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TITLE OF THESIS / TITRE DE LA THÈSE: Canadian Foreign Aid Policy, 1965-1973

UNIVERSITY / UNIVERSITÉ: University of Alberta

DEGREE FOR WHICH THESIS WAS PRESENTED / DEGRÉ POUR LEQUEL CETTE THÈSE FUT PRÉSENTÉE: Master of Arts

YEAR THIS DEGREE CONFERRED / ANNÉE D'OBTENTION DE CE GRADE: 1976

NAME OF SUPERVISOR / NOM DU DIRECTEUR DE THÈSE: G. R. Davy

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THE UNIVERSITY OF ALBERTA  
Canadian Foreign Aid Policy, 1965-1974

by



William P. Donahue

A THESIS

SUBMITTED TO THE FACULTY OF GRADUATE STUDIES AND RESEARCH  
IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE DEGREE  
OF MASTER OF ARTS

DEPARTMENT OF POLITICAL SCIENCE

EDMONTON, ALBERTA

SPRING, 1976

THE UNIVERSITY OF ALBERTA  
FACULTY OF GRADUATE STUDIES AND RESEARCH

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The undersigned certify that they have read, and recommend to the Faculty of Graduate Studies, and Research, for acceptance, a thesis entitled Canadian Foreign Aid Policy, 1965-1974 submitted by William P. Donahue in partial fulfilment of the requirements for the degree of Master of Arts.

\_\_\_\_\_  
Supervisor  
\_\_\_\_\_  
\_\_\_\_\_

Date: April 15, 1976



## Abstract

This thesis is an empirical analysis of Canadian foreign aid policy during the period 1965 to 1974. The study looks at the quantitative and qualitative aspects of aid given by Canada to seventy-six recipient nations.

The measurement and definition of foreign aid precede the actual case study in order to give the reader some conceptual understanding of the subject. The history of Canadian foreign aid is presented to update other academic studies covering the inception of the programme.

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## INTRODUCTION

The failure of world society to provide "a safe and happy life" for all is not caused by any present lack of physical resources. The problem today is not one of absolute physical shortage but of economic and social maldistribution and misuse; mankind's predicament is rooted primarily in economic and social structures and behavior within and between nations.

Barbara Ward  
"The Declaration of Cocoyoc"<sup>1</sup>

A great deal of attention has been paid recently to an integrated approach to international development. The call for a "New International Economic Order" entails a re-evaluation of the economic relationships between rich and poor countries.<sup>2</sup> Developing nations are now demanding international measures which will stabilize their commodity prices, increase processing (value added) for their raw materials, create preferences for their

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<sup>1</sup>Quoted in The New Internationalist, No. 35 (October, 1975), p. 11.

<sup>2</sup>"A Declaration on the Establishment of a New International Economic Order" was achieved by consensus at the Sixth Special Session of the United Nations General Assembly in April, 1974.

2  
manufacturing, reduce non-tariff barriers in developed markets, insure the transfer of appropriate technologies, and include them in international monetary reform.

In the 'fifties and 'sixties, foreign aid played a major role in the economic relationships between developed and developing nations. Many early disciples of foreign aid believed that foreign aid alone could eradicate world poverty and bring about global economic development. When this unrealistic expectation was not realized, reformists began to talk of selective development and "take-off into self-sustaining growth."<sup>3</sup> This reformist view was equally misleading and was "merely a rationalization of donors' hopes to be rid of aid before too long."<sup>4</sup> The presumed failure of aid to provide unrealistic results led to a general disillusionment on the part of donors and recipients alike.

Among illusionists, there was a tendency to jump to the conclusion that aid, or at least the aid of their imaginings, had had its day, and to seek some alternatives, such as massive reorganization of world trade, on which a new illusion could be built.<sup>5</sup>

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<sup>3</sup>W. W. Rostow, ed., The Economics of Take-off into Sustained Growth (London: Macmillan and Co., Ltd., 1963).

<sup>4</sup>Paul Streeten, "A Poor Nation's Guide to Getting Aid," New Society (1 February 1968), p. 154.

<sup>5</sup>John White, The Politics of Foreign Aid (London: The Bodley Head, 1974), p. 15.

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Foreign aid is only one aspect, albeit an important one, in the development process and must be considered in the context of limited objectives over the longer term. The United Nations Conference on Trade and Development recognised that there was no single solution to development when it dropped its call for "trade not aid", and replaced it with "trade as well as aid."<sup>6</sup>

Foreign aid can best be understood by regarding it as a contribution "at the margin" in a developing economy. It is not the purpose of aid to develop an economy but rather to hasten the day when development will be achieved. Aid, like development itself, is necessarily a long-term endeavour. If aid is to contribute at the margin of a developing economy, then it must be targeted at the needs of that economy.

In order to study the role of aid in the development process, it must be distinguishable from other components. Misplaced aggregation in a number of areas has blurred the role of aid in the development process and made analysis unnecessarily difficult. Governments have replaced the word "aid" with more aggregative phrases such as "development assistance" and "official flows of

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<sup>6</sup>Harold Caustin, "Aid," in Dudley Seers and Leonard Joy, eds., Development in a Divided World (Middlesex: Pelican, 1971), p. 317.



resources," which mix grants, loans, trade incentives and direct private investment under the same heading. Terms such as the "Third World" are another form of aggregation and are essentially misleading. Development research and policy has tended to regard all aid recipients equally and thus failed to distinguish significant economic, political and demographic differences among these nations. Only recently have we begun to look at such crude distinctions as the resource poor, the land-locked and the least developed (LLDC's) nations. Thus, in order to understand the role of aid in the development process we must begin to acknowledge the difference between various transfers and also begin to distinguish between recipients.

A growing number of people are opposed to giving foreign aid. The "left" argues that aid is imperialistic or a form of neo-colonialism while the "right" points to lack of objective results.<sup>7</sup> This study does not attempt to provide a rationale for giving aid or to defend the concept but addresses itself to those who believe that foreign aid is a necessary part of the development process. The first two Chapters provide a conceptual analysis of the

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<sup>7</sup>For "left" position see Teresa Hayter, Aid as Imperialism (Middlesex: Penguin, 1971); for "right" view see P. T. Bauer, "Dissent on Foreign Aid" in Gerald M. Meier, ed., Leading Issues in Economic Development: Studies in International Poverty, Second. ed. (Singapore: Oxford University Press, 1971).

concept of aid and its measurement. The final two  
5  
- Chapters present an analysis of the aid policies of the  
Canadian government.

## CHAPTER 1

### THE DEFINITION OF FOREIGN AID

In the past three decades the term "foreign aid" has become an established part of the Canadian vernacular. Indeed, many Canadians hold strong views, either pro or con, regarding Canada's foreign aid programme. When millions of eggs spoil there is public outcry because this food could have been given to the needy around the world. When unemployment rises in Canada, many decry foreign aid asserting that "charity begins at home."

For all its usage there probably exist few terms which are more poorly understood in Canada today than "foreign aid." In part, this study will attempt to clarify the confusion which has arisen as to the meaning of "foreign aid." A great many terms are used as synonyms for aid--development assistance (official and private), resources flows (gross and net), export credits, soft loans, grant-like flows and even trade preferences. In fact, Canadians are subjected to a flood of information regarding Canadian aid. CIDA sends wheat to Bangladesh,

builds a dam in Brazil, or makes a loan to Nigeria to increase chicken production in that country. What, out of all these types of activities, can be seen as foreign aid? Are loans foreign aid in the same manner as gifts? The United States is by far the largest aid donor in the international scene. If one looks at U.S. aid, much of what passes for aid is military assistance, export credits available to any country willing to buy American goods, and U.S. government guarantees to private American firms undertaking commercial enterprise in the Third World. Clearly, this type of aid differs from what the non-expert considers to be foreign aid. What is required then is a working definition upon which there can be some agreement as to what is, and is not, aid.

It is absolutely necessary, therefore, to have some notion of what is and is not aid before one looks at the total flow of resources to examine Canada's performance vis à vis other donors. Delimiting the investigation to official flow, however, is not enough.

Different organizations and different countries include or exclude a variety of items. Thus, the Development Assistance Committee [DAC] of the OECD records "the flow of long-term financial resources to less developed countries and multilateral agencies" and this includes both official flows and private investment, private lending and export credits. Some bodies do not record private capital flows. But it is not merely a question of whether aid should include

flows of private resources, for official flows are very heterogeneous in character; including outright grants, loans on different terms of interest and payment, funds in convertible currencies and funds which are tied to spending in one country and which also may be tied to specific uses. Simple aggregation is therefore almost meaningless and certainly misleading.<sup>1</sup>

Harry Johnson is somewhat less kind when he refers to such reporting as a "rag bag of economically incomparable transactions."<sup>2</sup>

A definition of aid is therefore required so that such statistics can be distilled into meaningful form. For the purposes of this study, aid is: the official unidirectional transfer of real resources from developed nations to developing nations, for the purpose of promoting the economic development of the recipient. Hopefully, this definition delimits that portion of the total flow which can be considered aid while at the same time satisfying the criteria of both expert and non-expert usage.

The use of the word "unidirectional" is meant to point out the fact that there is a negative flow from developing nations to developed nations. Clearly, this is the distinction between a grant and a loan. By

<sup>1</sup>J. M. Healey, The Economics of Aid (Middlesex: Penguin Books Ltd., 1971), p. 1.

<sup>2</sup>H. G. Johnson, Economic Policies Towards Less Developed Nations (Washington: Brookings Institute, 1967), p. 118.

definition, a loan promises future repayment. Not only money flows out of developing nations, but human capital as well. The so-called "brain-drain" in the Third World denotes this reverse flow. As Gerald Helleiner puts it, "large numbers of educated people . . . are 'voting with their feet' to join the developed world."<sup>3</sup> Loans, by definition, imply a reverse flow of resources from the client to the lender. In actuality, one should deduct the brain-drain from the technical assistance programmes of the developing nations in order to arrive at the unrequited transfer which we are calling aid.

An important aspect of the definition just presented is the specification of aid as the transfer of real resources. All too often, there is a tendency to confuse the accounting procedure of aid with the actual aid transfer. In other words, the dollar value of aid is an accounting mechanism used by a donor country to account for the amount of resources involved in the transfer. "It is doubtful whether any government suffers. . . from money illusion" concerning its aid commitments.<sup>4</sup> When Allan MacEachen, the present Secretary of State for External Affairs, announces that Canada's aid budget will be

<sup>3</sup>Gerald Helleiner, "The Development Business: Next Steps," International Journal, XXV (Winter, 1969-70), p. 160.

<sup>4</sup>Johnson, Economic Policies, p. 121.

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\$933 million for the fiscal year 1975-76. He is only using economic shorthand to say that Canada's aid programme will involve that amount of Canadian resources which can be accounted for by that amount of currency. He might as well have said that Canada will devote so many tractors, so many doctors or so many tons of wheat to its aid programme.

When experts from the developing nations themselves talk about financing local costs in developing nations they ~~often discuss the accounting mechanism with the donor~~ transfer. How is it possible for a donor to pay for the recipient's local costs (wages, housing, lumber, etc.) with the donor's currency? Simply by allocating so much more money to a specific project to cover local costs will not work. Workers in the recipient nation cannot eat the donor's currency; they cannot sleep in it; it is in fact worthless to them. The currency only represents the donor's goods and services which do not exist in the recipient nation. The only value that currency has to the recipient is in the form of foreign exchange. The local costs are not covered by this transfer and the recipient will have to devote part of its own resources to cover local costs arising out of that project. This can happen in two ways.

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Statement by the Honourable Allan J. MacEachen, Secretary of State for External Affairs and Minister Responsible for the Canadian International Development Agency to the Standing Committee of the House of Commons on External Affairs and National Defense, April 10, 1975" (Ottawa: CIDA), p. 1.

First, the recipient can allocate part of its own scarce development resources. Second, it can create the assets needed to finance the local content which would then be inflationary. The transfer problem stems directly from the confusion of the currency value of aid and the real value of aid. There is no method by which a donor can directly finance the local content of an aid project with its own currency and/or resources. This transfer problem will be referred to again later in this study and will be considered.

Aid in the form being examined in this study had no significant precedent before the Marshall Plan because it has come to denote some form of direct benefit to the recipient. One would be hard put to defend military assistance as a form of foreign aid. In effect, foreign aid (since the Marshall Plan) has come to mean economic assistance for the economic benefit of the recipient.

In the history of diplomacy, subsidies and tributes have been common, and war among allies was already given by Britain in the eighteenth century and the Napoleonic wars, but peacetime economic aid among governments is novel.<sup>6</sup>

Milton Friedman<sup>7</sup> attempts to defend military

<sup>6</sup>Gorin Ohlin, Foreign Aid Policies Reconsidered (Paris: Development Research Centre, O.E.C.D., 1956), p. 9.

<sup>7</sup>Milton Friedman, "Foreign Economic Aid: Means and Objectives," in Foreign Aid: Selected Readings, ed. by Jagdish Bhagwati and Richard Eckstein (Middlesex: Penguin Books Ltd., 1970), pp. 63-78.



assistance as an indirect form of economic assistance.  
 Friedman logically argues that military assistance takes  
 that portion of the recipient's budget which would have  
 been spent on defense in any event, for the purpose of  
 economic development. This argument fails for two reasons.  
 First, Friedman overlooks the fact that the intention of  
 both the donor and the recipient was military and not  
 economic. Second, the argument assumes that the military  
 expenditure would have been made in any event, the  
 expenditure which the recipient would have made for defense  
 in the event the assistance was not forthcoming.

Foreign aid, then, broadly means economic assist-  
 ance for the economic benefit of the recipient. As pointed  
 out earlier, however, not all economic assistance is aid.

The central pitfall is the word "aid" itself,  
 which by analogy with personal relationships,  
 implies not only benefit to the recipient but a  
 degree of sacrifice by the donor. In reality,  
 most of what passes for aid under present inter-  
 national definitions brings some return to donors.  
 . . . A first clarification demands therefore  
 that the ambiguous general use of the word "aid"  
 be dropped in favor of a descriptive phrase like  
 "capital flow" or, as DAC /Development Assistance  
 Committee of OECD/ puts it more precisely, the  
 "flow of official long-term financial resources."  
 Aid could remain as popular shorthand for general  
 notions assistance; but in its technical sense,  
 it might more aptly be limited to covering grants  
 and what DAC calls "grant-like loans."<sup>6</sup>

<sup>6</sup> Keith Spicer, A Samaritan State? External Aid in  
 Canada's Foreign Policy (Toronto: University of Toronto  
 Press, 1966), pp. 41-42.

Dr. Spicer recommends that the phrase "aid" be disregarded and that the DAC criteria be accepted instead. Far from alleviating the problem, Dr. Spicer's suggestion only serves to compound it. It was, in fact, this type of equivocation between incomparable transfers which gave rise to the problem in the first place. DAC acknowledges the problem and seeks to substitute its own terms of reference rather than attempt a solution.

given to this term "foreign aid". Normally it is used in this Report to denote only the flow of government grants and official lending exceeding five years and contributions to multilateral agencies from official sources. These flows all represent resources or purchasing power made available by donor countries to less developed countries, though they may differ widely in their terms and conditions under which they are provided. While it may be debatable whether such flows should equally all be called aid, there is hardly any doubt that they would not be available to the recipients in normal commercial channels on the same terms and conditions and for the same purposes.<sup>9</sup>

The crucial problem with the DAC approach is the phrase "on the same terms." The difference between an aid transaction and a commercial transaction is not a matter of degree (i.e., the terms of the transaction) but rather a matter of kind. If, for example, a bank lends money at a 6% interest rate and a government lends the same amount at

<sup>9</sup> Development Assistance: Efforts and Policies, 1963 (Paris: Development Assistance Committee, OECD, 1964), p. 21; emphasis added.

... is the latter... the former is not? Both provide economic assistance and both promote the economic development of the recipient. The aid component is the difference between the two arrangements but it is not equal to either. In other words, aid involves a resource transfer from the donor to the recipient. Quite simply, "aid is a gift."<sup>10</sup>

<sup>11</sup> should refer only to the value of the subsidy implicit in the total flow of resources. Thus, grants of convertible currency are not aid in their full sense. They are an insignificant element. It is clearly misleading to lump these (and some other kinds of "aid") together, when assessing either cost to donors and lender or benefit to recipients. Money lenders may benefit their clients, but we do not think of them as giving aid.<sup>11</sup>

If this perspective is taken, one can rule out some of the existing definitions of aid. Jagdish N.

Bhagwati asserts that aid consists of

official grants and concessional loans in currency or in kind, which are broadly aimed at transferring resources from DC's (Developed Countries) to LDC's (Less Developed Countries) on developmental and/or income-distributional grounds.<sup>12</sup>

<sup>10</sup> Healey, The Economics of Aid, p. 14.

<sup>11</sup> J. W. Clifford and I.M.D. Little, International Aid: A Discussion of the Flow of Public Resources from Rich to Poor Countries (Chicago: Aldine Publishing Company, 1965), p. 13.

<sup>12</sup> Jagdish Bhagwati, Amount and Sharing of Aid (Washington: Overseas Development Institute, Monograph No. 2, 1970), p. 2.

