International Project Finance
The case of Kuwait Fund for Arab Economic Development

by
Sulaiman Ahmed Al-Jassar

M.A. Economics, Yale University, 1988
B.Sc. Economic-Finance, Bentley College, 1985

Submitted to the Departments of Civil and Environmental Engineering and Sloan school of
Management in Partial Fulfillment of the requirement for the degree OF

DOCTOR OF PHILOSOPHY

IN THE FIELD OF
INTERNATIONAL PROJECT FINANCE
AT THE

MASSACHUSETTS INSTITUTE OF TECHNOLOGY
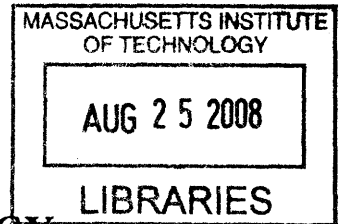
SEPTEMBER 2005
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Signature of the Author: _____
Departments of Civil and Environmental Engineering and Sloan School Management
August 10, 2005

Certified by: _____
Donald Lessard
Epoch Foundation Professor of International Mgmt
Sloan School of Management

Certified by: _____
Fred Moavenzadeh
James Mason Crafts Professor of Civil and
Environmental Engineering and Engineering Systems,
Director, Center for Technology, Policy and Industrial Development

Accepted by: _____
Birger Wernerfelt
J.C. Penney Professor of Management Science
Chair, Ph.D. Program, Sloan School of Management

Accepted by: _____
Andrew J. Whittle
Chairman, Departmental Committee for Graduate Students

INTERNATIONAL PROJECT FINANCE:
The case of Kuwait Fund for Arab Economic Development
BY
Sulaiman A. Al-Jassar

ABSTRACT[1]

This thesis examines the record of the Kuwait Fund for Arab Economic Development (KFAED) in light of changing fashions regarding the proper role and management of such funds in the development finance process. The key questions addressed are whether its concessional aid is allocated according to Donor Interest (DI) or Recipient Needs (RN), what precisely is the grant element in KFAED loans, whether this grant allocation is consistent with the fund's stated policy and if it is linked to one or more of the currently held views regarding how aid should be allocated in order to be most effective – to overcome the "two gaps," to strengthen institutions and governance or to reward/incentivize effective macroeconomic management.

The KFAED is an interesting and important subject of study for many reasons. After Saudi Arabia, Kuwait is the second largest Arab aid donor, having contributed a total of more than $18.5 billion between 1960 and 2002. It was the first to officially establish a bilateral aid institution: KFAED, which purports to be free of mercantilist motives as its aid is not tied to procurement, as is the case with most developed countries' aid institutions.

The thesis consists of three mutually dependent sections. The first surveys the domain of theoretical and empirical development economics since World War II. It reviews its evolution over time, linking successes and failures in development aid to the refinement of macroeconomic points of view among various schools of thought. Since the implementation of any economic policy is highly sensitive to the political goals of the policy makers, we show that the evolution of macroeconomic theory is not, in itself, able to account for

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changes in the pattern of development aid. "Fashions" in such aid reflect not only the past history of aid itself, but also the histories of the donor nations or their multi-lateral vehicles. Our specific interest in regional Arab geopolitical development is contextualized in order to trace the effects of development theory evolution on the Middle Eastern region.

The second section studies the aid allocation of the KFAED. It seeks to determine, among other things, whether the allocation of aid reflects recipient needs or donor interest. We modeled the allocation decision as a two-stage process: selection and allocation. The empirical analysis demonstrates that income, ethnicity, religion and politics are all factors in the selection stage. Arab, Muslims countries and more populous countries receive a higher share of the total aid allocated (allocation stage).

The third section extends the second by adding the third stage: grant element determination. It addresses two questions: how grant element is calculated and what factors influence its allocations. In addressing the first question, we offer a rationale for an adjusted discount rate in calculating grant element--the percentages of subsidy embedded in the loan. When this rate is applied, the results point to consistent overestimation of the traditionally published grant element statistics.

We then examine the grant element allocation. We find that the actual allocation is quite different than that implied by the stated policy of the KFAED. Chief among the sources of variation are political factors, income and sectors.

Finally, we test to see if the current grant element allocation is in line with any of the three views regarding how aid should be allocated: the two gap, macroeconomic management, and governance and institutions building. We find that it is weakly related to the two-gap view, but appears to bear no relation to the other two.

Thesis Supervisor: Donald Lessard
Title: Epoch Foundation Professor of International Management.
Sloan School of Management

Thesis Supervisor: Professor Fred Moavenzadeh
Title: Professor of Civil and Environmental Engineering
Director, Center for Technology, Policy, and Industrial Development
Director, Technology and Development Program

Thesis Errata Sheet

Author Sulaiman Ahmed Al-Jassar
Primary Dept. Civil and Environmental Engineering
Degree(s) Ph.D   **Graduation date** Sep 2005

Thesis title

INTERNATIONAL PROJECT FINANCE:
The case of Kuwait Fund for Arab Economic Development

Brief description of errata sheet

After submitting a hard copy of my thesis, I discovered the following mistakes: (a) some of the tables were out of numerical sequence, and (b) due to a mix-up caused by the computer program I was using, certain passages that were part of my source material were inserted into my text. I advised my committee and the school of the mix-up, and was advised to use an errata sheet to make corrections.

Number of pages 10 (11 maximum, including this page)

▶ **Author**: I request that the attached errata sheet be added to my thesis. I have attached two copies prepared as prescribed by the current *Specifications for Thesis Preparation*.

Signature of author   Date 7/8/2009

▶ **Thesis Supervisor** or **Dept. Chair**: I approve the attached errata sheet and recommend its addition to the student's thesis.

Signature   Date 8/03/09
Name Fred Moavenzadeh   ✓ Thesis supervisor   Dept. Chair

▶ **Dean for Graduate Education**: I approve the attached errata sheet and direct the Institute Archives to insert it into all copies of the student's thesis held by the MIT Libraries, both print and electronic.

Signature   Date 7/31/09
Name Steven R. Lerman

Addendum

The following pages list all current corrections to the submitted version of my PhD thesis. The mistakes were discovered after the Final version was submitted, and were noticed by the author during his attempt to apply the same study on other Arab developmental institutions.

The mistakes mostly involve instances in which source material was mistakenly included in the text when I ran a program on the text to check on the text's sources and formatting. Two sources that were deleted I have restored, and the rest have been already cited in the footnotes and end of chapter references. Due to formatting error, the tables numbering got mixed.

All errata are explained under three headings. The first cites page and line number, followed by the first and last words of the text to be replaced, followed by the corrected passage.

For the sake of clarity, I replaced a few long passages in their entirety despite the fact that they contain many lines that don't require correction.

Finally, these corrections do not affect any of the thesis results or conclusion. We apologize for any inconvenience this may cause the reader.

Page 68 Line 2
Replace "This is… observations." with:
There is a widespread perception, even in the aid community, that Kuwait's aid policy is driven largely by its solidarity with the development needs of poor countries, since, outside of its PP wealth, Kuwait could easily be in the same state. It is thus acting out of conscience rather than to gain self- interested and political ends. An econometric model for the allocation of KFAED concessional aid is proposed in this paper. We present the allocation decision as unfolding in two stages, namely: first, the decision to grant aid, and then, how much. These two steps will be explicitly modeled in order to capture and explain the relationship between them and KFAED decision process. We will apply models derived from the literature of aid allocation to frame the processes by which KFAED allocated and distributed aid during the 1974-2001 period, and see whether the determinants of aid really match its officially stated justifications.
Following this introduction, Section II provides a descriptive analysis of Kuwait aid in a historical perspective. In Section III, aid literature is reviewed, along with the hypotheses about Kuwait bilateral aid selection and distribution among recipient countries. This framework is tested in Section IV, and the empirical analyses and results are presented in Section V. Concluding observations.

Page 71 Line 9 Replace "he" with the

Page 73 Line 13: Replace "the basic... Rodrik (1996)" **with:**

The consensus point of view is that donor nations and entities allocate their foreign aid in order to maximize their own objectives, rather than seeking to achieve exogenous goals, such as those that emerge in the recipient states. The true motive set can only be logically inferred, outside of the unlikely case that the researcher gets a chance to examine the pertinent documents involved in the allocation process. The methodological assumption about aid allocation decisions is that the aid makers, in the donor states, look for recipients who must be a., worth targeting (for economic, strategic, or other reasons), and b., have mechanisms in place such that they can organize and adjust structures so as to bring them in line with the donor country's policy suggestions. The methodology thus involves establishing viable hypotheses relating aid flows to the observed characteristics of recipient countries and donors' other motives, (see McGillivray and White 1993a).

Earlier studies, (eg Wittkopf (1973), Mckinlay and Little (1977; 1978a, 1978b; 1979), McKinlay (1978), Maizels and Nissanke (1984) and Tsoutsoplides (1991)), treated recipient needs (hereafter RN) and donor interests (hereafter DI) separately, by modeling each as stand alone aspects of aid allocation.. The RN model assumes that the optimum plea for aid must appeal to the donor's sense of duty, as it were: thus, the appeal highlights and focuses on the recipient candidates economic and social welfare. On the other hand, the DI model supposes that donors use the allocation of aid to gain foreign policy and strategic objectives and/or to promote their own economic self-interest. From the RN point of view, developmental aid is a form of international justice. But the DI point of view seems to be the better approach to how the pattern of development aid has really evolved in the three decades prior to the 1990s, at least for bilateral donors. Not unexpectedly, however, the RN point of view does a better job of accounting for the pattern of multilateral aid allocation, since the latter necessarily dilutes the individual donating nation's self interest, according to Maizels and Nissanke (43 percent of the variation). The dilution of interests may allow multilateral agencies more elbow room to engage in enterprises that are less governed by political considerations than when the aid is bilateral, a point investigated by Rodrik (1996).

Page 75 Line 5
Replace "Grilli and Riess (1992)... countries" **with:**
and in attempt to construct an indicator of recipient needs, Grilli and Riess (1992) turned to the Human Development Index (HDI) prepared by the UN Development program, combining it with an index of external debt stocks to determine the recipient's debt burden. Trade with the donor countries (the recipient nation's exports) was taken as the measure of the recipient nation's commercial importance to the donor, while population size was included in order to account for small country bias. They reported that European bilateral aid allocation seemed to be definitely influenced by commercial motives. European multilateral aid allocations, on the other hand, are more influenced by considerations for development needs. Grilli and Riess also showed that the divergence between the bilateral and multilateral motive sets had increased over time, which, they speculated, may reflect the declining role of colonial ties and other (political) factors. They did not produce metrics for political and strategic motives, but the consensus assumption is that security probably plays some not insignificant role in the choice of recipients and the amount and type of aid in the post cold war global order.

Some studies (e.g. Daveri and Grilli 1991 and D'Agostino 1989) conducted on the pattern of aid allocation among individual donors have found a polar pattern in their aid allocation. This pattern ranges from an allocation policy guided entirely by self-interest (as with France) to one that is directed solely by recipient interest (as with Dutch and Nordic). Some other donors were in the middle of these extreme cases, like United Kingdom, Italy and Germany. Alesina and Dollar (1998) in their study of bilateral aid allocation between 1970-94, concluded that the donor's political considerations weigh more than recipient economic needs in the decision to allocate aid.

In line with the studies of the European states, others have found that the aid that flowed from three of the largest donor states, the United States, France and Japan, tended to go largely to 'friendly' countries. Again, the aid provision was not determined by the scope of economic needs or performance. According to Alesina and Dollar, this explains why "at best, [aid has been] only partially successful at promoting growth and reducing poverty" in recipient countries. While those recipients that have democratized received marginally more aid, an even more power determinant of aid provision has been colonial ties to the donor country or political alliance with the donor country. The authors have a lot of evidence for their claim that "an inefficient, economically closed, mismanaged non-democratic former colony friendly to its former colonizer, receives more foreign aid than another country with similar level of poverty, a superior policy stance, but without a past as a colony".

Dowling and Hiemenz (1985), Isenman (1976) and Karunaratne (1980) all observed that small recipient countries receive relatively larger amounts of aid per capita than larger countries, a tendency called small country bias in the literature. Some have made the case that there is also a bias towards the middle-income LDCs. .

Page 77 Line 1
Replace "A conceptually... Donors," **with**
Studying aid allocation by the 'sample selection models' lends more causative weight to the two-step decision making process in choosing to allocate aid. The first step (selection stage) involves deciding which among the potential recipient countries should be accorded aid; the second step (allocation stage) involves determining the mechanism: the quantity and type of aid. Dudley and Montmarquette (1976) decomposed Development Assistance Committee (DAC) aid programs in just this way. In their study, RN and DI are co-factors in the aid determination at both stages; however, they also found evidence for the 'band wagon' effect – recipients already receiving aid from other donors tend to be favored.

Page 77 Line 14
Replace "Other studies... for 1984-89 **[in a footnote number 13]". With:**
Other studies had followed this methodology by applying it a number of bilateral donors, like Canada (Dudley and Montmarquette 1978), Australia (McGillivray and Oczkowski 1991), the United States (Gang and Lehman 1990 and Eggelston 1987), the United Kingdom (McGillivray and Oczkowski 1992), and Denmark (Tarp et al. 1998). Trumbull and Wall (1994) extended the methodology to analyze total developing country ODA for 1984-89. (See Hjertholm and White for more details)

Page 78 Line 19
Replace "For example..suggest." **with:**
under KFAED's charter until 1974. After changes were made in the charter and in the goals of the organization, aid began to flow to non-Arab countries, so that one knowledgeable observer could claim in 1984 that "Arab aid is geographically balanced out" by aid to non-Arab countries. (Khaldi 1984: 13). However, as tables 3 and 4 suggest, this assessment is rather optimistic.

Page 79 Line 21
Replace "**For** another...with them," **with:**
Another determinant of DI is trade-related – that is, the notion that countries that are trading partners are more likely to receive aid from donor countries.

Page 80 Line 6
Replace "The shortcomings... (Easterly 1999)." **with:**
Researchers have long criticized taking per capita income as a comprehensive indicator for the well-being of a country (Moon 1991; Moon and Dixon 1992). If we can represent low well-being using other parameters as well as per capita income, then using only per capita income does not adequately reflect RN, or give us a scale to measure the need for foreign aid.. However, the simplicity of the per capita income standard has often proven too much for researchers, who often use it alone to assess need. After all, it is the most readily available statistic, one that requires no field work or further quantification; and also, as some have argued, per capita income remains the single most comprehensive index for well-being in spite of its problems. In other words, it gives you a rough but accurate rule of thumb for signaling a country's need for aid (Easterly 1999)

Page 80 Line 23 Replace "indictor" with "indicator"

Page 82 Line 3
Replace "The existing ...allocation decisions." **with:**
The existing literature disagrees on whether total aid should be assessed as aid per capita, which controls for the different population size of recipient nations, or as the dependent variable of the fact that there is a certain amount of money and a certain number of recipient candidates; in which case, population size must simply be one of the collateral variables that explains aid distribution patterns. To account for the fact that, all other things being equal, China or India are likely to receive more aid than, for example, Chad , as seems reasonable, we start out with a potential pool of aid that comes to a fixed amount of money to be allocated, which would mean that McGillivray and Oczkowski (1992: 1314) are correct to argue that, from the point of view of the donor, "distributing aid in per capita terms is both a difficult and cumbersome task," and thus not of primary concern. Instead, it is much easier for donors to divvy up the total amount of aid available to each recipient country, firstly, according to some population-blind formula, and only then, as McGillivray and Oczkowski (ibid.) remark, subject the allocated shares to a secondary process of population sensitive adjustment: "aid decision makers may well be aware of the corresponding per capita amounts, and may well adjust absolute amounts on this basis, but this is taken to represent a response to country size. In this context, per capita aid allocations are viewed

as the outcome of this process rather than the prime consideration". Thus, donor countries commit their aid to recipient countries firstly in terms of percentages from the whole pool, and only adjust and modify after the initial aid projections are solidified. It is believed that choosing the variable representing the optimal percentage of the pool of total aid available for the selected recipient nations approximates the way KFAED undertakes its aid allocation decisions.

Page 86 Line 14
Replace "Aid ...World Bank." **with:**
Aid data were obtained from KFAED from inception, 1962 until 2001. These include basic information for all projects, grants, countries and loans in their portfolio. Aid refers here to net official development assistance (ODA). It includes grants and highly concessional loans (that is, loans with a grant element of at least 25 percent) minus amortization. Since the aid data are in current Kuwaiti Dinar (KD), they have been transformed into US $ using the prevailing exchange rate KD/$. The dependent variable is the percentage of KFAED aid that a country receives as a share of the total annual aid budget. The dependent variable represents the output of the decision-making process that divvies up the aid into different slices. Per capita GNI, literacy, infant mortality and life expectancy were taken from World Development Indicators published by the World Bank.

Page 89 Line 17
Replace "The way ...mean." **with:**
The complexity of the UN voting variable makes it less useful as a meaningful coefficient. However, as pointed by Neumayer 2003d, one can say that the best case, in which a country's votes are identical to those of Kuwait, raises its chances of receiving a grant element by about 68 percent over a country whose voting similarity value is equal to the sample mean.

Page 92 Line 11
Replace "Arab ... Arab countries." **with:**
Arab countries are the most likely to receive aid; they also are most likely to receive significant aid, in comparison to non-Arab countries This is clearly evidence for the assertion that there is a bias in favor of Arab countries.

Page 93 Line 3
Replace "Poorer countries...aid recipients," **with:**
Poorer countries are more likely to be selected for aid, but this fact alone doesn't predict anything about the amount of aid. Nor is the trade variable a good predictor. Population size has an impact on the allocation decision, which means that more populous countries are more likely to be eligible for aid.

Page 93 Line 7
Replace "Neumayer (2003d).. selection stage," **with:**
This paper, and in parallel to Neumayer (2003d), deduced that ethnicity (being Arab) and religion (being Muslim) are major factors on KFAED allocation decision. The same inference was reached on the importance of the political alliance, as represented by voting similarity in the UN

General Assembly, in weighting on KFAED allocation decision. This makes KFAED an outlier when compared with Western donor aid decision-making processes, which exclude weighting by, ethnicity and religion (Alesina and Dollar, 2000). Political alliance, as measured by UN voting and a country's level of per capita income have an influence on the selection stage, but none on the allocation stage. Thus, understanding the KFAED aid allocation process requires segregating stage (1), of creating the aid pool and choosing eligible candidates, which is when donor interest (DI) has the most weight, from the selection stage (2), which is when recipient need (RN) emerges to play an important role.

