a combination of the pressure exerted on most national economies, and even more so on public finances, by the world wide recession, and a general disappointment with the output of foreign development assistance in terms of progress in the recipient countries. An increased awareness of the need of conditionality and monitoring to get beneficial results in recipient countries, coupled with concerns over rising unemployment in donor countries, is gradually inducing a more commercial and pragmatic approach to aid.

There are plenty of observations verifying this tendency among bilateral donors. France, Italy and Spain have for long practised extensive tying in a variety of ways, however. Japan has diminished its formal tying, but has instead developed sophisticated informal tying practices. Canada is reported to have decided to reorient its official flows towards more or less explicit support of commercial relations with South East Asia. The US, which also has had a traditional emphasis on untied aid, is shifting towards allocation of aid funds to so called capital export projects, referring to large and capital intensive exports to developing countries. Furthermore, the US has more or less stated that no American aid funds are to be made available for activities which directly or indirectly could have negative effects on employment at home. Among smaller donor countries, Denmark, Finland and others are making explicit efforts to increase the participation of domestic industry in bilateral as well as multilateral aid.

On the international level, issues related to aid and trade are subject to constant review in the OECD. Here, the question of tying practices has continuously been addressed by DAC. By defining a set of rules to be commonly applied by all members, the work focuses mainly on ensuring efficient and transparent ODA practices. In recent years, a number of reports have sought to highlight various aspects of tying practices.[7] The objective has been to analyse the scope of tied aid, and in relation to this, establish clear-cut definitions and a coherent reporting system. Examples are the DAC principles on Good Procurement Practices which are meant to serve as guidelines for efficient procurement in tied and untied bilateral aid.

The Consensus Agreement on subsidized export credits includes rules for associated financing. In the end of 1991, the parties[8] agreed to further limit such practices in the so-called "Helsinki Agreement". The new measures aim at limiting distortions in trade and aid by restricting ODA credits in the main target group for associated financing, low income countries other than the LLDCs, with the exception of credits on very soft terms. The main idea is that "commercially viable projects", i.e. projects with a sufficiently high expected return, could and should be financed under commercial conditions in ordinary financial markets. Each party can still make exceptions to the rules, but is then expected to officially explain and justify their reasons for doing so. Although the concept of "commercial viability" is transparent and easy to grasp in theory, its practical significance is vague and difficult to apply in a consistent manner, resulting in blurred distinctions between actual projects.

The impacts of the "Helsinki Agreement" have been far-reaching. The use of soft loans has certainly been restricted in fields such as telecommunications, energy and other forms of infrastructure. Some concern has been raised as to the question whether projects with a positive social economic return are treated as commercially viable on the basis of unrealistic calculations of tariffs and pricing. Meanwhile, it is clear that both individual firms and countries have been innovative in finding ways around the restrictions. This applies not only to the donor side, but very much to commercially interesting recipient countries, which demand at least as favorable terms for certain projects as in the past. Some donor countries, notably France, have made relatively frequent use of the possibility to neglect verdicts, further stretching the credibility of the agreement (DAC, 1993). It is still too early to evaluate the outcome, as a number of issues remain unresolved. At the present time, however, the playing field is characterized by uncertainty and a lack of transparency.

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7 See Jepma (1991 and 1992).

8 Australia, Canada, Finland, Japan, New Zealand, Norway, Sweden, Switzerland, the United States and the members of the EEC.

Among other efforts to untie aid can be mentioned the discussions within the European Community to incorporate bilateral aid in the agreements on public procurement.[9] So far there are no prospects for any major steps in that direction, however. This is partly due to the substantial differences in the degree to which the member countries provide foreign development assistance at all, and partly due to a lack of interest among countries with high tying levels, mainly France, Italy and Spain, in altering their practices (T&B Consult, 1993).

Summing up recent trends, there is an emphasis on promoting a stronger involvement by the private sector in development assistance. The attempts to untie aid, notably in DAC, have resulted in less formal tying, but various counteractions by firms and countries have created a situation with uncertain playing rules. Rather than formal tying, there is a reorientation in the geographical and sectoral direction of aid flows, and various efforts are made to bolster national firms through informal means. There is an increased exchange of information between firms and aid agencies, and a more active participation by the private sector in decision making on multilateral procurement.

9 These procurement rules apply to all goods, services and projects with values exceeding specified limits.

3. THE PROS AND CONS OF TYING AID.

The current trend towards conditionality and reciprocity in aid raises specific issues for those small economies which supply a relatively large share of total aid flows. In this chapter, we review the basic pros and cons of tying aid. Before doing so, however, we take a step backwards and consider the fundamentals of development.

3.1. Are Developing Countries Developing?

Following the end of colonialism, it was generally expected that the independence of Latin America, Asia and Africa would drastically improve the prospects for economic growth and pave the way for a higher standard of living. In many countries, however, hopes of closing the gap to the developed world have gradually been replaced by disappointment and confusion regarding how to proceed. With the notable exception of East Asia and parts of Latin America, many developing countries have failed to achieve sufficient growth – the gap in economic performance has, in fact, widened. Social indicators display a weak record, birth rates remain alarmingly high and a growing number of people live in absolute poverty. Along with the traditional headaches, enlarged problems emanate from urban congestion and evironmental degradation, ethnic conflicts, civil wars, the threat of AIDS epidemia, and so on.