From the foregoing discussion, exception can be taken to two points in Bhagwati's definition. First, aid is not wholly the same as a "concessional loan." Only that part of the loan which is concessional can be deemed to be aid. Second, exception should also be taken to the assertion that it is sufficient grounds to term a transaction as aid, if it is "broadly aimed at transferring resources from DC's to LDC's." Transactions which involve a two-way transfer are purely commercial while only ~~one transfer and be considered as aid.~~ Donor-recipient relationships and borrower-lender relationships are two-way transactions, but a donor-recipient relationship is unidirectional.

e A further distinction needs to be made at this point. Commercial and aid relationships are not necessarily mutually exclusive of one another. A transaction of a commercial transaction can be considered as aid depending on the terms of the transaction. If A lends B \$100.00 and expects B to repay only \$75.00 then a part of the transaction is commercial (the \$75.00 loan) while a portion may be considered as aid (the \$25.00 which is not repayable).

In 1968, Raymond F. Mikesell,<sup>13</sup> looked at the aid

<sup>13</sup>Raymond F. Mikesell, The Economics of Foreign Aid (Chicago: Aldine Publishing Company, 1968).

programme of the United States in particular and all other aid programmes in general. Mikesell defined aid as:

A transfer of real resources or immediate claims on resources (for example, foreign exchange) from one country to another, which would not have taken place as a consequence of the operation of market forces or in the absence of a specific official action designated to prohibit the transfer by the donor country.<sup>14</sup>

Mikesell admits, however, that his definition has two specific weaknesses. First, he wishes to exclude, as aid, government guarantees of private foreign investment. Second, he wishes to avoid any consideration of the donor's motives for giving aid, i.e., transferring resources.

Mikesell's first objective is in itself contradictory. If aid is a transfer of resources, then, by definition, the aid programme cannot be entirely domestic. The insurance by the U.S. government of an investment by a private company in a Third World country, takes place on two levels--first, between the private company and recipient country, and secondly between the private company and its own government. There is no necessary transaction between the two governments (although there may be). The venture is wholly commercial. If A intends to buy a car from B but first asks for insurance through C, then

<sup>14</sup> Ibid., p. 194.

it cannot be asserted that there is necessarily a trans-  
action between S and C. Mikesell goes on to point out that  
the U.S. government has made money on its underwriting  
programme.

Not only have the guarantee programmes not  
resulted in a net loss to the U.S. government--  
in fact they have been profitable--but there is  
no actuarial basis for determining likely  
losses. . . . Moreover, barring a worldwide  
catastrophe, there seems little likelihood  
that the unpaid callable subscriptions of the  
U.S. government to the World Bank and the  
Inter-American Development Bank will be called  
to meet losses of these institutions.

~~Mikesell states that some are substantial that without~~  
the U.S. government's action, private investment flows  
would not occur. This is a doubtful proposition in view  
of the apparent return on private investment in some devel-  
oping countries. There appears to be no grounds for the  
consideration of a government's subsidization of its  
domestic industry's foreign investments as critical to  
that flow, which is in any event, commercial and not aid.

The second consideration in Mikesell's definition  
is the pragmatic attempt to avoid any consideration of the  
donor's motives for giving aid. While one might sympathize  
with Mikesell's attempt to disregard this thorny problem,  
no definition which excludes this aspect could be con-  
sidered adequate.

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<sup>15</sup> Ibid.. p. 205.

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A distinction should be made between primary motivation and secondary motivation. Primary motivation refers to the broad purpose for giving foreign aid--to promote the economic development of the recipient. Secondary motives involve a plethora of smaller concerns--political gain, stimulation of the domestic economy, etc. Secondary motivation may or may not be detected in aid transfers while the promotion of economic development of the primary motive must be present if the transfer is to be deemed as aid. The heated controversy of the situation as to the motives for giving aid was aroused because it tried to match aid only to secondary motives. It is my contention that primary motivation arises only from humanitarian considerations and that specific motives are then attached to aid transfers.

None of the arguments from self interest (political, military and economic) of advanced countries, that had been used from time to time in support of official aid giving, was at all persuasive; the prime case for aid [has] to be made in terms of moral obligation of rich to poor, and [is] only as strong as that sense of moral obligation.<sup>16</sup>

All definitions of aid have one thing in common in that reference is made to the official transfers of resources. The reason for this is to identify the unit of analysis for aid. "Official" refers to the governments.

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<sup>16</sup>H. G. Johnson, The Crisis in Aid and the Pearson Report (Edinburgh: University of Edinburgh Press, 1970), p. 6.

either singularly or collectively, of the nations involved. Private flows and the actions of non-profit organizations, while certainly necessary to the overall development process, are not factors in the consideration of aid programmes.

3  
[Private flows] are promoted by commercial considerations, resulting in profit to the investors involved. The fact that they are generally of benefit to the recipient (or "host") LDC's put them in the same category as international trade: trade is also beneficial to all parties to the transaction but it is not aid. Therefore, just as neither exports of LDC's to the DC's are not considered to be aid to the LDC's, nor are imports of LDC's from DC's considered to be aid to the DC's, it makes no more sense to consider private commercial flows of capital to be part of foreign assistance to LDC's. The key question is really what official assistance, or what "governments" add to the total resource flow as a conscious supplement to the resources available to the LDC's.<sup>17</sup>

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<sup>17</sup> Bhagwati, Amount and Sharing of Aid, pp. 2-3.



## CHAPTER 2

### THE MEASUREMENT OF FOREIGN AID

As previously mentioned, official programmes are extremely heterogeneous in character.<sup>1</sup> No specific record of aid flow, as defined in this study, can directly be referenced in order to determine the magnitude of the flows.

For a variety of economic reasons the official measurement of aid transfers grossly overstates the amount of real resources transferred by aid-donors to aid-recipients and received by aid-recipients from the aid-donors--the two magnitudes [are] not necessarily even approximately the same.<sup>2</sup>

Referring to Barbara Ward's assertion that "aid has long since ceased to be a giveaway programme," Gerald Helleiner points out that "what is today statistically recorded as aid and served up for our selfcongratulation and the applause of the recipients, however, is something quite different from the concept of

<sup>1</sup>See Chapter 1, p. 8.

<sup>2</sup>H. G. Johnson, The Crisis in Aid and the Pearson Report (Edinburgh: University of Edinburgh Press, 1970), p. 6.

a giveaway."<sup>3</sup> It is the purpose of this study by means of previous definition, to examine what Helleiner calls "the giveaway" or what is referred to here as the "unidirectional transfer."

When analysing official flows it is necessary to construct a continuum on which the different types of flows can be placed.

FIGURE 1

The Aid Continuum

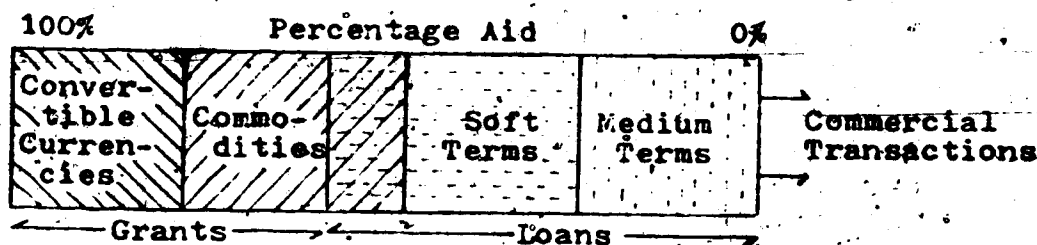


Figure 1 demonstrates that as the transaction moves from left to right on this continuum, the percentage of the nominal value of that transaction which can be deemed to be aid correspondingly decreases. There is a distinction made between grants-in-currency and grants-in-kind. This separation will be explained when the question of aid-tying is considered. The stipulation of the aid component of the loans portion of the continuum presents an immediate problem because the terms under which loans are made vary.

<sup>3</sup>Gerald Helleiner, "The Development Business: Next Steps," International Journal, XXV (Winter, 1969-70) p. 162.

Aid is the real cost of providing a loan, and the real cost of resources lent or given is the benefit foregone by not using them in their best alternative use.<sup>4</sup>

Two considerations arise concerning the foregone benefit: the grant equivalent element of the loan, and the opportunity cost of resources lent.

The grant element may be defined as "the difference between the face value of a loan and the present value of the future repayments (amortization and interest payments) discounted at proper rate of interest."<sup>5</sup> The mathematical calculation of this is outlined in Appendix II of this study. The purpose of such a calculation is to reduce all loans to their equivalent value in grants.

The discounting procedure is used to calculate the present value of all future payments (and receipts, where the loan may specify that part of the proceeds which will become available to the donor in the future) in order to obtain an equivalent value for the loan. The object is to find that grant, which, if made available in the present, would be the exact equivalent of the loan, after account has been taken of the future charges which must be met on the latter. These future charges (net), when discounted, are compared with the face value of the loan and the difference, when expressed as a percentage, is known as the "grant element" of the loan.<sup>6</sup>

In Figure 1, the continuum ranges from 100% grant equivalent

<sup>4</sup>J. M. Healey, The Economics of Aid (Middlesex: Penguin Books Ltd., 1971), p. 15.

<sup>5</sup>Göran Ohlin, Foreign Aid Policies Reconsidered (Paris: Development Centre of the OECD, 1966), p. 101.

<sup>6</sup>E. K. Hawkins, The Principles of Development Aid (Middlesex: Penguin Books Ltd., 1970), p. 31.

on the left, to 0% (commercial terms), on the right. Some argument has arisen over the rate of discount to be employed when calculating the grant equivalent of loans.

The logic behind discounting is that future payments and receipts are worth less than those in the present. ~~How, then, can the rate of discount be equal to the highest rate of return available for such funds?~~

The "highest rate of return," however, is contingent on a number of assumptions. If a domestic rate is to be used, should the public bond rate be chosen over the rate available to the private investor? Should the rate of discount be standardized to that of one international organization or should the rate be adjusted to the highest rate on the world market (e.g., the U.S. or Japanese rate)? Exactly what rate should be chosen is debated even among economists.<sup>8</sup> The Annual Report of the DAC employs a discount rate of 10%.<sup>9</sup> This reflects the assumed average return in the capital markets of the member countries. Raymond Mikesell argues that the discount rate should "reflect the relative scarcity of capital in the [donor] country, or the marginal rate of return on investment plus

<sup>7</sup> Ibid., p. 32.

<sup>8</sup> Jagdish Bhagwati, Amount and Sharing of Aid, (Washington: Overseas Development Institute, 1970), Monograph No. 2, p. 14.

<sup>9</sup> Development Assistance, 1968 (Paris: Development Assistance Committee, OECD, 1969), p. 2.

... Mikesell later states that the social rate of return on capital is higher than the rate of return on capital in alternative employment in the host country. ... The social rate of return is well above the market rate in capital markets and points to figures of between

... the subject of aid, like development plans, belong to political economy rather than economics proper.<sup>12</sup> The economic argument as to the discount rate to be employed overlooks the fact that the funds being analyzed are public funds. Assumptions concerning private markets or private investment opportunities are therefore irrelevant. No government will invest public funds in second mortgages or establish a high yield/high risk finance corporation. The previous definition of aid refers to "official flows" and the discount rate must then reflect "official alternative employments of capital."

John Pincus pioneered the grant equivalent approach in a report prepared for the Second United Nations Conference on Trade and Development (UNCTAD).<sup>13</sup> Pincus employed

<sup>10</sup> R. F. Mikesell, The Economics of Foreign Aid (Chicago: Aldine Publishing Company, 1968), p. 133; emphasis added.

<sup>11</sup> Ibid., p. 227. A social rate of return takes account of all monetary and non-monetary effects (multipliers, etc.) resulting from investment.

<sup>12</sup> Hawkins, p. 11.

<sup>13</sup> John Pincus, Economic Aid and International Cost

The purpose of this study was to determine the effect of the  
multilateral banks on the development of the world.  
This rate is lower than the domestic rate at least since 1962  
was approximately equal to six per cent.<sup>14</sup> This third rate  
of discount employed was the rate of return which private  
investors in the donor country might have required. This  
is the previously mentioned OECD figure of 10 per cent.  
Employing OECD figures for the period from 1962 to 1966,  
Pinchus arrived at the figures in Table 1. The degree to  
which different interest rates can affect the present  
equivalent value of a loan is represented graphically in  
Figure 2.

The employment of the 10 per cent (private invest-  
ment) discount rate can be seen to be inappropriate because  
the funds in question are public. The reason that such  
figures are often used is that the employment of a higher

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Sharing (Baltimore: Johns Hopkins Press, 1965).

<sup>14</sup> I.M.D. Little and J. M. Clifford, International  
Aid: A Discussion of the Flow of Public Resources from  
Rich to Poor Countries (Chicago: Aldine Publishing Company,  
1965), p. 73.

TABLE 1

GRANT EQUIVALENT OF LOAN COMMITMENTS  
WITH DIFFERING DISCOUNT RATES

	1962	1963	1964
Donors' Domestic Interest Rate	590.0 <sup>a</sup> (21.7)	785.0 (25.2)	1,050.0 (33.1)
IBRD Borrowing Rate	244.8 (9.0)	823.7 (11.2)	963.6 (30.4)
10 Per Cent	1,298.3 (47.8)	1,438.8 (50.0)	1,990.8 (62.1)
Nominal Value of Loan Commitments	2,714.5	2,877.2	3,681.9

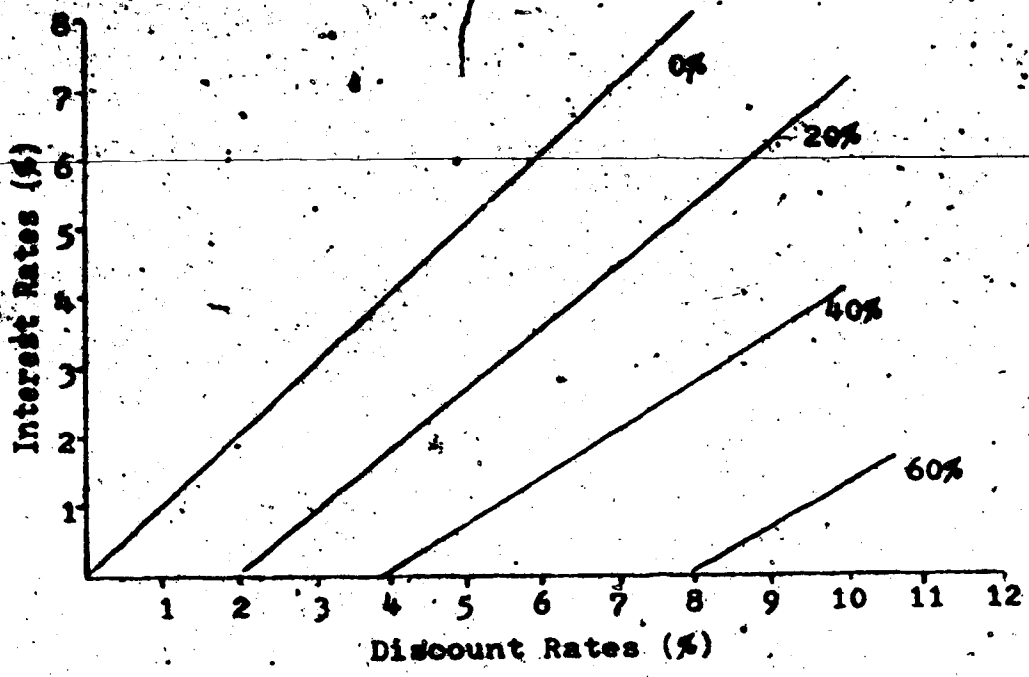
SOURCE: John Pincus, *Economic Aid and International Commitments*, p. 136.

<sup>a</sup> \$ millions (U.S.A.)

<sup>b</sup> Percentage of nominal value in parentheses.

FIGURE 2

Combinations of Interest Rates and Discount Rates  
with Each Element (\$)



Source: E. K. Hawkins, The Principles of Development  
Vol. 1, p. 38



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rate maintains the differential between the discount rate and the nominal rate of interest and therefore, by definition, enlarges the grant equivalent element of the loan. This type of equivocation between the public and private sectors, in the Gunnar Myrdal's words, "deviates from the truth in an opportunistic direction."<sup>15</sup>

IBRD's borrowing rate, also ignores certain public realities. The government of a developed country cannot borrow from that institution to raise the required funds. Further, funds forwarded to the Bank, which form international credits, are unlikely to be called upon by the contributing government. The funds provided to the IBRD, from the perspective of the donor, cannot be looked upon as an investment or an investment opportunity. This rate of discount would be applicable to an analysis of the recipients' benefits (such as Pincus') but cannot be applied to the donor.