Insert in the references in page 96
Henderson, Errol A.; Tucker, Richard, Clear and Present Strangers: The Clash of Civilizations and International Conflict: International Studies Quarterly, Volume 45, Number 2, June 2001, pp. 317-338.

Insert the following table in Page 97
Table (6): Arab, Muslim and African countries.

Arab countries
Bahrain, Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Oman, Somalia, Sudan, Syria, Tunisia and Yemen. This dummy covers all countries with a majority Arab population, apart from those Arab countries with major oil or gas reserves, which are aid donors themselves (Algeria, Iraq, Kuwait, Libya, Qatar, Saudi Arabia and the United Arab Emirates).
Muslim non Arab countries
Afghanistan, Albania, Azerbaijan, Bangladesh, Brunei, Burkina Faso, Eritrea, Gambia, Guinea, Guinea-Bissau, Indonesia, Iran, Kyrgyz Republic, Malaysia, Maldives Islands, Mali, Mauritania, Niger, Pakistan, Senegal, Somalia, Tajikistan, Turkey, Turkmenistan, Uzbekistan
African
Angola, Botswana, Burundi, Cameroon, Central African Republic, Comoros, Congo, Ethiopia, Gabon, Ghana, Ivory Coast, Lesotho, Liberia, Malagasy Republic, Malawi, Mauritius, Mozambique, Namibia, Rwanda, Sao Tome-Principe, Seychelles, Sierra Leone, South Africa, Swaziland, Togo, Uganda, Zaire, Zambia, Zanzibar, Zimbabwe

Source: Henderson and Tucker (2001)

Page 104 Line 8 replace "polices" with "policies"

Page 104 Line 18
Replace "From the flow... 1991-1995 period "**with:**
Out of the pool of all assistance funds, aid flows from developed countries to developing countries steadily increased, despite the fact that the growth of the sum total of aid faltered after 1995 (Lensink and White, 2000). As can be seen in Table 12 below, the LDCs have received higher share of these assistance funds compared to other group of recipients, both in term aid as a percentage of GNI and as per capita. In our time frames, aid inflows to the LDCs almost doubled, measured, again, in terms of percentage of GDP (aid per capita). The increase went from an average of 7.6 percent (US$15.2) in the 1976-80 periods to 11.6 percent (US$29) in the 1991-95 period, which was higher than the comparable increase in aid to the group of other low-income countries in the same period from 2.9 percent from 2.9 percent (US$7.3) to 4.4 percent (US$13.5). As for the rest recipient groups, there was a noticeable stagnation, and even declining trend, in aid flow started after 1986-1990 period.

Page 105 Line 11
Replace "This figure... (Tsikata, 1998, p.7)." **with:**
According to the two-gap model (Chenery and Strout , 1966) , this flow exceeds the required amount to achieve a growth rate of about 4 to 5 percent per year in developing countries; yet, we have not seen that kind of rate of growth in the developing countries since the 1980s.

In the two decades 1960-79, the median per capita growth achieved by developing countries was a slow 2.5 percent. In the subsequent two decades 1980-98, as observed by Easterly (1999, p. 2), it was even worse, there was no real median per capita growth among the developing countries; almost none of the countries outside Asia registered per capita growth at or above the 1960-79 average of 2.5 percent.

There is a widespread consensus that the 1980s were the "lost decade" for LDCs, but outside of the showcase Asian countries, the 1990s were the decade of increasing marginalization, inequality, poverty, social exclusion, and, especially among the African countries, violence. As noted by (Xayavong, 2002) the number of countries belonging to least developing class has increased rapidly. Since it compilation in 1971, the number of countries that were classified as LDC (poorest of the poor) had reached 49 in 2001. Botswana is the only country to be removed from the list. Several African countries experienced negative economic growth in the 1980s, despite the fact that they were receiving a substantially increased flow of aid (White, 1992a). " A large number of countries became more aid-dependent in the 1990s than they were in the late 1970s" (Tsikata, 1998, p.7).

Page 113 Line 5
Replace "A typical... (Thorbecke, 2002)." **with:**
, Which typically includes the removal of subsidies and price control, currency devaluation, trade liberalization and institutional changes at the sector level. (Thorbecke 2002)

Page 117 Line 10
Replace "As debt increases ...nation." **with:**
There will be little or no incentive for growth when debt increases beyond the optimal level (Point B), after which the marginal benefits of capital decrease. In this case, the debtor is said to be on the "wrong side" of the debt Laffer curve. It is beyond point (B), where grants will be more beneficial in creating incentive for growth and development.

Page 118 Line 12
Replace "This argument..allocated." **with:**
This argument is based on the fact that current concessional loans already have a large grant component and thus switching to grants allows resource transfer without the debt build-up that is currently handicapping many recipient countries and eventually will reduce the debt overhang effect. Furthermore, they argued that increasing the grant component would provide the aid institutions greater leverage in how funds are allocated. (Anagol, 2002).

Page 119 Line 6

Replace "External..countries." with:

External assistance is categorized as either aid or a combination of concessional finance, also known as "official development assistance" (ODA), and market-related or non-concessional finance. Aid-flows for development purposes account for the majority of LDC external assistance. However, LDCs often combine this with export credits and other types of non-concessional funding.

These categories are essentially segregated by the payback requirement: grants, of course, don't have to be repaid, while loans, the ODA component, are made on the premise that they will be paid back.

Page 119 Line 18

Replace "Loans ... OOF," with:

Of course, the LDCs can receive other loans, too. Those which are lent by a public sector institution (either an NGO or a state) for non-developmental purposes, or which are not concessional, are known as other official flows (OOF). Typically, military grants will fall under this category. So do export credits extended by donor governments or guaranteed by them.

Page 121 Line 1 delete the empty bracket ( )

Page 121 Line 11

Replace "The above... years." with:

The above reflects the loan terms at the time of commitment. The Present value is calculated on the assumption that the loan is fully disbursed on the date of contract, from which point forward the stream of future debt service payments is discounted. . In other words, the calculation of future interest payments assumes a total disbursement of the loan amount, which does not take into account that disbursements in actuality are in tranches that can take place over a number of years.

Page 122 Line 16

Replace "As stated.. profitable." with:

As stated earlier, the Development Assistance Committee (DAC) of the OECD requires that all concessional loans must have a 25 percent grant element, with the loan itself bearing a uniform 10 percent discount rate. This is the current basis used for defining ODA. However, this definition is insensitive to the actual interest rate over the period of the disbursement, which may actually be lower than the rate at the date the loan was officially made. In practice, this means that some so called concessional loans may actually end up being non-concessional or even profitable.

Page 142 Line 12

Replace "The way ... mean." with:

The UN voting variable can be interpreted on the lines of what was stated previously in chapter 2 (section II.4).

Page 144 Line 12

Replace "The Index.. prior to 1995 [in a footnote number 36]." with:

The Index consists of 10 specific components of economic freedom. Each component is rated (equally weighted) with a scale from 0 to 100. However, when using the index, our sample shrinks by two-thirds due to the absence of data prior to 1995. (Footnote)

Add Footnote: For more detail see the heritage foundation: http://www.heritage.org/index/PDF/Index09_Methodology.pdf.

Insert in the references in page 148

Anagol, Santosh; Reforming the International Development Association: Are Grants the Solution?: Department of Economics, Stanford University, 2002

Vilaphonh Xayavong ; A Macroeconometric Analysis of Foreign Aid in Economic Growth and Development in Least Developed Countries: A case of The Lao People's Democratic Republic (1978-2001), Dissertation, Massey University (2002)

Tables Numbering Corrections

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100	Caption	Table 1	5
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90	Caption	Table 4	9
91	Caption	Table 5	10
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ACKNOWLEDGEMENTS

I am indebt to Dr. Ali Al-Shamlan, KFAS Director General, who was instrumental in his support that started since he was the Minister of Higher Education. It is very much appreciated along with KFAS's grant.

I would like to thank my dear friend and colleague, Dr. Anwar Al-Mudhaf, for his constant encouragement while he was a PhD student and afterward. He was generous enough with his time and was able to put me in a relaxing mode during many years while we were both at the States. I wish his son Hamad learns from him and achieve the highest academic and professional goals.

Both Dr. Adel Al-Hussainan and Dr. Abbas Marafe were instrumental in paving the way to continue my research.

There are some I would like to thank, especially at the Finance Department, for their support and accommodations; Dr. Abduljaleel, Professor Al-Loughani, Dr. Al-Obaidan and Dr. Al-Saad all of whom stood behind me and defended me during the most difficult moment of my career; a moment when both my MIT PhD diploma and this dissertation's title were forged.

Both Ahmed Al-Mujalhem and Waleed Al-Bahar deserve thanks for helping furnishing the data from Kuwait Fund.

Danielle Severino comforted me before every committee meeting, and Cynthia Stewart was helpful throughout the years. Mahdi Mattar, Quis Al-Duwairi, and Krishnan Raghunathan were true friends during my time at MIT.

Finally and most importantly, to all my sisters: Nawal, Shareefa, Taiba, Liala and Anwar and my lonely brother, Muhammad; to all my brothers-in laws; and above all to my sweet mother, Aisha: you know what you have done for me. I know it too, although sometimes I do forget items on that endless list. Your constant support, patience and encouragement were the reason I am able finally to write this acknowledgement.

I dedicate this dissertation to my father.
August 15, 2005

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INTRODUCTION

This thesis examines the record of the Kuwait Fund for Arab Economic Development (KFAED) in light of changing fashions regarding the proper role and management of such funds in the development process. The key questions addressed are whether its concessional aid is allocated according to Donor Interest (DI) or Recipient Needs (RN), what precisely is the grant element in KFAED loans, and whether this grant allocation is consistent with the fund stated policy and if it is linked to one or more of the currently held views regarding how aid should be allocated in order to be most effective – to overcome the "two gaps," to strengthen institutions and governance or to reward/incentivize effective macroeconomic management.

KFAED is an interesting and important subject of study for many reasons. After Saudi Arabia, Kuwait has been the second largest Arab aid donor, having contributed a total of more than $18.5 billion between 1960 and 2002. It In 1961, Kuwait was the first to officially establish a bilateral aid institution: KFAED, which purports to be free of mercantilist movies as its aid is not tied to procurement, as is the case with most developed countries' aid institutions.

The thesis consists of three mutually dependent sections. We begin by giving an overview of the theoretical development aid literature. We then move to empirically investigate the allocation and analyze the concessionality of development aid from a donor source that is underconceptualized in the literature, namely, that aid which flows from South donors to South recipients.

Our overview surveys the domain of theoretical and empirical development economics since World War II. We review its evolution over time, linking successes and failures in development aid to the refinement of macroeconomic points of view among various schools of thought. Since the implementation of any economic policy is sensitive to the political goals of the policy makers, we show that the evolution of macroeconomic theory cannot, in itself, account for changes in the pattern of development aid. "Fashions" in such aid reflect not only the past history of aid projects themselves, but also the histories of the donor nations. Our specific interest in regional Arab geopolitical development is contextualized in order to trace the effects of development theory evolution on the Middle Eastern region.

Given that development aid was initially dominated by, on the one hand, the Western powers, with their histories of empire, and on the other hand, by the Soviet bloc, the entry into the aid arena by South-South donors presents us with questions concerning competition or cooperation with the models developed by the existing donors. Since the first entry of South-South donors occurred in the early 1960s, in establishing the Kuwait Fund for Arab Economic Development (KFAED), the major questions posed are: Did South-South relationships create new models of aid, or did they emulate old models? If we are "seeing" as a South-South donor does, are we aware of gaps in the development aid network which North-South donors are missing? What stated goals were advanced by development aid? How did these goals intersect with goals that guided the existing donors?

norms. In the case of KFAED (as in the case with other developing countries' institutions, especially from the petroleum exporting countries), aid is not tied to procurement, as is the case with most developed countries' aid institutions. Since one of the drivers of giving aid has traditionally been the goal of achieving economic complementarities, it is of interest that KFAED is positioned to "brag" about not trying for the betterment of the recipients." In the vacuum left by the non-existence of economic interest, however, other interests can rush in. Thus, the search for other implied interests will help us to see the general strategy behind KFAED's aid allocation.

It is to this search we turn in our second chapter. Our aim is to derive a sense of the donor's strategic interest in concessional aid in general, and to see how these interests merge with or fall into conflict with the recipient's economic and development needs. The larger goal of developing economic complementarities was a point of contention during the 1960s and 70s. Structuralists and the dependency school criticized Western aid programs as being essentially oriented towards donor economic self-advantage.

Kuwait is a test case of the altruistic model: what happens when a country can supply aid without seeking economic advantage? One hypothesis would be that into the vacuum of interest rush other interests, such as security. The criticism of aid as an instrument of economic hegemony assumes a zero-sum game in which the benefit of the donor country only comes at the expense of the recipient country. There are, of course, a number of degrees between altruism and exploitation. Thus, we can sharpen our sense of the justifiability of claims about the skewing away from true need created by the

economic interests of donor countries by examining how outlier aid sources such as KFAED define and respond to need.

We formulate the aid allocation decision as a two-stage process: selection and allocation. In modeling these stages, we are able to detect the common factors and characteristics that differentiate between countries that receive aid and those that don't. Once KFAED has selected a country to receive, the allocation stage sets the quantity of the aid going to the recipient.

Although KFAED's claims that economic disinterestedness (the absence of any procurement mandates) distinguishes it from other donor agencies, the result shows that KFAED's concessional loan allocation policy does not vary much from that of other donor countries. The pattern of allocation indicates, rather, that recipients are preferred due not only to purely economic and development factors, but also to political, religious and ethnic factors with roots in KFAED's security-seeking framework. This reflects the preference for regional stability as part of Kuwait's overall strategy.

In our third chapter, we go one step down the ladder in KFAED's allocation decision process to empirically study the grant element level mechanisms. There are major interpretative conflicts revolving around grant element analytics in the literature. In this chapter, we attempt to settle the debate by exploring the terms in which concessional conditions on the grant element are calculated. It is here that the pressures shaping "competition" among donors – that is, competition among the terms of the grant that favor the recipients – show up. Our analysis shows that the published grant element is

inflated, and that even some concessional loans turn out to be costlier to the recipients than market-based rate loans.

When we test KFAED's declared vs. actual allocation policy, we find major deviations between the two policies that imply the set of real motives governing actual decision-making are different from stated motives. We are particularly concerned that the macroeconomic drivers of IFI aid packages, upon which KFAED's conditional lending seems to be modeled, have failed to be seriously implemented. What this means is that institution building and governance in KFAED's recipient band have made no inroads on the statist form that the conditions of loaning are supposed to dismantle or reform. Without those reforms, institutional and governances, economic growth cannot be disentangled from rent seeking or the subsidizing of enterprises that are ultimately of benefit to the preservation of the power structure, rather than to the opening up of opportunity spaces in these economies. If aid is used as an external resource by the power elite in statist economies to prop up old command-and-control structures, the aid actually does long-term harm to the recipient country.

Applying the third stage of the decision-making process to KFAED allows us to select out ethnicity and political factors as determinants of the grant element decision. The result of this is that grants do not track recipient need. In fact, there is significant understatement of grant element to higher income recipients in certain sectors like agriculture and significant overstatement of grant element to lower income recipients, sometimes in the same sector. To put it in practical terms, an irrigation project in Jordan has more chance of being approved with higher grant element than a fertilizer project in

Mozambique, even though Jordan has a higher income than Mozambique, its agricultural potential is less than Mozambique's, and its chance for suffering from famine or near famine conditions is much less than Mozambique's. This is an unexpected deviation from the policies that officially govern KFAED.

We conclude with an examination of the salient macroeconomic features of the Middle Eastern region, the major target of KFAED's funding. Given the shift to human development measurements, with emphasis on health, education, and human rights, we consider the question of KFAED's own situation with regard to this shift. Will KFAED establish itself as a broker of a new set of human development norms, or will it occupy the position of enabler, allowing nations to escape the conditions of reform necessary to implement those reforms? We recommend that KFAED leverage its small scale to specialize in terms of its core competencies in the development field, such as financial services, and that it take advantage of its broker position to cross boundaries that are ideologically sealed to IFIs, due to the suspicion that IFIs are pursuing an agenda that merely benefits the West.

CHAPTER ONE

I. ECONOMIC DEVELOPMENT: THEORY AND POLICY

Given these shifts and developments in the world politics and economy, this chapter we will provide a review of theoretical and applied development economics. It is necessary to background this discussion with a review of the interwar period, for that period influenced the policy choices that determined the initial framework of both the multilateral organizations and the domestic economic policies pursued by the major economic powers during postwar reconstruction and the first phase of the Cold War. Since the Cold War operated as the major global political constraint in shaping the foreign aid policies of the major blocs, we will be guided by Howard White's recent assessment:

Until the mid-1950s the US was the only donor of note, including its role as the main funder of the UN system. The launch of Soviet aid in 1956 started in a period of explicit competition between the US and USSR with aid as an instrument of foreign policy interests. Countries with colonies, notably the UK and France, became donors as they shed their last substantial colonies in the early to mid-1960s, with others, such as the Scandinavian countries, establishing formal aid programs by the late 1960s. Multilateral aid, in the shape of the UN, has been present since the 1950s, but gained importance with the growth of the World Bank and IMF from the early 1970s. (White 2002, 1)

White's summary misses, however, one historically important factor: the emergence of OPEC countries in the seventies and eighties as providers of loans and grants to LDCs, most notably; the Kuwait Fund for Arab Economic Development (hereafter KFAED)

In our review, we will follow a chronological approach to review the literature in development economics:

I.1   Introduction.

At the San Francisco conference that founded the United Nations (UN) in 1945, there were only 13 nations from Africa and Asia. Five of the Asian nations played 'host' to foreign troops – in other words, their sovereignty was severely limited by sponsoring European nations. (Hurewitz, 1965) In the two decades following the founding of the UN, a wave of decolonization changed this picture dramatically. Between 1955 and 1960, 29 former colonies joined the General Assembly. By 1994, the General Assembly had expanded to 184 members. (Patterson, 1995) This expansion of nation states reflected changes in the world picture caused by the collapse of European colonial empires, wars between decolonized nations, and, in the early nineties, changes brought by the collapse of the Soviet Union. Naturally, these events had a major impact on the international political structure and the economic relationships between what were called, in the sixties, "under-developed" countries (now referred to as Least Developed Countries, or LDCs) and developed countries.

