The Mith of Capital Requirement in Development

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There is a wide contention in the literature of Development Finance, that externally generated resources, particulary Official Development Aid, do not enhance capital formation in developing countries. Some assertions go even further and show cases where foreign capital inflow actually halted or at least retarded the development process. The reasons put forward for this negative impact are based on: 1) Contention by some scholars that foreign aid to a developing country supplements the national consumption and does not augment savings; 2) Skepticism by some on the importance of capital, in the first place, on development. This skepticism is based on the development of Western Europe after World War II, which they contend was due to an increase in per capita output and not due to any significant increases in capital inputs. The former group conclude that, to the extent that foreign aid does not increase the economies savings rate it cannot help development. While the latter group significantly discount the importance of capital as an economic input, since in their assertion, increase in capital alone is not known to have lead to economic progress.

The purpose of this essay is to demonstrate that increased production which is undeniably the *sine qua non* of development is more of a function of some social elements in a society such as the degree of entrepreneurship, social institutions, social ingenuity, nature of political leadership and so forth, than it is of the use of capital. I argue that capital, in its physical and financial elements, is important to development but only to the degree that it is complemented by these indigenous social factors.

It is also the purpose of this paper to discuss these social factors as much as the available space allows.

The Need for Economic Assistance

International sources of savings are necessitated by the great desire of developing countries to upgrade the standard of living of their lot. That requires financing new activities for development and with rampant low savings rates in these countries, external sources to supplement internal savings is an inevitable alternative. This damaging insufficiency of domestic savings is attributable to a whole gamut of institutional, economical and cultural factors.

The degree of a country's capital formation (capital formation here means long-term investment to create future productive capacity in its physical, financial and human aspects) is a direct function of the level of its investments. An increase in disposable income unaccompanied by increase in marginal propensity to consume is a necessary condition to increased savings. But increased savings do not automatically translate into investments. Other essential conditions must be fulfilled before savings are transformed into investments. It is extremely important to realize that saving is the final residue of an individual's disposable income, and hence, talking about savings assumes that the individual income reached a sufficiently high level to spillover into savings. The dilemma is to discern the cut-off beween consumption and savings, how much to consume and how much to save out of a given income. It is tempting to say that the individual must first consume goods and services that sustain a minimum standard of living. This includes water, food, housing and health services to reduce the incidence of epidemic diseases and to save the rest of the income for future consumption.

A number of points need further considerations.

1) Minimum requirement: The average individual in low income countries such as Somalia may not earn enough income to cover the minimally essential needs to survive and subsequently death from starvation and related diseases is prevalent.

2) The «Demonstration Effect»: Levels of consumption in developing countries are rising, despite low income levels. The demonstration effect operates on the international level. People in low income countries imitate the advaced consumption of people in high income countries. In Somalia some women in urban areas demand West German furniture and home decorations before completing a marriage contract - a classic case of international demonstration effect. Professor Raguar Nurkse puts it more succinctly:

> When people come into contact with superior goods or superior patterns of consumption, with new articles or new ways of meeting old wants, they are apt to feel after a while a certain restlessness and dissatisfaction. Their knowledge is extended, their imagination stimulated; new desires are aroused, the propensity to consume is shifted upward (Raguar Nurkse 1952: 62-63)

These temptations to emulate advanced consumption patterns inevitably limit the supply of investible funds and present serious problems for the poor countries. It can be argued that the newly emerging wants may act as an incentive to make people work harder and, hence, to increase production but it does not follow that the increased output can be saved and invested. The demonstration effect may also operate domestically; the low income majority in a developing country is lured by the conspicuous consumption patterns of its indigenous economic elites. One can talk about rural-urban demonstration effect as well.

3) Consumption-investment preference: A crucial point in the notion of investments is that one can curtail present consumption only to the extent that consuming it in the future is somehow preferable to the present. A belief is widely held in some Islamic societies of the developing world that whatever income is earned today is for the consumption of today, while tomorrow's earning is no one responsability but the Provider's, as God. Of course one must be active and industrious, but the ultimate power to provide each day's consumption (RIZQ), separate from oher days, lies with God. This notion, by extension holds that, through the head of the family, additional income will be provided by God for each additional child born to a family.