The final alternative discounting rate, the donor's domestic interest rate, comes closest to representing alternative employments of public capital. A government can raise capital in basically three ways: taxation, increasing the money supply and borrowing. The funds to which this analysis is addressing itself cannot be generated by increasing the money supply since the measure must

<sup>15</sup>Gunnar Myrdal, Against the Stream: Critical Essays on Economics (New York: Vintage Books, 1975), p. 158.

ultimately be reduced to real resources, not money.<sup>16</sup> A government borrows capital by issuing long-term government bonds for which it pays subscribers a given rate of interest. This interest, plus the cost of issuing the bond (printing, accounting, etc., or approximately one per cent), may be said to be equivalent to the alternative use of public funds. If the government had not used these funds for the transfer of resources to developing nations, it could have bought back or retired previous (or current) bond issues.

The final alternative, ~~taxation~~, withholds from the private sector a fixed amount of ~~capital~~ for investment. The distinction must be made again ~~between~~ government and private investment. The government, after having taxed the private sector, wholly controls the capital assets. To discount at the private rate of interest ignores the explicit transfer to the public sector and would amount to double-counting the capital stock. These funds could be used by the government to retire or buy back the same bond issues (i.e., reduce the public debt) mentioned in the previous example. The rate of discount would still be the long-term government bond rate. In fact, given the narrow alternatives open to a government, it is the contention of this study that this is the best alternative usage of

<sup>16</sup> Inflation is controlled for by analyzing flows as a percentage of the gross national product at market prices.

public funds and therefore the most reasonable discount rate.

One further issue remains regarding the matter of the discount rate to be employed in computing the grant equivalent of international development loans. Clifford and Little contend that 35 per cent is also an allowable discount rate.<sup>17</sup> The rationale used to justify this extraordinarily high figure is that "some allowance for the possibility that any of these loans will not be repaid as scheduled" must be made.<sup>18</sup> This assertion is truly absurd. This approach strikes at the immediate core of the issue by begging the question "why tender the funds in the form of a loan in the first place?" The point of the exercise is to establish empirically what portions of the loan in fact amount to a unidirectional transfer. The remainder is exactly the same as a commercial loan within the donor economy.

Banking is not commonly regarded as a charitable activity, no matter how useful its services. A repaid loan on commercial terms is not considered a loss, and such benefits as the borrower derives from it he also pays for. Development banking, like all forms of banking, serves to reduce risks by improving the organization of the capital market and thus improve the terms upon which credit is available.<sup>19</sup>

If the entire transaction is to be discounted in the first place, i.e., compared to other commercial transactions,

<sup>17</sup> Clifford and Little p. 73.

<sup>18</sup> Ibid.

<sup>19</sup> Ohlin, p. 90.

then to change ~~the~~ in the midst of analysis, to rediscount, compounds questionable policy with bad economic analysis.

Perhaps the greatest attraction of this method of measuring aid (the grant equivalent approach) is that the reverse flow, repayments of interest and principal, from recipient to donor, is accounted for in a single calculation. In fact, to subtract the reverse flow of IBC's to DC's, having already calculated the present value equivalent of all future repayments of principal and interest, would be a form of double counting.

A numerical example should illustrate the principles involved. Assume \$1,000 is lent for a period of 20 years at five per cent interest and a five year grace period is allowed before repayment of principal begins. The present value of the future payments of interest and principal, employing an eight per cent discount rate, is approximately \$760. The loan then has the equivalent value of a grant of \$240. (The nominal value of the loan less the present value of future repayments.) As a percentage of the face value of the loan, the grant equivalent is approximately 24%. Now assume that the same loan (\$1,000) is extended for a period of 50 years, at 3/4% interest, with a grace period of 10 years. Employing the same discount rate of eight per cent, the present value of future repayments is approximately \$210. The grant equivalent of this loan is

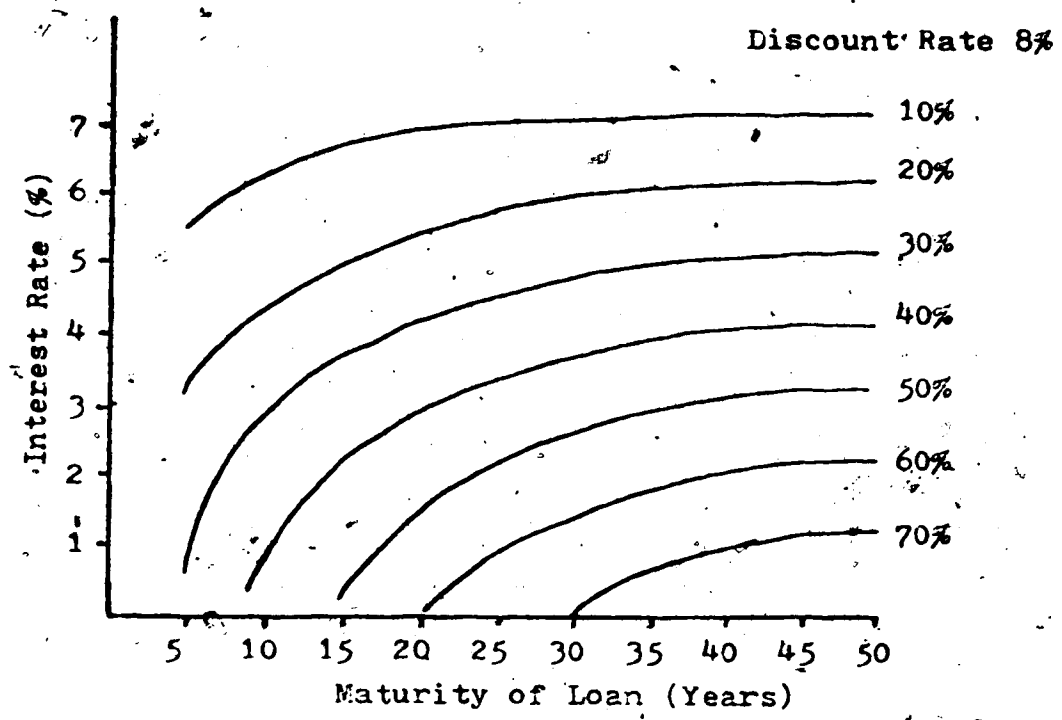
\$790 or 79% of its face value. Thus, varying the terms under which the loan is offered can substantially change its grant equivalent value without altering its face value. This situation has been represented graphically in Figure 3. All points on the given isogrants represent different combinations of terms yielding the same grant equivalent value. Further, it should be noted that the grant equivalent is ~~most~~ more responsive to changes in interest rates than to changes in maturity.

The grant equivalent approach offers a method by which economic apples and oranges (grants and loans) can be added together and thereby analyzed. Unfortunately, the aid programmes of the developed countries also contain a wide variety of other fruits which must similarly be reduced before the analysis can proceed. A further problem arises when grants and/or loans-in-kind (development prunes) are considered. The question of aid-in-kind is inextricably linked to the question of aid-tying.

There are two ways in which aid can be tied: by procurement and by project. Procurement or source-tying means that aid funds must be spent in the donor country. Project tying specifies that the funds are to be used on only certain items within the donor country.

The provision of aid in its present predominantly bilateral and project-tied form involve certain inefficiencies that reduce its effectiveness and usefulness to the recipients by reducing the real value of the resources it transfers and restricting

FIGURE 3  
Combinations of Loan Terms with Same  
Grant Element (%)



SOURCE: E. K. Hawkins, The Principles of Development Aid, p. 37.

the uses to which it may be put.<sup>20</sup>

Aid-in-kind creates a problem because the domestic cost of the resources transferred may differ substantially from the world market price for that commodity. The basic question becomes whether to value such aid at domestic or world prices.<sup>21</sup> Such discrepancies will arise if the donor is not the most efficient producer of the goods involved in the aid transfer. If, for example, an Australian aid project required machine lathes and West Germany produced these lathes at the lowest cost, then the difference between Australian lathes and West German lathes must be accounted for before the aid transaction can be meaningfully analyzed.

It was pointed out earlier that the transfer should not be confused with the accounting mechanism. In other words, it is the real resources involved and not their dollar value which must be investigated. As long as the donor is transferring real resources the nominal value of those resources is of little importance. If a given aid transaction involves the transfer of one hundred tractors, the transfer should not look at the one million or two million dollars at which the transfer is valued.

To argue, as some developing nations have, that

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<sup>20</sup> H. G. Johnson, Economic Policies Toward Less Developed Nations (Washington: Brookings Institute, 1967), p. 80.

<sup>21</sup> Pineus, p. 131.

had one and a half million dollars (domestic price) been transferred instead of one million dollars (world prices), ~~more tractors would have been received. It is an aid transfer~~ with the transfer of real resources (tractors). The donor has transferred one hundred tractors and this is the amount of aid involved. The other fifty tractors (the difference between donor price and world price) does not alter the aid transfer.

The situation just stated relates to grants-in-kind. Grants by definition are wholly equal to the aid transfers. No adjustment is necessary because when this transfer is compared to the donor's gross national product (GNP) the amount of sacrifice (percentage of GNP) accounted for by the aid programme will be the same as the same transfer made by the most efficient producer. Not all commodity transfers are grants.

When commodity transfers take the form of loans, the analysis can no longer be confined to the donor economy because the recipient must repay the donor for the commodity involved. In this case, the recipient may very well be penalized by the donor's inefficient production. In the example used above, the donor would be asking the recipient to pay for fifty tractors which it did not receive. Because there is a reverse flow from recipient to donor, the overall relationship must be evaluated. Having taken out the grant equivalent of the loan, the residual



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amount must then be compared with the world price for the commodity involved. This would then serve to reduce the real resources transfer because netting out the excess ~~resources transfer~~ the grant transfer of the loan. The difference between the domestic price and the world price is, in effect, not aid, but rather a government subsidy to inefficient domestic production.

A more efficient solution would be the element of excess cost imposed by tying  $\Delta$  in the case of a loan/ to be given in the form of a grant and charged to some domestic expenditure account (as export promotion, domestic transfer, or domestic production subsidy) rather than against the foreign aid program.<sup>22</sup>

This approach would redress the imbalance caused by the reverse flow. The grant equivalent of the loan would therefore return to its original value. The additional grant could not be counted as aid because it only replaces the subsidy originally provided by the recipient.

Another set of considerations arise out of the method of tendering aid projects. It is very possible that producers in the donor country, realizing the freedom of action of the recipient country in employing tied funds, will use their monopolistic advantage (either singularly or collectively) to raise their prices much higher than would be possible in a competitive market.

The worldwide tendering on projects, which are then ostensibly assigned to different tied sources according to the successful tenders, will not

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<sup>22</sup>Johnson, Economic Policies, p. 125.

...generally yield the maximum number of bids and  
...to check  
...aid funds  
...the

...limited flexibility, which may reflect this monopoly position.

This is a refined way of saying that suppliers in the donor economies are not above "price gouging" if given the chance. Until and unless aid funds are untied by donor governments, careful scrutiny of bidding practices should be maintained to avoid both donor and recipient governments falling victim to such practices.

The above discussion on commodity aid and tied aid has assumed that the factors of production in the donor economy are fully employed. If the factors of production in the donor country are not fully employed or are immobile, then the opportunity cost of resource transfers is lower. In the extreme case where factors have no alternative employment, the opportunity cost is zero. It is important, however, not to confuse opportunity cost for the donor with the value of the resource transfer. If a certain commodity is truly a surplus in the donor economy (wheat, for example), this is not to say that it has no value as aid. The

<sup>23</sup>Jagdish Bhagwati, "The Tying of Aid," in Foreign Aid: Selected Readings, ed. by J. Bhagwati and R. S. Eckaus (Middlesex: Penguin Books, 1970), p. 256.

...the primary surplus is a condition for the  
...is possible.

In order to evaluate surplus commodity transfers it is necessary to return to the original definition of aid. Two questions must therefore be answered. Is this a transfer of real resources? Certainly. Is this intended to contribute to the economic development of the recipient? This second question is more difficult to answer and requires further analysis.

If a commodity is surplus in the donor's economy it could still have a world market price.<sup>25</sup> If other nations are willing to trade their goods or to buy the commodity which is surplus in the domestic economy, then that commodity has a market value, i.e., the world market price. When the commodity is used as aid, two considerations arise if it has a world market value. First, if there is strong demand for the commodity internationally,

<sup>24</sup> Bhagwati, Amount and Sharing of Aid, pp. 8-9.

<sup>25</sup> Very few commodities are truly surplus and the discussion refers to a "declared surplus" which is removed from the confines of the domestic market.

is aid. If there is a demand for the commodity in the recipient country, then the transfer will be developmental. If there is no demand for the commodity in the recipient economy, then the transfer is not developmental and will be detrimental to that country's development. If a

recipient country is not lacking in agricultural production then the transfer of surplus food grains can harm that economy by decreasing the marginal utility of its food production. The added grain in this case could drive down the price of domestically produced food and thereby provide a disincentive toward further production. While it is not the purpose of this study to examine the domestic policy of the donor which gives rise to such surplus commodity transfers, it should be noted that that policy is in all probability economically inefficient.

Aid in the form of surplus agricultural products reduces the incentives for the recipients to increase productivity in agriculture (which tends anyway to be starved of investment resources by planners interested in industrialization) even though it is the largest, and an obviously back-

...the conflicts between the requirements of the foreign aid agency and other objectives of economic policy.

...surplus, such as those under Public Law 480 in the United States, may be intended to subsidize the domestic economy and may have little or no intention with regard to the economic development of the recipients of such surpluses. Section (2) of the Agricultural Trade Development and Assistance Act (1954) or P.L. 480<sup>27</sup> states:

<sup>26</sup>Johnson, Economic Policies, pp. 3-4.

<sup>27</sup>P.L. 480 is divided into four sections:

- 1. Type I provides for commodity sales for local (recipient) currency;
- 2. Type II provides surplus agricultural commodities for use in emergency assistance;
- 3. Type III provides surplus agricultural commodities for voluntary agencies (e.g., OAS);
- 4. Type IV provides agricultural commodities for long-term dollar credits.

Types II and III could be considered as aid under the present definition but types I and IV (which are by far the largest) are commercial transactions which in no way can be considered to be aid. See Kikusell, pp. 184-93; Clifford and Little estimate that the net contributions of P.L. 480 (i.e., flow of resources to the LDC's) amounted to only 20% of face value of the programs in the years 1962-63 (p. 166). An excellent analytical treatment of P.L. 480 can be found in Alexis E. Lachmann, The Local Currency Proceeds of Foreign Aid (Paris: Development Centre of the Organization for Economic Cooperation and Development, 1968).



The purpose of this Chapter has been to establish  
the "ground rules" for the following case study.  
The author has tried to provide a clear description of what  
is and what is not said. This Chapter has provided the  
background and the tools required for the case study.

## THE HISTORY OF CANADIAN FOREIGN AID

Concessional economic transfers by Canada are unique to the post 1945 period. At the end of the Second World War, North Americans began to be concerned with the damage sustained by Britain and our European allies. Because Britain had accounted for a considerable portion of Canadian trade prior to the outbreak of war, the Canadian government was anxious to re-establish these markets. During the period from 1945 to 1950 Canada's contributions to programmes such as the Marshall Plan and the United Nations Relief and Rehabilitation Agency (UNRRA) amounted to over two billion dollars.<sup>1</sup>

The definition of aid used by this study would not classify the above contributions as foreign aid. These programmes were intended to rebuild rather than develop the

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<sup>1</sup> Keith Spicer, A Samaritan State? External Aid in Canada's Foreign Policy (Toronto: University of Toronto Press, 1966), p. 252. This figure includes \$271 million in grants and \$1,767 million in loans. Over half of the total amount or \$1,185 million was loaned to the United Kingdom.



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damaged economies of Europe. Clearly there is a  
difference between a programme of repairing an existing  
structure and one that builds the entire structure. For  
example, the physical and human infrastructures which exis-  
ted in Britain in 1945 were already developed whereas in

physical or human, existed prior to the initiation of the  
development process. Although there have been attempts  
made to trace the beginning of foreign aid to 1945,<sup>2</sup> for the  
purposes of this study foreign aid did not commence until  
1950.

Canadian aid, as it is defined in this study, begins  
in 1950 with the Colombo Plan. Canada's original contribu-  
tion was \$25 million.<sup>3</sup> The Colombo Plan was initially a  
Commonwealth sponsored programme focused primarily on South-  
East Asia. The term "plan" is somewhat misleading as no  
specific plan was formulated nor was there anything estab-  
lished by the agreement which could function as a planning  
mechanism. The Colombo Plan, as with most Commonwealth

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<sup>2</sup> See Corin Ohlin, Foreign Aid Policies Reconsidered  
(Paris: Development Research Center, 1966), p. 9; also  
see John White, The Politics of Foreign Aid (London: The  
Bodley Head Ltd., 1974), pp. 198-203.

<sup>3</sup> "Canada and the Colombo Plan," A Statement by the  
Secretary of State for External Affairs, L. B. Pearson  
(Canada, House of Commons Debates, 21 February 1951,  
pp. 537-8); excerpt reprinted in R. A. Mackay, ed.,  
Canadian Foreign Policy, 1945-1954: Selected Speeches and  
Documents (Toronto: McClelland and Stewart Ltd.; 1971),  
p. 369.

programmes, can best be described as a form of consultative-bilateralism.<sup>4</sup> The Plan was originally seen as a six year commitment by the participating governments but has grown and expanded to become the present Canadian aid programme.