The dimension of such problems makes it a matter of extreme urgency to find effective measures to promote *real* development. The problem is *how*. Views on this matter have changed considerably over the years. Some have stressed the need to support key functions, others have argued that the panacea is to address bottlenecks. At one point, the problems were interpreted as mostly domestic, at another point they were viewed as inherent to power-relations between developed and developing countries.

On the whole, however, there has been a general move away from the perspective that development problems emanate from the scarcity of capital per se, and hence can be resolved by incentives which stimulate higher domestic savings or an inflow of capital from abroad. Rather, an increased emphasis is placed on the role of human skills, in the form of trained personnel as well as the ability to organize the work force in an appropriate way. Failure in these respects leads to mismanagement, which in turn shows up as a shortage of means.

Developing countries are certainly in great need of an influx of resources in the form of capital as well as technology. Still, merely providing such resources will in most instances prove insufficient and ineffective. There must also be an adequate environment.

3.2. Absence of Market Solutions.

The observed difficulties to achieve growth in developing countries have raised demands for a cut-back of aid flows, letting countries take responsibility on their own for the state they are in, and leaving the development problems to be addressed by market forces. It should be made clear, however, that many developing countries are simply unable to develop without development assistance. Private capital does not flow in spontaneously from abroad. In many countries, there is virtually no other source of foreign exchange than that provided by foreign aid, and there is no way that market forces alone would be able to install the infrastructure that would be needed to change the course of events.

In some respects, the behaviour of developed countries is far from constructive. The use of non-tariff barriers, such as quotas which restrict the volume of imports, reduces the prospects of export-oriented growth strategies in general (Andersson, 1993). The two kinds of products for which the developing world has a clear-cut comparative advantage, agricultural products and textiles, are particularly ill-treated. Attempts to enforce even marginal reductions in the export subsidies of rich countries in the agricultural field have contributed to the current stalemate in the Uruguay Round. The lack of affirmative multilateral principles in the world trade system further opens the door to unfair trading practices, imposed by individual countries or groups of countries which have a strong bargaining power in bilateral negotiations.

Other reasons for the insufficiency of market-solutions are to be found in the international capital markets, and in the economies of information. Credit rationing may result from the risk of debt repudiation, limited taxing power on the part of the creditor country government over national wealth, and imperfections related to the supply of loans (such as the risk of panic among creditors).[1] Capital may consequently remain scarce in a country over extended periods of time. The situation may deteriorate further due to the prevalence of sizable debt burdens, accumulated when interest rates were low and requiring mounting interest payments when they rise, soaring inflation and over-valued exchange rates.

Such factors explain why the behavior of developing countries becomes geared towards reducing the acute shortage of foreign exchange, even when this occurs at the expense of long-term values. Investment in infrastructure, basic education and training which tends to generate a return only with a time-lag is downplayed in spite of its fundamental importance for the prospects of long-term growth.

Contrary to ordinary goods, knowledge and information take the form of public goods, which ideally should be universally accessible once they are existant. Ex ante, however, private actors need to expect that they will be able to keep new knowledge to themselves sufficiently long to make a profit, if they are to invest in its buildup in the first place. Private actors cannot be expected to undertake investment which will partly benefit others. The geographical distance between industrialized and developing countries, cultural differences, changes in the political environment, etc, further hamper the establishment of mutually profitable relations in trade and investment. Multinational companies, normally based in developed countries, have a great potential for transferring valuable technology and knowledge to third-world countries. In states of limited information flows due to scattered exchange, however, large private firms can rather reap monopolistic profits in poor countries by achieving control over the supply of technology or the access to distribution with respect to the markets of developed economies (Moran, 1985).

The success of development efforts strongly depends on the ability of developed and developing countries to overcome the obstacles to forming mutually beneficial commercial relations. In a broad sense, "aid" serves as one of the few possible instruments to finance the necessary infrastructure, and break up structural impediments. Without the presence of a

1 There are essentially three conditions for a perfect capital market. Firstly, the marginal utility of consumption each period should equal the discounted utility of wealth. Secondly, investment should be undertaken each period until the marginal product equals the cost of capital. Finally, the discounted value of consumption should equal the discounted value of productive wealth, see e.g. Eaton and Gersovitz (1981), Sachs and Cohen (1982), Sachs (1984) and others.

long-term growth strategy and an appropriate macroeconomic framework, however, aid can make more harm than good. Such considerations make it clear that aid policies cannot be understood in isolation, but need to be consistent with other forms of international co-operation in order to reduce aid dependency. Since it is an integral part of foreign policy, ODA actually serves as a key factor in the establishment of long-term political and commercial relations between sovereign countries. Recognizing the various objectives of aid, the crucial question is how to move in the right direction.