4) Foreign exchange constraint: Most of the arguments of the necessity of foreign aid are based on the insufficiency of domestic savings as explained above and the contention that foreign aid is necessary to supplement internal savings in the process of capital formation. But even when domestic savings are sufficiently large to finance all proposed development projects, it is still difficult to overcome the foreign exchange constraint. Therefore, foreign aid is still required for the aquisition of foreign goods and services necessary for promoting domestic development (Meier 1976: 330-334).

The foregoing notes are serious problems that, along with other factors, are responsible for the insufficient savings levels in the developing countries.

Other development constraints exist, some of which are institutional in nature that posit difficult and progress hampering problems. Some of these are elaborated in the next section.

Capital Formation Cycle

A number of crucial steps must be made in the process of transforming an increase in real income to the final productive process of investments which leads to capital formation and, theoretically, to economic development, *ceteris paribus*.

An increase in real income provides an individual with the capacity to save, but without appropriate incentives, the saved portions may end up in unproductive saving vaults, i.e., under mattresses. Considered separately, individual savings may seem negligible, but they can contribute to capital formation significantly if pooled and used collectively. This is precisely where depository institutions could play major roles.

Financial institutions, particularly commercial banks, are used in some developing countries by savers for their provision of physical safety only. Some merchants even opt to use their homes as a bank by purchasing strong metal vaults and, if necessary, hiring armed watchmen for its protection. For many small savers, it is not worth all the paperwork and bureaucratic red tape to take 50-100 shilling monthly savings to the bank. Under these circumstance, therefore, where other investment oppurtunities — corporate equity and bonds, government bills etc. are not available — people opt to keep their money in their pockets even with the intention to save.

In addition to this, commercial banks in some countries are not strong on confidentiality and some savers may be discouraged by the fear that their competitors may find out their financial strength and act accordingly. In extreme cases, these banks, which are mostly owned by the state, may be given the order either to report to a special government agency those who deposit large amounts of money or else to have them get clearance from the government as precondition to accepting their deposits — a strong disincentive to use the bank.

Under normal circumstances, the interest that a bank offers to its depositors is a function, in part, of the cost of its own capital. Commercial bank in the lower income countries hold state assets and with the existing lack of commercial expertise and the limited investment opportunities in their domestic markets, it is hard for them to determine an appropriate interest schedule that is both attractive to investors and profitable. Thus, a major incentive for investment has been lacking.

The constraints explained above, some of which are due to the low income nature of these societies while others are due to a combination of low absorptive capacities of local economies, international and domestic demonstration effects and the absence of financial expertise, all contribute to severe shortages in capital formation.

Consequently, the need for external finances, namely foreign aid-to fill the gap between required investment and available internal savings becomes an inescapable reality.

Foreign Aid and Development[1]

The most important issue to be critically analysed in the process of transfer of capital to developing countries is its historic contribution to development. «If financial development aid is to achieve its end,» writes Gaston Leduc of the University of Paris, «it should normally lead to a quantitative increase of investment in the recipient country and hence raise the rate of increase of the aggregate national product» (Leduc 1966). Excessive time and effort should not be wasted on examining reasons for which aid is given. It is more productive to understand the relationship between aid inflow into a country and the degree of its development. Studies of this relationship have used different variables as a measure of development (dependent variable). Changes in the rate of domestic savings were tested against capital inflow, either over time or across countries, and conclusions were made as to whether foreign aid effected change in internal savings in either direction. Results of some of the studies are summarized in Table 1.

Changes in standard of living, as measured by the changes in per capita income were also tested against foreign aid inflow, the point being that knowing the association between foreign aid inflow and some development index or indices will either justify or disapprove major efforts that are taken to secure external capital.

In the following sections I will discuss the arguments for and against foreign aid based, in some cases, on its observed association with internal savings and, in other cases, on its political and distributional ramifications.

Results of studies

Most of the studies put internal savings rates as the response variable and postulated its changes to be a function of a numer of variables one of which is foreign aid or total capital inflow.[2] Some of the results are summarized below.