The UN was not the only international organization to emerge at the end of World War II. Equally important was the Bretton Woods agreement concluded between the United States and Britain in 1944 that generated the West's international financial architecture, both by establishing rules on currency and capital flows, through Bretton Woods, and by founding the World Bank and the International Monetary Fund[2].

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[2] In 1947, in Geneva, the General Agreement on Tariffs and Trade (GATT) was established.

1. The Marshall Plan to the Alliance for Progress (1947-1961)

2. The Alliance for Progress to the Crisis Years (1961 – 1981)

3. The Crisis Years to the present (1981 – 2001)

We will briefly review the founding of the major International Financial Institutions (hereafter IFIs). We will examine the prototype of foreign aid, the Marshall Plan.

In our first period, we will start from Lewis' theory of the "dual economy." Within this general framework, we will show how various schools of growth provided a theoretical justification for certain kinds of large scale aid. While this period is marked by decolonization, which presented, on the surface, a radical break with previous forms of governance, the elites in the newly emerging states did not significantly dissent from the "dual economy" consensus. Instead, they used it as a map to modernization. As we shall see, when Kuwait emerged from its semi-autonomous status within the Commonwealth to independence in 1961, the dual economy model was embedded in the decision making of the most advanced Arab states -- Egypt and Syria. The dual economy models implied that developing economies shared a certain homogeneity. According to this viewpoint, the agricultural sector in, say, Brazil, was comparable to the one in Morocco or in India. Geographic and cultural differences introduced only minor modifications.

In our second period, we will show how the Harrod-Domar model, used, as was modified by Chenery and Strout, to create both a model to forecast growth and a policy of developmental aid aimed at filling the two gaps: the saving-investment gap and the foreign exchange gap. we will review the structuralist school with its emphasis on

modernization and import substitution industrialization. This school, associated with the UN's Economic Commission for Latin America, operated to create a critical view among third world elites in the sixties and seventies (was called Latin school of thoughts).

This period had witnessed the oil shocks of the seventies and the breakdown of the Keynesian consensus in the developed countries, a powerful neo-classical "counter-revolution" in development economics that criticized the dependence on state intervention in the economic sphere. The neo-classical economists also developed models for evaluating aid. Politically, this period was marked by two wars between Israel and the Arab states in the Middle East, which introduced changes of status into the Arab and North African internal political blocs. The ideological domination established by Nassar in Egypt collapsed, and with it two distinct wings emerged. The conservative Gulf States, on the one hand, including Kuwait, sought the goal of having Western states recognize the validity of Palestinian claims within the established international economic order. The more radical wing, led variously by the Libyans or the Iraqis, wanted to use oil as a weapon to gain not only a Palestinian state, but a greater importance altogether in the world system.

In tandem with these political events, the oil producing states became the first significant South-South donors. The influx of funds from Kuwait and the other Gulf States introduced a peculiar component into the political economy of foreign aid, insofar as the donor states were not trying to develop trade complementarities with recipient states. On the one hand, this kind of aid could theoretically have embodied a countervailing resource to the aid from developed countries or IFIs, of which the incentive was

ultimately self-seeking – the expansion of trade, the use of cheaper labor to lower high manufacturing costs, etc. On the other hand, Kuwait and other South-South donors did have political, security-seeking goals. Ultimately, Kuwait's aid in this period was not distinguished by any major departure from the programs already set by the IFIs and the bi-lateral aid of the Americans and the Europeans.

Our third period saw the triumph, on the one hand, during the Reagan and Thatcher administrations, of neo-liberalism – with the world- wide drive to privatize and to knock down impediments to the free flow of goods and services world-wide – and, on the other hand, increasing emphasis on governance and institutions. For Kuwait and other Middle Eastern donor states, this period was marked by the deflation of oil prices and the consequent drying up of windfall gains. There was a lag in the shift towards human development, attributable, perhaps, to the security-seeking nature of the Gulf state's foreign aid programs. The structural adjustments of the eighties and the governance concerns of the nineties directly confronted the political structure of Middle Eastern states. That kind of confrontation was imperfectly aligned with the Gulf States' preference for stability, which meant, in effect, that the Middle Eastern donor states engaged in a practical competition in the terms of foreign aid agreements, allowing recipient states to escape the magnitude of changes envisioned by IFI donors.

I.2   The interwar period

World War I is generally held to mark the end of the first wave of globalization (Ferguson, 2005), defined in terms of four intersecting trends: a., national barriers to free trade are dismantled; b., international capital flows, such as foreign direct investment,

enlarge to a significant proportion of total global investment; c., international legal frameworks are arrived upon by major global powers and embodied in international institutions; and d., falling costs in transportation and communication stimulate export growth and international economic coordination. (Sachs, 98) It is often noticed that, by some measures, the world economy was more interdependent, with greater FDI (Bairoch and Kozul-Wright, 1996)[3] and fewer barriers to migration (deregulating the international labor market) in 1913 (Lal, 1998) than in the 1990s. In the period between 1919 and 1945, the pre-war consensus was shattered and international trade and finance was dispersed among several separate frameworks.

The Bretton Woods system

The above history was on the minds of Keynes and his American counterpart, Harry Dexter White, when they hammered out what became known as the Bretton Woods accord in 1944. The U.S. had already been trying to undermine the "'Sterling bloc," insisting, as a condition of the Lend Lease program to Britain, on the elimination of all forms of discriminatory treatment in international commerce (Armstrong, Glyn, Harrison, 1991). The US was particularly anxious to take away the British advantages of favorable concessions in Middle Eastern oil fields. To show their determination, the US policy makers reversed the thirties trend towards state micro-management, by lifting the gasoline rationing in the US twenty-four hours after the Japanese surrender. (Yergin, 1991) Shortly after the war, the US broke off its production and marketing protocols

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[3] For a comparison of foreign direct investment during the height of the 19th century British empire with the U.S. from 1950-1982, see Oneal, John R. and Oneal, Frances H. 1988

with Britain. However, the Allies certainly did not want a repeat of the debilitating economic competition of the thirties. Nor did the Allies want to dismantle their domestic policy that was formed in response to the mass unemployment of the Depression. While New York banks pressed for the most liberalized terms they could achieve, Keynes insisted on allowing partial state control over capital flows, as well as abridging the market in currencies by creating a flexible but fixed exchange rate for currencies. This is not to say that the designers of the Bretton Woods agreement did not envision modifications in the system, or did not provide a liberalizing direction in which those modifications would take hold.

U.S. Foreign Assistance to Europe

According to a recent essay by Irma Adelman, "the experiential roots of economic development can be found in the reconstruction of Western Europe after the end of World War II. There, the Marshall Plan, which financed the reconstruction of infrastructure and physical capital destroyed by the war, led to a very quick economic recovery." (Adelman 2001, 106) This accord with the liberal Cold War view of American actions taken in the postwar period, as W.W. Rostow remarked, "the whole process of European revival and the beginnings of postwar growth were framed by an American policy that earnestly sought to learn from the errors of the postwar years." In Rostow's view, the American policy included:

- "Lowering tariffs;

- Making money available on an international scale by aid and loans; and

- Encouraging, when necessary, state intervention to modify the troughs of the business cycle." (Rostow 1978, 236-237)

Rostow's view is more valuable because of his enormously influential role, both as a development economist and as a policy maker and advisor to various American administrations. Among the long-term goals of the Marshall Plan was increasing the interdependence of European economies by eliminating barriers to trade and national subsidies, making Europe one large single market. Still, it was not the specific intention of the planners to see European nations institutionalize a common market, as happened later, or trans-national forms of governance separate from American leadership. (Parsons, 2002)

The other effect of the Marshall Plan was to crystallize the tensions between the Soviet Bloc and the Western Bloc on the economic level. Marshall Plan aid was rejected by the Soviets. Rostow sees the political dimension of the Marshall Plan as co-equal with the economic dimension:

The Schools of Growth

> "The close link between economic development and economic growth is simultaneously a matter of importance as well as a source of considerable confusion. There can scarcely be any doubt that, given other things, an expansion of opulence must make a contribution to the living conditions of the people in question. It was therefore entirely natural that the early writings in development economics, when it emerged as a subject after World War Two, concentrated to a great extent on ways of achieving economic growth, and in particular increasing the gross national product (GNP) and total employment." –
> Amartya Sen

Given the history of the interwar period we have reviewed above in Section (2), the dominant economic paradigm in the immediate post-war period modified considerably the older, classical liberal tradition.

In the Keynesian phase of development economics, the Harrod-Domar model seemed a perfect instrument. With it, one had a normative template for analyzing growth, and, as importantly, relating that analysis to the concern with oversupply that pre-occupied economists at this time. The next step was to establish, within a given LDC, the percentile of the economy that went into different sectors, given that growth as a linear function of the different factors constituting economic activities in agriculture, industry and services will be composite reflecting sectorial asymmetries. W. Arthur Lewis gave the name "dual economy" to the structural separation of the "capitalist" and "traditional" sectors in national economies. Lewis' theory is presented in terms that presume a "stage" theory of growth. Lewis assumed that the capitalist sector, or that of industry (services were not, at this point, fully broken out as a separate sector), uses the low level of wages to accrue capital necessary for further investment. In the traditional economy, however, low wages keep workers in a steady state without adding to savings or investment potential of owners. This derives from features of the agricultural sector in which there are low opportunity costs for capital formation. When the natural rate of growth puts more labor in the agricultural sector by way of pure population growth, that labor becomes less productive. Modernization of agriculture – large-scale farming and mechanization – squeezes out even more excess labor. Foreign aid, in this model, should supplement domestic savings in order to finance investment in the advanced capitalist

sector – industry – thus utilizing the capacity latent in the unproductive labor overflow from the agricultural sector. In terms of Lewis' stages, the "turning point" in an underdeveloped economy occurs when the excess drawn from the traditional sector by the expanding capitalist sector, which relies on a the quantity of the pool of unskilled labor to keep wages constant, reaches a turning point, after which the labor market tightens and the unskilled laborer's wage is a variable upward (Truong 1976).

Two influential models of the stages of growth based on the European and American experience were Rostow's and Gerschenkron's. Rostow, with whom the phrase "stages of growth" is associated since the publication of his book; these stages consist of a linear sequence of five stages broadly defining the unilateral path to development. The five stages became a mantra for development studies in the sixties. Particularly important, to Rostow and the policy makers he influenced, was "takeoff" into sustained growth – the stage at which traditional economies modernize.[4] Gershenkron, also used the study of the rise of developed economies – especially Britain, Germany and Russia – to show that, under variables some of which could not be reproduced across countries (the relative position of the national economy within the world economy, for instance) and some of which varied for reasons having to do with endogenous preferences in financing, there existed a common, statistically prominent phase – a "spurt" of growth – that verified Lewis' turning point.

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[4] Rostow's theory has become a veritable football for development economists. See Nicolas Craft 2001 and Paul Streeten, 1967.

Rosenstein-Rodan (1943) labeled this the "big push." Paul Krugman has called this the "the essential high development model," since Rosenstein-Rodan incorporated two assumptions into it: the assumption of economies of scale, and a premonition of Lewis' dual economy (Krugman, 1994).

Egypt was clearly the most advanced economy in the Middle East region during this period. The officers' revolution of 1952 advocated agrarian reform acts that followed the classic outline of the dual economy school, breaking up large estates and encouraging large rural landholders to invest in industry. The anti-colonial ideology of the early Nasser regime did not exclude cooperation with the native Egyptian free enterprise sector. The regime instituted the ISI program of raising tariffs on imported goods, while lowering taxes on domestic manufacturers and their products. However, some have traced the trend towards a heavy public sector role as early as 1954. In effect, the state percentage of the GNP rose from 13% to 18% from 1952 to 1960, but the percent of the public sector's share of gross capital formation rose from 28% to 74% -- the latter figures reflect the true direction of the Egyptian economy. (Aoude, 1994), both Syria and Iraq mimicked this essential structure.

As for the other states, the oil states, the critical dependency of the industrial nations on oil was not noticed due to the relatively low price of oil in the fifties and sixties, and its stability. The development framework of South-South development aid was dominated by the international economic regime that accorded the donor place exclusively to highly developed industrial nations of the North. The small aid agencies

founded by Kuwait and in the sixties did not fit the development theory paradigms of the period.

I.3   Alliance for Progress to the Crisis Years

The Alliance for Progress was the most publicized development plan since the Marshall Plan. It was one of a number of development projects that were either started or completed in the sixties. It marks the intersection of a number of schools of thought.

The sixties and seventies, in terms of development theory, can be broken down into distinct phases. Hollis Chenery, who become a vice president at the World Bank, used his influence to assert in his most influential views (with Alan Strout in their article)

> "The possibilities of securing rapid and sustained development by effective use of foreign assistance has been strikingly demonstrated for the past decade by countries such as Greece, Israel, Taiwan and the Philippines." (Chenery and Strout 1966, 679)

Anne O. Krueger, who coined the word rent-seeking to define profit taking from unproductive activity (using a model developed by Gordon Tullock), wrote that the ways in which the state apparatus grows in LDCs, fed by development aid, took up the opportunities that could have been filled by more innovative, market-oriented entrepreneurs as "competition for entry into government service [becomes] in part a competition for rents." (Krueger 1974, 293). These shifts signified shifts in applied development economics, away from models that promoted Industry Substitution Industrialization (ISI) and towards Export Oriented Industrialization (EOI).

On the political plane, these two decades witnessed major changes in the composition of international trade and finance policies. Restrictions on international trade

in capital markets were lifted in the seventies, in the wake of the collapse of the Bretton Woods currency regime. Two oil shocks, in 1973 and 1979, created negative trends in terms of trade for oil-importing LDCs. The current account deficit for oil-importing developing countries is estimated to have increased more than threefold in real terms from 1970 to1980. (Griffith-Jones and Rodriguez 1984) The boom in petrodollars affected a major shift in donor nations, as the OPEC countries emerged as major donors, with the rate of giving as a percentage of GDP favorable to the average among the major industrialized countries.[5] Private lending institutions, like Citibank, also rushed in. The result was that burgeoning debt came to characterize the government budgets of LDCs and midrange developed economies, like Argentina.

The World Bank also played an active role in this. When Robert McNamara became president of the bank in 1968, he signaled the new, aggressive posture he envisioned for the organization after only two weeks on the job by announcing that the Bank would loan $11.6 billion over the next five years, which was more than it had loaned in the past twenty. During his term as president he expanded the bank's role among the IFI significantly. He also ended the policy of tilting lending disproportionately towards industrialization, as per the assumptions of the dual economy model of modernization. Under McNamara, "loans for agriculture became the fastest-growing segment of Bank lending." However, much of that lending went to benefit large scale farming enterprises. In a sense, the dual economy model, here, has simply been modified

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[5] For more details, see Cohen, Charles, and Werker, Eric. 2004

to modernize the agricultural sector, using technologies that weren't available in the fifties. (Caulfield, 1996)

The structuralist /dependency school

The structuralist school was heavily influenced by the history of Latin America. Two factors blinded the structuralist school to trends in development pertinent to the Middle Eastern experience. One was the school's heavy dependence on the historical trajectory of the Latin American economy. The Latin American resource endowment was such that export concentration was either in products that were highly substitutable (such as foodstuff) or subject to stocking tactics in the developed nations (such as tin). The second was the relative stability of primary product export as opposed to manufacture export in the postwar period. (Macbean, 1964).

Thus, the narrative of the capture of primary product exporting economies by developed industrial economies underconceptualized the Middle Eastern experience and misinterpreted the strategic place of oil among staples exports. The critical dependency of the major industrial nations on oil was further disguised by the relatively low price of oil in the fifties and sixties, and its stability. The locus for developing a framework to understand South-South development aid should have been in the structuralist school, if anywhere in this period. Yet here, too, theory was unconsciously dominated by a picture of the international economic regime that accorded the donor place exclusively to highly developed industrial nations of the North. The small aid agencies founded by Kuwait and

Saudi Arabia in the sixties and seventies did not fit the development theory paradigms of the period.

The dual economy model

In 1999, William Easterly published a study of the economic models used by the IFI. He found that the Financial Gap model (his name for what is more commonly called the two gap model) "used by over 90 percent of country desk economists of the World Bank" although, in Easterly's view, "it [had] died in the academic literature some time ago."

Chenery and Strout's paper can be considered both the highwater mark of mainstream development economics and a point of departure for both the neo-classical renewal, which was to come in the seventies and become dominant in the eighties, and for the institutional and governance concerns that became important in the nineties. Hollis Chenery (who served a long and distinguished career in the World Bank) was influenced by previous case studies he had done on Greece and Israel. The Chenery-Strout model (also called Chenery-Strout-Bruno, from an earlier form of the model in a paper Chenery wrote with Michael Bruno) spots two "gaps" in a developing nation's growth – investment limited growth, due to insufficient savings, and trade limited growth, due to insufficient exports to pay for imports. Therefore, the Chenery-Strout model, basing its aids estimates on Harrod-Domar forecasts of future growth of a given LDC, built a model for delivering the kind of aid that could overcome the two bottlenecks – that could, in their words, "avoid incentives to building excess capacity or reducing

savings." (Chenery and Strout, 1966) As later critics have pointed out, while the Chenery-Strout model improved on earlier development models by making import capacity a separate potential constraint, and getting away from the linear capital-output ratio assumed under Harrod-Domar, "the assumptions about the contribution of foreign resources were not changed. It was maintained that they were exactly additive to domestic savings and domestically financed imports." (Hansen and Tarp, 1999)

It is important to note that Chenery and Strout's paper does outline those areas into which development economics would go, in the next couple of decades, even if Chenery and Strout's model was treated, as Easterly implies, as an obsolete Keynesian relic: "The central questions for assistance policy are the measurement of the effectiveness of external assistance, the policies which recipient countries should follow to make the best use of external resources and the basis for allocating resources among countries" (Chenery and Strout 1966, 723),in other words, evaluation, institutional change, and convergence – watchwords even today.