At the time the Colombo Plan was being formulated, there was no perceived distinction between rebuilding in Europe and the developmental problems of South-East Asia. The Marshall Plan was, by general consensus, extremely successful. In retrospect, one can see how this inability to distinguish between reconstruction and development gave rise to misplaced expectations and later to unwarranted criticism of the supposed failure of programmes such as the Colombo Plan. The basic premise of the Marshall Plan was the infusion into an economy of vast amounts of capital over a short length of time. The Marshall Plan followed this approach while the Colombo Plan did not. John White points out that the average annual per capita receipts under the Marshall Plan amounted to about \$12, mostly in grants (or about \$20 at 1970 prices), while the average annual per capita receipts for the developing countries in the period 1968-70 amounted to only \$4.38, of which the bulk was in the form of loans.<sup>5</sup>

The Colombo Plan derived much of its original impetus from the Cold War. The primary motive of the scheme

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<sup>4</sup>Spicer, p. 71.

<sup>5</sup>White, p. 200.

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was development while the underlying or secondary motive was combating the spread of communism. Lester B. Pearson in an address to the Canadian Conference on Aid to Underdeveloped Countries in 1955 made a similar distinction regarding the dual motivation of the Colombo Plan.

We should ask ourselves from time to time whether we would be doing what we are if the political and military menace of Soviet and Chinese communism did not exist. It sometimes seems to me that we in the West come near to owing at least one debt of gratitude to international communists--and we have precious little to thank them for over the past few years--for helping us to keep up to the mark in these matters. It is a sorry commentary on the post-war period that without them and the threat which they represent we might not so readily have done what we should have been doing anyway.

The history of Canadian aid from 1950 to 1965 has been well treated elsewhere. The following brief discussion borrows heavily from that study.<sup>6</sup>

Following the Colombo Conference in January, 1950, the Canadian government set up an interdepartmental group chaired by External Affairs, and represented by concerned departments such as Finance, Trade and Commerce, Labour, Agriculture, Mines and Technical Surveys, National Health and Welfare as well as the Bank of Canada. The group called itself the Interdepartmental Group on Technical Assistance (IGTA). The main inputs to this committee came from

<sup>6</sup>Quoted in Spicer, p. 22.

<sup>7</sup>Spicer, pp. 93-119.

External Affairs, whose primary concern was with the broad control of aid policy as it related to the overall direction of Canada's foreign policy. Trade and Commerce took general administrative control of the fledgling programme.

A special agency was established by IGTA to administer what was at the time considered to be a temporary programme. The new agency was called the International Economic and Technical Co-operation Division (IETCD) and was housed in the Department of Trade and Commerce. Nik Cavell, a private industry executive with experience in Asia, was appointed as administrator of the new agency. The agency initially consisted of Mr. Cavell and three or four officers from Trade and Commerce.<sup>8</sup> The IETCD began functioning in 1951 and continued until the appointment of Mr. Cavell as High Commissioner to Ceylon in 1958. The agency was given general responsibility for technical and capital assistance programmes under the Colombo Plan, although actual policy decisions remained the responsibility of IGTA.

In 1958 IETCD was rebaptized the Economic and Technical Assistance Branch (ETAB) and Dr. O. E. Ault, a former senior officer in the Civil Service Commission was named as its director. The Conservative government of John Diefenbaker sought to expand the Canadian aid programme.

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<sup>8</sup> James Eayrs, The Art of the Possible: Government and Foreign Policy in Canada (Toronto: University of Toronto Press, 1961), p.-59.

but continued the Commonwealth bias initiated by the Colombo Plan. The Canada-West Indies Aid Programme (which later became the Commonwealth Caribbean Programme), The Commonwealth Technical Assistance Plan and the Commonwealth Scholarship and Fellowship Plan, were all initiated by ETAB in 1958.

In 1960, the Canadian government realized that aid could no longer be considered a short-term programme. This change was in no small way due to the creation in that year of the Organization for Economic Co-operation and Development (OECD). The OECD grew out of the former Organization for European Economic Co-operation which had been the coordinating body in Europe for the Marshall Plan. The Development Assistance Committee (DAC) was established by the OECD in 1961. The function of DAC is to provide a forum in which donors could "consult on methods . . . for expanding and improving the flow of long-term funds and other development assistance."<sup>9</sup>

The United States began in 1960 formally to press Canada and other DAC members to increase the volume of their aid to developing countries. At both the London and Tokyo meetings of DAC in 1961, the United States applied pressure on other member governments (Canada, France,

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<sup>9</sup> Development Assistance (Paris: OECD, 1964), p. 4.

Germany, Italy, Japan, the Netherlands, Belgium, Portugal and the United Kingdom) to bring their aid contributions to the developing nations up to one per cent of their gross national products.<sup>10</sup> One of the reasons why the other members might have rejected the U.S. proposal was the implied loss of sovereignty. Countries have not in the past accepted an arrangement through which they would be constrained in the formulation of their national budgets. What the U.S. was in fact proposing was an international tax.

Although the United States proposal was rejected by other members, it did in fact result in the only existing mechanism by which foreign aid policies can be compared and, to some extent, criticized. As valuable as a scrutinizing device may be in such vital areas as development assistance, neither DAC nor the OECD itself has the political power to regulate the policies of its members. The formation of DAC has, however, had a profound effect on Canadian foreign aid policy.

In 1960 the Canadian government established a unified agency to deal with foreign aid policy. The External Aid Office (EAO) was established to bring order to a previously chaotic situation. H. O. Meran, a career

<sup>10</sup> John Pincus, Economic Aid and International Cost Sharing (Baltimore: The Johns Hopkins Press, 1965), p. 110.

diplomat in External Affairs, was appointed Director-General of the new agency. The EAO had what its predecessor lacked, a direct route to a cabinet minister in that the Director-General reported directly to the Secretary of State for External Affairs. The reorganization gave the Canadian programme the necessary administrative capability to cope

international challenges during the period of the EAO. Canada's assistance grew from \$81.9 million in 1961 to \$247.9 million in 1967.<sup>11</sup> This period witnessed the birth of the francophone aid programme and a multilateral commitment in Latin America via the Inter-American Development Bank.

Aid to francophone countries traces its origins to two significant events in the early sixties. The first of these was the "Quiet Revolution" in Quebec wherein the province began to push for a greater voice in the realm of foreign policy. Quebec pointed out quite rightly the excessive Commonwealth bias of Canada's aid programme.

Le Commonwealth n'est pas toute l'humanité, . . . il existe des pays sous-développés où la langue de communication est le français. . . . Il y a la une question d'égalité et de justice.<sup>12</sup>

Canada's aid programme began with the Colombo Plan, initially

<sup>11</sup> Canada, CIDA, Annual Review, '69 (Ottawa, 1970), p. 24.

<sup>12</sup> Le Devoir, 16 January 1960.

Commonwealth program, and had no existing Commonwealth language connection. In point of fact, the Commonwealth was the only real connection Canada has had with the developing nations.

The rationale for creating a separate francophone program is somewhat questionable. In essence, the argument is based on geographical location and the fact that it is to be with the francophone countries. However, it is

not the language spoken in a country which qualifies it to receive Canadian aid but rather some criteria based on need. There is no existing political entity in Africa which corresponds to this programme and the rationale for the programme must therefore be based upon domestic considerations. C'est questionne d'egalite et de justice et de necessite, ce n'est pas une question de langage.

The second event which gave rise to a francophone aid programme was the decolonisation by France of its former possessions in Africa. France has in fact been one of the major obstacles to a francophone programme for Canada since 1960. This did not overcome the fact that these emerging nations in francophone Africa were still heavily reliant on France for the bulk of their assistance, particularly in terms of administrative infrastructure. Canadian aid personnel often dealt through French administrators in these countries during the early days of the programme. These new Canadian overtures were not at all welcomed by



... of ... also ... the ... before it ... of the ...

Table 1.

**TABLE 2**  
**BIENNAL DISBURSEMENTS IN FRANCOPHONE AFRICA:**  
**1972-1973/74**

Year (Fiscal)	Amount (\$ millions)	% of Total Canadian Disbursements
1962/65*	1.57	0.5
1965/66*	4.04	2.5
1966/67*	10.68	4.7
1967/68*	12.09	4.8
1968/69	14.53	10.0
1969/70	21.66	10.2
1970/71	29.70	10.6
1971/72	45.13	15.9
1972/73	59.08	17.9
1973/74	66.65	18.1

\*Figures based on allocations rather than disbursements.

SOURCE: CIDA Annual Reviews, 1969-1973/74.

A second region in which a programme was launched by the EAO was Latin America. Canada has been under pressure for some time by the United States and many Latin American countries to join the Organization of American

forwarded... money to Latin America... (International Development Association) rate of 6.75 per cent interest, a ten year grace period, and equal annual payments over fifty years. This subscription was raised to \$10.5 million in 1967 and later decreased to \$7 million in 1973.<sup>13</sup>

Canada's bilateral program in Latin America did not begin until 1971 although previous Annual Reviews continued to list the IADB subscription as such.

Three events in 1968 provided the impetus for still further change in Canada's foreign aid policy. The first was Pierre Trudeau's assumption of the leadership of the governing Liberal Party. Part of the Trudeau platform was

<sup>13</sup>Peter C. DeBell, Canada's Search for New Roles: Foreign Policy in the Trudeau Era (London: Oxford University Press for RIIA, 1972), pp. 116-117.

<sup>14</sup>Canadian International Development Agency, Annual Review, 1973-74 (Ottawa: CIDA, 1975), p. 40.

... the Commission on International Development, established in 1961, was the first major international development organization to be created since the end of World War II.

... the Commission on International Development, established in 1961, was the first major international development organization to be created since the end of World War II.

The Commission on International Development was established by the United States and the President of the World Bank, and hence the report was referred to as the Pearson Report. The report was part of the international effort to put a stop to the steadily declining development efforts. The United States, by far the largest donor, had begun substantially to reduce the amount of assistance being transferred to the developing countries.<sup>15</sup> The Commission was made up of eight members. Six of these members came from developed countries (all of whom had previously served their respective countries as ministers or senior officials) and thus their thirty-five odd recommendations

<sup>15</sup> Pierre Elliot Trudeau, "International Development as a Requirement for Peace," External Affairs, XX (Jan., 1968), p. 246; also see DeWalt, op. cit.

<sup>16</sup> Partners in Development: Report of the Commission on International Development, L. B. Pearson, Chairman (New York: Praeger Publishers, 1969). Hereafter called Pearson Report.

<sup>17</sup> See Figure 1, Chapter IV and Figure 2, p. 71.

The... of... in... covered... value... failed...

The... which affected aid policy in... in the late... and the United Nations Conference on Trade and Development (UNCTAD) held in New Delhi in 1964. The first UNCTAD meeting at Geneva in 1964 had not been prepared to deal with the solidarity and organization displayed by the developing nations. The poorer nations, "the Group of Seventy-seven" as they became known, for the first time collectively pressed their grievances against "the Rich Man's Club" (GATT, DAC, etc.). Not only were the developed countries not making a sufficient or consistent effort in the field of development assistance, but in fact the mechanisms of exchange, "the terms of trade" to quote Raul Prebisch's now famous document,<sup>19</sup> were deteriorating and the gap between rich and poor was widening. The

<sup>18</sup> white, p: 195.

<sup>19</sup> Raul Prebisch, "Towards a New Trade Policy." Report by the Secretary General of UNCTAD, United Nations, 1964.

34  
The 1965 meeting was a significant event in the history of international development assistance. It was the first time that the New Delhi meeting was held in the presence of the two groups. The 1965 meeting was in no small way responsible for the establishment of the Group of 77. The New Delhi meeting also marked the start of the realization of the developing nations and the inability of the western powers

position. A great deal of international activity was generated for a brief interval by UNCTAD but subsided until the emergence of OPEC in the early 'seventies. The anticipation of a major confrontation in 1965 at New Delhi did force the western nations to reflect upon their own policies and to attempt some reordering before the conference.

In Canada these three events served to focus the attention of the government on the organizational structure of the EAO. Canada's foreign aid was in the midst of a period of rapid expansion, which, if Canada was to meet the proposed U.N. target of 0.7 per cent Gross National Product for official development assistance, would have to increase even more rapidly. The Trudeau government, using the framework established by H. O. Moran, created a new agency to administer all aspects of Canada's international development assistance. The new agency was called the Canadian International Development Agency (CIDA) and

Kauffman F. Strong, an experienced businessman, was named as its president. Whereas the EAC had had only partial autonomy from the administration of the Department of External Affairs, CIDA was to have complete autonomy while still maintaining its accountability to the Secretary of State for External Affairs. Canada's aid budget had a significant absolute increase from 381.9 million in 1960/61 to 503.3 million in 1968/69 and the programme was now

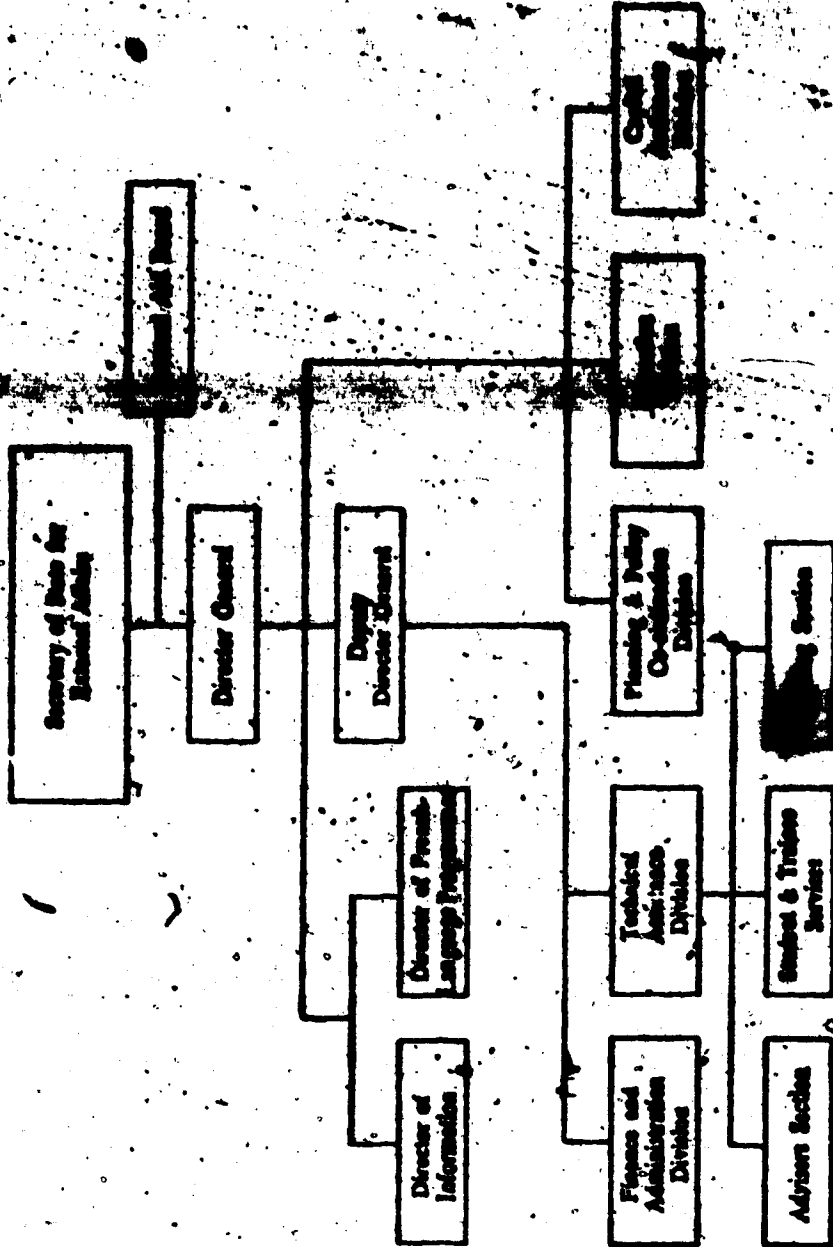
The 1968/69 budgetary allocations still represented only 0.33 per cent of the GNP for 1968<sup>21</sup>--less than half of the U.N. target figure.

Structurally, CIDA differed only marginally from its predecessor. (See Charts 1 and 2). The significant difference between the two agencies was the role of the new Canadian International Development Board. In the previous administration the Director-General had been accountable to the External Aid Board which acted as a consultative mechanism. Under the CIDA reorganization the Board's function was reduced to that of an advisor to the President. The difference between the two is that the former had a voice in policy decisions while the latter does not. In effect CIDA has become a quasi-crown corporation accountable only to the Secretary of State for

<sup>20</sup> CIDA, Annual Review, '69, p. 26.