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[1] The section draws heavily from Abdirahman Dualeh Beileh (1984, pp. 43-50).

[2] Major studies that have been done in this area include: Anisur Rahman (1967); Griffin and Enos (1970); Griffin (1970); Weisskopf (1972).

Table 1 - *The Effect of Resource inflows on Savings or Investment*

Author	Number of observations	Time series or cross section	Savings or Investment	Effect
Griffin & Enos	32	C	S	—0.73
A. Rahman	31	C	S	—0.25
Areskoug	22	T	I	—0.40
Weisskopf	38	T	S	—0.23
Chenery	16	T	S	0.64 to —1.15
Chenery	90	C	S	—0.49
Chenery	90	C	I	—0.11

Source: Refer to Leduc 1966 and also Chenery and Strout 1976.

Some of these studies looked at the changes in savings rates or investment rates of selected countries overtime, while others studied changes on a comparative basis across countries. The «effect» column indicates the marginal propensity to save or investment out of each additional dollar received as an external capital. For example, Weisskopf's study finds the following relationship:

$$S = a + \underset{(t=65.9)}{0.1834Y} - \underset{(t=5.3)}{0.227F} + \underset{(t=4.6)}{0.176E}$$

Where Y = Gross domestic Product
F = Net Foreign Capital inflow (not only foreign aid)
S = Gross saving
E = Total Exports
a = Intercept, and varies among countries

The model postulates that changes in the gross savings levels in each country are explained by changes in their respective gross domestic products, net foreign capital inflows into each country and the magnitude of their export levels. It is quite evident from the t-values that all three variables are significantly associated with savings and about 90 percent of total variations of savings on the average is accounted for by three variables.[3] However, it can be seen that the foreign capital inflow variable shows a negative association with gross savings; for every one dollar of foreign capital inflow, the gross savings decline by about 23 cents. Other studies also showed negative association, and that is the basis for a widely held hypothesis that foreign capital inflow actually delays economic progress. Reasons for this inverse relationship are cast as follows:

1) That foreign capital may go to the protection of infant industries by giving them easy credits made possible by the availability of foreign capital. Such soft credit reduces incentives of local investors to save.

2) In cases of private capital inflow, foreign investors may take up the few investment opportunities in the local market, leaving the local entrepreneur with no incentive to save.

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[3] For the actual study, see Weisskopf (ibid.).

3) Foreign capital inflow stimulates international and domestic demonstration effect, increases the craving for consumption of imported goods made available by foreign capital and, therefore, indirectly decreases savings.

4) Massive politically oriented aid inflow helps governments in developing countries to cover up the negative ramifications of their activities.[4] A good example is the overthrow of President Jaafar Nemeri in the Sudan. The sixty-seven million dollar aid package signed with the United States to bail him out was just a few days too late.

5) The bulk of foreign assistance may be poured into gigantic, and wasteful projects that are promulgated for political reasons. It may be used to finance balance of payments deficits that are sometimes created as means to receive more aid from the developed world.

6) Expectation of more aid discourages governments in developing countries to structure internal programs, however painful, that are designed to increase domestic savings. A good example can be drawn out from the first-five year development plan of Somalia, 1963-1967, where planners wrote:

> «A substantial amount of aid is expected from the European common market which is providing U.S. 500 million as assistance to the associate member countries of the common market. The Somali Republic should be entitled to a substantial share out of this amount...» (Ministry of Planning 1963).

There is no doubt that Somalia needed and continues to need external help in formulating and financing her development programs. It is due to that evident need that about 80 percent of development financing come from external sources in the 1963-1986. Nevertheless, the kind or argument presented by the planners displays a dangerously injudicious approach to development and only serves to perpetuate economic dependence on external sources.

