Foreign Aid: Its Significance as a Source of Capital Formation in Sri Lanka

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Abstract

Capital formation is a key requirement for economic growth and development in a country. Domestic savings primarily contribute to increase capital formation and there by determine economic growth. However, domestic savings in most developing countries including Sri Lanka have been inadequate to meet the capital needs due to the investment-savings and import-export gaps in these countries. Foreign aid has become as an important source of bridging these two gaps and to achieve their targeted growth rate. The objective of this study is to analyze the need of foreign aid as a source of capital formation and assess its significance for economic growth in Sri Lanka. The study mainly depends on secondary data of Central bank of Sri Lanka and the World Bank as well as other related literature. Foreign aid creates both positive and negative effects on developing countries and therefore, it is a vital need to find ways and means to obtain maximum benefits from available foreign aid and to speed up the initial administrative procedure for the utilization of foreign aid in a sustainable manner.

Key words: Foreign Aid, Capital Formation, Investment-Savings and Import-Export gaps, Extensionist and Non-Extensionist school of thought, Absorptive capacity.

Introduction

Capital formation is a key requirement for economic growth and development in a country. Generally it is accepted that capital accumulation can help raise per capita income and living standards in an economy by allowing a proper use of underutilized labour and natural resources to generate increased production of goods and services. Domestic savings contribute primarily to capital formation. Evidently, in most developing countries including Sri Lanka, domestic savings have been inadequate to help promote capital formation to achieve the expected growth rates. Foreign Aid as the

transfer of resources from developed countries to developing countries, either through bilateral donors or multilateral donors has become an important source of external financing to fulfil their capital requirements since the world war 11. Many countries in the world accept foreign assistance and get different benefits along with a few adverse results and the implication of foreign assistance has made it a debatable issue. The objective of this study is to analyze the need of foreign aid to supplement capital formation and assess its significance for economic growth and development in developing countries giving special reference to Sri Lanka. The study mainly depends on secondary data of Central bank of Sri Lanka and the World Bank as well as other relevant literature.

The paper is divided into number of sections. Section 2 presents the theoretical aspect of capital formation in relation to capital needs and foreign aid. The definition for foreign aid is given in section 3 while Section 4 explains the two-gap approach in relation to foreign aid in developing countries. Section 5 analyses the requirement of foreign aid in Sri Lanka and its impact on the economy. It considers the critical views of foreign aid regarding the economic growth in developing countries in section 6 and finally concluding part of this study is in section 7.

Foreign aid and capital formation

Physical capital as a key factor of economic growth, is regarded as one that necessitates increased investment and thereby the volume of capital. This is further ascertained in the modern growth theory starting with the Harrod-Domar model: Domar, 1946, 1947 and Harrod, 1939 (Hossain and Chowdhury, 1998: 81). It shows that the rate of economic growth (g_y) in the steady state equals the productivity of capital (σ) multiplied by the rate of savings or investment (s) such that:

$$g_y=\sigma s \quad (1)$$

If the productivity of capital is considered fixed, economic growth is found to be directly linked with the rate of saving which leads to increase in investment and economic growth.

Accordingly, all empirical studies of inter-country differences in growth rates suggest that high growth is determined by high investment rates. Investment today as much as in the past remains crucial to growth.

However, developing countries are not in a position to generate adequate investment funds from domestic sources. Therefore, capital accumulation from foreign sources: comprising both official development assistance and private capital flows remains an important means of economic growth. This implies that in most developing countries with superior investment performance, foreign savings play a complementary role in the provision of financial resources for economic growth and development especially in an open economy with perfect capital mobility.

In this context, the basic Harrod–Domar model can also be extended for an open economy. Foreign capital inflows as a proportion of aggregate output can be denoted by k^f, and then the Harrod-Domar model can be written as follows.

$$g_{y=\sigma}(k^f+s) \quad (2)$$

Through such an extension of the Harrod-Domar model, it is possible to formalize the rate of foreign capital in economic growth in developing countries (Hossain and Chowdhury, 1998).

Foreign aid: Definition

Foreign aid is broadly defined as the international transfer of funds in the form of loans and grants. Loans should be repaid with interest rates and other charges while grants are considered as outright transfers of funds without any obligations to repay.

Foreign aid has been given different meanings by different schools of thought with respect to its structure, its factors such as interest rate determination, repayment and other modalities.