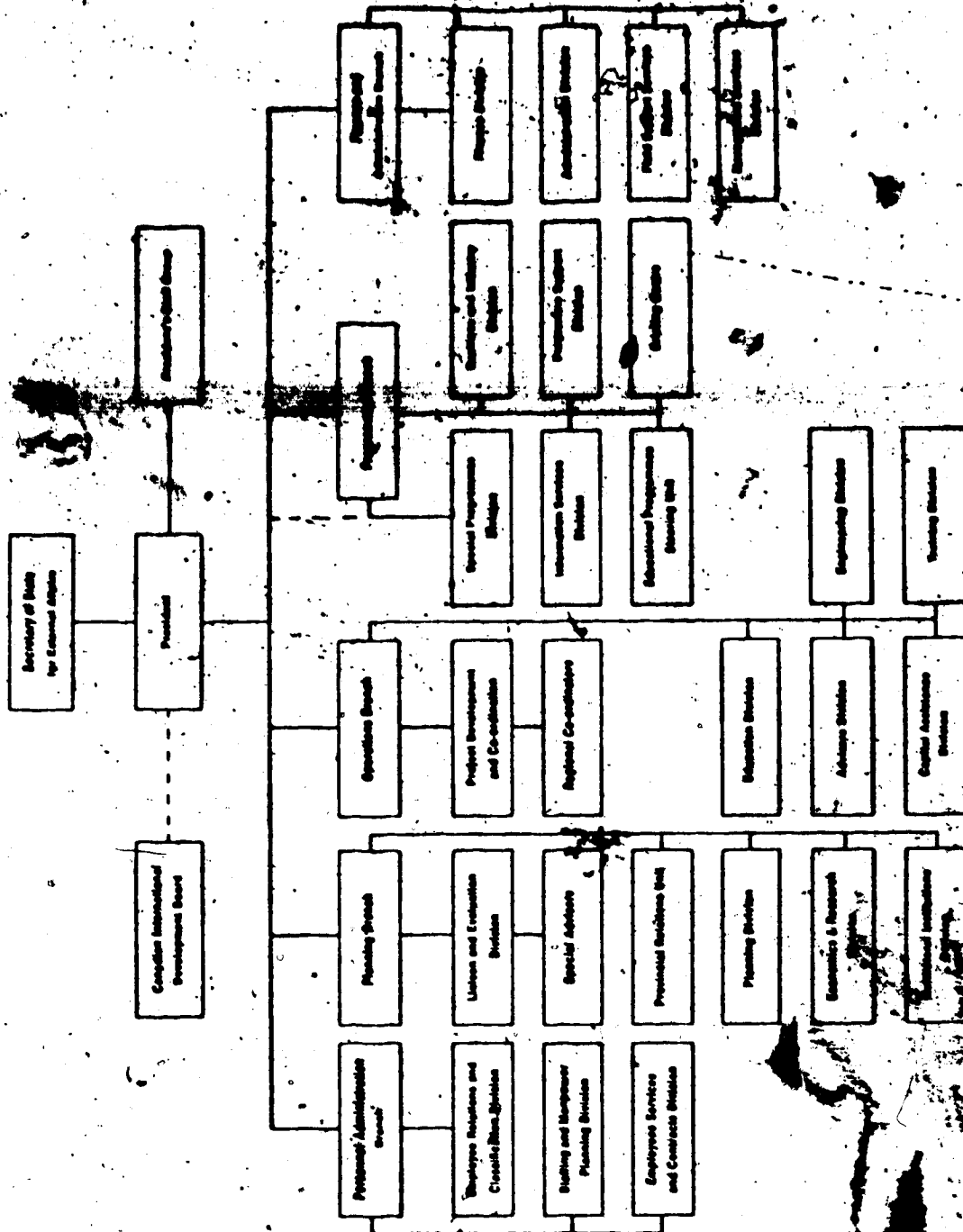
<sup>21</sup> Ibid.

Chart 1, External Aid Office



SOURCE: Keith Spicer, Samaritan State?, p. 111.

Chart 1. Structure of the Canadian International Development Agency



SOURCE: CIDA, Annual Review, 1969, p. 54.



External Affairs. The reality of its unique position surfaced during the recent debate about the administration of CIDA. The President is not responsible to parliament or, more specifically, the Standing Committee on External Affairs and Defence for CIDA's spending. That Committee has been unable to have the CIDA-commissioned Price Waterhouse Report on the internal problems of the agency tabled before it. The President has only to account in the most general way for Canadian aid spending during the previous year. Specifics of CIDA's spending are privileged information not available to the public or parliament without consent of the Secretary of State for External Affairs. The necessity to recognize CIDA's distinct position in our government's foreign policy has also produced an agency which does not come under scrutiny by either parliament or public. This is a regrettable situation which the government, to this point, has not seen fit to correct.

The Trudeau government fulfilled its campaign promises and undertook a comprehensive review of Canada's foreign policy. The resulting 1970 White Paper<sup>22</sup> on Canada's international development assistance policy included the following provisions:

- a) the reduction of Canadian procurement regulations

<sup>22</sup> Canada, Department of External Affairs, Foreign Policy for Canadians: International Development (Ottawa: Information Canada, 1970).

(aid-tying) from the previous 66 per cent level by allowing 20 per cent to be completely untied;

- b) shipping costs were no longer to be considered as local costs and could therefore be covered by CIDA;
- c) multilateral aid was to be increased to 25 per cent of official Canadian aid;
- d) bilateral assistance would increase for francophone programmes;
- e) "countries of concentration" would account for in the order of 80 per cent of Canada's aid allocations;
- f) the creation of an International Development Research Centre in Canada to provide necessary research for developing countries.

CIDA enjoys the status of having a non-lapsing budget. This concept was introduced by the EAO in recognition of the fact that development projects cannot be constrained by Canada's fiscal budgeting. Projects often require considerable time before plans can become operative. Whereas other government departments have their unspent appropriations transferred to the consolidated revenue fund at the end of the fiscal year, CIDA is allowed to accumulate its unexpended funds. Although this is a worthwhile measure, it has also been a cause of embarrassment for CIDA. The agency has consistently been unable to expend its appropriations with the result that the non-lapsing fund has grown constantly. In 1973/74, CIDA was able to reduce the size

of the fund by donating \$100 million<sup>23</sup> to multilateral emergency relief during the energy crisis. In 1974/75 the size of the fund provoked a heated parliamentary debate as rumors circulated in Ottawa that CIDA was looking to empty over \$200 million dollars from the fund before its new estimates came before the Standing Committee on External Affairs and Defence.<sup>24</sup> The problem was resolved quite simply when Allan MacEachen, the Secretary of State for External Affairs, added \$200 million from the fund to the 1975/76 appropriation. The published figure for Canadian aid in the current fiscal year (1974/75) is \$933 million. The amount submitted to the Standing Committee was \$712 million to which \$221 million was added from the fund.<sup>25</sup>

With the publication of the White Paper, Prime Minister Trudeau announced the appointment of a new President for CIDA. Paul Gerin-Lajoie, a former Quebec political figure, assumed the leadership of the agency. The basic structure of CIDA remained unchanged (see Charts 1 and 2). Maurice Strong moved on to the Canadian embassy in Japan and later took over the United Nations Environment Agency.

<sup>23</sup>Canadian Institute of International Affairs, International Canada, V (April, 1974), p. 70.

<sup>24</sup>Canada, House of Commons Debates, Vol. 119, No. 80 (Ottawa: Queen's Printer), pp. 3397-3427.

<sup>25</sup>"Statement by the Honourable Allan J. MacEachen, Secretary of State for External Affairs and Minister responsible for the Canadian International Development Agency, to the Standing Committee of the House of Commons on External Affairs and National Defence, April 10, 1975" (Ottawa: CIDA), p. 3.

On April 10, 1975, Allan MacEachern told the Standing Committee that CIDA was in the process of developing a five year plan for Canadian aid policy.<sup>26</sup> The new CIDA strategy for the years 1975-80 was published and released in September of 1975. The Strategy for International Development Co-operation, 1975-80<sup>27</sup> amounts to a new "White Paper" on Canadian aid. Borrowing heavily from the 1975 DAC review,<sup>28</sup> the paper begins by outlining the new position of oil in the international economy and the effect on Third World development of the new oil prices. The Introduction points out quite rightly that it is the non-oil producing LDC's which suffer the most from the increased cost.<sup>29</sup> The Report goes on to point out the disastrous consequences for such least developed countries (LEDC's) as Bangladesh, of both natural and "the recent man-made upheavals." What is not mentioned is the support for OPEC's policies in the Third World!<sup>30</sup> Why should countries which face economic ruin at the hands of a greedy cartel wholly support such policies? What are the real implications of this development for the Canadian aid programme? These questions were not addressed in the document.

<sup>26</sup> Ibid., p. 1.

<sup>27</sup> Canada, Strategy for International Development Cooperation, 1975-1980 (Ottawa: Information Canada, September, 1975). Hereafter called Strategy.

<sup>28</sup> (Paris: OECD, 1975).

<sup>29</sup> Strategy, p. 3.

<sup>30</sup> See "In OPEC We Trust," New Internationalist, No. 35 (October, 1975), p. 18.

Third World countries are calling for a "New International Economic Order" (NIEO).<sup>31</sup> Primary producers in the Third World have been holding regular meetings in an attempt to form a "cartel". The

Increasingly, it may be expected that the developing countries will attempt to exercise whatever leverage they possess to protect their welfare and to reduce their vulnerability and dependence on the actions of the industrialized nations. The forms of such leverage open to them are various and each brings with it major implications for international peace or security. Cartels of primary commodity producers for such diverse resources as bauxite, copper, iron ore and coffee are already being created. It may not be unrealistic to imagine unilateral debt repudiation, nationalization of foreign investments, and blocking of international monetary reform as further steps developing countries might take. Should frustration turn to complete despair, one cannot rule out the possibility of more violent measures.<sup>32</sup>

Fortunately or unfortunately, from an economic perspective, more "OPEC type" cartels in other commodities are not probable.<sup>33</sup> Unilateral debt repudiation may be forced upon many LDC's as the "zero hour" approaches and the debt load of development overtakes national revenues.<sup>34</sup> Nationaliza-

<sup>31</sup>Resolution passed by U.N. 6th Special Assembly in April, 1975. See New Internationalist, n. 30.

<sup>32</sup>Strategy, p. 4; emphasis added.

<sup>33</sup>Raymond P. Mikesell, "More Third World Cartels Ahead?" Challenge, XVII (Nov.-Dec., 1974), pp. 24-31.

<sup>34</sup>G. K. Helleiner, "The Development Business: Next Steps," International Journal, XIV (Winter, 1969-70), p. 171.

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have become politically militant regarding development issues. Canada seems to be offering vague responses when concrete policy is required.

It is not the threat, real or imaginary, from the Third World which should motivate Canada's foreign aid in the future. The reason why developed nations should assist developing countries arises solely from the demonstrated poverty of the latter. Before externalizing the development problem, the Canadian government should seriously examine its own development assistance policies. The following chapter is an attempt to point out some of the problems arising out of Canada's recent development assistance efforts.

## THE DIMENSIONS AND DETERMINANTS OF CANADIAN ASSISTANCE AID

In 1968 the developed countries spent some \$15 billion on cigarettes and some \$35 billion on alcohol.<sup>1</sup> North Americans spend more every year on their pets than they do on development assistance for the entire Third World. The priority placed upon development assistance, by comparison, seems misplaced.

This study focuses on the development efforts of only one of the developed nations--Canada. It is my opinion that the Canadian aid programme is one of the best vis à vis other donors. The criticisms made here can, in all probability, be applied to the other donors. Criticism of our efforts is necessary if Canadians are to play their full role in the development process. Awareness of our own faults will allow us to work toward a rational development policy which will be consistent with

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<sup>1</sup> Partners in Development: Report of the Commission on International Development; L. B. Pearson, Chairman (New York: Praeger Publishers, 1969), p. 4.

Canada is only a very small donor among other DAC members.

Appendix 1 of this study shows the relative efforts of the seventeen DAC members. It should be noted however that Official Development Assistance is not fully and as defined by this study. - ODA includes contributions such as "grant-like contributions" and "government long-term capital." The former includes such programmes as P.L. 480 while the latter entails any loans with a maturity of more than one year. Official flows, as defined by DAC, must meet two criteria:

- (a) [Programmes must be] administered with the promotion of the economic development and welfare of developing countries as their main objective; and
- (b) their financial terms [must be] intended to

<sup>2</sup>Canada, Strategy for International Co-operation, 1975-1980 (Ottawa: Information Canada, 1975), p. 15. Hereafter called Strategy.



as "net official flows." This net category includes both official and unofficial flows. It is made up of both official and unofficial flows. Further, ODA figures are normally given as net of liquidation on previous lending. This means that capital repayments are subtracted from new lending.<sup>3</sup> DAC figures therefore deduct repayments of the principal but do not deduct interest payments.

When the above is considered in the light of the definition of aid presented by this study, the actual aid included in Appendix 1 is considerably smaller than the figures imply. Myrdal claims that in the case of the United States, the largest aid donor, "making an honest account of what can be classified as genuine aid would . . . reduce the official figures by more than half.

<sup>3</sup>Development Assistance  
1969 (Paris: OECD, 1970), pp. 241-2.

<sup>4</sup>John White, The Politics of Foreign Aid (London: The Bodley Head, 1974), p. 146.

<sup>5</sup>Raymond F. Mikesell, The Economics of Foreign Aid (Chicago: Aldine Publishing Co., 1968), p. 196.

of that the price of goods from the developed countries have risen considerably relative to the countries of the developing countries. As a result of this, the ratios of ODA to GNP of the developed countries as a whole have substantially decreased since the late 'sixties' (Figure 5). This points to a growing lack of commitment on the part of the rich to the development process.

#### The Dimensions of Canadian Aid

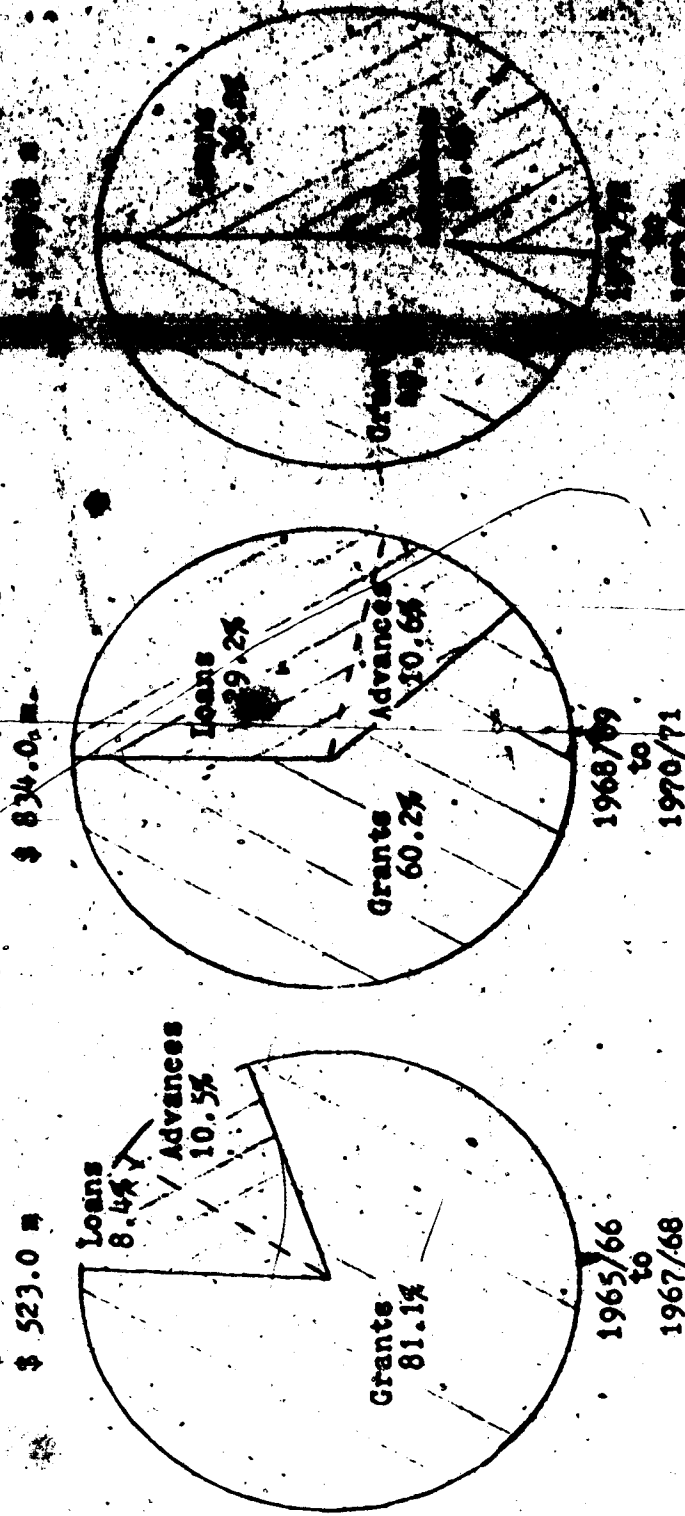
The amount of foreign aid as defined by this study is dependent on two factors. First, the real resources transferred are contingent upon the form of the transfer. In other words, the grant equivalent value of our transfers is substantially smaller than the nominal figures which equate grants and loans. The second factor is that most Canadian aid is tied, i.e. that projects funded must meet Canadian content provisions. As will be seen later, the tying of aid is not nearly as serious in the

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<sup>6</sup>Gunnar Myrdal, Against the Stream: Critical Essays on Economics (New York: Vintage Books, 1975), p. 127.