Foreign capital, especially foreign aid, creates a tendency among the policy makers of developing countries to shy away from taking some painful but constructive steps to mobilize internal sources of revenues. Relevant to this problem is the strong argument that, some governments in developing countries take foreign aid as if it were a gift and hence exacerbate the economic problems of subsequent years, not to mention overtaxing future generations. In a debate on Africa, held at the University of Wisconsin, in the spring of 1985 an ambassador of a developing country to United States and former minister of trade said, in answering a question about the problems of debt, «We keep on overeating, we get sick, and we see the doctor, IMF, for treatment». «Why do you continue overeating?» he was asked. «Because there is plenty of cheap food around», he answered. Peter Bauer persuasively shows that aid perpetuates economically damaging ideas and attitudes in developing countries: «Opportunities and resources for advance of oneself and one's family must come from someone else — the state, the rulers, one's superiors, richer people or foreigners. In this sense, aid pauperises those it purports to assist».

This line of argument is supported by other scholars such as Simon Kuznets who questions the importance of capital. He makes the point that the contribution of capital to the rise in the per capita income in the advanced countries during

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[4] For more reasons, see Bauer (1974).

the post World War II period was fairly small or less than 14 percent. The rest of the increase was due to multiplication in productivity per man/hour and not an increase in capital input per person (Kuznets 1964: 41). Peter T. Bauer makes the strongest assertion against foreign aid by writing that,

> «I shall argue here that foreign aid is plainly not indispensible to economic progress, and indeed likely to obstruct it. Foreign aid increase the resources of the recipient governments and countries, that is, it makes possibile additional consumption and investment. But it does not follow that aid increases the rate of development». (Bauer 1976:95).

Others, however, hold the idea that foreign aid is essential for economic progress, and without it, economic development will be seriously delayed. Professor Gustav Papanek makes an important point when he notes that, in the aid process, assistance is sought by developing countries when their economies are in serious trouble, that is when internal saving is low, therefore, the negative association may be coming from this reverse phenomenon (Papanek 1972). This argument, however, can only be taken as persuasive if foreign assistance were used solely for economic development. As discussed, above, other purposes for aid may be more formidable than economic progress. It is important to note that even those who found the negative association in their studies think aid is not unimportant. Some of them, in fact, recommend it.

Concluding Remarks

It is common knowledge that increased and sustained production is the key to development. The debate on the importance of capital to development is based on traditional models of economic growth that overemphasize capital as the most important input of production. Capital is only as important as the other economic inputs as labor, entrepreneurship and technology. Perhaps the most important economic inputs are what may be called the «thinking» elements — namely, labor, entrepreneurial skills, and the general desire of the public to develop.

The importance of capital in the transitional period to augment internal savings and cover imported inputs of the economy cannot be over-emphasized, but there should be no illusion about the fact that an ultimate and sustained economic development is dependent on people's ability and desire to better themselves and on their social organizations, leaders, and political institutions. Without a positive presence and performance of these latter factors, a world of capital to any country will not make a bit of difference. This datum must be taken seriously by both donors and recipients.

These characteristics are crucial to the extent that the supply of capital and other resources can be thought of as the result or outcome of the people and their social arrangements. Most of the failures of foreign economic assistance, therefore, could be accounted for by fallibilities in these intrinsic factors. This is not, at all, to imply that capital as an economic input is not important. It is quite unlikely that any typical Asian or African country could meet all the overwhelming requirements of skill formation, institution building, investment allocation, etc., without external capital flow from the more developed countries. In the initial stages of development external capital is an extremely crucial input.

Chenery and Strout make an illustrative note to this effect, that «the substantial increases in internal savings that have been achieved in a decade of strong growth — from 7 percent to 12 percent in the Philippines, 11 percent to 16 percent in Taiwan, 6 percent to 14 percent in Greece and 9 percent to 12 percent in Israel — demonstrate the speed of aid sustained growth once rapid development has taken hold» (Chenery and Strout 1976). These and other countries, such as South Korea, clearly show the importance of foreign economic assistance for sustained capital formation if it is used appropriately. Hong Kong, for example, was a desolate rock before the turn of the century and it has since turned into a world center of manufacturing and exports goods in a heavy scale. This is where human faculties and resources, as an important economic input, make a crucial difference.

I would like to argue that misuse of the foreign aid accounts for a major part of the negative association found between its inflow and economic development, a misuse which is not due to foreign aid being consumed as many people maintain, but is due to some important factors missing, such as local managerial skills, entrepreneurship and efficient local development institutions. It is high time that these factors are taken seriously into consideration.

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