According to Saeed (1995) foreign aid can be defined as a loan that is given by a country to another country on the concessional rates. These concessional elements are:

a. Rates of interest lower than the prevailing rates of interest in the international commercial money market.
b. Longer period for repayment.
c. Grant, which does not entail the payment of the principal or interest i.e. a free gift.

Accordingly, foreign aid should meet two criteria.

1. The objective should be non-commercial from the point of view of the donor.
2. It should be characterized by concessional terms in respect of interest rate and repayment period of borrowed capital; and these terms should be softer than commercial terms.

It is the flow of resources and technical assistance to developing nations directly from the government of developed countries or from international organizations such as World Bank. Loans are given in different ways. They are classified as concessional and non-concessional loans and also project loans and non-project loans. Concessional loans are given for a long term or short term, but after the concessional period is over they should be repaid along with the interest rate. Non-concessional loans can be divided into project loans and non-project loans. Project loans are given for a certain kind of project and therefore, those loans cannot be used according to the consent of aid receiving country. Sometimes, they have to buy machinery, intermediate goods, technology and management expertise for the project from only the countries that supply loans. Therefore, aid-receiving countries have to pay such an indirect cost other than the direct cost such as interest rate. Non-project loans have no such obligations, and they can be used for any kind of development purposes, but they are given to limited extent.
As far as grants are concerned, it is a free gift from one government to another or from an institution to a government. It is given on a

humanitarian basis, especially in terms of emergencies, droughts, floods, wars or other special purposes. With respect to grants, aid donors do not expect any kind of benefits from aid receiving countries. However, they are known as tied and un-tied aid. If it is a tied aid, it is necessary to have the donor's approval for spending such grants. But un-tied aid is free from such obligations and can be used for any kind of development project or a welfare activity.

There is no unique source of foreign aid. It may be from a single country or from a group of countries. On the basis of the kind of donor it may be divided foreign aid in two types.

1. Bilateral Aid
   Aid that is given from the government of one donor country to a recipient country is called bilateral aid. It is basically a one to one relationship of two states. It depends upon the political and economic relationship of the two countries coupled with the willingness of the donor country.
2. Multilateral Aid
   Multilateral aid is given by certain international financial institutions, agencies or organizations to the government of developing countries. It is given in order to raise the pace of economic development in recipient countries.

Two-gap approach and Foreign aid

Hollis Chennery and his associates (Chenery and Bruno, 1962; Chenery and Strout, 1966; Chenery and MacEwan, 1966; Chenery and Eckstein, 1970) have developed a firm basis of foreign aid in the form of Two Gap Model. The idea is that the investment-savings gap and export-import gap or foreign exchange gap are two separate and independent constraints on the attainment of a target rate of growth in developing countries. Chenery explained foreign aid as a way of filling these two gaps in order to achieve the targeted growth rate of an economy. These two gaps can be explained as follows.

1. Investment-Savings Gap

A saving gap increases when the domestic savings rate is less than the investment required to achieve the targeted rate of growth. For example, if the targeted growth rate of national real income is 6 % per

annum and the capital output ratio is 4:1 then, economy must save 24 % of its national income to achieve this targeted growth rate. If only 14 % of savings can be mobilized domestically, the savings gap is 10 % of national income. The country can achieve the target growth rate by filling this savings gap with foreign aid.

In terms of the saving- investment gap, foreign capital needs (Fk) can be expressed as

$$Fk = Ir - Sd \quad (3)$$

Where,

Ir is total investment required to achieve the output target and Sd is potential domestic savings. Most studies on foreign capital needs have focused on estimating the need for foreign capital to achieve a target growth rate.

2. Foreign Exchange Gap

Similarly, a fixed relationship is postulated between targeted foreign exchange requirements and net export earnings. If net export earnings fall short of foreign exchange requirements, a foreign exchange gap appears which can be filled by foreign aid.

It simply can be expressed as follows.

$$Fk = Mr - X \quad (4)$$

Where, Fk stands for foreign capital needs and Mr and X stand for total import requirements and potential export earnings respectively. This formulation postulates a required relationship of imports to output and exogenously determined level of exports.