The Neo-classical counter-revolution

Neo-classical development economics produced, in Paul Krugman's words, a "counter-revolution" in the seventies. Building on work by Peter Bauer and inspired by Hayekian themes, neo-classical theory had three prongs: a., a critique of the underconceptualization of "fungibility" in the mainstream theory of aid; b., a critique of rent-seeking encouraged by state intervention in the economy; and c., a non-Keynesian model of growth, based on Solow's Total Factor Productivity model.

a. Under-conceptualization of fungibility. The idea that development aid can be targeted in such a way that it is segregated from other sectors of the economy, and can thus be considered simply additive, was criticized by Griffin (1970, 1972). Griffin maintained that aid intended for investment may have the unintended effect of "diverting" the aid to finance consumption or nondevelopmental expenditure, which would fail to fill the "gaps". Furthermore, even if the aid increases public savings and investment, this may be offset by reductions in private savings and investment. The argument about fungibility has become a theme in negative evaluations of the relation between aid and growth. Most recently, a cross-country assessment of growth in LDCs by Boone (1994) used data from ninety-six LDCs over the 1971-1990 period and claimed that foreign assistance played no role at all in growth, for just the reasons postulated by Griffin. However, in Tarp and Hansen's survey of cross-country analyses of aid, Boone's work was considered an outlier, with most surveys showing some positive effect from aid. (Hansen and Tarp1999). The usual aggregation from different LDCs to form the basis for a regression has been criticized by Pack and Pack (1990), whose single country survey of Indonesia found that the data on fungibility was mixed: "In the largest categories [Industry, mining, electrical power, transportation, tourism, aid is spent for the purposes for which it was given, but the additional revenues raised by the government are allocated to those types of expenditure least favored by foreign aid." (Pack and Pack 1990, 193)

Rent-seeking, as we have already noted, Anne O. Krueger introduced a term into the vocabulary of development economics: rent-seeking. The models came out of the

public choice school at the University of Chicago, which used game theoretical equilibrium models to capture institutional behaviors, and showed an expansion of the object of economics from strictly defined markets. The neo-classical school, being well equipped with the informal insights of Bauer and Hayek (inspired by the classical liberalism of Smith, Ricardo and Mill), was able to supply a trans-cultural answer to the question of the perpetual clientelism, cronyism and corruption that emerged in LDCs by showing that certain mainstream policies – for instance, the encouragement of inward looking important substitution industrialization -- provided classic niches for the growth of state-sponsored rent extraction, while incorporating systematic disincentives to entrepreneurial behavior and innovation. The models of rent-seeking that came out of the economics of public choice pointed in two directions: a., the importance of creating structures of governance that would not seriously distort the allocative benefits accruing to the open market; and b., the passage from inward-looking development assisted policies (ISI policies, and the creation of policies designed to support Primary Import Substitution) to Export Oriented Industrialization (EOI). EOI was advantaged, during the seventies and into the eighties, by the shift in the donor constituency from bilateral and multilateral aid packages to private and public aid flows, brokered through IFIs.

The neo-classical model of growth. The third prong in the neo-classical assault was the replacement of the Harrod-Domar model by Solow's growth accounting model, in which a national economy's total real output consists of the sum of capital and labor inputs weighted by each factor's share in national income – plus a residual resulting from contributions other than labor and capital. The residual is generally considered to be some

sum of technological and organizational improvement. Policies that would favor the residual, according to Solow's model, are going to be growth producing. Given the argument from fungibility and rent-seeking, development aid that is directed towards state supported economic activity will not support the residual, since it deprives an economy of those inputs, from competition in the world marketplace, that would drive technological and organizational improvement.

The groundwork of the neoclassical revolution, laid during this period, bore fruit in the eighties. "The World Bank's World Development Report 1987, prepared at the height of the neoclassical resurgence and representing the core of its views on trade policy and the role of government. This WDR contrasts 'inward-oriented' and 'outward-oriented' regimes, grouped into 'strongly' and 'moderately' outward-oriented: in this simplified classification, outward orientation is associated with liberal trade policies, and is shown to perform distinctly better. The transition from outward-oriented trade strategy to a neoliberal government is made smoothly, glossing over issues of whether or not outward-oriented Asian countries are really 'liberal' in their resource allocation policies. The policy conclusion is thus undiluted trade liberalization." (Lall and Latsch 1998, 449) Thus, the enormous conceptual shift from the policies of the Keynesian period became inscribed in the very international financial architecture that Keynes was so instrumental in building.

Given the neo-classical theory on incentives and the public choice investigation of the ways the structuring of incentive sets effect national economies, the elements for an institutional analysis of the new set of donor states and institutions that appeared in the

seventies can be envisioned. To do so, one must go beyond neo-classical theory, with its

set parameters of loss and gain measured in discrete, exchangeable units; and one must

extrapolate from the public choice theory investigation of immanent institutional

structures and their effects within the national system. Such a theory would try to put in

relation a nation's incentive sets and the decision matrixes that model the level of state

activity within the system of states, and its simultaneous reflection within the national

economy. In the case of the wealthy donor Middle Eastern states, there is a categorical

mix that lies outside the original development economic, which mirrored the assumption

that donor states would be major industrial states. In this framework, a state that relied

heavily on primary product export was not supposed to accumulate the surplus that would

allow for extensive foreign assistance. Thus, there was no theoretical framework for

analyzing, from the point of view of development, the windfall gain era during which

states   without   the   classical   economic   infrastructures   that   made   for   trade

complementarities allocated part of their export wealth as aid.

Institutionalists have conceptualized the forces that constrain organizations,

positing exogenous factors (for instance, of rivalries within a market, or within a political

system) as well as endogenous factors (agents and traditions within the organization).

The distinction between exogenous and endogenous factors are fuzzier for larger

collectives. For instance, a state that aims at security looks at both outward enemies and

internal hostility to the elite that heads the state. These may or may not be connected.

Similarly, there are regional traditions and cross state agents to consider. Two large

shaping pressures on the Middle Eastern donors, and particularly on Kuwait, given its

size, can be distinguished, given the insights of public choice theory. One pressure was the attraction of entrenched forms and programs of aid already in existence, with a history of implementation. The IFIs and the major industrial nations (both bi-laterally and in regional blocks) had "filled in" the alternatives to aid by the time Kuwait could afford a major donor role. These entrenched methods had been contingent on trade advantages and the growth of that international economic system which had benefited the developed countries. The second pressure was regional. The system of corporatist or one party rule in the Nasserite and post-Nasser states had provided the region with stability. Stability and security were historically drivers behind much of Kuwait's aid. The incentive set for foreign assistance, for a country like Kuwait, embodied latent conflicts: on the one hand, there were developmental goals that had evolved among nations seeking trade advantages within the post war financial system; on the other hand, there were the security and stability goals set for Kuwait by its position in the Middle Eastern region which might encourage supporting inefficient economic regimes as a fair tradeoff for defense. Of course, the North-South aid flow was not insulated from the security concerns of the traditional donor nations, either, particularly during the Cold War. Still, as the IFIs turned to structural adjustment and conditional aid, the latent contradiction in Kuwait's donor incentives were aggravated. This meant, eventually, that Kuwait became a broker between those states dominated by predatory institutions – those that allowed one party to prey on the most innovative and profitable economic sectors and actors – and developmental institutions. (Dacin, 1997; Haggard, 2004; Roland, 2004)

I.4   The Era of Crisis up to the present

The models of development up through the early seventies had used templates coming from a., the growth of the Soviet Union, with its emphasis on command and control structures and autarky; and b., the Keynesian quest to modify the business cycle through the social welfare state. The template that succeeded them, from the seventies until the present, was the deregulation and privatization policies pursued, first, by Thatcher in England and Reagan in the United States, and then, to one degree or another, by other of the major industrial countries. From the fifties to the seventies, the Marshall Plan, which apparently promoted the recovery of the European economies, was a constant reference. This reference was supplanted, in the neo-liberal era, by the "tiger" economies of East Asia. Gustav Ranis (1981) survey: "Employment, Income Distribution and Growth in the East Asian Context: a comparative analysis" is the locus classicus for this reorientation. Ranis showed that Taiwan and Korea implemented a milder ISI strategy in the sixties, with a lower rate of protection and with greater attention to the agricultural sector than was advised by the precepts of classical modernization. Export of land or labor resource based products was invested back into industry. At the end of the sixties, both economies moved into the "primary export substitution" phase, finding their production function in the world economy.6 The controversies remain over the extent and success of the combination of market forces and state dirigisme that organized the successful transition and continuance in the PES stage.

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[6] For a summary of Ranis and a discussion of EOS, see Evans and Alizadeh (1984).

Otherwise, the salient fact for LDCs in the eighties ("the lost decade") was chronic and

extensive crisis. As Crisp and Kelly put it:

> "The flaws in the inward-looking development strategy, which evolved
> after the depression of the 1930s, were only gradually revealed. Between
> 1950 and 1980 developing countries in Latin America grew more rapidly,
> on average, than industrialized nations. However, average growth rates
> masked some underlying problems that would be exacerbated by the late
> 1970s. First, in most of the developing world outside East Asia, extensive
> government intervention made economies slow to react to international
> developments, and the possibility of particularistic government policy was
> an incentive for unproductive rent-seeking activities by the private sector.
> In addition, these same governments were very inefficient in their
> collection of taxes and had to use inflationary financing to maintain
> government spending patterns. Third, the inward orientation of the
> economies meant the foreign exchange supply remained dependent on
> volatile primary-product markets. The oil shocks of the 1970s quickly
> consumed available foreign exchange, and governments turned to
> international loans to pay for petroleum and other imports as well as to
> support government spending." (Crisp and Kelly 1999, 534)

The debt crises that appeared as the outward symptom of the larger depression

among the LDCs began with the Mexican default on its foreign debt in 1982, and the

structural adjustment package that was effected by a soon to be familiar consortium of the

IMF, the US Treasury and private banks. The two Mexican crises framed a series of

crises, and debt relief, structural adjustment packages, all over the underdeveloped world

– drawing in such middle ranged countries as Argentina.

The end of the Cold War, in the nineties, saw the emergence of a new World

Bank category – transitional economies. The transitional economies consisted of the

former Communist countries in Eastern Europe and Russia. These countries, the Asian

tigers, the explosive growth of China, and heady growth in the United States defined the

economic tone of the era, which was one of "animal spirits," to use Keynes' phrase.

While the financial crises that arose in 1998, among the Asian countries, did not lead to a world wide slowdown, it certainly dampened optimism. Finally, in 2002, Argentina – a poster child for neo-liberal policies, ranked the "free-est" economy in the world by Heritage Foundation in 1999 – experienced a sudden and disastrous contraction: "a default on government debts, a nearly 75 percent devaluation of the peso, an economic contraction that sent the GDP back to 1993 levels, an unemployment rate of 22 percent, the collapse of the banking system despite a freeze on bank deposits, and the creation of more than one and a half million new poor in just six months." (Corrales 2002, 29)

In the domain of development economic theory, the period under review saw the practical triumph of the "Washington consensus."[7] This had its roots in the neo-classical growth model and the suspicion of the negative effects of state intervention derived from public choice theory.

The linkage between growth and poverty reduction also became contentious in this period. Already, in 1955, Simon Kuznets had postulated that income would describe a U in the early phase of development, as labor, freed from the subsistence sector, flooded the industrial sector. Therefore, "economic development appears to be associated for a longer part of the process with worsening income distribution." (Braulke, 1983) However, as income slumped in the eighties and the nineties did not show the convergence between LDCs and developed countries predicted by the H-O-K trade theory, the issue of poverty reduction was re-examined. The question of the conflict between the package of structural adjustment policies (SAP) and the proclaimed goal of

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[7] For a history of the term by its inventor, see Williamson 2000.

poverty reduction by the World Bank was sharply underlined in a survey by Nancy

Birdsall and Juan Luis Londoño (1997)

The existence of poverty and the lack of convergence between LDCs and

developed economies produced new approaches in this period. The "new growth theory"

contested the assumption, central to Solow, that the residual is exogenous. Instead,

theorists, led by Romer and Lucas, developed endogenous growth theories, postulating

that knowledge and technical innovation were outputs of research investment. The

institutionalists explored the theoretical consequences of the insight that "markets are

embedded in larger socio-political systems." (Gilpin, 2001)

Structural Adjustment Policy (SAP)

In an overview of World Bank trade policies, Anne O. Krueger and Sarath

Rajapatirana give the following account of the motives and mechanisms of SAP:

> "With the difficulties oil importing 'inner oriented' countries were encountering in the late 1970s, Bank policies and activities changed. The Bank moved away from traditional complete reliance on project lending, and began devoting part of its activities to 'Structural Adjustment Loans' (SALs). The essential idea was that many developing countries' economies had to 'adjust' to the changing international economic environment (including the then-high price of oil) and shift the structure of the economies so that they could sustain growth in the face of the need to earn more foreign exchange. As it was increasingly recognized, the reforms of trade and payments regime were integral to future growth prospects; reform measures came to be enumerated in SALs. The SAL itself was a quick disbursing loan (3-4 years) with economy-wide policy conditions, usually linked to the release of two to three tranches. In addition, the Bank began making Trade Policy Adjustment Loans (TPALs) and Sectoral Adjustment Loans (SECALs) to countries where objectives were focused on trade or on one sector of the economy. Like SALs they were also quick disbursing loans. Some SECALs had important trade policy components while some others (such as agricultural loans) contained provisions for trade policy reforms to remove distortions that had adversely impacted the sector in question." (Krueger and Rajapatirana 1999, 720)

The results of the "economy-wide policy conditions" imposed uniformly on African, Asian and Latin American LCDs have been mixed. According to Nafzinger, the "In Africa, Bank/Fund lending to resolve external crises was usually linked to devaluation, decontrol of prices, reduction in social spending, privatization, and increased trade, but sequencing these adjustments often exacerbated the countries' predicament." Nafzinger points to a further problems in the race to "primary product export growth," as inter-LDC competition lessens return (Nafziger, 1993) thus creating a familiar bottleneck of the type addressed by Chenery-Strout. Indeed, "[sustaining] growth in the face of the need to earn more foreign exchange" begs the question of the residual, seeming to mix an early set of models – of the Harrod-Domar type – with neo-classical public choice concerns, as spending on education and social infrastructure were cut to meet SAP objectives.

An often cited study by Burnside and Dollar (2000) using World Bank data to create a panel of 56 countries and six four-year time periods from 1970 to 1993 showed positive effects of aid. The determinants for good economic policy track Friedman's list: openness to trade, low inflation, budget balancing or surpluses, a relatively low percentage of the GNP taken up by the government, and so on (Burnside and Dollar, 2000). Noticeably absent from Friedman's list is any concern with over-production or the modifying of the business cycle – his list is temporally invariant. And thus the lessons of the Keynesian age recede. However, such prescriptions are, of course, more popular at the peak of the cycle – the book appeared in 1999 – than at the trough. When the United States entered into recession in 2001, it proceeded to ignore the advice on budget restraints and to inflate the money supply in the orthodox post-war fashion.

Governance and institutions building

If a good policy environment is a pre-requisite to the best use of developmental aid, then it would seem to follow that governance – the elimination of rent-seeking behavior, the embedding of property rights in the legal system, the amelioration of class or ethnic privileges, and respect for human rights, among other things, became part of the standard IFI debt relief or aid package. Governance conditionalities (GRCs) became especially important in the late eighties to the programs instituted by the IMF and the World Bank in Africa. However, the enforcement of GRCs is problematic. "In most cases they are dated covenants, but, unlike quantitative performance criteria, they are not explicitly tranche release conditions. A government may promise to do a., b., c., but the consequences of not doing so are unclear." Governance has become a policy domain of interest not only to IFIs but to a burgeoning industry of human rights NGOs, as well as the United States government and the EU.

There are, generally, two problems with good governance as a development aid goal:

- It is unclear how and by what criteria different developmental aspects are impacted by or are conceptually encompassed by the good governance agenda. For example, is health a good governance issue? Since the World Bank is the largest financial contributor to health-related projects, (Ruger, 2005) this is a vital question. Yet it is unclear what trade-offs are acceptable in enlarging or shrinking the public role in healthcare in LDCs. This takes us into mesh of commitments that force choices between healthcare and the extension of Intellectual Property

standards, as devised in the US, the EU and Japan and promoted by the WTO, to

LDCs, and poverty reduction. The same holds for environmental protection.

- However, there is a related inefficiency in governance conditionality. The

problems of enforcement are re-enforced by the cost of monitoring and securing

good governance. Easterly brings the problems to mind with the example of a

poor person in the countryside in Ethiopia wanting to get a pothole fixed:

"The Ethiopian government looks to foreign aid for financing of public services. This poor person somehow communicates his desires to "civil society representatives" and/or non-governmental organizations (NGOs), who allegedly articulate his needs through the government of Ethiopia to the international donors. The national government solicits a "poverty reduction support credit" (PRSC) from the World Bank (also known as the International Bank for Reconstruction and Development, or IBRD) and a Poverty Reduction and Growth Facility (PRGF) from the International Monetary Fund (IMF). To get loans from the IMF and World Bank, the government completes a satisfactory poverty reduction strategy paper (PRSP), in consultation with civil society, NGOs, and other donors and creditors. The government prepares the PRSP in light of the fourteen point Comprehensive Development Frameworks (CDF) of the World Bank. The World Bank follows a series of internal steps to approve a PRSC, including the preparation of a Country Assistance Strategy (CAS), a pre-appraisal mission, an appraisal mission, negotiations, and Board approval, all in accordance with OD 8.60, OP4.01, and Interim PRSC Guidelines. The government also seeks qualification for the Enhanced Heavily Indebted Poor Countries (Enhanced HIPC) Initiative so that the new loan doesn't simply go to service old loans. The creditors and the government conduct a debt sustainability analysis (DSA). HIPC, PRSC, and PRGF require numerous reform conditions such as participation of the poor, poverty reducing government expenditure monitored through annual Public Expenditure Reviews (PERs), fiscal deficit targets, revenue mobilization targets, and structural reforms such as Civil Service Reform Program, implementation of a Financial Information Management System (FIMS) in government, financial sector reform in line with the Basel standards and the eleven areas of International Standards and Codes recommended by the IMF and World Bank..." (Easterly 2002, 223-224)

An archaeologist of bureaucratic procedures would find, at each stage of this cumbersome process (we have only included a portion of the total process) some governance intention that was undoubtedly motivated by the abuses of the past. But the sum total is a system that creates a large cost simply in the monitoring and specifying of its own procedures. Partnering with the IFIs are LDC administrators who act within weak agencies and institutions anyway, and whose direction of productivity is distorted to fit with the IFI bureaucracies rather than to public service of the citizenry. It is no wonder that, in the first study carried out of the effectiveness of the adjustment conditionality of World Bank programs, out of fourteen countries surveyed, only three proved successful. "Slippage" from the conditionality is often overlooked. (Dijkstra, 2002) A paradox of the good policy environment is that, if it makes the crucial difference in the good done by development aid, it must somehow precede that aid – and if it precedes that aid, the socio-economic conditions that allowed for the good policy environment in the first place might not be such as to really require aid.