3.3 Objectives and Advantages of Aid.

The difficulties which hamper development in the first place also make it difficult to provide effective aid. There are many examples of cases in which development assistance has not been successful in generating development. On the contrary, aid may help to preserve inadequate structures which allow corrupt regimes or bureaucracies to stay in power without having to adjust, thereby accounting for a continued mismanagement of resources. This makes it crucial to evaluate and adjust the functioning of aid. Changes are necessary both in order to improve prospects for development in poor countries, and to strengthen the support for such assistance in rich countries.

Official development assistance is complicated by the fact that its main objective, in the long run, is to abolish itself in favor of political and commercial relations that can be sustained on their own. Its intermediate goals are sometimes vague and hard to operationalise, sometimes contradictory to one another. While it is expected to promote development in a broad sense, development assistance is inevitably linked to commercial interests and political considerations. These may or may not coincide with development objectives.

In this context, there are distinctions to be made between bilateral and multilateral aid (Mellor and Masters, 1991). Multilateral agencies enjoy a comparative advantage in the coordination of human and financial resources and in economies to scale. Bilateral agencies, on the other hand, locate, adapt and apply skills acquired in their respective countries. They can also exploit already existing bilateral economic, political and historical relations in their interaction with recipient countries. These differences speak in favor of a certain specialization in aid functions, with bilateral agencies channeling home-country resources and skills into productive activities within the recipient society.

With intentions to promote sustainable development, aid donors are faced with plenty of dilemmas. It is regrettable but logical that those countries which have the greatest needs tend to be the most difficult to help. Insufficient or inefficient physical and administrative infrastructural services reduce the receptive capacity of a country. A "Catch 22" situation results, where resources cannot be distributed because of lack of distribution, and in which deficiencies cannot be remedied because of the presence of other deficiencies.

By its nature, development assistance has generally focused on state-to-state transfers, and support of the public sector and planning (Lele and Nabi, 1991). However, a general consensus is now being formed among donors that the role of the state should be to support and complement the prevalence of a sound private sector in general, instead of providing detailed guidance or even substituting for it. This casts new light on the role of foreign development assistance. Contrary to their traditional role, donor institutions must consider the possibilities as well as needs of the private sector, and try to pave the way for effective market mechanisms.

The stronger connection between aid and the development of commercial relations between donor country and recipient, is evidence of a changing balance in considerations. The trends in development assistance point to a pronounced emphasis on reciprocity, i.e. that both donor and recipient should benefit from aid.

The instrument most commonly used for this purpose is the tying of aid funds. The objective is thus twofold:

1) a closer monitoring of aid, with stronger conditionality, and

2) support of home country industries without imposing the burden of larger budget deficits.

Although the decision to implement tying is normally taken unilaterally on the part of the donor country, it may be motivated by actions by the recipient country. In some cases, recipient countries are actively promoting tied aid, partly as a means to obtain wanted projects at a good price. Moreover, tying may be motivated as a response to actions by other donors. In order to achieve neutrality, tying by one donor country may induce tying by others as well.

From an efficiency perspective, tying is associated with potential avantages as well as disadvantages. Since the point of departure is a state of substantial distortions, tying does not necessarily imply that inefficiencies are magnified. Nor does tying in itself secure an efficient use of resources. The following section highlights the most important arguments[2] in favor of and against tied aid, from the perspective of Sweden as a donor country.

3.4. Advantages of Tying.

Tying may directly increase exports. Restricting aid funds to the procurement of Swedish goods and services, whether in the form of balance of payments support or project assistance, increases exports from Sweden at the expense of foreign competitors. This may stimulate, e.g., increased employment at home. The primary effect arises from the actual export value of the project as well as after-sales service. There is also likely to be a secondary effect, since Swedish exporters tend to use more Swedish suppliers for intermediate inputs than foreign competitors.

Tying may indirectly increase exports. When tying leads to an increased Swedish presence, developing countries are likely to obtain more information about Swedish companies and their special competence. Effectively designed and managed projects provide Swedish industry with good-will in general. Moreover, experience from working in developing countries increases firms' knowledge of and competence for LDC markets. Hence, Swedish firms may:

- increase their knowledge of developing countries in general,
- develop country- or region-specific knowledge in terms of language, culture, contacts, potentially interesting projects, etc.,
- learn how to address their own special constraints,
- acquire experience of special requirements and needed product-adjustments, and
- identify potential new markets, i.e. products and services so constructed or organized as to fit LDCs in general or the actual country specifically.

In the long run, Swedish products would then become better suited for further engagement in ODA projects (on behalf of Swedish or other aid agencies) as well as for commercial relations following from previous aid projects.

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2 For a more detailed treatment, see for example Bhagwati (1985), Hamilton (1976), Jepma (1991) and Jepma (1992).

Tying of aid may increase public support for development assistance. If tax payments allocated to aid are seen to generate employment in Sweden, this could have a positive effect on the public's attitude towards development assistance. Foreign aid would be seen as a priority not competing with, but rather supporting, employment creation measures in Sweden. Tying to Swedish exports could also increase the tangibility and accountability of development assistance. It would be easier for the public to identify with a specific project than with a more general and vague resource transfer.