In national income accounting, an excess of investment over domestic savings is equivalent to a surplus of imports over exports. The national income equation can be written from the expenditure side as

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Income= Consumption + Investment +Export –Imports

Since saving is equal to income minus consumption (S =Y-C), we have,

Saving = Investment + Export - Imports

or

Investment – Saving = Export – Imports

A surplus of imports over exports financed by foreign borrowing allows a country to expend more than it produces or to invest more than it saves. In accounting terms, the foreign resources are required to supplement domestic savings is the same whether the need is just for more resources for capital formation or for imports as well. The identity between the two gaps: the investment-savings (I-S) gap and the import-export (M-X) gap follow from the nature of the accounting procedures. It is a matter of arithmetic that if country invests more than it saves, a balance of payments deficit will result. In other words, an excess of imports over exports necessarily implies an excess of resources used by an economy over resources supplied by it or an excess of investment over savings. This is the starting point of two-gap analysis (Thirlwall, 1983:290).

Accordingly, this approach emphasizes the dependence of capital accumulation and economic growth in developing countries on foreign capital through two channels. The first involves resources needed for investment. External capital flows allow developing countries to invest more than they can save, thereby closing their saving-investment gap.

The second gap relates to foreign exchange availability and arises because of the dependence of investment and growth in developing countries, on imported consumer goods, intermediate goods and capital goods. Even if domestic savings are sufficient to finance all the investment needed, a developing country would still be unable to undertake the investment if it does not earn enough foreign exchange to pay for the imports required. Investment would thus be constrained by the lack of adequate foreign exchange rather than domestic

savings. Consequently, production capacity would be underutilized, income and savings would be reduced and growth would be below potential. Foreign capital inflows can fill this foreign-exchange gap allowing imports, investment, income and savings to be raised above the levels otherwise constrained by export earrings.

Chennery and Strout (1966) justify existence of two gaps, foreign aid and their gradual development leading to higher growth rate in four stages.

1. Foreign aid both loans and grants can play a critical role in supplementing domestic resources in order to relieve investment-savings and import-export gaps.
2. Foreign aid can make possible advances to accelerate growth making considerable structural changes in developing countries. It is assumed to be facilitated and accelerated the process of development by generating additional domestic savings.
3. External resources in the form of foreign aid contribute to mobilize and allocate all productive resources. In this sense three types of resources have been distinguished, they are: 1. The supplement of domestic savings to fill the gap between domestic savings and investment required for a reasonable level of growth. 2. The supply of skills, managerial and organizational ability and 3. The supply of imported commodities and services required for filling the gap of exports and imports.
4. In the long-run, developing countries can obtain a substantial economic growth with the help of foreign aid and therefore, the future investment requirements could be supplied by domestic savings. In this stage, there will be a situation in the economy when $I < S$ and $M < X$ and the country will be in a position to repay debt aid and loans.

Foreign Aid in the Case of Sri Lanka

Although economic growth and development are the prime objectives of Sri Lanka, one of the main obstacles to achieving the growth and development prospects is lack of savings to meet the basic capital requirements. This is often explained in terms of what is popularly known as the vicious circle of underdevelopment or poverty. The

basic idea is that Sri Lanka with low rates of savings and investment grow slowly which in turn keeps the rates of saving and investment low. It implies that domestic sources of capital formation in Sri Lanka are not sufficient to reach the targeted rate of economic growth. As a result, there is no alternative to placing much emphasis on foreign sources.

As mentioned above classical economists were of the view that prior savings are the determinant of investment. This is the basis of the traditional policy recommendation that in order to increase the pace of economic growth, savings need to be increased to spur capital formation. However, the question is how to accumulate the domestic savings to meet the development targets of the country.

The level of domestic savings in Sri Lanka from various sources indicates that, savings are inadequate to meet the financial requirements in the economy. In other words, there is a gap between investment and savings, which is termed as investment-savings gap. Domestic savings, which include private savings and government savings and institutional savings are not in a sufficient level for variety of reasons.

Private savings have been in a low level as a result of low per capita income, subsistence life style of the people, high consumption pattern and other social activities of their day to day life. Besides, the smallness of the upper middle class which has better saving capacity, less developed capital markets, poor organization of saving institutions and high consumption pattern among the affluent classes with its demonstration effect on others who have the capacity to save. In addition, other factors influencing the saving habits such as social customs that necessitates spending on social occasions of the family and friends, also act as constraints on purposeful personal savings. Various impediments in the financial sector also have had a detrimental effect on both private savings and investment in Sri Lanka.