I.5   Kuwait Fund for Arab economic development

While the pattern described by the development aid provided by the Kuwait Fund shares commonalities with the trajectory of development aid provided by the developed countries in the postwar period, it also reflects the political and economic history of its region. The oil-producing Arab states are in the peculiar position of being dependent on a primary product export (petroleum) that plays a crucial role in all industrialized economies without facing any real rivalry from synthetics or substitutes – unlike, for example, rubber sap, which was supplanted by synthetic rubber when supply was cut off during World War II to various industrial states, and which thereby lost its monopolistic position in the supply reserve. Thus, unlike other "peripheral economies" [Prebish], the major oil-producing states have had potential countervailing power in the international marketplace, the exercise of which has been tempered since 1979, but which may well increase as supply falls below demand.

In this section, we will give a brief overview of the entangled history of Kuwait and the Middle East from the beginning of the fund, in 1961, with attention to the political factors that have affected development and aid from the Gulf's oil producing donor countries. There are two aspects of the foreign assistance relationship that bear on Kuwait.

A.   Kuwait's own interest in providing foreign assistance. As we will show, Kuwait's incentive to provide foreign assistance is not shaped by the prospect of long-range trade benefits, as are the bilateral aid programs of the US and Europe. Kuwait's single sector

export economy provides a surplus that has not been used to diversify Kuwait's economic base. Such a base would develop the potential to exploit economic complementarities that would emerge from the development of the economies of less developed countries in the Middle East. Instead, the surplus has gone into expanding the public sector and foreign investment in developed economies. Thus, Kuwait's foreign assistance has to be viewed in the context of security-seeking.

B.   Foreign assistance from the perspective of rent-seeking, authoritarian regimes. While there has been a high level of conflict in the Middle Eastern system, there is a low level of structural political change. Democratization is low, compared to other LDC regions (Latin America, Southeast Asia). Loans and grants have operated to preserve the system by increasing the influence of the state sector, which in turn is taken to insure the overall regional stability in Kuwait's interest. This can lead, in the long run, to failure, as the stability of an authoritarian system such as Iraq's (to which Kuwait loaned heavily in the eighties) advanced by predictable stages in the direction of an ultimately threatening act of exterior aggression, i.e., the invasion of Kuwait. Thus the conditionality of loans that are made by the IFIs to promote structural adjustment and reforms have a political connotation that can make Kuwait's loans more attractive. This is balanced by Kuwait's clientalist position vis-à-vis Europe and the United States.

We will then examine the disbursement mechanism evolved by the Kuwait Fund, and the formative changes to the domain of Fund targets that have shifted the emphasis on aid from grants towards the construction of traditional infrastructure projects (from the sixties to 1980) to the years of structural adjustment (during the eighties and the nineties)

to the signs of an incipient shift towards human capital projects (health, education and governance).

The position of Kuwait in the Middle East.

The first oil strike in the Gulf region, at Masjid-i Suleiman in Iran in 1908, set in motion the search for oil all around the Persian Gulf. Up until the thirties, the Kuwaiti economy was largely dominated by the merchant class that profited from the Gulf trade. It was a semi-autonomous British dependency ruled by the Al Sabah family. In 1934, the first leases were taken out by the Kuwait Oil Company (KOC). Coincidentally, the first influx of oil money came at the same time that the Kuwait merchant class mounted its most serious attempt to unseat the Al Sabah family, in 1938. Otherwise, the Al Sabah family has shown a remarkable cohesion and the willingness to devolve power in order to stay in power that is unique among the ruling families in the Gulf States. (Herb 1999)

The wealth that accumulated from oil money presented a problem to the British in the fifties, as the British sterling policy extended to its territorial dependents laws conducive to maintaining the value of sterling as an international currency. As the oil-producing states dollarized their petroleum market, Kuwait secured the right to a free market in dollars and sterling, resulting in what was called the "sterling gap" – that is, the increasing exchange of sterling for dollars reflecting the sterling's depreciating value. Behind the concern about keeping sterling as Kuwait's main currency of exchange was a desire for investment in the UK. This desire was behind the formation of the Kuwait Investment Board, in 1953, which included, initially, a representative from the Bank of England. The desire to keep Kuwait in the British zone increased after the fall of the Iraqi

monarchy in 1958, and the subsequent secession of Iraq from the sterling zone. It was only after the threat from Iraq to Kuwait's national independence that the British were persuaded to support active Kuwait investment in Arab countries. (Smith 2003) Thus, though the structures of political governance officially changed after the series of notes in 1961 that brought about Kuwait independence, the pattern of interaction between the state and the economy had already been largely formed. The political profile Kuwait chose to follow, up until the 1967 Arab-Israel war, was consistent with the closeness between the ruling family and the UK, which in turn operated as a vector to other developed countries. Unlike other Arab states in which nationalism played a major factor in the fifties and sixties, the ruling family was able to afford a parliament and a relatively free press without the fear of a nationalist/military coup.

To understand how Kuwait's foreign assistance policy has evolved, it is necessary to cast a glance at the Middle Eastern and North African system. Since 1961, the Middle East has exhibited both a high degree of conflict and a low degree of structural change in the instruments of governance. There have been costly wars between Israel and its neighbors (1967, 1973, 1983), the overthrow of the Shah of Iran (1979), a major war between Iraq and Iran (1980-1989), the invasion of Kuwait by Iraq (1990-1991), the American invasion of Iraq (2003-), civil war in Sudan (1989-), civil war in Lebanon (1975-1989), a guerilla war between Turkey and Kurdish paramilitaries (1983-1995), and several other wars and coups. In addition, Islamic countries in Central Asia have experienced a high degree of conflict. At the same time, the pattern of governance common to most states in the Middle East in 1961 has remained relatively stable.

Mehran Kamrava divides undemocratic governments in the Middle East into three ideal types: a), exclusionary states, which govern by means of the traditional instruments of repression (military, secret police); b), inclusionary states, which govern by using populist symbols, rhetoric and movements to legitimate the ruling clique's administration, while at the same time employing exclusionary instruments of repression; and c), sultanistic states, in which some ruling family retains power. (Kamrava 1999) Kuwait falls into the last category, along with Bahrain, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Jordan and Morocco.

This region-wide political dimension has two effects on Kuwait's foreign assistance – first, on the rationale for that assistance, and second, on its effects on the recipient states. Tétreault has noted the continuity between the client list policies pursued by the Al Sabah family under British protection and the security-seeking policies of the independent state of Kuwait. In Tétreault's model, foreign assistance has an internal security-seeking effect – placating potential nationalistic/Islamist opposition – and an external security-seeking effect – purchasing a form of insurance from an assortment of both regional and international powers in order to secure the territory of the state from exterior threat. The starkest example of the former is the aid that was channeled to Iraq during Iraq's conflict with Iran. This aid secured Kuwait from potential Iraqi and Iranian aggression. When, in 1990, Iraq invaded Kuwait, Kuwait's investments and history with Western countries – notably the UK – served as an entry point to rally these countries to Kuwait's defense. (Tétreault 1991, 1995)

Kuwait's role as a major oil exporter endows its bilateral foreign assistance with a different set of interests than those that shape American or European foreign assistance programs, insofar as Kuwait is not seeking eventual trade or economic complementarities with its target countries.

> "Kuwait's economy is characterised by heavy dependence on one sector, i.e. mining and quarrying (mainly oil), for its sustenance. The domestic non-mining production base is limited, with agriculture and manufacturing (which includes petroleum refineries that constitute 67% of manufacturing's value-added) accounting for 0.4 per cent and 11 per cent, respectively, of the country's GDP. Most of the country's annual crude oil output and its products are exported, and the necessary capital and consumer items, including food, clothing and durable goods, are imported. In 1995, exports and imports of goods and services constituted 53 per cent and 43 per cent of the country's GDP, respectively. Furthermore, private sector activities are limited to a few economic sectors." (Burney, Al-Mussallam 1999)

As a single-sector economy, Kuwait also exhibits a structural migration towards overwhelming public sector employment and away from private employment, with the percentage of Kuwaitis in the latter growing to more than 75 percent in the mid seventies, during a period of windfall gain from oil price hikes. That percentage has risen since, through a deep economic downturn in the eighties, through the deficits of the 90s, to the current upturn.

> "Kuwait's generous welfare system is the envy of most citizens in the industrialised nations. The state provides its 825,000 nationals with free healthcare and education, low-cost housing loans, subsidised essential foodstuffs, power, water and gasoline, as well as constitutional guarantees for life employment in governmental organisations. Indeed, between 90-95 per cent of the Kuwaiti workforce is employed in the civil service or state owned enterprises, including the parastatals." (Siddiqi 2001)

At the same time, the windfall gain attracted considerable in-migration, with non-Kuwaitis filling the private employment slots. This created an unofficial regional

dependency on the oil economy as non-oil producing, labor exporting countries, like Yemen and Somalia, swelled per capita income with remittances sent home by laborers in the richer countries. Yemen, for instance, raised its per capita income six times with the remittances generated by the Saudi boom in the seventies. (Chaudhry 89) If Kuwait's strategy is to create stability in the region to preserve its own social order, its efforts to do so can unintentionally create linkages – such as those between private workers in Kuwait and the countries of their origin – which develop novel and unexpected benefits and risks.

Since the fifties, efforts have been made across the political systems of the region to create regional economic integration. Inter-Arab trade never became more than a tenth of the aggregate Arab trade total in the fifties and sixties. One reason for this was the lack of exploitable economic complementarities. When Kuwait joined the initial committee to create an Arab Common market in 1962, it was the only significant oil exporter among the five states (Egypt, Syria, Jordan and Morocco, and Kuwait) to do so. Kuwait eventually withdrew from the treaty that would stage the abolition of all duties between the states, which points once again to the anomalies created by Kuwait's single-sector economy. (Owen, 1998)

Until 1967, Egypt and Nasser's combination of state socialism and nationalism was the dominant ideological driver behind Arab integration. Saudi Arabia and the Gulf states, hostile to Nasser and closer to the West, had not successfully exerted their economic power to create a competing political space. As one metric of Egypt's political power, it contributed 40 to 50 percent of the Arab League's budget. The change in the balance of power was signaled by the Khartoum Arab Summit in 1967, which "was

crucial in embodying the change of political poles in the Arab system. It formalized the decline of the radical Arab order and its subservience to what can be termed 'political petrolism.' The death of Nasser on September 28, 1970 (the ninth anniversary of Syria's secession from the United Arab Republic) removed the nationalist's symbol and their reference point. The resulting leadership vacuum was to be filled, almost by default, by petro-powers." (Korany, 1991)

Kuwait joined the oil-producing states in pledging assistance earmarked for military assistance to the "front-line" states of Egypt, Syria and Jordan at the Khartoum conference. Collectively, these transfers were estimated at about $400 million annually in the 1970-1973 period. However, it wasn't until the 1972 coordination of the OPEC states in renegotiating the price of oil, and the OAPEC oil embargo of 1973, that the petro-powers showed both their political muscle and ushered in the era of windfall profits. The OAPEC powers were not, however, undivided. While the 1973 embargo succeeded because the conservative Gulf states – Saudi Arabia, Kuwait, and the UAE – joined the more radical states, Libya and Iraq, the conservative states never intended the embargo to do real injury to the international economic order, and were receptive to signals from the United States after the Yom Kippur war that they took as a modification of the pro-Israel stance taken by the Americans. (Ahrari, 1979)

The embargo had two results: on the one hand, it ushered in an era of windfall profits for the oil-producing states. On the other hand, by driving up the price of oil, it created a balance of trade crisis for developing states, among which were several Arab states.

There were four possible strategies for the windfall gains by the oil-producing states: a), foreign investment; b), foreign assistance; c), expansion of government services; and d), domestic investment. The division between these four possibilities depended on the state's degree of in-migration, its geography, its security needs, its endogenous population growth, and the size of its domestic market. (Hazleton, 1978) Kuwait had the means to accomplish its security-seeking goals both internally – in terms of an expanded public sector – and externally – in terms of foreign investment and assistance. Foreign investment, here, does not entail, as it does with other developed capitalist states, investment by private businesses headquartered in those states. Rather, foreign investment has to be looked at through the peculiar status of Kuwait businesses, which operate as both independent entities and as parts of the state. Tétreault, in studying the reaction of the Kuwaiti Petroleum Corporation to the invasion of Kuwait, has aptly used the analogy to the medieval theory of the king's two bodies, with the state serving as the king's metaphorical body. Similarly, the boundary between KPC as a corporate actor and KPC as a state actor is attenuated to the point where it can operate as one or another in succession, or both simultaneously.   Thus investment by Kuwait can function strategically as private investment or state policy. (Tétreault, 1999)

On the other hand, the volatility of revenue depending on petroleum export makes it very hard, however, to project any trend into the future. Unlike countries with other primary product exports, where the economic landscape can only benefit from diversification, the benefit from diversifying given the surplus provided by oil price

upswings is harder to argue for. So far, there is no predictive model for a recurrent, cyclical windfall economy of the oil producing type.

The recipients: benefits and rent-seeking

In the sixties, development in the Middle East followed the standard modernization model. This model – heavily oriented towards large-scale infrastructure projects and import substituting industrialization – dovetailed with the corporatist mentality of the various ruling cliques. "In this early populist phase, the state drew the existing but still weak working classes and urban middle classes into its rank in order to mobilize the human resources of the country, and their political support, behind its development strategies. In return for their support, the state offered them welfare services and production and supply of new consumer products." (Ehteshami, Murphy 1996) The countries of the Middle East and North Africa suffered, in the seventies and eighties, the same convergence of two problems that have globally effected LDCs: the stagnation of those economies structured by development strategies of the sixties, and the shock of negative terms of trade following the seventies oil spikes. The structural adjustment demand by the IFIs and Western donors was a powerful force for liberalization in the eighties and nineties among other LDCs, since they were designed to diminish the rent-seeking that enable ruling elites to contain rivalries and opposition groups. Yet the Middle East lagged behind on these trends. In a case study of Syria, Hinnebusch has shown how the ruling clique has to balance political and economic rationality. If liberalization is to succeed, the bourgeoisie, the entrepreneurial private sector, must be freed from constraints on its business activities. But the ruling elite, based in the public

sector, views the bourgeoisie as a rival. In addition, the popular base of the regime

(unionized workers, public employees, and small property-holding peasants), are likely to

be threatened by market reforms. The regime has responded with a strategy of

incremental liberalization and transitional alliances between segments of the

entrepreneurial class and the military to cushion the political impact of the structural

changes. In addition, it has used the cushion provided by upward swings in oil wealth and

Arab aid to sequence and control its policy of selective liberalization. (Hinnebusch 1997)

Is having a competing market for aid – South-South aid – important to the stabilization of

the system? Is it the one of the intentions of Kuwait's foreign assistance policy?

In the 1984 statement of the project appraisal criteria and financing policies of the

Kuwait Fund, the advantages of Arab Aid are overtly tied to Kuwait's disinterestedness,

as an oil producer, and the non-interventionist, non-political nature of the aid, noting that

funding

> "… is essentially highly concessional and non-tied. Being non-tied, it offers the
> opportunity to recipients to procure the desired quality of goods and services
> from the lowest cost source. Not only that, but it frees the beneficiaries from
> committing themselves to project designs and technologies that may not be the
> most suitable to their needs and circumstances. Thus, it can be safely claimed
> that Arab aid with no political, commercial or similar strings attached to it
> possesses all the qualities that are highly desirable for increasing aid
> effectiveness." (Kuwait Fund 1984)

Behind the rhetoric, what seems to be on offer here is the kind of aid ideally

suited to preserving the status quo power relations in states that are growing short on

those resources that would preserve non-democratic rule based on inclusionary populism.

However, it is a real question whether or not it can be the case that aid is effective when it

is simply inserted neutrally in a system of institutions that are structured by a high degree

of rent-seeking. In a 1976 study of the Kuwait Fund, Demir wrote that Kuwait "projects an image of political and ideological neutrality." (Demir 1976) In the framework of security-seeking, the Kuwait Fund does well to capitalize on that image. In that sense, the competition with the IFIs provided by the Kuwait Fund and other of the oil producing countries aid programs may well contribute to the lag in the liberalization of Middle Eastern and North African countries. If foreign aid disguises the cost of unsustainable political activity, it can be classified as a moral hazard just as much as insuring a risky investment can be so classified. Instances in the Middle East could include Israel (with US aid cushioning the Israeli population from the cost of the West Bank occupation) (Lustick 1982) and Egypt (with multiple sources of aid, the Egyptian ruling elite has been able to ward off reforms that would destroy the Nasserite one-party system or neutralize its inclusionary basis among the population by welfare reforms) (Glasser 1995).

However, behind the neutrality, Demir notes that the Kuwait Fund has evolved to tighten controls and challenge corruption in the assistance process. "Since corruption cannot be ruled out as a symptom of economic and social life in the Middle East, a tighter control on the use of Funds by the Fund has both economic and political advantages." (Demir 1976) This evolution is mirrored in the funding process, which we will now survey

The Kuwait Fund: evolution of the process

According to a 1984 Kuwaiti Fund overview, the Fund's "appraisal pipeline" is structured like this:

a. A project is submitted by the government of a country within the Fund's ambit for consideration.

b. The project is considered from the point of view of its design and function. If the project seems well designed, it is next judged as to its feasibility and the availability of resources (technology, human resources, and other sources of funding) to ensure its completion. The Fund is willing to supply the expertise to make these evaluations and projections in cooperation with the potential recipient.

c. Criteria examined include poverty alleviation and need, but do not include governance. The Fund highlights its neutrality, in fact: "It [the Kuwait Fund] does not concern itself with the social and economic orientations of the recipient country so long as any measures taken by such recipient do not affect the success of the development operation in question."

d. Financial criteria are described as follows: "While economic appraisal is made from the perspective of the country's objectives, financial appraisal, on the other hand, is concerned with the financial viability of the investment and its effect on the financial position of the project-operating entity. Thus, such measures as the Internal Financial Rate of Return (IFRR), the debt service ratio, the debt-equity ratio, the current ratio, the average rate of return on gross fixed assets and net fixed assets, and other financial measures are computed and evaluated to determine the impact of the proposed operation on the financial soundness of the entity. The financial analysis and projections are undertaken not merely as an exercise, but as a means for guiding the most appropriate steps, actions and measures that could be implemented to ensure a sound and viable financial position which enables the entity to perform smoothly and steadily."