Tying of aid may be a justified response to other countries' tying practices. In situations and markets where there is evidence that other developed countries tie their aid to a large extent, it would seem reasonable that Swedish companies not be disadvantaged by a lack of governmental support. Tying of aid is then used as a matching device.

Tying of aid may restore competition in distorted markets. Some markets and sectors are particularly interesting from a commercial perspective, giving rise to fierce competition between potential suppliers. Virtually all interested parties have to offer conditional credits as an export-promoting device, integrating financial competition with commercial competition. A competitive Swedish bid may then be rejected unless Sweden is prepared to support the exporter with at least as advantageous financial terms as those provided by other countries. Moreover, in many of the former colonies, priorities in trade and development are influenced by history and politics, not by competitive forces, thereby creating informal tying to the former coloniser. Untied means will then automatically benefit exporters from the dominant country, hampering competition and cost effectiveness.

Tying may improve and facilitate the transfer of Swedish resources. Tying implies an active involvement by the private sector in development assistance. It may increase and strengthen the linkages between the Swedish base of technology and know-how, the aid agencies and the recipient. There may be an information advantage if tying accomplishes closer cooperation. This could help identifying potential Swedish resources, developing and adjusting such resources to the needs of developing countries.

Tying may impede mismanagement of resources. By involving Swedish resources, tying facilitates monitoring of development assistance. The donor can maintain more effective control, not only of the recipient's use of funds, but also of the exporting firm's performance. The contracted firm presumably has an interest in maintaining good relations with the aid agencies for future cooperation. As a result, Swedish technological and administrative competence could more effectively be transferred to the recipient. Source-tying can then be used in order to impose conditionality.

3.5. Disadvantages of Tying.

Tying may result in less cost effectiveness. Restricting procurement to Swedish goods and services could limit competition. The procuring agent, whether the aid agency or the recipient, may have to deal with a monopoly or oligopoly situation, where one or a few companies have a substantial advantage in bargaining power. This is likely to result in higher prices than would have been the case with international bidding, increasing the cost for development assistance and reducing the value for the recipient. Moreover, it could lead to the protection of inefficient industry, resulting in aid-dependent companies.

Tying may result in limited choice. In a similar way, tying will limit the choice of goods and services available to the recipient, which can damage the quality of the assistance given. There may exist other suppliers whose goods or services better fit the special requirements of the recipient than the Swedish. If this is the case, untying would increase the recipient's welfare by expanding choice.

Tying may lead to a substitution of trade for aid. Aid funds are expected to increase the financial flow to developing countries by supporting projects which are socially profitable, but which would not have been feasible without concessional financing. The effect, however, could be the replacement of commercial flows by aid flows. This is commonly referred to as *fungibility*. Where tying is used as an export-promoting device by all donors, aid funds may reduce instead of increase commercial relations.

Tying may lead to geographical aid diversion. If the purpose of tying is to increase Swedish exports, aid funds will not necessarily be used in accordance with Swedish development priorities. Aid diversion in a geographical sense may arise if tying redirects aid flows from poorer and less creditworthy countries to commercially interesting developing countries.

Tying may lead to sectoral aid diversion. Project exports may be favored at the expense of credit programs, or larger projects be favored at the expense of small-scale investments. Support of infrastructure, a sector which is largely characterized by large and capital-intensive investments, may lead to crowding out of, e.g., education and health.

Tying may be an obstacle to the recipients' involvement in ODA. Tying aid funds limits the resources available for local-cost funding. As a result, the possibility of using and developing competence in the recipient country, instead of relying on Swedish provision of goods and services, may be neglected.

Tying may be contradictory to liberalised markets. Today, virtually all development assistance is made conditional upon sound economic policies in the recipient countries. It is expected that recipient countries' efforts are directed towards liberalising markets, reducing protectionism and limiting state involvement in the private sector. Increased protectionist measures from the developed countries through tying may then send contradictory signals to developing countries.

Tying may be an inefficient form of export and employment support. An alternative use of budget funds could be more efficient in supporting industrial activity than the tying of aid funds. Moreover, increased exports to developing countries may not have significant effects on the balance of payments or home country employment, e.g. because multinational companies deliver equipment from subsidiaries abroad, high imports of input goods, capital-intensive projects, and so on.

The above arguments for and against tying indicate potential gains and conflicts. Advantages and disadvantages show up with a varying magnitude, however. Given the diversity of activities and regions covered by aid, different aspects of tying should be perceived in terms of possibilities and risks rather than absolute definitions.

Thus, efficiency arguments *may* favor tying of aid, due to difficulties inherent in the actual aid process. The reason may be tying by other donor countries, lack of knowledge on the recipient side of the donor's resource base, as well as other market and policy failures in the recipient economy. At the same time, there is a need of checks to prevent mismanagement of aid funds.

4. TIED AID AND EFFICIENCY.

Some issues need to be more thoroughly addressed from an efficiency perspective – the effects of tying on exports and the actual impacts on cost effectiveness. First, disregarding the questions of development objectives and costs, does aid exert a significant impact on exports? Moreover, will *tying* of aid make a difference in this respect? From the perspective of promoting development, what can be said about the consequences of tying for cost effectiveness in development assistance? Some empirical observations are given below, again centering on the Swedish case.