Government savings, which is defined as the current account surplus of the government budget, is also not at a satisfactory level. For

decades, the government budget has been in deficit as the government expenditure exceeded its revenue thereby increasing the budget deficit year by year. Therefore, government dis-savings further added to the reduction in available resources from domestic sources for investment. In the government sector, the current expenditure has always exceeded its revenue resulting in current account deficit or making dis-savings. The government savings were limited as a result of increasing trend of currant expenditure on social and welfare expenses, interest payments, salaries and wages, pension payments, transfers and subsidies to private and government sector and other expenditure on defense, and also the capital expenditure on public investment programmes. In this situation, heavy government borrowings from the financial market to finance the budget deficit have preempted resources available to the private sector too.

At the same time there was a decreasing trend of government revenue as a result of shortfalls in revenue collection especially in tax revenue and non-tax revenue of the government fiscal operations. The tax revenue which was 14.0 per cent as a per cent of GDP in 2002 declined to 13.0 per cent in 2009 (Central Bank of Sri Lanka, 2009). Non tax revenue declined from 2.5 per cent to 1.7 per cent during the same period of time. At the same time, the Value Added Tax (VAT) introduced by unifying Goods and Services Tax (GST) and National Security Levy (NSL), has become the main revenue source and is expected to generate revenue close to one half of tax receipts. A series of measures were introduced in 2003 to expand the VAT base and improve the net collection. However, the combined collection from GST, VAT and NSL of 6 per cent of GDP in 2002 fell to 3.6 per cent in 2009 under a unified VAT collection. Hence, the decline in government tax revenue is partly attributed to the operation of multiple VAT rates, administrative weaknesses in the tax collection mechanism and also in the tax refund mechanism (Central Bank of Sri Lanka, 2003, 2009). In addition, the rapid expansion in tax incentives, infrastructure subsidies, import duty exceptions and other measures adopted to attract FDI resulted in declining the government revenue to a certain extent.

An increase in expenditure entirely on account of current expenditure over the total revenue resulted in the deficit of the current account of the budget. As a result, overall budget deficit of Sri Lanka was 8.0 per cent as a per cent of GDP during the period of 1999-2009. Likewise continued government dis-savings reflected in the rising current account deficit was the other contributory factor for the declining of domestic savings.

At the same time, Sri Lanka had experienced an unfavorable balance of payments position for a long period of time. It is required to import more to meet the growing necessities of development, but export earnings are not sufficient to meet the increasing domestic needs. This is the so-called foreign exchange or import-export gap, which was around US$ 2680 during the last 10 year period from 2000-2009 (Central Bank of Sri Lanka, 2009). However, Sri Lanka wants to import capital goods, technical-know-how, intermediate goods and raw materials to accelerate her economic growth. One method of paying for such imports is through increasing her exports. The exports can be increased either by producing more export goods or curtailing domestic consumption. But, as a developing country, Sri Lanka has only limited productive capacity and therefore, it is not possible to increase exports substantially particularly in the short term. Curtailment of consumption, on the other hand involves a lot of sacrifice and it cannot be adopted with much success in a democratic country like Sri Lanka.

Within this background, if Sri Lanka depends on her own resources it will have to sacrifice not only her consumption but also wait for a considerably long period of time to enjoy the fruits of development. Therefore, alternative sources that are foreign capital or external financing has become essential in one form or other to overcome this problem and to accelerate the pace of economic growth. The average investment ratio and average savings ratio in Sri Lanka for the period of 1999-2009 has been around 25.3 percent and 16.3 per cent of GDP respectively. Accordingly, it resulted in keeping the investment-savings gap at 9.0 per cent in the last ten years (Central Bank of Sri Lanka, 2003, 2007 and 2009).

During the past 10 years the average growth rate in Sri Lanka is 4.5 per cent and this is far below the expected growth rate of 8 or 10 per cent level. The inadequacy of capital formation due to the low level of domestic savings has been a major reason for the low rate of economic growth in Sri Lanka. As mentioned above, this was due to both continuation of dis-savings habit by the public sector and relatively low savings habit in the private sector. The institutional sector also could not perform too well in the context of the economic set back in recent years and as a result, its savings have been stagnant.

Experience shows that it had not been possible to reach expected growth rate for a long time. Measures are therefore necessary to raise private savings as well as government savings to raise the domestic savings to GDP ratio to inadequate level to cover the high investment required to achieve the desirable growth rate over 8 per cent. Given this low level of savings there is no question that Sri Lanka has to increase its investment rate particularly by tapping external finance with grants and loans (**Table 1**).