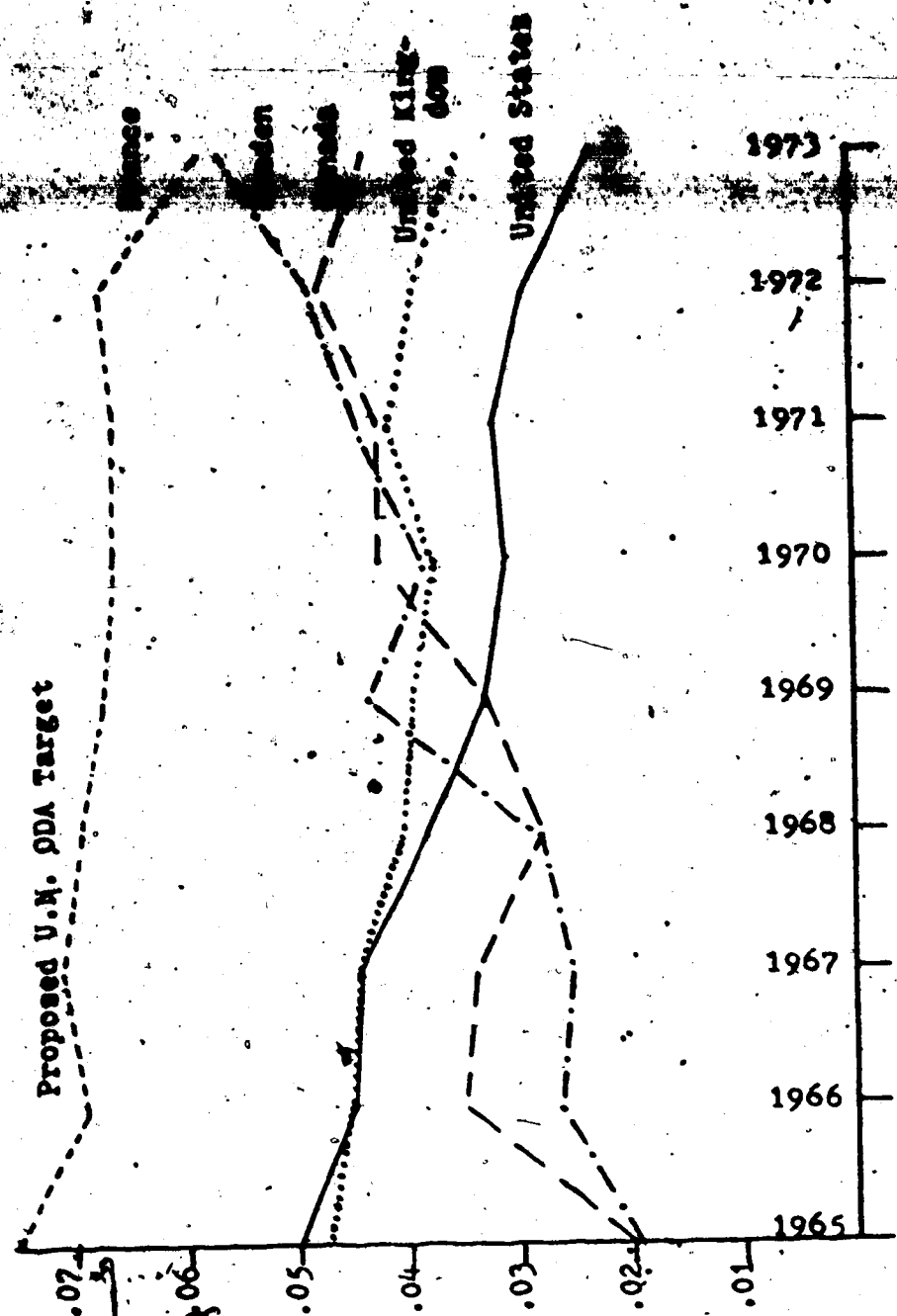
<sup>7</sup>Ibid.

Figure 4. The Decreasing Role of Grants in Canadian Development



SOURCE: CIDA Policy Branch

Figure 5. ODA Efforts, 1965-1973: Canada, United States, France, United Kingdom and Sweden.



SOURCE: From Appendix I.

measurement of aid as the manipulation of the terms of the assistance.

In the earlier chapters it was pointed out that the rate at which loans are discounted is the single most important factor in determining the "aid" content of our ~~development assistance programme. The discount rate~~ used by this study, the long-term government bond rate, is thought to reflect the opportunity cost of public capital. Reuber's study<sup>8</sup> employed four separate discount rates: 5%, 10%, 15% and 20%. Table 3 shows the breakdown of the Canadian programme on a grant-equivalent basis with the nominal amount of the loan but only two discount rates were used. The 10% discount rate is that employed by DAC in assessing the terms of assistance while the long-term government bond rate reflects the assumption of the study. The period covered by the Table is from the 1967/68 fiscal year to 1973/74. The Reuber study covered the period from 1950/51 to 1966/67 (shown in Table 4), and it included Export Development Credits while the figures for this study do not. The exact terms of the loans covered were unavailable from CIDA but an average of the terms was available from DAC's Annual Review. All publications of the Canadian government employ the larger DAC rate in the calculation of the grant elements.

<sup>8</sup> Grant Reuber, "Canada's Economic Policies Towards Less Developed Nations," Canadian Journal of Economics (November, 1968), pp. 669-698.

TABLE 3  
GRANT EQUIVALENT VALUE OF CANADIAN FOREIGN AID DISBURSEMENTS, 1967-1973  
(\$1,000 Canadian)

Year	Grants	Loans	Total	Grant Equivalents		Totals	
				OECD Rate - Bond Rate	Bond Rate	OECD Rate	Bond Rate
1967/68	\$ 41,260	\$ 39,060	\$ 80,320	\$ 33,849 (86.7%)	\$ 28,260 (72.4%)	\$ 75,109	\$ 69,520
1968/69	35,830	57,980	93,810	52,745 (90.7%)	47,980 (82.8%)	88,575	83,810
1969/70	47,910	90,990	138,900	79,879 (87.8%)	73,938 (81.3%)	127,789	121,848
1970/71	50,960	120,250	171,210	106,655 (88.7%)	99,058 (82.4%)	157,615	150,318
1971/72	53,790	140,130	193,920	111,469 (79.5%)	95,444 (68.1%)	165,259	149,234
1972/73	81,180	150,040	231,220	136,085 (90.7%)	125,686 (83.8%)	212,265	206,866
1973/74	117,130	178,930	296,060	160,722 (89.8%)	149,831 (83.7%)	277,852	266,961

SOURCES: DAC Annual Review, 1974; Canada Yearbook, 1973; OMA Policy Branch.



The extremely questionable part of the Canadian programme is the use of development loans. According to the recent "White Paper," the total grant element of Canadian assistance "will remain not less than 90 per cent."<sup>9</sup> The development loan policy is economically irrational. If Canada is giving away over 90 per cent of the loan, why is it loaning the funds in the first place? Surely administrative resources freed by changing from loans to grants would almost offset the additional subsidy. The initiation of the Canadian loan programme is an example of Canada continuing to accept other donors' policies when there is no reason for doing so. We have known for some time that the point at which total development inflows will be overtaken by LDC outflows of amortization is rapidly approaching. UNCTAD has forecast 1975 as the year in which this "zero hour" will occur for many LDC's.<sup>10</sup> When this point is reached the development process will become a drain on the economies of the poorer nations forcing many to default on payment. Surely partaking in such a process is contrary to the stated commitment of the Canadian government. Yet having accepted this approach the "New Strategy" seeks to correct a serious malady by applying only first-aid.

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<sup>9</sup>Strategy. p. 30.

<sup>10</sup>Reuber, pp. 677-78.



Point 15: Relief of Third World Debt  
The Government recognizes the serious problem of indebtedness for developing countries and will continue to take a forthcoming *(sic)* attitude towards the provision of debt relief on a case-by-case basis and when exceptional circumstances warrant it.

The real remedy lies in changing the cause of the indebtedness loans. Canada's terms are very soft but they are loans nonetheless. If we are already giving away over 90 per cent of the value then there is little or nothing to support the inefficiency of asking LDC's to repay us. we intend to encourage other donors, whose terms are often much harsher, to give serious considerations to the implications of indebtedness, then we should begin by abandoning our own loan programme as Australia has done. Further, because we have already foregone the resources transferred by loans, we lose virtually nothing by forgiving all previous indebtedness incurred under the programme. Such a gesture on the part of Canada would in one single effort increase the amount of resources available to recipients of Canadian aid by the total amount of currently outstanding Canadian loans. Canada's voice at international forums would also be substantially increased by such concrete commitments.

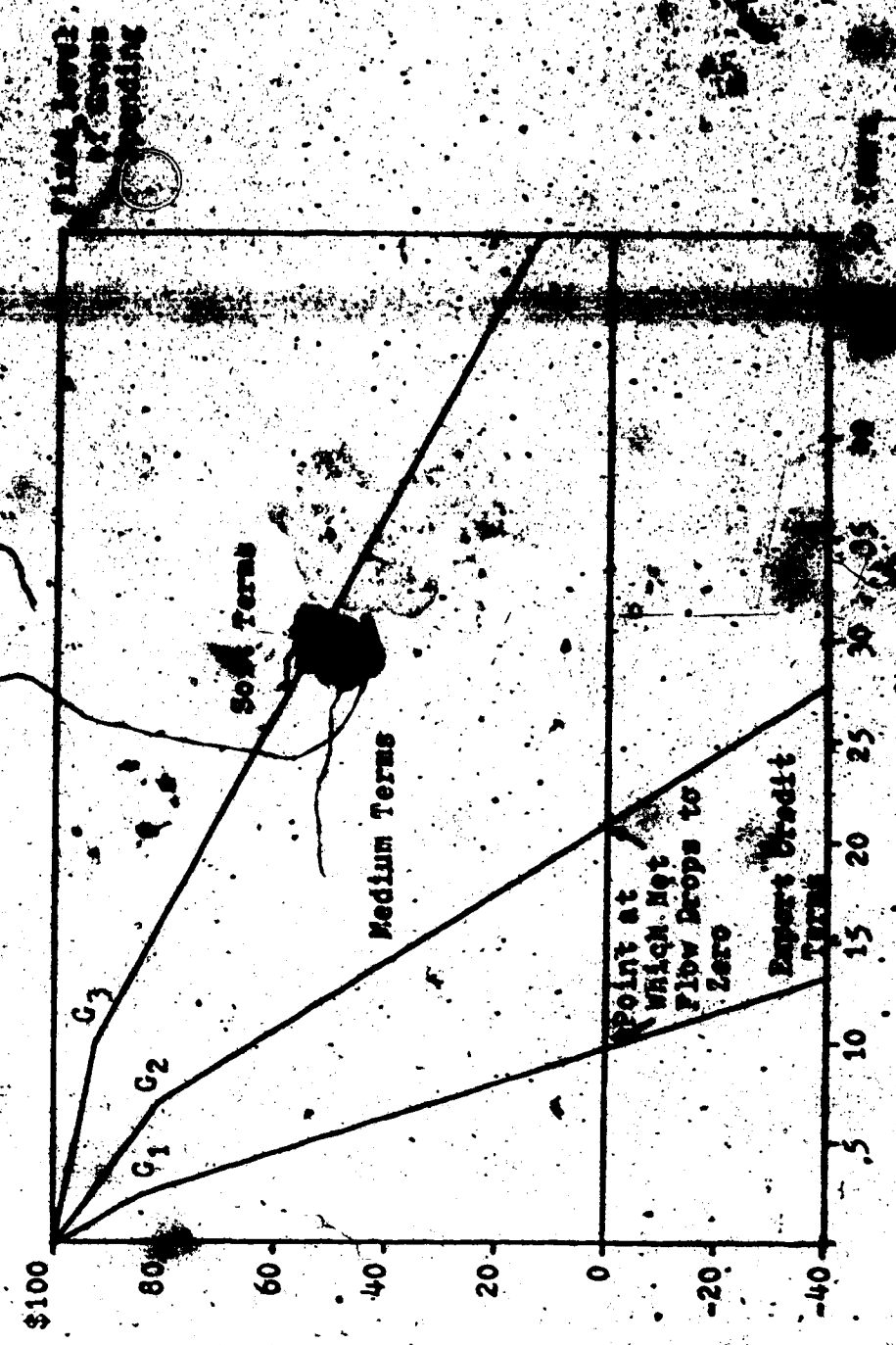
I shall return later to the probable causes of continuing the development loan programme. An examination

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<sup>11</sup> Strategy. p. 33.

of the transfer problem created by debt servicing should serve to clarify the rationale for recommending a change in Canadian policy. If country A receives a Canadian development loan, disregarding for a moment any other loans from other donors, then the following scenario would take place. If A is an ongoing recipient of such loans, i.e. receives loans from year 1 to year n, then the only way of preventing the net transfer from falling to zero is constantly to increase the volume of new lending. If the amortization period is held constant at X years (50 years for most Canadian loans) and the amount of the loan in year one is Y or \$100, disregarding the complication of a grace period and assuming no interest at all, then in year two A would owe Canada  $Y/X$  ( $100/50$ ) or \$2. If Canada wishes to keep the net transfer constant at \$100 in year two, the new lending would have to be  $Y(1+1/X)$  or \$102. In the nth year new lending would have to be  $Y(1+1/X)^{n-1}$  so that at the end of 50 years its lending would have to be increased by 169 per cent just to maintain a net transfer of \$100 (see Figure 6). The results of the above in terms of policy should be obvious. If new lending fails to increase at the above rate then the net transfer will fall to zero. If we wish to maintain a flow of \$100, simply using a grant of \$100 per year would, in the long run, be less costly to Canada

Figure 6: Decline in Net Flow of Resources from Canada if Gross Lending Remains Constant



SOURCES: From Mikewell, p. 109 and CIDA Policy Branch.

...that they are repayable, for the most part, in Canadian dollars. The Canadian government provides a certain number of Canadian dollars to the recipient. A certain amount of this money in Canada may be used for development purposes a grace period of ...

...really had these dollars as part of its market for foreign exchange as receiving the loan would have transferred the Canadian dollar equivalent of the loan to Canada thus saving foreign exchange that would have accrued to it had the loan not been made in the first place. This latter point assumes that Canada would have purchased the imports in any event but the contention here is that any exchange is immeasurably better than nothing. The above argument refers to the long-term probable outcome of development lending by Canada. The effects may not surface for another 15 years but since more donors are laying claim to the scarce foreign exchange of developing nations, Canada must now act to prevent its occurrence.

The second factor which affects the quantity of Canadian aid is that it is tied to Canadian sources. As mentioned earlier, the Canadian government has tried since 1965 to reduce the Canadian-content restrictions of CIDA's

...be tied by ...  
...of ...  
...of ...  
...of ...  
...of ...

...the transfer ...  
...whether or not ...  
...aid is ...

The flow of aid ... whether or not there is  
a reverse flow must be ... from the nominal  
value of the transfer. ... must be accounted for  
to the Canadian economy. ... Canadian ... value of  
the transfer. The transfer is equal to its market value  
provided that it is in the form of a grant. If the trans-  
fer is made in the form of a loan ... must be discounted  
to a grant ... value. The single exception which  
arises is the case of a surplus transfer. ... very well  
be the case, that a commodity has no market value in our  
country if we have ... of it already. This argument  
was frequently used in the case of Canadian food aid in  
the early '50s. Surplus transfers of food grains  
would qualify as aid under the present definition provided







The study was conducted by the author and his colleagues in the United States and Europe. The data were collected from 1947 to 1952. The study was published in the Journal of Political Economy in 1953.

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The study excluded the United States, France, Australia, Belgium and Portugal, because they were deemed to be colonial or ex-colonial countries that have actively sought to maintain their influence among their colonies and former colonies.<sup>15</sup> Australia was said to have a "special interest" in South East Asia (especially New Guinea).<sup>16</sup> It should be pointed out, however, that the

<sup>14</sup> Op. cit.  
<sup>15</sup> Ibid., p. 671.

\*Statistical determinants  
<sup>16</sup> Ibid.



United Kingdom and the Netherlands were also to be  
others who might seek to see the world as a whole to  
the former colonies. The United Kingdom had a special  
interest in South East Asia of which the  
the former as a whole. These four countries were not  
concerned with the former claims but rather with the  
the former as a whole. The former as a whole.

... of the former as a whole. The former as a whole.  
... of the former as a whole. The former as a whole.  
the independent variables are correlated to one another.  
A reasonably strong correlation which exists between  
two or more independent variables in a multiple regression  
equation is referred to as multicollinearity. There is no  
specific statistical test for multicollinearity but it can  
be seen by entering the variables in a stepwise regression.  
The reasoning for this is that if the variables are highly  
interrelated then both would explain approximately the  
same amount of variation in the dependent variable, regard-  
less of their order in the stepwise analysis.

In the Roper model the two independent variables  
are GNP and population. Some evidence of the high inter-  
correlation can be found in Appendix I of that study.<sup>18</sup>

<sup>17</sup> Ibid., p. 672, n. 5.