The typical projects funded by the Kuwait Fund up through 1984 were largely industrial, agricultural or infrastructural. Human capital projects involving health, education, and research and development were not blocked out as distinct parts of KF aid and loan disbursement, nor were environmental considerations prioritized. The 1984

guidelines admittedly anteceded the World Bank and UN led turn to Human Development (HD). However, Human Development grants must be given a different portfolio and framework of assessment and cooperation if they are to succeed. Perhaps the orientation to HD funding has been difficult for bilateral donors – for instance, as funding for education by the World Bank has doubled in the 1986 to 1998 period, bilateral funding has been volatile, with a downturn in the period from 1990 to 1993. (Alexander 2001). Education grants for curriculum development, school building, and educational manpower are harder to design to fit the KFAED's preferred neutral or stabilizing intervention model, since such projects invariably run into question of gender and income disparities that are less visible in designing infrastructural projects. Similar questions arise with projects involving health, research and development, and the environment – all of which bring in questions of governance. At the same time, the need for HD funding is growing – for example, it is estimated that funding to sustain primary education in the Middle East and North Africa to accommodate the population will have to grow by a third. How Kuwait's traditional security-seeking foreign assistance programs accommodate these new opportunities and threats is a question that requires looking more closely at the political economy of the KFAED

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CHAPTER TWO

II. CONCESSIONAL LOANS ALLOCATION

Abstract

This paper is a study of aid allocation by the Kuwait Fund for Arab Economic Development (KFAED) from1974 to 2001. It seeks to determine, among other things, whether the allocation of aid reflects recipient needs (RN) or donor interests (DI). It includes: (i) a review of Kuwait Fund operations; (ii) a review of the aid allocation literature; (iii) constructing the hypotheses regarding KFAED's aid allocations, and (iv) a formulation of an Econometric model to explain the allocation process of aid. The paper will use a two stage model, the first step is whether to select a country or not, and the second involves how much aid to commit. The empirical analysis demonstrates that income, ethnicity, religion and politics are all factors in the selection stage. Both the ethnicity and religion of the recipient and more populous countries have an influence on allocation stage.

II.1   Introduction

The Development aid literature has focused, in general, on either estimating the recipients' needs or assessing its impact on the recipient, while the literature on aid allocation deals with both determining the aid size and the motives behind its allocation. Given the importance of studying the impact of aid on development, it can not be achieved without understanding aid allocation process and motives; how much aid is allocated and to whom (Tarp et al 1998).

Additionally, given the vast research that has been conducted in the literature, there is little literature covering Arab aid. This gap creates a genuine need for applying this research to Arab aid allocation. Therefore, the research focuses on investigating the allocation and the factors that determine grant allocation policy. Kuwait Fund for Arab Economic Development will be used as a case in our analysis. Examining the volume of aid during the last few decades shows its importance as the largest and oldest Arab bilateral development institution.

The above importance stems from the fact that Arab aid had reached close to $120 billion in 2004, representing almost 1.3 percent of their GNP and 13 percent of total world aid. Some researchers had attributed this gap to the lack of accurate published data on the part of Arab developmental institutions. But in recent years, Arab donors started publishing their data and statistics, making feasible the potential of filling the gap in the literature.

This paper will analyze how the Kuwait Fund for Arabic Economic Development (KFAED, hereafter) aid allocation has evolved since the early 1970s. This is of particular interest due to the widespread perception that the aid policy of Kuwait, as a small developing donor country, is driven largely by the development needs of poor countries rather than by more self- interested and political motives. An econometric model for the allocation of KFAED concessional aid is proposed in this paper. We present the allocation decision as two stages involved in the aid allocation process, namely: the decision to grant aid or not, and then, if yes, how much. These two steps will be explicitly modeled in order to capture and explain the relationship between them and KFAED decision process. The literature of aid allocation will be applied to derive conclusions about the significance and parameter signs of the different officially stated motives behind KFAED's allocations during the period 1974-2001.

Following this introduction, Section II provides a descriptive analysis of Kuwait aid in a historical perspective. In Section III, existing literature is reviewed, along with the hypotheses about Kuwait bilateral aid selection and distribution among recipient countries. This framework is made quantifiable in Section IV, and the empirical analyses are summarized in Section V. Concluding observations

II.2   Kuwait AID[8]

After Saudi Arabia, Kuwait was the second largest Arab aid donor, having contributed a total of more than $18.5 billion between 1960 and 2002 (Table 1). In 1961,

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[8] Draws from a survey from Imady (1982)

Kuwait was the first to officially establish a bilateral aid institution: KFAED. In terms of

GNP, Kuwaiti aid has ranged from 3% in the 1980's, 5% in the early 90's and around 1%

in 2002, well above the UN mandated .7% , and well exceeding all western donors. As

figure 1 show.

Kuwait contributes aid through three main channels: The Ministry of Finance; the

Kuwait Fund for Arab Economic Development and the General Board for the Gulf and

Southern Arabia (Imady 1982).

Kuwait Fund for Arab Economic Development (KFAED):

Established in 1961, KFAED was the arm for extending concessional loans to

finance development project to Arab and other developing countries. KFAED was an

independent agency with an initial authorized capital of Kuwaiti Dinar (KD) 50 million

($140 million), it increased to KD 2 billion ($7.2 billion) in 1981. Its paid-up capital at

the end of June 2003 was KD 2000 million ($7.2 billion), and it had an accumulated

general reserve amounting to KD 1.453 billion ($4.8 billion). (KFAED annual report

2003)

The stated purpose of KFAED is to assist Arab and other developing countries by

providing loans on concessional terms for specific projects that are likely to have a

favorable impact on the borrower's economic development, while yielding a satisfactory

rate of economic return. Until 1981, the Kuwait Fund's activities were limited to loans

and relatively small technical assistance grants. A new statutes adopted in 1981 also

enable the KFAED to participate in the capital stock of development-oriented

corporations controlled by developing countries and of international and foreign development institutions assisting developing countries.

At the end of 2003, total loan commitments totaled $11.8 billion for a total of 631 loans, most of which were on concessional terms (Table 2 and figure 1 show annual KFAED loans). Up to 1974, KFAED lending was limited to only Arab countries; however, following the 500% increase in its capital, lending activities accelerated after 1975. The peak level of commitments occurred in 1981-82 following a 100% increase of its capital and the adoption of the new statutes. The level of commitments fell to slightly more than $300 million per annum since 1984. However, and as figure 1 shows, loans picked up just before the invasion of Kuwait and continue to grow through the nineties with the exception of 1994 when the loan commitment declined below 250 million dollars.

KFAED disburses loans relatively quickly. Its loan utilization ratio (percentage of gross disbursements to total committed loans) stood at 75 percent at the end of June 2003, higher than for most other Arab development agencies. Cumulative gross disbursements amounted to KD 2532 million ($8.1 billion) as of June 30, 2003, and cumulative loan repayments were about KD 1298 million ($4.2 billion). Net loan disbursements have displayed a relatively regular trend, growing from a small amount in 1973 to a little more than $200 million annually in 1976-79. It increased to an average of $325 million per annum between 1980 and 1986. In 1987, concessional disbursements fell to $88 million. In 1988, for the first time, repayments exceeded disbursements, totaling a minus $6.5 million. This worsened in 1989, with net disbursement being a negative $12.5 million.

The increase in the level of new commitments in 1989 for the first time in seven years was expected to increase the disbursements in the years ahead, but KFAED's operations were disrupted by the invasion of Kuwait in August 1990. However, KFAED was able to operate from London the same month. As a matter of fact, it continued committing loans during the occupation where over 400 million dollars were committed in 1990, the year of the invasion, compared to slightly more than 270 million dollars in 1989. After the liberation, KFAED decided to include two regions into its recipients, The newly independent stated from former Soviet Union and Latin America. Furthermore, as he following table shows, KFAED average annual loans have increased in the 1990's to in access of 450$ million compared to 330 $ millions in1980's.

Table 1 KFAED annual loans (decades) in US $

Decade	Annual Loan
1960s	24,451,355
1970s	176,449,081
1980s	332,179,623
1990s	458,658,091
2000s[9]	461,726,893

In addition to loan disbursements and small technical assistance grants, the KFAED contributes part of its capital for participations in multilateral development institutions in the name of the State of Kuwait; a total of KD 285 million ($950 million) was disbursed by 2003 for this purpose to Arab fund, ADB, the African Development Fund, BADEA, the Inter-Arab Investment Guarantee Corporation, and IDA. (KFAED internal memo)

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[9] Up to 2003.

Although the KFAED has been allowed to lend to non-Arab developing countries since July 1974, and 65 countries have benefited from its aid, as table (3) shows, the geographic distribution of its aid flows has remained heavily tilted toward Arab countries, representing on average 50.9 percent of the total in 1989, and increased to 52.6 percent by 2003. The second largest beneficiary has been Asia; however its share had declined from 28.7 percent to 20.6 percent in 2003, followed by Africa (17 percent), Central Asia (6.4 percent) and Latin America (2.4 percent). Table (4) shows the sectoral distribution of loans indicates a clear preference for infrastructural projects, which accounted for more than 60 percent of commitments between 1962 and 2003. Agricultural and industrial projects, along with energy and other projects made up about 20 percent each of the total. In particular, since the inception of the Kuwait Fund, the transport and communications sector ranked first with a share of 30.5 percent in 1989 and increased to 35.1 percent by 2003, followed by electricity (23.3 percent in 1989 to 22.3 in 2003), agriculture (21.2 percent in 1989 to 21.2), industry (17.7 percent in 1989 to 13.3 percent in 2003), water and sewerage (6.6 percent in 1989 to 11 percent in 2003), and other sectors (0.7 percent in 1989 to 1.9 in 2003).

Table (5) shows the KFAED grant element has increased from 38% in 1960's to %48.47 in 2003. In similar fashion, the KFAED average loan amount has increased from 9$ million per loan to more than 23$ million per loan in the same time period.

KFAED is often ending coordinating aid policies originating from Arab institutions. As of June 30, 2003, 631 projects had been co-financed with one or more development institutions and joint financing was an element in an estimated 55.3 percent

of the total value of the loans extended by the KFAED. Furthermore, it represents Kuwait

in a number of Arab and international multilateral development organizations, as well as

in the World Bank consultative groups for several countries and in the Development

Committee. Finally, it supervised 28 grants extended by the State of Kuwait to a number

of Arab and sub-Saharan African developing countries, with a total value of KD 93

million ($300 million).

II.3   The Basis of Aid Allocation: Literature Review[10]

The aid allocation literature seeks to explain the interests and motives of donors

by collating patterns in the allocation of aid with the stated policies of the donor

institution or state. The aid literature considers foreign aid assistance as an instrument to

be facilitated to help accomplish a number of objectives; economic, political, as well as

humanitarian and development ones. The basic assertion of aid allocation literature is that

in pursuing these objectives the donor is motivated to allocate their foreign aid in such a

way as to maximize the benefits of attaining these objectives. Since actual motives, not

the declared ones, they are not directly observable, explanatory analysis aims at the

decision-making process of turning motives into allocations. The assumption is that aid

will be allocated to those recipients who exhibit characteristics (economic, political,

strategic, or other), which are believed by the donor to be a., worth targeting, and b., to be

amenable to such behavioral changes as would be consistent with its own interests. The

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[10] Draws on the survey paper by McGillivray and White (1993a). See Hjertholm, P and White, H (2000) for
more detail survey.

methodology thus involves establishing viable hypotheses relating aid flows to the observed characteristics of recipient countries and donors' other motives, (see McGillivray and White 1993a).

Earlier explanatory studies, (e.g. Wittkopf (1973), Mckinlay and Little (1977; 1978a, 1978b; 1979), McKinlay (1978), Maizels and Nissanke (1984) and Tsoutsoplides (1991)), treated recipient needs (hereafter RN) and donor interests (hereafter DI) separately, by modeling each of the two models of aid allocation as stand alone. The RN model assumes a need-based perspective on the part of the donor, positing the economic and social requirements of recipient countries need as the sole determinants of aid allocation. On the other hand, the DI model takes a different interest-based perspective, assuming that donors allocate aid for the purpose of promoting their foreign policy and strategic objectives and/or economic self-interest. The general result of the empirical evidence in the three decades prior to the 1990s suggests serious doubt about the extent to which the recipient need model can explain aid allocations from bilateral donors. Not unexpectedly, however, multilateral aid allocation was comparatively well explained by the RN model estimated by Maizels and Nissanke (43 per cent of the variation). This may be partly explained by the fact that multilateral agencies are less governed by political considerations than bilateral agencies, a point investigated by Rodrik (1996).

With regard to the US bilateral aid, Mckinlay and Little (1979) reached a similar conclusion, claiming that US foreign policy considerations almost always trumped humanitarian concerns to explain the course of US aid allocation, However,

Tsoutsoplides (1991), found that the DI model was a worse predictor for total European aid than the RN model, although the reverse is true when only bilateral aid is considered.

A different approach of study aid allocation has applied so-called 'hybrid models', a comprehensive model which encompass both RN and DI into one model. In applying this model on European Aid,. Grilli and Riess (1992), for example, used the Human Development Index (HDI)[11] as an indicator of recipient needs, with external debt stocks added as an additional indicator of debt burden. Exports to donor countries measured commercial importance, while population size was included in order to account for small country bias, his results indicate that European bilateral aid allocation is influenced by commercial motives. European multilateral aid allocations, on the other hand, are more influenced by considerations for development needs. Reflecting on the reasons for the generally better explanatory power of the applied model over time, Grilli and Riess suggested the declining role of colonial ties and other (political) factors. Political and strategic motives are not explicitly tested for, but while the extent to which these factors influence aid allocations has diminished since the demise of the cold war, security consideration may nevertheless have played a role in some cases.

Yet other studies (e.g. Daveri and Grilli 1991 and D'Agostino 1989) on the allocational pattern of individual donors found evidence of a 'polar pattern' among them. At one end, French aid appeared entirely guided by French interest, and at the other, Dutch and Nordic aid appeared to be driven almost wholly by recipient needs.12 In

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[11] Whether or not the Human Development Index is a suitable indicator of development is a moot point.

[12] A recent study on Danish aid by Tarp et al. (1998), while confirming the importance of recipient needs in the determination of Danish aid allocations, also found evidence of commercial interests, as well as

between these contrasting cases were found donors like the United Kingdom, Italy and Germany. Supporting the notion of a very diverse pattern of aid allocation among donors, the recent study by Alesina and Dollar (1998) of bilateral aid allocation during 1970-94, found evidence "that the direction of foreign aid is dictated by political and strategic considerations, much more than by economic needs and policy performance of the recipients". Aid from the United States, France and Japan (accounting for a very large share of total aid) largely went to 'friendly' countries, regardless of economic needs and performance, with Nordic aid much more sensitive to these factors. The authors propose that this pattern of aid flows partly explains why past aid has been, "at best, only partially successful at promoting growth and reducing poverty" in recipient countries. While recipients that have democratized have, at the margin, received more aid, colonial past and political alliances have been the major determinants of aid flows. The authors paradigm claim is that "an inefficient, economically closed, mismanaged non-democratic former colony friendly to its former colonizer, receives more foreign aid than another country with similar level of poverty, a superior policy stance, but without a past as a colony".

A couple of studies (e.g. Dowling and Hiemenz 1985, Isenman 1976 and Karunaratne 1980) have highlighted and sought to explain the small country bias often observed in donors aid programs (there also being a possibility of middle-income biases), which means the tendency for small recipient countries to receive relatively larger amounts of aid per capita than larger countries.

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increased political pre-occupation with human rights. Evidence of an increased role of political developments in recipient countries has also been found by Alesina and Dollar (1998).

A conceptually different method is proposed in studying the aid allocation by the 'sample selection models' The idea is that aid allocation process is a two-step decision-making process. The first step (selection stage) involves deciding which countries to include in the aid program, and the next step (allocation stage) involves determining how much aid the countries selected will receive. Dudley and Montmarquette (1976) used this method in studying Development Assistance Committee (DAC) aid. . They found both the selection and allocation stages to be influenced by RN (i.e. income per capita and population size), and on DI (i.e. economic and political self-interest, and on the 'band wagon' effect- the tendency to allocate aid to countries already receiving aid from other donors. In his recent paper, Neumayer (2003) confirmed the intersection between RN and DI when applied the approach on total Arab aid. His result documents that being poor, Arab, Muslim, African, and having political ties will result in obtaining aid from Arab multilateral institutions.

Other studies had followed this methodology by applying it to bilateral donors, like Canada (Dudley and Montmarquette 1978), Australia (McGillivray and Oczkowski 1991), the United States (Gang and Lehman 1990 and Eggelston 1987), the United Kingdom (McGillivray and Oczkowski 1992), and Denmark (Tarp et al. 1998). Trumbull and Wall (1994), using also an extended version of the Dudley-Montmarquette model, performed an analysis of total developing country ODA for 1984-89.

Factors determining Kuwait aid allocation

The existing literature that deals with Arab aid allocation had mentioned many factors that may have some influence on the direction and volume of Arab aid.

Kuwait as having a majority of Muslims would naturally extend aid to Muslim countries than not. This religious preference is argued by Mertz and Mertz (1983) in that Arab donors are biased with respect to Islamic countries. However, Khaldi (1984: 13) rejects the suggestion that Islamic countries might be favored by Arab aid in claiming that 'Arab aid does not have any religious character'. Porter (1986: 63), on the other hand, believes that the 'Islamic connection', while existent, 'appears to be of relatively small significance among the motivations underlying the Arab aid effort and its distribution'. Therefore, the hypothesis states:

Hypothesis I: *The recipient being a Muslim country will be a positive factor in KFAED aid allocation*

From its name, KFAED has begun its lending activities limited to Arab only states. At least in the early years; Arab countries were the sole beneficiaries of KFAED's aid (Van den Boogaerde, 1991). For example, only Arab countries were eligible for the receipt of aid from the KFAED until 1974. However, generally speaking, eligibility and the range of recipient countries widened substantially after the very early periods of Arab aid allocation. Already in 1984, Khaldi (1984: 13) claimed that "Arab aid is geographically balanced out" and is not heavily biased towards Arab countries. However, this "balanced out" is not clear in KFAED case, as tables 3 and 4 suggest. The hypothesis states:

Hypothesis II: The recipient being an Arab country will be a positive factor in KFAED aid allocation.

In addition to Arab, some suggest (Neumayer 2003d) that being sub-Saharan African country might influence KFAED allocation decision. This stem from the fact that the Arab League was and still in pursuit of Afro-Arab unity. In addition to that, there is a traditionally strong political, historical and cultural links between African countries and Arab countries (Simmons, 1981). The third hypothesis states:

Hypothesis III: The recipient_being an African country will be a positive factor in KFAED aid allocation.

From the DI, it is expected that Kuwait will favor countries that have policy positions similar to theirs. Such an indicator can be the similarity of United Nations voting behavior of Kuwait and the recipient.