4.1. Effects on Exports.

For Sweden, developing countries account for a relatively small and declining share of total exports, down from some 15% in 1980 to 10% in 1992.[1] Still, developing countries are potentially interesting markets for Swedish exporters. Some economies in East Asia and Latin America display a strong increase in their demand for technology and consumption goods. The People's Republic of China is currently the single most rapidly growing export market for Swedish industry. The aid dependent markets in sub-Saharan Africa have largely stagnated however. Their needs are mostly oriented towards capital goods, human skills and support of appropriate technologies.

By international standards, Sweden shows a disappointing performance in commercial relations with the developing world. A relatively small weight of developing countries in Swedish exports may broadly be explained by geographical and cultural distance, technological mismatch, information and distribution deficiencies, etc. However, the share of exports directed to developing countries has declined relatively more for Sweden than for OECD-countries in general. The substantial Swedish involvement in concessional cooperation with the third world raises questions about the nature of the relationship between aid and exports, and of particular interest for this essay, tied aid.

1 SCB, time series database.

There is limited evidence on the relationship between ODA and exports from donor countries. Some studies have demonstrated the presence of sizable effects, for example, Schumacher (1981) and May et al. (1982) argue for a one-to-one relationship between aid and commercial returns for Germany and Great Britain respectively. At the same time, there is little doubt that the most interesting commercial aspects of aid are those associated with the indirect, and dynamic, effects.

In the case of Sweden, it should be noted that exports to poor countries are extremely aid dependant, especially in sub-Saharan Africa. Substantial imports of capital goods and appropriate technologies are here directly related to the availability of means from donor countries. This is reflected in questionnaires sent out to Swedish companies in connection to this project. To provide some anecdotal evidence, a major Swedish exporter in the field of infrastructure, reported that three out of five of the largest markets in the developing world were to 100%, directly or indirectly, related to aid projects.

There have only been disparate attempts to assess how aid has affected the Swedish economy. The existing studies have focused on single, large projects. A detailed input-output calculation of a large construction project in Sri Lanka, the Kotmale power station[2], shows that the project generated the equivalent of 3 500 employees for one year. The employment effects from the Uri power station project in India, also financed with Swedish tied aid, are estimated at 11 000 - 12 000[3].

In spite of such cases, it has commonly been argued that the tying of aid can only exert a marginal impact on Swedish exports. This partly reflects the small share of developing countries in commercial relations. In a number of rapidly growing markets, however, fierce competition among exporters and tough strategies on the recipient side have made the availability of soft financing a prerequisite for competitiveness. For example, more than half of the Swedish deliveries in recent years to the People's Republic of China, appear to have been competely dependent on it. As for the longer run, ODA may indirectly exert an even larger leverage effect on exports.

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2 PM 1984:42, SCB.

3 SvD 15-8 93.

There are several examples of pioneer projects being followed by additional orders, which could be financed with ordinary commercial export credits or be paid in cash directly. Examples with specific relevance to Sweden are Algeria, Tunisia, Morocco and Pakistan. BITS-financed concessional credits played a key role in allowing Ericsson to enter the Algerian telecommunications market in 1986. From there on, its support has in effect assisted the company's establishment of a continuous market position. The introduction of other projects in China has followed a similar pattern. The availability of tied aid has also permitted a number of small Swedish companies to establish themelves in China, particularly in the provision of environmental services.

In poor and depressed markets in sub-Saharan Africa, such as those of Ethiopia, Tanzania, Angola and Zimbabwe, tied import support in the form of grants has similarly been a prerequisite for Swedish manufacturers to enter. There are cases in which tying neutralised subsidized competition from other donors and served to overcome information problems. In other cases, foreign exchange was inaccessible for imports from Sweden, since the import support of other donors was tied whereas Sweden's was untied. There is evidence of projects in which sizable imports for this reason were acquired from subsidiaries of Swedish companies in the European Community instead of the parent company in Sweden.

Multilateral aid, in contrast to bilateral, is typically provided on unconditional terms. There are some exceptions, however, such as cofinancing and consultant trust funds. These concepts apply to aid projects effectuated in concerted action between multilateral organizations and bilateral donors, where the latter tie aid in some sense. In co-financing, a distinction should be made between joint and parallel financing. Joint financing is essentially comparable with ordinary multilateral aid, while parallel financing rather resembles the practices in bilateral aid. In the latter case, there is consequently greater scope for direct links with private firms in donor countries. Consultant trust funds are provided by a bilateral donor, and put at the disposal of a multilateral organization, meaning that project preparation is tied to the hiring of consultants from the donor country. This may imply that the project is designed in a way which favors companies from the donor country once it comes to procurement and actual implementation.

Without going into detail, it should be noted that multilateral assistance so far has played only a small role for Swedish exports, in spite of the relatively large share of Swedish aid resources which are channeled through multilateral organizations. Some other small donor countries have performed better in this respect, such as Austria and Denmark.