<sup>18</sup> Ibid., p. 695.

Equation 1.1 shows that 77% of the variation in dependent  
 time is explained by GNP (0.77). Equation 1.3 states  
 that population explains 77% of that same variation. The  
 combined explanation, equation 1.1, is only 92% or 15  
 higher than the bivariate results taken alone. Consider-  
 ing that these figures have been reduced, the increased  
 explanation is probably nil. One might have expected  
 these results in that labour (population) is a necessary  
 component of the production process. It is not surprising  
 that labour is an important factor in the production process  
 the size of the labour force is dependent on the population  
 base. The variables of GNP and population are interrelated  
 by definition and this is shown by the statistical results  
 of the study's model. Since multicollinearity exists in  
 the model, the use and results of regression analysis is  
 unwarranted and perhaps misleading. Reuber's conclusion  
 that foreign aid is a "luxury good" cannot be statistically  
 based on the results of the analysis he presents in the  
 study. A per capita gross national product variable might  
 serve to collapse the two variables and thereby avoid the  
 problem of multicollinearity. The study does demonstrate,  
 however, that the size of an aid programme is dependent  
 on the size of the GNP. This only says that richer donors,  
 i.e. higher levels of GNP, are associated with higher  
 expenditures.

A final problem with the Barber study is the size of the data base. The study uses the UNCTAD data prepared by John Pincus. The rather limited number of observations<sup>19</sup> was necessitated by the lack of existing data at the time the study was attempted. Very little can be determined in the way of trends by the use of such a small number of cases in time-series analysis. Hopefully the improving facilities of DAC will eventually lead to more conclusive results.

The first assumption tested by the present study was that Canada's foreign aid programme was a response to socio-economic conditions in recipient countries.

... that Canadian assistance is going where it is most needed; and I can assure the Standing committee that the new CIDA strategy for the years 1975-80 will emphasize still further, rather than reverse, this basic orientation.<sup>20</sup>

Canadians have been led to believe that it is Third World conditions which determine Canada's aid programme. A variety of socio-economic variables<sup>21</sup> were compiled for

<sup>19</sup> Fifty when using 10 donors and 70 when all 14 are used.

<sup>20</sup> Statement by the Honourable Allan J. MacEachen, Secretary of State for External Affairs and Minister Responsible for the Canadian International Development Agency, to the Standing Committee of the House of Commons on External Affairs and National Defence, April 10, 1975 (Ottawa: CIDA), p. 5.

<sup>21</sup> Discrete variables were also combined to yield new variables. e.g. Per Capita GNP X Population ÷ GNP.

Canadian aid expenditures from 1965/66 to 1971/72 were disaggregated by grants, loans and food aid. Exports to Canada and imports from Canada were recorded for the same time period. Two forms of data matrices were established. The time series matrix used for examining trends and growth rates was 76 countries by nine fiscal periods. The socio-economic matrix was 59 discrete socio-economic and aid variables by 76 countries. The data was also coded by geographic area as outlined by CIDA. The cases composition of each area was:

1. Asia -- 19 cases
2. Francophone Africa -- 20 cases
3. Commonwealth Africa -- 14 cases
4. Commonwealth Caribbean -- 7 cases
5. Latin America -- 12 cases
6. Other -- 4 cases

One of the recurring problems in development analysis is large variation in size between cases. India's population as compared to Burundi's can cause serious research

1. Per-capita gross national product
2. Infant mortality rates
3. Literacy rate
4. Daily caloric intake
5. Percentage of primary production in exports
6. Percentage of manufacturing in gross domestic product
7. Population growth rate
8. Real growth rate in GNP for 1960 to 1970
9. Real growth rate in 1971
10. Real growth rate in 1972
11. Real growth rate in 1973
12. ODA receipts (1968-1970) from the United States
13. ODA receipts (1968-1970) from the United Kingdom
14. Population in 1971

problems. Because of India's size, it receives large absolute amounts of development assistance but on a relative or per capita basis its receipts are conversely very small. Two methods were used by this study to standardize cases. In the first instance, Pearson Product Moment correlations, which are susceptible to "outliers" in the data were compared to Tau B correlations which are not because the Kendall correlation ranks rather than measures the deviations in the data. Significance tests were not applicable to the results as the data contained the universe of Canadian aid recipients.

There is no statistical evidence to support the assertions of the Canadian government that its aid programme is determined by the needs of the recipient countries. If the unheard-of correlation acceptance level of  $\pm 0.5$  ( $R^2 = 0.25$ ) is accepted for both the Pearson Product Moment, and Kendall's Tau B is applied to the Canadian programme, there is still no relationship to indicate a definitive policy. In the simplest terms, the results of the present study indicate that, when taken from the perspective of recipient need, Canada's aid policy is almost wholly random. For example, the assertion that the poverty of a recipient determines whether loans or grants are provided is unsupported. The correlation ( $r$ ) between a country's per capita gross national product and its

receipt of Canadian development grants range from a low of -0.15 in 1972 to a high of -0.19 in 1970. The correlation between loans and per capita gross national product ranges from -0.09 to -0.16. Another example is that Canada is sending food to the world's hungry. Accepting that Canada has responded quickly and with generosity to world emergencies such as Bangladesh and the Sahel disasters, the bulk of our food aid has purportedly gone to feed the undernourished. One would expect to find relationships, but does not, between food aid and daily caloric intake. In this instance, the correlations range from a low of -0.11 in 1970 to a high of -0.20 in 1972.

Canada also has been criticized for following the policies of Britain and/or the United States. Using the OECD figures on both British and American aid, this accusation is also not substantiated by this study. Canada does not follow Britain and/or the United States in either size or location of its development assistance. Another accusation leveled at the Canadian government is that it favours some geographic or political area such as Asia, Commonwealth or Francophone countries. Only very minor deviations were found when the data was disaggregated by geographic sector. There were no changes sufficient to support such a claim.

In brief, there is no statistical evidence to support

the claim that Canadian development assistance has been determined by needs within developing countries.

John White suggests two factors which go a long way towards explaining aid expenditures--visibility and inertia.<sup>22</sup> By visibility, White means that aid agencies require "some sort of general retrospective test of the success and failure of their operations."<sup>23</sup> In other words, the aid administrator wants to see results. It follows, therefore, that with a fixed amount of aid, the agency will favour smaller recipients vis à vis larger recipients. In essence, White is restating the concentration of aid argument so often voiced by Canadian decision-makers.

The tendency in the past has been to look at aid receipts on a relative or per capita basis. As previously pointed out,<sup>24</sup> this method of standardizing aid receipts does not avoid the vast population differences between large and small recipients. Statistically the absolute or per capita approaches both result in "outliers" which render the results meaningless. In order to test this assertion by White, this study employed a Kendall's rather than a Pearson correlation. Since the Tau B approach ranks rather than measures the deviation, the

<sup>22</sup>White, pp. 41-45.

<sup>23</sup>Ibid.

<sup>24</sup>See above, Chapter 4, p. 88.

cases are automatically standardized. The findings of this approach do not support White's assertion. For the total Canadian programme the Tau B correlation between aid receipts and population was 0.32 as opposed to a Pearson correlation of 0.90. Both correlations are positive, i.e. do not support the hypothesis which stipulates an inverse correlation, and the Tau B correlation is far too low to be meaningful.

A somewhat more reasonable explanation of the relatively high aid receipts in smaller countries would be the administrative structure of the donor agency. If an aid agency is structural according to geographic area (e.g. CIDA) then smaller areas would receive aid on the basis of administrative input. In other words, if so many personnel are assigned to a geographic area then the size of the area becomes crucial to the efficiency of administering all aspects of the programme. A smaller population area means fewer projects and more man-hours per project and therefore a greater ability to handle efficiently a relatively larger budget. As the size of the client population increases the number of projects grows geometrically and man-hours are less efficiently used. As the programme grows there is a necessity to increase the number of agency staff in that area proportionate to the number of projects and funds required.



There is therefore a diseconomy of scale in the administration of larger programmes because more and more man-hours are used to coordinate the programme.

The second factor which, according to White's study, seems to explain aid expenditures is inertia. By inertia White means that the aid programme itself is the best determinant of aid expenditures and distribution. The current jargon refers to this inertia factor as "incrementalism."<sup>25</sup> The example often cited by incremental analysts is that the best predictor of today's weather is yesterday's weather. In this sense, White says, present aid spending is determined by previous aid spending.

If one compares the volumes of aid to different countries in a given year, and tries to identify some single factor which explains the differences between them, the factor which fits best is the volume of aid to each country in the previous year.<sup>26</sup>

The technical test for incremental spending policy is to calculate the correlation coefficient between aid flows to recipients in different years.

The DAC found the correlation coefficient for the period of 1964 to 1967 varied between 0.92 and 0.98.<sup>27</sup>

The present study compared Canadian aid spending in 76

<sup>25</sup> David Braybrooke and Charles Lindblom, "Types of Decision Making," in James N. Roseman, ed., International Politics and Foreign Policy, second edition (New York: Free Press, 1969).

<sup>26</sup> White, p. 43; emphasis added.

<sup>27</sup> DAC Annual Review, 1969, p. 178.

countries over the fiscal period of 1965/66 to 1973/74. The approach used tested for incremental spending for total expenditures as well as disaggregating the data by grants, loans and food aid. The incremental spending thesis was strongly confirmed by the results in all categories. For total aid (grants and loans) since 1965 the correlation coefficient of aid spending compared to spending in the previous year is given in Table 5.

TABLE 5  
CORRELATION COEFFICIENTS: PRESENT SPENDING WITH  
SPENDING IN PREVIOUS FISCAL YEAR

Type	1966	1967	1968	1969	1970	1971	1972	1973
Grants	0.99	0.90	0.89	0.89	0.95	0.91	0.91	0.97
Loans	0.97	0.69	0.97	0.98	0.98	0.93	0.94	0.91
Food	0.97	0.99	0.99	0.99	0.98	0.98	0.66	0.89
Total*	0.99	0.97	0.97	0.97	0.99	0.93	0.96	0.88

\*Total=Grants + Loans

It is obvious from Table 5 that Canada's aid programme has followed, almost totally, the previous year's spending. The results are taken over 76 recipients and over nine years. Canada's aid programme is therefore extremely static. If country X received Y dollars last year, it will receive  $Y_i$  dollars this year (i=an incremental deviation). To use White's terminology, the CIDA programme is a captive of its own inertia.

The most striking point in the Table is the fact that food aid has followed the pattern found for grants and loans. The sharp decline in the correlation coefficients in 1972 reflects the situation which arose in Bangladesh. The coefficient shows some signs of returning to the previous incremental trend in 1973. Subsequent observations should confirm this return to the incremental norm.

What does it mean to say CIDA's spending policy is incremental? Basically, incrementalism means that the agency has become its own focal point. Incrementalism arises when an agency does not formulate specific objectives or when it does not attempt to bring its policies to bear on specified objectives. The underlying premise in incremental theory is that fundamental policy changes cannot originate within the agency but are only possible from without, as in the case of natural disasters (Bangladesh). As time passes, an incremental policy gathers more and more momentum and any fundamental change required also grows incrementally. It is therefore necessary to base an incremental policy on a sound programme because all faults in that programme will grow incrementally as well. The previous example of the development loan programme is a case in point. What was initially envisaged as a method of substantially increasing the total volume of aid has

brought with it the unforeseen problem of unmanageable debt burdens in the Third World and the consequent decline in the volume of aid transferred. Because the development loan programme has been gathering momentum since the early 'sixties, agencies such as CIDA are unable to effect what would be a fundamental policy change. What we find instead is an incremental solution such as rescheduling of loans rather than fundamental change such as discontinuing the programme or forgiving the loans.

CIDA has coupled incremental spending with astronomical growth. The rate of incremental change has been exponential rather than linear. In order to derive the rate of growth in CIDA's spending it was assumed that:

$$E_t = E_{t-1} + g(E_{t-1}) \quad \text{or}$$

$$E_t = (1+g)E_{t-1}$$

where  $E_t$  represents present spending and  $g$  represents the annual growth rate. The general model derived from the above is:

$$E_t = (1+g)^n E_{t-n}$$

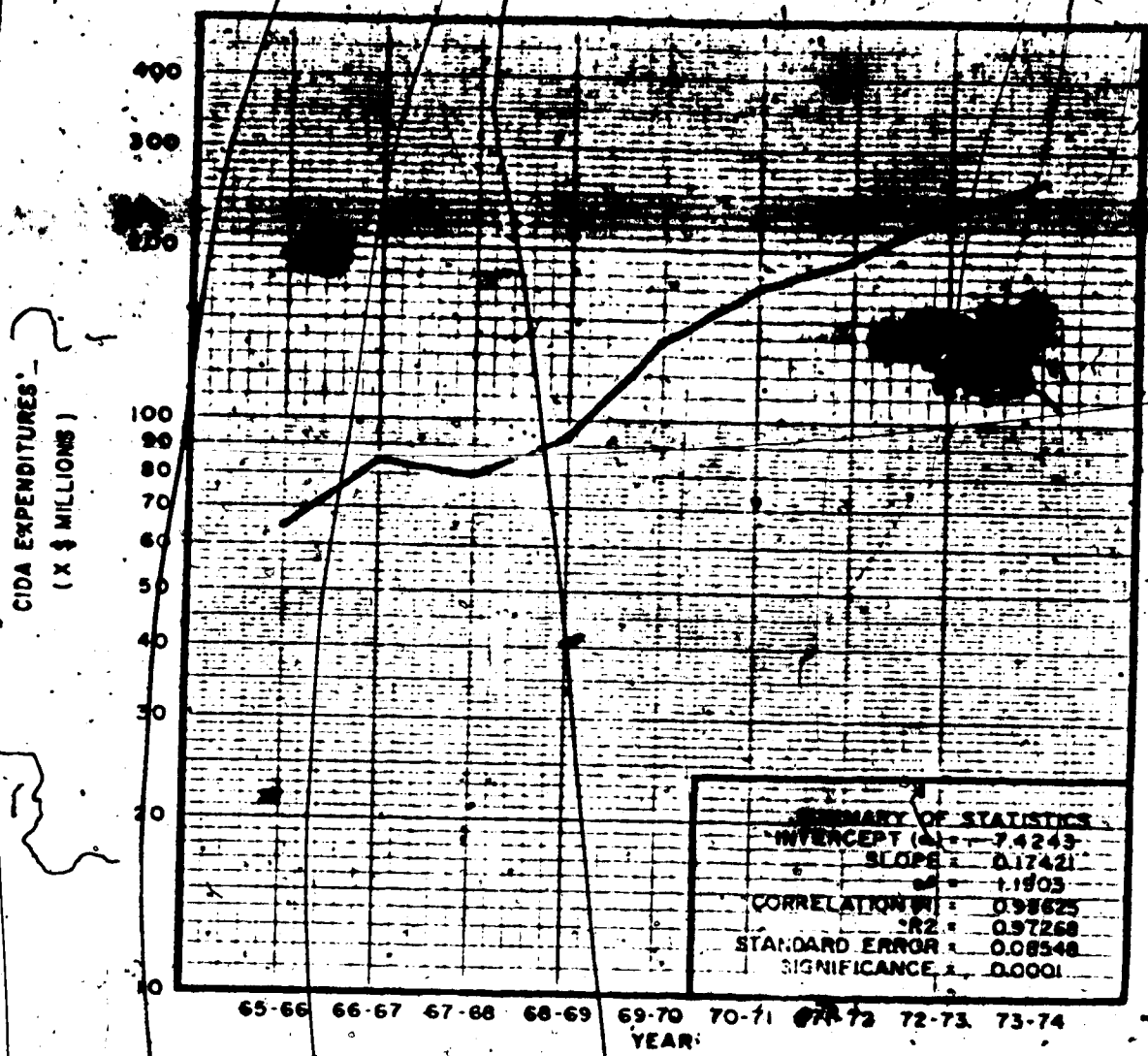
where  $n$  represents the number of years being examined.

This model can be fitted to ordinary least squares such that:

$$\text{Log } E_t = \text{Log } a + \beta \text{Log } t$$

where  $a$  = the log of the intercept value and  $\beta = g(1+g)$ .

Figure 7



LOGARITHMIC REGRESSION OF CIDA EXPENDITURES  
1965 - 66 TO 1973 - 74

Hence the growth rate  $g$  can be derived by subtracting 1 from the antilog of  $\beta$ , i.e.,  $(\text{antilog } \beta - 1.0)$ .<sup>28</sup> When CIDA spending (grants and loans) was examined from 1965/66 to 1973/74, the rate of growth was found to be 19.03% compounded annually.<sup>29</sup> Figure 7 visually demonstrates the results. The correlation ( $R$ ) was 0.99 and the explained variation ( $R^2$ ) was 0.97 or 97%. The results were significant at the 0.0001 or 99.999% level.

CIDA, according to the recent "White Paper," will continue to emphasize the growth of expenditures. How much Canada gives under its aid programme is not as important as how we give it. In the long term, incremental policy will lead to a disillusionment on the part of the government, the recipient, and the taxpayer. Canada's aid programme should grow but policy must be based on clearly stated objectives derived from recipient needs rather than previous spending.