Hypothesis IV: The United nation voting behavior of the recipient in relation to Kuwait will be a positive factor in aid allocation of KFAED.

Another factor that might impact the DI that is often employed in the aid allocation literature is some trade-related proxy. The idea of using such a variable is that donors might be more willing to give aid to countries that are major trading partners with them. The hypothesis is:

Hypothesis V: The level of trade between the recipient and Kuwait will be a positive factor in aid allocation of KFAED.

Recipient Needs (RN) Factors

The single most common and most relevant indicator variable of RN included in studies of aid allocation is a country's level of income. It represents the income of the

average citizen. The lower this income is, the poorer on average a country is and

therefore the more in need of aid. In its guidelines on developmental aid, KFAED states

clearly that aid should be concentrated on the poorest countries.

Of course, income is an imperfect indicator of RN average income levels as it

does not tell anything about the distribution of income, nor is income everything that is

relevant for the welfare of people. The shortcomings of per capita income as a

comprehensive indicator for the well-being of a country have long since been recognized

and criticized (Moon 1991; Moon and Dixon 1992). If low well-being reflects high need

for foreign aid, then using only per capita income as a variable does not adequately

reflect RN. In spite of this, the existing literature has often only used per capita income,

first because it is more readily available than many other potential candidates and second

because some do argue that, in spite of its problems, per capita income remains the single

most comprehensive index for well-being and therefore for signaling a country's need for

aid (Easterly 1999). KFAED, like many other aid donors, might take the need of potential

recipient countries into account in favoring poorer countries. For example, KFAED's

former Director Al-Humaidi (1984: 60) claims that it has been the general policy of

Kuwait Fund to favor "those countries of the developing world which are more in need of

assistance than others". The hypothesis states:

> **Hypothesis VI:** *The higher income recipient has the lesser chance of aid allocation from KFAED.*

To take into account development needs of the recipient, beside the above

mentioned economic indictor, an index comprising both the health and education of a

country. One of the indexes is called the Physical Quality of Life Index (PQLI). It is used

here in addition to per capita income. It was first developed by Morris (1979) in a report

published for the Overseas Development Council and has been used for example by

Maizels and Nissanke (1984) in their early analysis of bilateral and multilateral aid flows

and by Tsoutsoplides (1991) on EC aid allocation. The PQLI is an aggregate measure of

life expectancy, infant mortality and literacy. The hypothesis states:

> ***Hypothesis VII***: *The higher a recipient's development need as represented by PQLI the higher the aid allocation of KFAED.*

II.4   Research design

In accordance with the vast majority of the literature, aid in our study refers to

loans with grants --highly concessional loans (i.e. loans with a grant element of at least

25 percent) that are "undertaken by the official sector", administered with the

"promotion of the economic development and welfare" of the recipient countries as its

main objective (OECD 2002b: 294).

Our classification, in this research, of aid is aid commitment (decided) and not

aid disbursed (actual). Commitments are defined by "a firm obligation expressed in

writing", whereas disbursements "record the actual international transfer of financial

resources"(OECD 2002b: 292). We argue, as White and McGillivray (1995), that

commitments are the more relevant variable if we need to analyze the determinants of aid

allocation by donors, as commitments are "the decision variable of the donor" over which

they exert full control.

The Dependent Variable

The existing literature disagrees on whether total aid should be the dependent variable or aid per capita. The latter controls for the fact that countries differ in their population sizes. If total aid is taken to be the dependent variable, then at the least population size must be one of the explanatory variables to account for the fact that, all other things being equal, China or India are likely to receive more aid than, for example, Chad. In most cases, it seems reasonable to presume that there is an overall fixed amount of money to be allocated. Given this overall constraint, McGillivray and Oczkowski (1992: 1314) are correct in arguing that "distributing aid in per capita terms ...is both a difficult and cumbersome task" as care needs to be taken neither to overshoot nor undershoot the fixed overall amount of money available. It is much easier for donors to allocate a share of the total amount of aid available to each recipient country. As McGillivray and Oczkowski (ibid.) point out, in this process of dividing the cake "aid decision makers may well be aware of the corresponding per capita amounts, and may well adjust absolute amounts on this basis, but this is taken to represent a response to country size. In this context, per capita aid allocations are viewed as the outcome of this process rather than the prime consideration". Therefore, the amount of aid committed to a recipient country is taken as a share or percentage of the total amount of aid allocated by the donor to be the dependent variable. It is believed that this variable approximates best the way KFAED undertakes its aid allocation decisions.

The Independent Variables

In accordance with the literature on aid allocation, variables that cover recipient need (RN) and donor interest (DI) are included. The choice of variables was undertaken with a view towards maximizing the sample. In other words, the aim was to have variables that, if at all possible, are available for all countries for which World Bank and KFAED provides aid data. The justification for this is to avoid selection bias, which occurs if data are not randomly, but systematically, missing. For example, very poor countries and countries on the verge of collapse of state order often have poor data availability.

Recipient needs (RN) and Donor interest (DI) Variables

As previously stated, recipient's per capita income is the most commonly used variable indicating the economic need, while Physical Quality of Life Index (PQLI) corresponding to the recipient's development needs.

First: For the trade-related variables, we use here the natural log of the value of exports and imports from Kuwait (data taken from Gleditsch 2001).

Second, in order to check for potential bias towards Arab countries, A dummy variable is used. An Arab dummy variable was set to 1 for Arab and 0 for non-Arab. This dummy covers all countries with a majority Arab population.

An African dummy is set to 1 for all African countries except those which are Arab.

An Islamic dummy is set to 1 for all countries with majority Muslims, other than Arab countries. (Table 6 shows Arab, Muslim, and African countries).

Third, to test the importance of DI that are more directly political, we have two variables: The first one is to reflect a political alliance between a donor and a recipient. Gartzke, Jo and Tucker (1999) created a measure that estimates of the alliance extracted from the UN voting records. The second variable is population size. More populous countries is believed to be more eligible for aid due to their greater importance in comparison to countries with a smaller population size.

Methodology

Studying the determinants of KFAED aid allocation requires clarifying the decision process that takes place in deciding on extending a concessional loan to particular recipient. It is not only do recipients receive different amounts of aid, but some countries do not receive any aid at all. Furthermore, there are many poor countries that don't receive aid, while other relatively richer; countries receive a high volume of aid. Therefore, we will examine whether the factors determining the selection of a country are the same as those determining the amount of aid for the recipient.

To summarize, our problem is

$$Y = \begin{cases} 1 & if & Y^* \succ 0 \\ 0 & if & Y^* \ otherwise \end{cases}$$

where Y will take the value of 1, if aid is positive and 0 otherwise. What classes of models are natural candidates? Let $Y_k = 1$ if country k receives a concessional loan and 0 otherwise. A Logit model is a natural candidate for modeling this dichotomous uncertain outcome. Conditional on $Y_k = 1$, the amount of aid Y_k can be modeled in a variety of ways.

The Logit model posits that the true underlying relationship may be represented as a conditional probability of group membership (no concessional loan or positive one) in the form13:

$$Logit \ (Y) = \alpha + \beta_1 x_1 + \ldots\ldots + \beta_k x_k$$

where Y is the dependent variable representing positive aid if equal to 1, and 0 for no aid. X's are the explanatory variables; that we are testing their effect on the decision to grant aid or not. It is known that the above Logit equation can be transformed into conditional probabilities:

$$\Pr\left(Y = 1/x\right) = \frac{e^{(\alpha + \beta_1 x_1 + \ldots + \beta_k x_k)}}{1 + e^{(\alpha + \beta_1 x_1 + \ldots + \beta_k x_k)}}$$

where $\Pr(Y = 1/x)$ is the probability of granting aid conditional on independent variable x.

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[13] Probit can be used as well

Model specification

To emulate the data situation facing KFAED's management at the time of the decision-making, All explanatory variables enter the regressions with a one- year lag. Some studies use a two-year lag instead. The dependent variable was logged to render its distribution less skewed. As concerns explanatory variables, the population, income and exports variables were logged in order to allow an elasticity interpretation of their coefficients. If both the dependent and the explanatory variables are in logged form, then the respective coefficient can be interpreted as stating by how many percent the dependent variable is increasing or decreasing given a 1 percent increase in the explanatory variable.

Data

Aid data were obtained from KFAED from inception, 1962 until 2001. These include basic information for all projects, grants, countries and loans in their portfolio. Aid refers here to net official development assistance (ODA). It measures the disbursement of grants and highly concessional loans (that is, loans with a grant element of at least 25 percent) minus amortization. Since the aid data are in current Kuwaiti Dinar (KD), they have been transformed into US $ using the prevailing exchange rate KD/$. The dependent variable is the (natural log) of the amount of KFAED aid that a country receives as a share of the total amount allocated, which is the total annual aid budget. Such a dependent variable seeks to represent the actual decision-making process. There is a fixed aid budget on which is decided what recipient country receives what share of the

total cake, if anything. Per capita GNI, literacy, infant mortality and life expectancy were taken from World Development Indicators published by the World Bank

The sample

The sample consists of all eligible countries with the exception of the USA, Canada, Japan, DAC countries, Saudi Arabia and the UAE. As mentioned earlier, the sample covers the period 1972 -2002. Unfortunately, a number of countries and observation were lost due to lack of data in the explanatory variables.14

II.5   Empirical Analysis

The Selection Stage

We ran the Logit to determine the factors that make a recipient country eligible for aid (selection stage) on XLSTAT software. The model is specified as follows:

$$Logit\ Y_t = \alpha_0 + \beta_1 Arab + \beta_2 Musl + \beta_3 Africa + \beta_4 UN_{t-1} + \beta_5 Trade_{t-1}$$
$$+ \beta_6 LnPLQI_{t-1} + \beta_7 LnPop_{t-1} + \beta_8 Ln\ PerCapita_{t-1}$$

The summary statistics for the above Logit is in table [6].

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[14] These include Antigua and Barbuda, Barbados, Belize, Bhutan, Botswana, Brunei, Burkina Faso, Cape Verde, Central African Republic, Comoros, Djibouti, Dominica, Equatorial Guinea, Eritrea, Fiji, Gabon, Grenada, Maldives, Malta, the Marshall Islands, Mauritius, Micronesia, Mongolia, North Korea, Palau, Qatar, Samoa, São Tome e Principe, the Seychelles, Slovakia, the Solomon Islands, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines and Vanuatu.

Table 2 Logit estimation-Selection stage

Variable	β	X^2	$Pr. > \chi^2$
Arab***	2.105	222	< 0.0001
Muslim***	0.947	46	< 0.0001
Africa	0.244	2.74	0.098
UN**	0.874	31.71	< 0.0001
TRADE	0	0.63	0.428
Ln PLQI	-0.047	0.27	0.606
Ln POP***	0.105	9.5	0.002
Ln Per Capita***	-0.235	16.58	< 0.0001
Observations	5027		
Countries	85		
Log Likelihood	-1328		
*** significant	1%		
**Significant	5%		

Table (1) shows that five of the explanatory variables are significant in KFAED choice in granting aid. A country that is Arab, Muslim, populous, poor and vote with Kuwait is statically significantly and more likely to be selected to receive aid from KFAED. The trade variable might be explained incorrectly if we only rely on the existing literature about the Arab aid. As explained before, unlike western aid, Arab aid is untied aid which may not let the donor look at commercial/trade interest. However, other Arab donors in general and Kuwait in particular are exporters of one single commodity, oil, and have nothing to export or gain any benefit to tie their aid. Furthermore, the industrialized countries are the main importers from Kuwait and the vast majority of Kuwaiti imports originate from those same countries. Those countries were excluded from the sample, it is not unexpected to have insignificant estimates for the trade variable.

The lack of significance of (PLQI) should not be surprising. More often, donors place more weight on such visible and easy to understand variables as per capita income and not on indicator like PLQI.

Table (2) shows the odds for the binary explanatory variable:

Table 3 Binary variables elasticity

Variable	β	Exp(β)
Arab	2.105	8.2
Muslim	0.947	2.58
UN	0.874	2.4

For a recipient to be an Arab, the odds are 8.2 to be selected by KFAED to receive aid compared to non-Arab. For Muslim country, the odds are 2.58 compared to non-Muslim country.

The above results are in line with the prediction in the literature. Due to Arab solidarity, Kuwaiti aid allocation is tilted more toward Arab countries than toward others. The same applies to Muslim and African countries. The number of Arab countries that received aid from KFAED over the sample period is 17 out of 21, all less developed, and therefore it is expected that an Arab country be selected in the first stage. The number of African countries is 40 out of 41, all but 5 of which were Muslim countries (Iran, Kuwait, Saudi Arabia, Qatar and UAE).

The way UN voting variable[15] is constructed makes it more difficult to provide a useful interpretation of its coefficient. However, one can say that a country with voting

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[15] This is similar to Neumayer (2003d) interpretations.

identical to Kuwait is estimated to receive a share of aid that is about 68 per cent higher than a country whose voting similarity value is equal to the sample mean.

The allocation stage

The second stage will determine the factors influencing the amount of aid allocated. Ordinary least square (OLS) is employed:

$$Ln\ \%AID_t = \alpha_0 + \beta_1 Arab + \beta_2 Musl + \beta_3 Africa + \beta_4 UN_{t-1} + \beta_5 Trade_{t-1}$$
$$+ \beta_6 LnPLQI_{t-1} + \beta_7 LnPop_{t-1} + \beta_8 Ln\ PerCapita_{t-1}$$

Note that we have the same independent variables in both stages; however, here we are examining their significance on the amount of aid distributed. The summary statistics are in table (3)

Table 4 Ordinary Least Square estimation-Allocation stage

Parameter	Value	S.D	t	Pr > t
Arab***	1.208	0.089	13.5	< 0.0001
Muslim***	0.267	0.089	3	0.003
Africa	-0.088	0.092	-0.9	0.336
UN	-0.007	0.095	-0.08	0.937
TRADE	0.001	0.001	1.5	0.143
Ln PLQI	0.031	0.06	0.52	0.604
Ln POP***	0.189	0.023	8.17	< 0.0001
Ln Per Capita	0.049	0.044	1.1	0.267
No. observation	463			
**Significant	5%			
*** significant	1%			
R^2	0.714			

Table (3) shows that neither per capita nor is the similarity of votes statically significant at this stage as they were in the first stage. Arab, Muslim and populous

countries not only have higher probabilities of being selected to receive aid, but, as shown above, they receive a higher share of aid, too.

Table 5 binary variables elasticity-Allocation stage

Variable	β	Exp(β)
Arab	1.208	3.35
Muslim	0.267	1.31
Ln POP	0.189	1.21

From table (4), it is estimated that to receive a share aid from KFAED that is about 335 percent higher than to non-Arab country, which clearly underscores the importance of being Arab. For a Muslim recipient, it is 31 percent. A one percent increase in population size leads to an aid share that is about 19 percent higher.

From the above two stages, the results do support some of the hypotheses presented in Section III, chief among them, the existence of an Arab bias in KFAED aid allocation. Bias toward Muslim countries is also clearly demonstrated in both stages.

It is worth noting that KFAED's lending decision variable is the loan amount, however, an interesting result was found when we ran the same model, with the log of aid/capita as the dependent variable. The allocations continue to be of that DI bias as table 6 shows.

Table 6 Allocation stage (AID/Capita).

Parameter	Value	S.D	t	Pr > t
Arab***	-0.303	0.111	-2.727	**0.007**
Muslim	-0.179	0.113	-1.585	0.114
Africa	-0.061	0.115	-0.525	0.599
UN	-0.050	0.120	-0.418	0.676
TRADE**	0.001	0.001	2.202	**0.028**
Ln PLQI	-0.051	0.076	-0.665	0.506
Ln POP***	0.182	0.029	6.195	**< 0.0001**
Ln Per Capita	-0.037	0.055	-0.669	0.504
No. observation	463			
**Significant	5%			
*** significant	1%			
R^2	0.231			

However, despite the fact Arab recipients are allocated higher amount of concessional loan, it is still receive less aid per capita compared to non-Arab recipients.

Trade variable, as predicted by our hypothesis, turns out both significant and positive.

The above result reinforces our earlier result that KFAED's allocation is tilted toward DI more than RN.

II.6   Conclusion

The results show the importance of being Arab for receiving aid from KFAED. Arab countries and more likely to receive aid and if they do receive some amount of aid, they also receive significantly more aid than non-Arab countries

Therefore, clear evidence for the presence of biasness toward on Arab countries. However, non-Arab but Muslim Countries are more likely to be both selected by KFAED' to receive aid than non-Muslim countries, and once selected, they receive more aid than their counterparts. Furthermore, a country with political alliance with Kuwait is

more likely to be selected to receive aid. However, this same attribute has no effect on the amount of aid received.

Poorer countries are more likely to be selected for aid but bear no effect on the amount of aid.. The trade variable tested insignificant, as expected. Population size matters when it comes to the allocation stage, and more populous countries are more likely to be eligible as an aid recipients.

In conclusion, similar to Neumayer (2003d), this paper has shown the important role that ethnic and religious similarity (being Arab and Islamic) as well as voting similarity in the UN General Assembly has on the allocation of aid by KFAED. As far as ethnic and religious similarity is concerned, Arab aid allocation is quite different from aid allocation by Western donors. For example, Alesina and Dollar (2000) do not find evidence that religion plays a major role in their allocation of aid. Political alliance, as measured by UN voting, and a country's level of per capita income have an influence on the selection stage but none on the allocation stage. Some aspects of donor interest (DI) thus clearly have an important role in KFAED aid allocation at both stages, but recipient need (RN) does so only at the selection stage.