4.2. Cost Effectiveness.

Although tied aid clearly can improve export performance, especially by indirectly facilitating entry and expansion in new markets, distortions may still arise. There is an obvious risk of adverse effects on cost effectiveness. The fundamental reason is not merely the likelihood of malicious overpricing on the part of a company that takes advantage of a monopolistic situation. Donor country companies are not internationally competitive in providing all kinds of goods to recipient countries, due to transportation costs or other factors. Grants that are tied to business options for such firms are thereby reduced in value. For loans, part of the excess cost will actually have to be paid back by the recipient. In this context, however, it is vital to bear in mind that cost effectiveness will not necessarily refer to the cheapest alternative, but to that which offers the most appropriate combination of cost and quality.

Empirical work on cost effectiveness in tied aid is not abundant. A partial reason is that the efficient price level is difficult to assess for all but standardised products. Calculations on services and large projects require that quality as well as cost aspects are thoroughly considered, while relevant comparable offers may not exist. Some studies have tried to estimate whether officially supported and subsidized export credits do, in fact, result in excessive costs (Raynauld, 1992). The evidence is mixed, indicating that prices are primarily determined by the level of competition among creditors. In cases where international competitive bidding has not been a prerequisite for concessional credits, however, prices have exceeded the competitive level quite substantially.[4]

In Nicaragua, for example, tying import support to procurement from Sweden has proven distortive in several respects. Price comparisons show that Swedish firms, if at all replying, did not make competitive offers. Distance to the market, limited size and lacking

4 For example, an evaluation of Norweigan Concessionary Credits by Hansen et al. (1989) points to offers exceeding the internationally competitive level by 15-30%.

creditworthiness of the Nicaraguan economy appear to have discouraged firms or made them impose a substantial risk premium on prices. In Costa Rica, Nicaragua and Tunisia, there are indications that consultant services in the form of technical co-operation have exceeded the competitive market price – in some cases by a 20-25 % mark-up. The nature of services renders price evaluations even more difficult, and there appears to be limited national and international competition. This mixed record takes us back to the importance of how aid is tied.

With the objectives of providing effective ODA and promoting sound commercial relations between donors and recipient countries, the advantages or disadvantages of tying depend essentially on whether it promotes efficiency. From a development assistance perspective, it is clear that budget funds allocated to development assistance should be kept in line with aid priorities. The emphasis on efficiency is not less relevant in regard to export promotion efforts. In the long run, only cost-effective, well designed and managed projects will have favorable dynamic effects on exports due to good-will, improved linkages, etc. Public support for aid is likely to depend on whether tying is perceived as exerting a positive impact on exports and domestic employment.

If only a small number of large home country firms are able to reap excessive profits from tied (or indeed untied) aid, the potential for positive spill-over effects may be severely damaged. A costly and malfunctioning use of budget funds to support non-competitive industrial activity through tying will have the opposite effect on public opinion. Again, the relative success or failure of tied aid can be expected to depend on the circumstances and forms under which it is implemented.

4.3. Promoting Efficient ODA.

How can tying practices be related to different situations and conditions? Building on the previous conclusions, the purpose is here to formulate suggestions concerning where and how aid may be tied. First, some basic principles should be established in order to clarify distinctions and focus on relevant aspects. The effectiveness of tied aid will depend on several factors:

1. That the primary objective of ODA is to promote development in a wide sense in the recipient countries.

2. That aid flows are directed to countries, sectors and activities where they can be expected to be used efficiently.

3. Accordingly, that tying of aid flows is not made an objective in itself, but that the main priority is to give aid such that a donor's special competence is upgraded and transferred as efficiently as possible.

4. That aid is tied in forms which improve and facilitate market mechanisms, not counteract them.

5. That aid is not tied in forms which unnecessarily reduce flexibility.

6. That mechanisms exist or are created which ensure adequate pricing.

These basic principles have implications for the organization and implementation of development assistance. They bring focus to the importance of donors' competitive advantages, the structure of competition and information flows, the recipient's bargaining position, and evaluation and co-ordination .

Competitive Advantage.

Irrespective of recipient, it is a prerequisite for efficiency that aid is, in effect, tied only to activities where there is a donor-specific competitive advantage. Such advantages are associated with technologies and skills that can be matched to the needs of the recipient at the best value for money. In aid, the concept of competitiveness must thus include not only appropriate technology and skills, but also the ability to transfer technology and know-how. Tying aid to other activities will result in losses with the recipient country experiencing a reduced value of aid. In the donor country, the allocation of resources is then distorted and inefficient economic structures are preserved.

Competition and Information.

In order to develop competitive advantages in aid, it is essential that there is not a shield against competition, that procurement practices are efficient and that information is effectively channeled between aid agencies and the private sector in the donor country.

For *large projects*, involving soft- and hardware components of specific design, international competitive bidding is generally the most efficient way of obtaining value for money. Tied aid funds can be provided ex post when national companies have won the contract in international competition. The disadvantage of solely relying on ex post tied aid, is that it makes it more difficult to plan for and develop a consistent aid policy.