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<sup>28</sup> See Boris Pesek, "Economic Growth and Its Measurement" in W. L. Johnson and D. R. Kamerschen, eds., Readings in Economic Development (Cincinnati: South Western Publishing Co., 1972), pp. 132-154.

<sup>29</sup> Growth not adjusted for domestic inflation. When converted to a constant figure this growth rate is 8.7%. The disaggregated growth rates support the previous argument regarding development loans. The growth rate for grants was 8.9% in current terms and -0.5% in real terms while the growth rate for loans was 37.7% in current terms and 25.8% in real terms!

## CONCLUSION

This study has considered some of the more relevant theoretical considerations of foreign aid and has applied these and other criteria to Canadian foreign aid policy since 1965. The study can therefore be divided between theoretical considerations of foreign aid and the Canadian case study.

A number of conclusions were formulated by this study regarding foreign aid theory. The definition of foreign aid advanced by this study is as follows.

Foreign aid is the official unidirectional transfer of real resources from developed nations to developing nations, for the purpose of promoting the economic development of the recipient.

The measurement of foreign aid is contingent upon the operating assumptions posed by this definition. The definition explicitly denies that commercial transactions can be classified as foreign aid because the transfers must be unidirectional. This distinction led to three findings which were felt to be significant regarding the measurement of aid flows.

First, by using the noncommercial approach, foreign aid can be looked at as forming a continuum, which ranges

from grants of convertible currency (100% aid) to fully commercial transactions (non-aid). This approach seems useful in dealing with the multitude of terms which are often attached to an aid transfer.

Second, it was found that the discount rate employed in evaluating the "grant-equivalent" value of aid is the single most important factor in measuring aid. This study concluded that the only rate which should be employed in calculating the grant equivalent is the long-term government bond rate. Since the capital involved is public rather than private, it is felt that rates applicable to the private sector are inappropriate and often misleading.

Finally, the employment of this scalar technique and the present definition is useful in quantifying transfers-in-kind. Again, the most important factor in quantifying commodity aid is the terms of the transfer. Grants-in-kind are aid to their full value provided the commodities can be assigned a market value in the domestic economy and/or in the recipient country. A loan which applies to a commodity should be measured at the world market price because the domestic price reflects a domestic subsidy.

Chapter 3 of this study was broadly aimed at updating the history of Canadian foreign aid. Keith Spicer's book, A Samaritan State?, provides a thorough examination of the history of Canadian foreign aid before 1965. Unfortunately, there has been no follow-up to that



study although it would certainly be useful.

The case study introduced by Chapter 3 and continued in Chapter 4 is felt to be the relevant issue for the present study. There were basically two questions examined:

- 1) How much "foreign aid" does Canada give?
- 2) What determines Canada's foreign aid spending?

The answer to the first question is that Canadian "foreign aid" is somewhat less than the figures published by CIDA. The relevant point raised was the difference between the figure derived when the OECD discount rate is employed and the results when the long-term government bond rate is used. The fact that either discount rate results in a very high proportion of concessionality, i.e. grant equivalent, must force serious reconsideration of Canada's development loan programme. The loan programme should be eliminated as it is counter-productive to the development process to which the Canadian government has stated its commitment.

The original problem posed by this study was to evaluate the magnitude of Canada's response to the needs of recipients. The conclusion of this study is that there is no statistical relationship between recipient needs and Canadian policy. This random pattern of distribution of Canadian funds suggested a high degree of ad hoc decision-making. This subsequent hypothesis was almost perfectly confirmed when prior spending was used as a criterion. The

levels of incrementalism visible in Canada's foreign aid policy reflect the preoccupation of CIDA with disbursement to the virtual exclusion of all else. The recent "White Paper" fails to provide what is urgently required by the agency—concrete development objectives. Indeed, the major focus of the paper is increasing disbursements in order to reach the internationally accepted figures of 0.7 per cent of the GNP. At a current growth rate of over 19 per cent annually, the directionless spending will become more serious. The Canadian government has been under considerable pressure both domestically and internationally to reach the U.N. target figure. What is required is not more aid but better aid. The question of quantity should not be addressed before the quality of the programmes has been examined. The Canadian effort to increase the amount of its assistance to developing nations shows a commitment to development but has also forced CIDA to emphasize disbursement and has not allowed the agency to examine its objectives in concrete terms. In point of fact, Canada could increase its "foreign aid" substantially without increasing its expenditures.

Appendix I

APPENDIX I  
NET FUNDS OF OFFICIAL DEVELOPMENT ASSISTANCE FROM DAC MEMBERS TO LESS DEVELOPED COUNTRIES  
AND MULTI-LATERAL AGENCIES, 1965-1973

Country	1972 Per capita \$ US	1966	1967	1968	1969	1970	1971	1972	1973
Australia	3620	119	126	157	160	175	202	267	286
		.52	.53	.60	.57	.56	.53	.59	.44
		4	3	3	3	3	4	4	8
Austria	2730	32	31	26	23	16	11	12	18
		.34	.31	.24	.20	.11	.07	.09	.13
		9	10	12	14	12	17	17	16-17
Belgium	3600	102	76	89	88	116	120	166	193
		.59	.42	.45	.42	.50	.46	.50	.55
		2	7	5	5	5	5	5	5
Canada	4760	97	187	198	175	245	346	331	492
		.20	.35	.34	.28	.33	.42	.42	.47
		11	9	9	.11	10-11	6	8	7
Denmark	4210	13	28	26	29	54	59	74	96
		.13	.19	.21	.23	.38	.38	.43	.45
		16	13	14	13	8-9	7-8	7	8
France	3790	752	745	826	874	955	971	1075	1320
		.75	.69	.71	.69	.67	.66	.66	.67
		1	1	2	1	2	2	2	2-3
Germany	4170	431	440	528	553	579	599	734	808
		.38	.37	.43	.41	.38	.32	.38	.31
		7	8	8	6	8-9	10-11	10	11
Italy	2180	60	78	155	146	150	167	183	302
		.10	.12	.22	.19	.16	.16	.18	.09
		15	15	13	15	15-16	15	16	16-17
Japan	2750	244	283	384	356	436	458	511	611
		.28	.28	.32	.29	.26	.29	.23	.21
		10	11	10	12	13	13-14	13-14	14-15

Appendix I  
(Continued)

Country	1972 Per capita BASE	1965	1966	1967	1968	1969	1970	1971	1972	1973		
Netherlands	3430	10	A	70	94	114	134	163	196	216	307	322
			B	.36	.45	.49	.53	.50	.61	.58	.67	.54
			C	8	5-6	4	4	695	3	3	2-3	4
New Zealand	M/A	M/A	M/A	M/A	M/A	M/A	M/A	12	14	17	19	29
			B	--	--	--	--	.22	.23	.23	.23	.27
			C	--	--	--	--	14	13-14	13-14	13	12
Norway	3900	7	A	11	14	15	27	30	37	42	63	64
			B	.16	.18	.17	.29	.30	.32	.33	.33	.45
			C	13	14	15	9	12	10-11	11	9	7
Portugal	860	16	A	21	24	27	35	70	81	99	154	75
			B	.37	.59	2-02	.69	1.20	.67	1.42	1.79	.91
			C	3	2	1	2	1	1	1	1	1
Sweden	5080	2	A	38	57	60	71	121	117	159	181	275
			B	.19	.26	.25	.28	.43	.30	.44	.48	.56
			C	12	12	11	10	6	7-8	6	6	3
Switzerland	4700	4	A	12	14	12	23	30	30	28	65	64
			B	.08	.10	.07	.13	.16	.15	.12	.21	.13
			C	16	16	16	16	15-16	15	15	14-15	15
United Kingdom	2730	14	A	472	486	485	413	431	447	562	609	603
			B	.47	.46	.44	.40	.30	.27	.41	.39	.35
			C	6	4	6-7	7	7	9	9	10	11
United States	5510	1	A	2445	2459	2567	3303	3080	3056	3324	3349	6 2948
			B	.50	.45	.44	.38	.35	.31	.32	.29	.23
			C	5	5-6	6-7	8	10-11	12	12	12	14

A = Net Flow (305 Millions); B = Flows (CIP at market prices); C = Rest of member based on flow as I CIP.

SOURCE : DAC Annual Reviews, 1965-1974.

## APPENDIX II

## THE GRANT ELEMENT IN DEVELOPMENT LENDING\*

When loans are made on concessionary terms, these may be said to comprise an aid element, and it is reasonable to wish to estimate this grant element in cash terms and regard it as the sacrifice (or benefit) associated with such loans. The natural definition of the grant element is the difference between the face value of a loan and the present value of all future repayments (amortisation and interest payments), discounted at a proper rate of interest.<sup>1</sup>

## The Grant Element

The choice of the proper discount rate cannot, in the absence of an integrated world capital market, be the same if the attention is focussed on the sacrifices of the lenders and on the benefits of the borrowers. In the first case, a rate expressing the prevailing long-term yield on public capital is an appropriate measure of the opportunity cost of public loanable funds. In the second case, the alternative rates available to borrowers in underdeveloped

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\*SOURCE: Gorin Ohlin, Foreign Aid Policies Re-considered (Paris: Development Assistance Committee of the OECD, 1966), pp. 101-105.

<sup>1</sup>Cf. John A. Pincus, "The Cost of Foreign Aid," Review of Economics and Statistics, XLV (1963), pp. 360-367.

countries are more elusive; their access to free capital markets is sporadic. In any case, the long term rate that would represent the borrowers' opportunity cost is clearly a good deal higher than that which pertains to the lenders.

The present note is only concerned with the formal aspects of the problem: given the terms of a development loan and an appropriate rate of discount, how can the concessionary element readily be estimated?<sup>2</sup>

Public loans of the kind we are here concerned with typically provide for a grace period of a certain number of years during which no repayment of principal is made. Thereafter, principal is usually repayable in equal instalments, although other amortisation principles are occasionally followed. In the case of certain United Kingdom loans with maturities of 25 years and grace periods of seven years, interest payments are also waived during this grace period, which obviously reduces the effective rate of interest.

In the following, it is for convenience assumed that amortisation and interest payments are made continuously, rather than at discreet intervals of six months or a year. We use the notation:

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<sup>2</sup>In Wilson E. Schmidt's paper, "The Economics of Charity: Loans versus Grants," Journal of Political Economy, August, 1964, which appeared after the completion of this note, the discrete formulas for present cost are derived, though without consideration of grace periods.

L	face value of the loan
P	present value of future repayments at time of lending
$p = P/L$	present value as share of face value
$S = L - P$	subsidy or grant element
$s = S/L$	grant element as share of face value
i	rate of interest
q	rate of discount
T	tenure
G	grace period
D	net indebtedness

In the first place, it may now be observed that, if the rate of interest is not concessionary, there can be no grant element in the sense in which the term is used here. The grace period and the amortisation schedule, no matter how important they may be in other respects, will not alter the fact that the discounted present value of repayments will equal the face value.

The outstanding debt at time  $t$  is  $D(t)$ , interest payments, therefore,  $i D(t) dt$ , and amortisation payments  $D(t) dt$ . The present value of these payments, discounted at a rate  $q$ , is:

$$P = \int_0^T (i D(t) - D(t)) e^{-qt} dt \quad (1)$$

As  $D(0) = 0$ , partial integration gives:

$$P = L - (q-i) \int_0^T D(t) e^{-qt} dt \quad (2)$$

With a rate of discount different from the interest rate of the loan, a grant element will arise, and it will depend on the mode of amortisation. I assume that during the grace period,  $G$ , there is no repayment of principal but that principal is then repaid in equal instalments in the remaining years of the loan, at a rate of  $\frac{L}{T-G}$ . During the first  $G$  years, only interest payments are made, their present value is:

$$P_1 = \int_0^G iL e^{-qt} dt = \frac{iL}{q} (1 - e^{-qG}) \quad (3)$$

The present value of the repayments of principal and payments of interest made after the grace period is:

$$P_2 = \int_G^T \left[ \frac{L}{T-G} + iL \left(1 - \frac{t-G}{T-G}\right) \right] e^{-qt} dt \quad (4)$$

which is easily shown to be:

$$P_2 = \frac{1}{q} L e^{-qG} + \left(1 - \frac{1}{q}\right) L \frac{e^{-qG} - e^{-qT}}{q(T-G)} \quad (5)$$

Adding  $P_1$  and  $P_2$  gives the solution for this case.

If the present value is written as a proportion of the face value:

$$p = \frac{1}{q} + \left(1 - \frac{1}{q}\right) \frac{e^{-qG} - e^{-qT}}{q(T-G)} \quad (6)$$

If there is no grace period, i. e.  $G = 0$ , this reduces to:

$$p = \frac{1}{q} + \left(1 - \frac{1}{q}\right) \frac{1 - e^{-qT}}{qT} \quad (7)$$

or:

$$s_0 = \left(1 - \frac{1}{q}\right) \left(1 - \frac{1 - e^{-qT}}{qT}\right) \quad (8)$$



For very short-term loans,  $q$  is fairly small and as an illustrative approximation one may expand  $q^{-t}$  in series and drop the terms beyond the second power. This reduces  $q^{-t}$  so that the grant element is simply:

$$a_g = \frac{1}{2}(q-1)T \quad (9)$$

In other words, the concession in interest to the rate of interest is applied to the average balance of the loan over the term of maturity.

When the discount rate is not permissible, and the formula used to estimate the grant element in long-term loans with a grace period is (8) or more correctly, its complement:

$$a = \left(1 - \frac{1}{q}\right) \left(1 - \frac{q^{-nG} - q^{-nT}}{q(T-G)}\right) \quad (10)$$

In Tables 1-4, this expression has been calculated for loans of 10, 20, 30 and 40 years maturity, with grace periods of 0, 5 and 10 years.

The tables actually show great regularity, and when the discount rate is too high, it is possible to use the following rules of thumb:

Each concession of one percentage point in the interest rate (below the discount rate, seen as an alternative for the lender) gives rise to a grant element of:

4 per cent of the face value for a 10-year loan;

7 per cent for a 20-year loan;

9 per cent for a 30-year loan, and

10 per cent for a 40-year loan.

A grace period will increase the grant element by the proportion  $G/T$ . Take as an example a loan given at 30 per cent, rather than a prevailing normal rate of 6 per cent, maturing in 20 years and with a grace period of 5 years. The grant element will be:

$$s = T \times (2.5 + \frac{5}{20}) = 26\%$$

which is in accordance with Table 2, which shows 25.5

An even more approximate way is to use the following formula:

$$s \approx (q - 1) (2.5 + \frac{G}{T}) (1 + \frac{q}{T}) \quad (11)$$

The simplicity of this formula is gained at some sacrifice of precision, but it is serviceable in the relevant range<sup>1</sup>. To illustrate, a 10-year loan at 4 per cent, discounted at a rate of 6 per cent, will contain a grant element of

<sup>1</sup> When the grace period is relatively short compared to the maturity, expansion of (10) shows that it can be written as:

$$s = (q - 1) (1 + \frac{G}{T}) \frac{1}{q} (1 - \frac{1 - e^{-qT}}{qT})$$

$$\text{Now, } \frac{1}{q} (1 - \frac{1 - e^{-qT}}{qT}) = T (\frac{1}{2} - \frac{1}{3!} qT + \frac{1}{4!} q^2 T^2 - \dots)$$

but when  $qT \ll 1$ , this series converges very slowly. However, when  $q = 6$  per cent, a least-squares fit over the range between 10 and 40 years gives the linear approximation  $2.49 + 0.205 T$ .

$(6-4) (2.5 + 2) = 9 \text{ per cent.}$

The correct figure is 8.7 per cent, according to Table 1. A 25 year loan with a 3-year grace period, carrying an interest rate of 3 per cent and discounted at 6 per cent has a discounted present value of

$(6 - 3) (2.5 + 6) (1 + 1/6) = 30 \text{ per cent.}$

The correct ratio, according to Table 3, is 30.5 per cent. A soft development loan of 40 years maturity,

discounted as in the other cases at 6 per cent, gives:

$(6 - 2) (2.5 + 8) (1 + 1/6) = 52 \text{ per cent}$

while the actual figure in Table 2 is 49.4.

If not only amortisation but interest as well is waived during the grace period, a direct and substantial grant element will, of course, result, whatever the rate of discount. Its present value will be that of  $P_1$  in (3). Thus, for a loan of the type given by the United Kingdom, a maturity of 25 years, a grace period of 7 years and a rate of interest of 5.5 per cent, this waiver amounts to a grant element of 31.2 per cent, even if 5.5 is taken as a normal market rate so that no concession is involved on that account - which is, more or less, the principle on which the interest on United Kingdom loans has been set.

Such a waiver may, of course, alternatively be seen as a reduction of the effective rate of interest. The

effective rate of interest may be said to be that rate of discount which would make the present value of the remaining flow of repayments equal to the face value. That present value is expressed by  $P_2$  in (4), and the effective rate of interest will be that  $q$  which makes  $P_2 = L$ . For the loan described in the previous paragraph, the waiver of interest payments during the grace period turns out to reduce the effective rate of interest from 4 to 2.75

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