Table 1
Net Receipts of Foreign Aid in Sri Lanka: 1988-2009

Year	Loans Rs. Mn.	Grants Rs Mn.	Total Rs. Mn	Foreign Aid as a% of GDP
1988-1991	11880	6890.5	18770.5	7.0
1992-1998	13585	7694	21564.7	3.6
1999	8604	6761	15365	1.5
2000	10070	5145	12215	1.4
2001	19396	5500	24896	2.0
2002	10113	7079	17192	1.2

2003	53213	7956	61169	3.4
2004	45256	8681	53937	2.6
2005	53820	32640	86460	3.5
2006	48887	30068	78955	2.7
2007	129633	30508	160141	4.5
2008	8019	31222	39241	0.9
2009	110585	25922	136507	2.8

Source: Central Bank of Sri Lanka, 2009.

With the establishment of Aid Consortium, which is known as the Aid Group in 1965, Sri Lanka has been able to obtain substantial foreign aid to relieve the unfavourable situation in the internal and external shocks in the economy. Foreign aid flows to Sri Lanka reached its peak in the 1990s, but since then fluctuations are evident in the foreign aid flows as a percent of GDP. According to **Table 1**, foreign aid flows decreased from 7.0 per cent during the period from 1988-1991 to 3.6 per cent in the period of 1992-1998 and it further dropped to 1.2 per cent in 2002. After that, foreign aid as a per cent of GDP increased to 4.5 per cent in 2007 because of aid flows to road development, education, power, water supply and irrigation, Small Medium Enterprise (SME) development, airport and port developments and rehabilitation of tsunami and conflict affected infrastructure projects. However, foreign inflows consisting of both loans and grants decreased to nearly 1 per cent of GDP in 2008, mainly due to the global financial crisis. After that there is an increase from 1 percent to 2.8 per cent in 2009.

Meanwhile, the eligibility criteria for giving foreign aid to developing countries by multinational and bilateral donors have changed significantly. For example, Asian Development Bank's eligibility criteria are based on factors such as per capita income and debt servicing capacity. According to these criteria, countries are classified into different categories. In the year 2000, Sri Lanka graduated from category A (countries with the greatest need for aid) to category B1. This has mentioned that lending by the ADB to Sri Lanka is no longer only concessional aid but a combination of concessional and non-concessional loans.

The World Bank has also introduced its graduation policy for lending to developing countries. Accordingly, a country that reaches to per capita income of US$ 925 (at 1997 prices) will no longer be eligible for only International Development Assistance but will have to maintain IBRD (International Bank for Reconstruction and Development) assistance that comes more stringent terms and conditions. The per capita income in Sri Lanka increased from US$ 274 in 1980 to US$ 1617 in 2007. In the year 2008 per capita income rose to US$ 2014.Therefore, bilateral and multilateral donors have forced to curtail concessional loans and to impose stringent terms and conditions in supplying foreign aid to Sri Lanka. And also aid receiving countries have to depend not only on certain performance measures such as aid utilization, sustainability of the projects, but also on the performance of the reform process in the country. These factors also have contributed to the significant declining in foreign aid flows to Sri Lanka and created a significant strain on the balance of payment.

Table 2

External Debt and Debt Service Payments in Sri Lanka: 1978-2009

Years	Total External Debt (US$ millions)	Total External Debt as % of GDP	Debt Service Payment as a % of Exports *
1978-1990	3258	56.0	19.9
1991	6489	72.1	18.5
1992	6832	70.4	17.1
1993	7602	73.4	13.8
1994	8298	70.8	13.7
1995	8694	66.7	16.5
1996	8486	61.1	15.3

1997	8197	54.3	13.3
1998	8749	55.5	13.3
1999	9088	57.8	15.2
2000	9031	54.5	14.7
2001	8373	53.2	13.2
2002	9333	56.3	13.2
2003	10735.0	56.9	11.6
2004	11346.0	54.9	11.6.
2005	11354.0	46.5	7.9
2006	11981.4	42.4	12.7
2007	13989.5	43.2	13.1
2008	15106.6	37.1	15.1
2009	18662.1	44.5	19.0

*As a percentage of earnings from merchandise exports and services
Source: Central Bank of Sri Lanka, Annual Report, 2009

Raising funds through loans however, increased the country's debt service burden (**Table 2**). Sri Lanka's average debt outstanding from 1978-1990 was US$ 3258 million, but there was a marked increase during the subsequent period from US$ 6489 million in 1991 when it shot up to US$ 18662 million in 2009. However, foreign loans had to be repaid with amortization and interest rates covering the debt service payments.