Furthermore, it is necessary to guard competition and allow for arrangements which are flexible even in situations where funds are tied ex ante. In case there is no international (donor) competition for specific projects, the donor should pay attention to the domestic level of competition. To avoid distortions, no resources should in advance be locked into an irrevocable commitment of tying, especially not to specific companies. If international competitive bidding or other methods indicate that national companies are not offering an appropriate combination of cost and quality, there should be options to continue with an international tender, or to choose not to participate at all.

Tying practices are not limited to large projects. Aid may also be tied to *commodities*, in the form of direct deliveries from the donor country and through tied import support. For standardized products, the competitive price-level should be relatively easy to establish. Intuition as well as experience from 100% tied import support speaks against this form of tying. On the other hand, there are cases in which untied import support have turned out to be severely damaging for Swedish companies, especially in countries with highly corrupt regimes where *other* donor countries have tied *their* import support. A certain degree of discretion is consequently required.

Services in, e.g. technical co-operation, tend to be tied to 100% although domestic competition may be limited (DAC, 1993). As pointed out, the nature of services renders evaluations less straightforward. Linkages tend to hinge on personal contacts and long-term relations. From an efficiency perspective, it is nevertheless evident that tying in services should be subject to the same considerations regarding competitiveness as in goods. There are clear indications that the cost for tied services often exceeds market value. It would therefore be helpful with a closer monitoring of pricing in development projects, and establishment of reference data which could be constantly updated (Hansen et al., 1989).

An emphasis on cost effectiveness will counteract attempts to use tying as an instrument for specific company support. Information must be made available not only for a few large and well-connected firms, which have a superior ability to lobby for their interests. It is in society's interest that knowledge and information is available at reasonable costs in wider circles. This is crucial for facilitating an *efficient* involvement by private firms in tied aid, and *more* involvement in untied aid. In Denmark, for example, efforts are being made to improve the information structure. Examples of arrangements are regular contacts and meetings between aid agencies and representatives from firms, and the establishment of an on-line data base for multilateral projects (T&B consult, 1993).

To prevent dominance by individual actors, aid agencies can to some extent foster the build-up of specific competence within alternative private organizations, which are subjected to competition among each other. This would force private firms to improve efficiency and adapt output to development objectives. Through such an upgrading of skills in this direction among multiple firms, the private industry of the donor country would become more capable of winning projects in the open competiton of multilateral or untied aid projects as well. Consultancy business is of particular importance in this context, due to its strategic function of determining the direction and design of aid projects in general. Even when aid projects are untied, a competitive edge in the consultancy stage opens up possibilities for a country to participate in the implementation stage as well.

The Recipient Side

The consequences of tying are influenced by the specific situation in the recipient country. In Indonesia, China and Tunisia, for example, there is intense competition between donors for various projects, reducing the risk of excess costs due to tying. There are also countries where certain donors are favored for political and historical reasons. Formal tying can then serve to increase the level of competition by levelling out an informal one.

In countries where inefficiency and corruption are widespread in the bureaucracy of the recipient country, or the necessary administrative capabilities are lacking, there are strong arguments in favor of conditionality on the part of the donor. Tying represents one possibility, given that it is connected to close monitoring and evaluation. Poor and aid dependent countries may, on the other hand, be of limited commercial interest to donors. Furthermore, they are generally in a weak bargaining position, and their needs may differ significantly from the technology available from the donor countries. Thus, unlike relatively rich LDCs, these countries are far from always able to invite donors to compete for activities which are incorporated in a general development strategy. Where procurement skills and competition are lacking, ineffective assistance, co-ordination and cost problems arise. Here, emphasis should be put on helping to improve administrative capacity as well as organizing local involvement and decentralized decision making.

These considerations underline the importance of not allowing aid to be redirected from where it is of greatest use to recipients to where it is of greatest use to donors. A crucial aspect of this matter is the danger of applying the technology of well-developed donor countries, rather than adapting it to what is appropriate in recipient countries. There must not be a return to "White Elephants" - large-scale projects out of touch with the needs and abilities of those that obtain them.

Evaluation and Coordination

The importance of encouraging market mechanisms and private sector interaction in aid has been a leitmotif in the previous sections. As a consequence, it becomes imperative to improve evaluation and coordination. This is vital in order to avoid aid diversion, and a bombardment of unstructured and ad hoc operations from a multitude of sources.

The initiative for aid projects need not always be taken by aid agencies – there should be more scope for private initiatives. The decision whether aid financing should be provided must nevertheless lie with aid agencies, as it is their responsibility to ensure that aid funds are used effectively and in compliance with aid objectives.

The matter of coordination deserves special attention in bilateral aid with a tying component. First, there is a need for coordination with the recipient to establish *where* donor country resources are most useful. Efforts must be made to allow for flexibility within the framework of long-term planning. Second, different donors must coordinate their actions in order to avoid overlapping as well as neglect of important issues.