The total debt outstanding of Sri Lanka in 1980s averaged to 56 per cent of GDP while average debt service payment as a percentage of export earnings was recorded as 20 per cent. At the beginning of 1990s, there was an increasing trend of total debt outstanding in Sri Lanka. In 1993 the total external debt outstanding was nearly 73 per cent of GDP. But it has reduced to 37 per cent in 2008 and then increased to 44.5 percent in 2009. However, it was a result of cutting back of foreign loans to Sri Lanka due to the foreign debt problem as well as the rigid conditions of supplying loans to developing countries. At the same time, debt service ratio as a percentage of exports has reduced from 20 per cent in 1980s to 8 percent in 2005, but there is a little increment thereafter. This decreasing trend of total debt service ratio was the result of taking a large amount of loans at highly concessional rates.

There are some other reasons for this changing pattern of external debt and debt service ratio. First, the worldwide availability of funds for Official Development Assistance (ODA) has been shrinking over time. Budgetary allocations in industrial countries for giving foreign aid to developing countries have been reduced owing to fiscal consolidation efforts of their governments. Second, with the end of the cold war, the political and strategic significance of providing official foreign assistance has been diminished. Third, the collapse of the Soviet Union has also stopped the foreign aid flows to the former communists block countries. According to this new environment, foreign aid flows to developing countries have been declining globally since 1990s.

Critical Views on Foreign Aid

There are two schools of thought on the role of foreign assistance. They are:

1. Extensionist Schools of Thought
2. Non- Extensionist Schools of Thought
   (Hussain Shash etal., 2005).

1. Extensionist Schools of Thought

According to Extensionist Schools of Thought, foreign aid is more effective when it acts as a catalyst to greater domestic development effort by overcoming bottlenecks. It permits the recipient developing countries to invest more than it is able to save domestically and import more than it can finance through its exports. There is no argument that foreign aid is essential for capital formation and to break the vicious circle of poverty. Foreign aid, besides transferring physical and financial capital to developing countries, also brings in the technical know-how, highly qualified persons with administrative experience and advanced techniques of production. It provides opportunities for local labour to be trained in new skills. Thus foreign aid helps to accelerate the rate of economic growth in the aid recipient country.

Besides, foreign aid helps to build overhead capital and basic infrastructure like railways, highways, roads canals, power stations in developing countries. Overhead capital requires huge amounts of investment and these projects have long gestation period that is they take a long period of time to bear fruit or generate income. Therefore, a developing country like Sri Lanka cannot easily provide required huge financial resources for building such capital through domestic sources. Such overhead capital can be built through foreign aid and foundation can be laid for economic growth in a country.

In addition, foreign aid can play a key role in the industrialization process in developing countries. A country like Sri Lanka cannot establish basic heavy key industries from its own resources because these industries require large amount of physical capital, human capital and also a large amount of financial resources. With the establishment of heavy industries, the external economies emerge and the cost of production of other industries decline leading to industrialization in the country. The private sector investors in developing countries are reluctant to invest on such industries because they are risky ventures. With the help of foreign aid such risky businesses can be established.

Foreign aid also increases employment opportunities in developing countries by building overhead capital, establishing new industries, by utilizing idle natural resources and by opening up new areas for development. As a result, surplus labour from rural areas moves into these areas and thus it helps to reduce both open and under employment problem in developing countries.

There are some empirical studies that foreign aid can play a positive role on economic growth and development. Dhakal etal. (1996) conducted a causality test between foreign aid and economic growth for four Asian and four African countries and found that the exception of Kenya and Nepal foreign aid was positively and significantly related to economic growth. Burnside and Dollar (2000) found that in poor countries with sound economic policies, foreign aid accelerates economic growth. They further suggested that the outcome depends on whether aid is used to finance capital investment or consumption expenditure. To the extent that aid is invested, it will be effective; to the extent that it is consumed, it will be ineffective. Some developing countries that received substantial foreign assistance such as Greece, Pakistan, Malaysia, South Korea Taiwan and Israel have benefited from foreign aid (Chenery and his associates, 1962; 1966; 1970). Cassen (1986) has done such an empirical study to find out the contribution of foreign aid to economic growth in developing countries. Accordingly, raising food production in South Asia, contributing to experimental rural education in Africa, increasing infrastructure investment to rural development schemes, supporting for population programmes in developing countries, foreign aid played a positive role in accelerating economic growth and development.