It follows that tying must not and need not imply an inward bilateral focus. On the contrary, co-financing with bilateral and/or multilateral donors may represent the most efficient option. This form of tying allows for specialization among donors as well as advantages of economies to scope and scale. However, efficiency advantages are captured only to the extent that procurement practices do involve real competition.

4.4 Link between Aid and Business?

In conclusion, there is a need to review the connection between foreign development assistance and the commercial relations with recipient countries. Efforts must be intensified to form a coherent framework which is consistent with development priorities. Aid and trade are interdependent in this respect. Aid is needed in many countries to build a base for development, but the only possible way out of poverty leads towards functioning commercial relations.

Although Sweden provides a large amount of aid relative to the size of the economy and has few other means to stimulate commercial relations with developing countries, there have been limited efforts to establish a complementary relationship between foreign development assistance and sound commercial relations. Given the small domestic economy, it may be optimal for small countries to provide a large share of total aid flows through multilateral channels. In bilateral aid, however, appropriate use of domestic resources is imperative. The challenge lies in adjusting, refining and applying those resources so as to make the largest possible contribution to present and future welfare in developing countries.

In this process, however, it is equally important to realize the need for a clear dividing line between aid and commercial interests, in the sense that aid funds must not support activities which are not socially profitable, or which ought to be financed on a commercial basis. Continued work is needed in international forums to create sound guidelines for development assistance. There is not least a need for guiding principles which help to dampen a redirection of aid funds away from the poorest and most needy to those which are most interesting from a commercial perspective. Furthermore, aid must not be distracted from those areas which need it the most, and not be induced to support other forms of technology and design than those which represent efficient resource use.

While the skills of private companies should be engaged in development assistance, tied or untied, all aid should not be redirected into activities which allow procurement from the donor country. The knowledge accumulated in donor organizations is of great value when it comes to training and organizing human skills, e.g. in rural development through decentralization of responsibilities. Accomplishing better results takes efforts both to expand the engagement of the private sector in the donor country *and* to upgrade the assistance of the recipient countries' own resources. Both aspects will require an increased ability to diffuse information and interact with the private sector in the donor country as well as in the recipient country.

Finally, it should be emphasized that the demand for reciprocity in aid needs to be parallelled by the urgent recognition of reciprocity in trade as well. The markets of the developed countries need to become more accessible with respect to imports from developing countries.

5. SUMMARY.

This study has argued that a general disappointment with the results of much foreign development assitance, in combination with the prolonged recession in developed countries, create a growing demand for conditionality and reciprocity in aid. The most commonly used instrument to secure commercial output is to tie aid funds to procurement of goods and services from the donor country. This practice is controversial from many perspectives, and has constantly been debated. It is therefore important to review the effects of tying aid.

A re-evaluation of foreign development assistance is not least important for small donor countries, such as the Nordic ones. These have relatively few commercial links with developing countries, provide a great deal of aid relative to the size of their economies and channel a large amount through multilateral agencies. In addition, the Nordic countries tie aid to a small degree by international comparison, and focus on the poorest developing countries (LLDCs).

Increasing reciprocity and conditionality in aid through tying may have both positive and negative influences on the aid process. On the one hand, both recipient and donor countries benefit from an expansion of sound commercial exchange. Tied aid funds, e.g. in the form of provision of soft credits, may serve as an efficient means of establishing initial, key linkages. On the other hand, there are risks of increased costs and a biased resource allocation. Given the presence of market and policy failures, the effects of tying aid will depend on the specific circumstances under which it is undertaken. This study has further argued that cost effectiveness is crucially influenced by the level of competition, which in turn depends on the approach adopted by donor countries as well as the character and strategy of recipient countries.

The private sector, with its accumulated human and technological resources, should play a key role in development assistance. Aid programmes can help to bridge the cultural and physical gap which tends to restrict commercial relations between developed and developing countries. However, aid must avoid favoring individual companies, which makes it essential that rivaling firms are offered equal opportunity to bid for projects. The potential contribution of aid in the context of commercial relations is particularly great in the involvement of medium and small scale enterprises, which envisage severe barriers with respect to information about business opportunities in developing countries. Furthermore, demands for procurement from the donor country must not replace efforts to develop the resource base of the recipient country itself.

Finally, it should be noted that the task of creating a more benefical link between foreign development assistance and the private sector requires a refined framework of analysis and evaluation. Current discussions mostly focus on the concept of return flows, which is of limited use from a practical perspective. For example, the return flow does not include the indirect effects of aid, which presumably should be the most important ones, and typically refrains from considering whether exports actually are a consequence of aid. In further research, we will address the pertinent question of how to develop indicators and methods which are more useful from a policy perspective.

List of Abbreviations

DAC

The Development Assistance Committee of the OECD. Members are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom and the United States.

ODA

Official Development Assistance.

OECD

Organization for Economic Development and Cooperation, formed in 1960 and incorporating all 24 industrialized countries as members.

LICs

Low Income Countries, with a GNP/capita below 610 USD.

LLDCs

Least Developed Countries, according to criteria defined by the United Nations. At present, 47 developing countries count as Least Developed

Other LICs

Low Income Countries excluding the Least Developed Countries.

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