2. Non- Extensionist Schools of Thought

Non-Extensionist School of Thought mainly expresses views against foreign assistance due to its negative relationship with growth. Initially, foreign aid in developing countries was given in terms of official grants and concessional loans. However, with the increasing debt problem in 1980s, the official capital both bilateral and multilateral aid began to shrink. As a result, developing countries were forced to borrow in the international markets at high interest rate, which carried high risk. For developing countries as a whole, the debt service burden (repayment of principal and the interest) and the stock of external debt has increased considerably. Therefore, in recent years, a good deal of concern has been expressed over the amount of borrowing and the future strain on the balance of payment in the form of debt service repayments. It is evident that foreign loans and aid help in overcoming immediate economic difficulties in the savings-investment and export-import gaps in developing countries. But foreign debt and debt servicing situation in these countries indicates that foreign aid has incurred indiscriminately for their development purposes by exacerbating balance of payment deficit as a result of rising debt repayment obligations. Therefore, there is a doubt that whether a developing country will have an opportunity to

be a net creditor country in the long-run as mentioned by Thirlwall (1983). On this ground, foreign aid has become as an important international economic issue in the context of international debt and debt servicing problem. This situation could be worse when aid giving countries as well as other organizations impose stringent terms and conditions in connection with the utilization of foreign aid in developing countries.

At the same time, developing countries have to adopt their political, economic and financial structure according to the recommendation of aid donors. They through conditionally can influence economic policies in developing countries. Although the most developing countries try to maintain their policy autonomy, there is overwhelming evidence that structural adjustment measures that many developing countries have undertaken since the early 1980s have been largely under pressure from aid donors including the international financial institutions such as the World Bank and the International Monetary Fund. There is another argument that excessive dependence on technical assistance with foreign aid produces adverse effect on local initiatives and the indigenous technology in developing countries.

According to the studies of Griffin and Enos (1970), Rahman (1968), Chenery and Eckstein (1970) and Areskoug (1973) found that foreign aid might not raise productive resources as it lowers domestic savings in both private and public sectors. Bauer and Yamey (1992) argued that foreign aid retards rather than promotes economic growth through various channels including disincentive effects on savings and lowering the efforts of economic development in developing countries. Levy (1988) confirmed that about 40 per cent of foreign aid in developing countries goes in to the consumption expenditure and therefore foreign aid does not increase economic growth in developing countries. Although the savings and investment are the major channels through which foreign aid affects on economic growth, Mosley etal. (1987) in their cross-country study found no evidence to support the idea that foreign aid promotes economic growth. According to statistical investigations made by Griffin and

Enos (1970) for 32 aid recipient countries, 25 per cent of foreign aid results in increasing investment and 75 per cent of foreign aid are spent on consumer goods. In this way, foreign aid does not increase domestic savings as it is used as a substitute for domestic savings. They claimed that a bigger part of foreign aid instead of being used for investment is used for consumption.

Conclusions

There is no doubt that foreign aid has contributed to supplement capital requirements in filling investment-savings and import-export gaps and maintaining economic growth in developing countries. There is no exception to Sri Lanka too. It is generally accepted that foreign aid promotes economic growth in developing countries by transferring not only capital but also modern technology and managerial skills, which are prerequisites for development programs in these countries. Foreign aid also helps to foster infrastructure facilities, which will lead to increase the productivity, structural transformation and the living standard of the people. Although Foreign Assistance Extensionists argue that foreign aid helps to promote growth and structural transformation in many developing countries, Non-Extensionists argue that foreign aid does not promote faster growth but may in fact retard it by substituting for, rather than supplementing domestic savings and investment. Also it exacerbates developing country's balance of payment deficits as a result of rising debt repayment obligations and the linking of aid to donor country exports. However as a capital deficiency country Sri Lanka needs foreign aid to accelerate its development process. In this context, it is evident that the extent of its contribution to economic growth and development will be determined by the country's absorptive capacity that is its ability to use aid funds wisely and productively.

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