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TABLES AND FIGURES
Table 7Arab Concessional Aid (net disbursement) 1970-2002

	70-74	75-79	80-84	85-89	90-94	95-99	2002	70-2002	(%)
All Arab	**7,696**	**31,870**	**32,741**	**15,515**	**13,429**	**6,811**	**3,398**	**117,513**	**100**
Gulf States	6,611	29,130	30,450	14,831	13,190	6,811	3,398	110,474	94
UAE	923	4,857	2,768	272	1957	482	219	11,902	10
SAUDI ARABIA	4,013	18,515	21,503	12,253	8,698	4,359	2,674	76,975	66
OMAN	...	...	6	198	189	77	24	542	0.5
QATAR	279	1,076	692	28	44	187	73	2,602	2.2
KUWAIT	1,396	4,682	5,481	2,080	2,302	1,706	408	18,453	16
OTHER ARAB	1,085	2,740	2,291	684	239	...	...	7,039	6

Source: arabaid.org

Figure 1 Annual KFAED Loans Commitments ($)
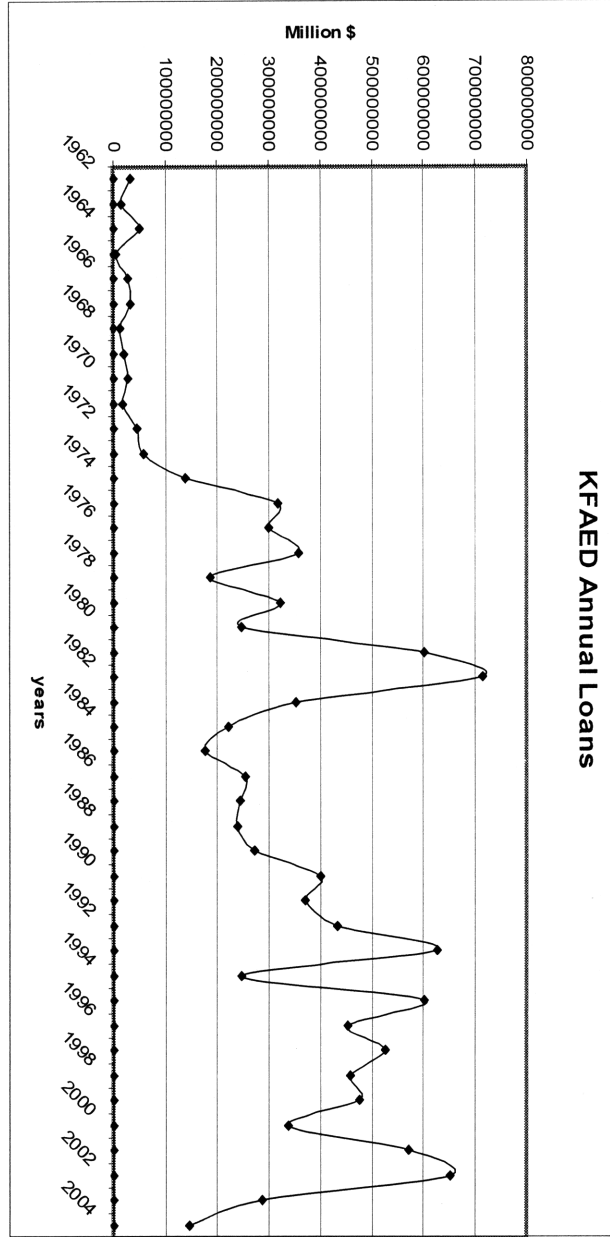
Table 8Total Annual Loans (in US $)

Year	Total Loans	Year	Total Loans
1962	33,239,559	1984	221,271,009
1963	16,243,116	1985	176,116,439
1964	49,597,420	1986	254,426,705
1965	4,923,394	1987	243,508,423
1966	27,611,581	1988	239,724,662
1967	31,550,067	1989	272,788,996
1968	12,857,500	1990	399,998,894
1969	19,588,200	1991	370,056,527
1970	27,441,129	1992	432,210,822
1971	16,820,328	1993	626,003,925
1972	44,303,758	1994	246,130,750
1973	58,056,044	1995	600,815,788
1974	137,682,785	1996	453,951,417
1975	316,938,833	1997	525,056,441
1976	298,889,734	1998	458,004,277
1977	355,979,916	1999	474,352,064
1978	185,684,383	2000	337,754,712
1979	322,693,895	2001	570,220,625
1980	246,221,064	2002	652,294,510
1981	601,020,624	2003	286,637,726
1982	714,147,457	2004	146,138,516
1983	352,570,849		

Table 9 Percentage distribution (Sectoral and regional)As of 2003

	Loans		Agriculture		Transportation		Energy		Industry		Water & Sewage		Communication	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
Arab	39%	52%	50%	64%	28%	37%	37%	53%	52%	54%	38%	57%	50%	86%
West African	17%	10%	17%	11%	21%	15%	13%	7%	2%	2%	28%	11%	21%	5%
Central, South & East African	13%	8%	9%	3%	17%	13%	13%	6%	10%	6%	9%	5%	21%	6%
East, South Asia & the Pacific	20%	21%	19%	17%	18%	22%	32%	31%	34%	37%	3%	3%	0%	0%
Latin American	5%	3%	2%	3%	9%	6%	1%	0%	0%	0%	5%	2%	0%	0%
Central Asian & European C	7%	7%	4%	2%	7%	8%	5%	3%	2%	1%	17%	23%	7%	2%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

Table 10 Sectoral distribution and regions

	Loans		Agriculture		Transportation		Energy		Industry		Water & Sewage		Communication	
	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount
Arab	252	1769	54	338	76	422	41	406	32	184	24	217	7	90
West African	112	337	18	57	55	169	14	55	1	6	18	41	3	5
Central, South & East African	87	254	10	18	45	143	14	42	6	20	6	20	3	7
East, South Asia & the Pacific	128	712	20	89	48	248	36	237	21	126	2	11	0	0
Latin American &	31	88	2	13	25	68	1	1	0	0	3	6	0	0
Central Asian & European	43	223	4	9	19	91	6	21	1	5	11	88	1	3
Total	653	3384	108	524	268	1142	112	762	61	341	64	383	14	105

Table 11 Grant Element and Average Loan

Decades	Average Loan Amount $	Grant Element	Grant Average $
1960	9,314,802	38.00%	3,539,442
1970	13,986,986	45.68%	6,389,021
1980	14,569,282	46.13%	6,720,154
1990	22,373,565	44.72%	10,005,388
2000	23,174,955	48.47%	11,232,823

Figure 2 average loans and average grant in US $
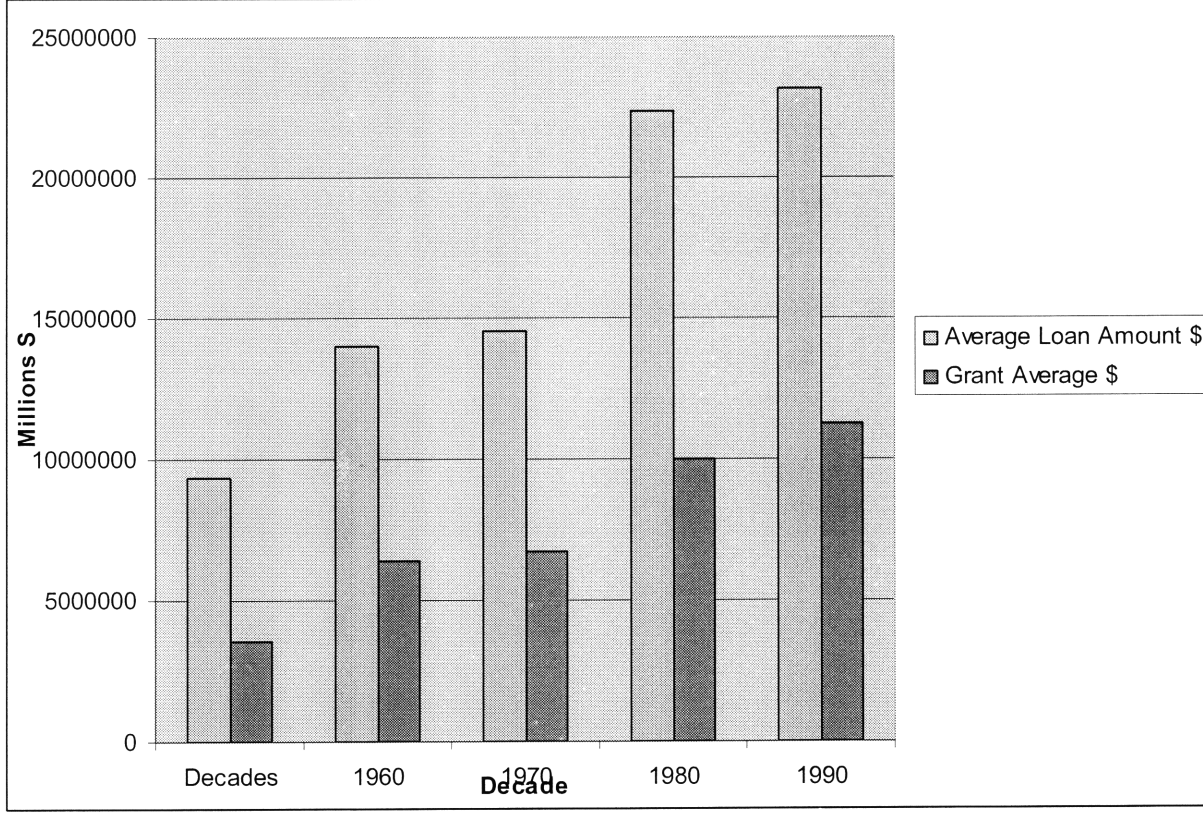
CHAPTER THREE

III. EMPIRICAL ANALYSIS OF GRANT ELEMENT:

Abstract

The focus of this study is the "grant element" embedded in the loans of the Kuwait Fund from 1982 to 2002. It is directed toward two questions: how large are grant elements and how are they allocated across countries and sectors? We offer a new rationale in support of using an adjusted discount rate in calculating grant element--the percentages of subsidy embedded in the loan. When this rate is applied to estimate the grant element, our results point to consistent overestimations of the KFAED published grant element statistics. We then examine the allocation of this grant element in loans across recipient countries and sectors. We find that the actual allocation is quite different than that implied by the stated policy of the KFAED. We also test to see if the allocation is in line with either of three views regarding how aid should be allocated: gap, macro-management, governance and institution- building. We find that it is weakly related to gap, but appears to bear no relation to the other two. While this does not demonstrate that KFAED only focuses on gap, it does indicate that to the extent that they focus on macro-management or governance, their decisions regarding grant element do not bear this out We tested the difference in KFAED's declared vs. actual grant element policy. The results show that political factors, income and sectors play a role in the deviations between the two. Finally, we tested development aid allocation hypotheses; we found KFAED's grant allocation only follows the two-gap hypothesis in its development aid strategy.

III.1 Introduction

The past forty years witnessed major changes within the domain of International Financial Institutions (IFIs). Those changes are on two fronts: the changing role and motivation of aid and the increase in flow of assistance funds to developing countries. From the role of aid side, the primary role of development aid has shifted from filling the financing gap to fostering stable macroeconomic polices to enforcing good governance and institutional building. Each has only succeeded in providing a partial framework within which to resolve the puzzle of poverty and the key to economic growth. The net result is that despite decades of economic aid, most of the least developed countries (LDCs) have shown correspondingly little real growth; in fact, heavy indebtedness to aid institutions has become a major impediment to growth for many LDCs. Consensus in the last five years has shifted towards converting loans to grants and thus reducing the debt overhang that held back growth in these countries. Determining the motive of development aid is critical as it dictates the donor's priorities and hence significantly affects the resultant investments and the outcome for the developing world.

From the flow of assistance funds, there was a steady rise in aid flows from developed countries to developing countries, despite the fact that the growth of aid faltered after 1995 (Lensink and White, 2000). As indicated in Table 10 below, the LDCs have received more foreign aid as a percentage of Gross National Income (GNI) and aid per capita than other groups of developing countries. Aid inflows have almost doubled in the LDCs, in that aid as a percentage of GDP (aid per capita) increased from 7.6 percent

(US$15.2) in the 1976-80 period to 11.6 percent (US$29) in the 1991-95 period. Among the group of other low-income countries, aid as a percentage of GNI (aid per capita) increased from 2.9 percent (US$7.3) in the 1976-80 periods to 4.4 percent (US$13.5) in the 1991-95 period. As for the rest of the group, aid as a percentage of GNI and aid per capita in the 1996-2000 period has not changed much from the 1970-75 period, but the trend for aid flow as a percentage of GDP has declined since the 1991-1995 period.

Table 12Foreign aid distribution (1976-2001)

	1976-80	1981-85	1986-90	1991-95	1996-2000
Aid (% of GNI)					
LDCs	7.6	7.5	9.5	11.6	7.7
Low income	2.9	2.9	3.6	4.4	2.7
Lower middle income	0.6	0.5	0.6	0.8	0.6
Upper middle income	0.2	0.2	0.3	0.4	0.2
Aid per capita (current US$)					
LDCs	15.2	19.1	26.8	28.9	21.5
Low income	7.3	8.5	11.7	13.5	10
Lower middle income	4.4	4.7	6.1	8.9	7.6
Upper middle income	4.1	6	8	16.4	10.5

By 1995, the flow of foreign aid to developing countries reached its peak of nearly US$520 billion. The cumulated amount of actual foreign aid flow by 1996 was more than US$12 trillion (OECD, 1997). This figure just exceeds the amount of foreign aid that is required to achieve a growth rate of about 4 to 5 percent per year in developing countries. However, developing countries have not experienced this rate of growth since the 1980s.

In 1960-79, the median per capita growth in developing countries was 2.5 percent. In 1980-98, the median per capita growth of developing countries was 0.0 percent, [and]

virtually no countries outside Asia registered per capita growth at or above the 1960-79 average of 2.5 percent.

While the 1980s were dubbed the "lost decade" for developing countries in general and LDCs in particular, the 1990s have become, for LDCs, the decade of increasing marginalization, inequality, poverty and social exclusion. The number of LDCs almost doubled from the first list compiled in the early 1970s to 49 countries in 2001. Only Botswana has "graduated" from the LDC group. During the 1980s, several African countries experienced negative economic growth despite a substantial increase of aid inflow to these countries (White, 1992a). "A large number of countries became more aid-dependent in the 1990s than they were in the late 1970s" (Tsikata, 1998, p.7).

In the mid-1990s, as a result of the above accumulated debt by many of the developing countries, there was a call to lessen the burden of this debt through many programs. Among these are HIPC, heavily indebt poor countries initiative, and HIPC II. In 2000, a renewed interest in lifting the burden of debt surfaced in the development community. The new call was, this time, directed toward increasing the concessionality, or grant element, in development aid. The chief architect of this new policy was the Meltzer Commission that was formed by the US Congress to review the state of US aid.

III.2 The research

While much of the aid literature has dealt extensively with assessing its effectiveness and role(s) in growth and development, another strand of the aid literature has focused mainly on studying donors' aid allocations and the motivations and interests influencing the policy. At the beginning of this decade, as a result of the failure of many

development policies of the past, a new debate surfaced in the aid community, calling for an increase in the concessionality in the already-concessional loans extended to the developing countries.

This research is an attempt to link the above two strands of literature by investigating whether actual aid allocation policy is influenced by these aid effectiveness criteria and roles. Through this linking, the research will have a profound understanding of the impact of aid and will add more clarity about the effectiveness of donors' allocation policy.

Unlike many of the prior studies that researched aid allocation, this research will use only the concessionality level--grant element--as opposed to total loan amount as the parameter of aid. However, before investigating such allocation, a closer look at the way grant element is being measured is required. By doing so, we will clarify the confusion surrounding the calculations of grant element that have not been addressed in the published aid statistics.

Furthermore, the lack of literature covering Arab aid creates a genuine need for applying this research to Arab aid allocation. Therefore, the research focuses on investigating the allocation and the factors that determine grant allocation policy. Kuwait Fund for Arab Economic Development (KFAED) will be used as a case in our analysis. Examining the volume of aid during the last few decades shows its importance as the largest and oldest Arab bilateral development institution. The above importance stems from the fact that Arab aid had reached close to $120 billion in 2004, representing almost 1.3 percent of their GNP and 13 percent of total world aid. Some researchers had attributed this gap in the literature to the lack of accurate published data on the part of Arab developmental

institutions. But in recent years, Arab donors started publishing their data and statistics, making feasible the potential of filling the gap.

Research Questions

The research seeks to clarify two aspect of grant element: estimation and allocation, each with its own questions:

1 **Grant element:**

   o What is grant element and how it is calculated?

   o What discount rate is used in grant element calculation? What discount rate should be used?

   o Does the grant element change significantly with the selected discount rate? And if so, what are the implications for KFAED's allocation policy?

2 **Allocation policy**

   o What is KFAED's declared grant element allocation policy vs. the real policy?

   o Does KFAED grant allocation take into consideration the roles of aid development, namely the financial gap, macroeconomic management and institutional strengthening and good governance as suggested by the literature?

Research Methodology

This paper uses Kuwait Fund for Arabic Economic Development as a case study and source of data. As mentioned in the first chapter, KFAED is the oldest and largest bilateral aid institution in the third world. We re-estimate KFAED's grant element based on a new and adjusted discount rate. The significance of the difference between the

published and the re-estimated grant element is tested. A fixed effect General Linear Model, with repeated measurement, is employed to test the difference in KFAED's declared vs. actual policy in grant element allocation. Additionally, the present allocation is tested against KFAED's policy regarding the roles and strategy of aid as presented in the literature review.

The research is structured in two parts. The first part presents the analytics of grant element and offers a re-estimation of the KFAED grant element. The second part empirically investigates how the KFAED currently makes its grant element allocation decision, by modeling grant element based on KFAED's declared policy and then testing the real policy on alternative roles of aid development, under both economic and institutional factors, as suggested by the literature.

The next section reviews the literature pertaining to the three gaps facing LDCs that are related to the role of aid in development. Section 3 summarizes the analytics of grant element and advances our argument for using donor's cost of funds as a proxy for discount rate. Section 4 presents the model, tests the hypotheses, and reports the result and conclusion.

III.3 Literature Review

In this section we examine the shifting role of development aid and the theories that fueled each of these strategic directions. We start with the three roles and strategies of aid as suggested by the literature. We end the section with the result of these strategies: the debt problem and the Meltzer recommendations.

The Role of Aid

As we discussed in detail in the first chapter, aid has taken on many roles in development over the past four decades. It started by assuming the role to fill the financial resource gaps, a view that was dominant in 1960s and 70s. These gaps happened on two fronts, both in the savings rate and hence capital generation and also in the foreign exchange. As this strategy failed to produce the desired results, a new role was then incorporated into the development aid strategy in the World Bank lending policy. Starting in 1980s, fiscal and macro-policy conditionality was incorporated in the development aid strategy. The Structural Adjustment Program (SAP) became the main focus of the World Bank. The underlying idea was that the developing countries needed fiscal restraint to create an attractive environment for investment. The resultant policies included drive towards privatization, reduction in government intervention in the economy, etc. The outcome of most of these programs was lackluster and actually led to negative outcomes and created a high debt problem in some developing countries. Towards the mid-1990s, another role for aid allocation was put forth. Governance and institutional strengthening became the central theme and main objective of World Bank lending policy. The following sections discuss these different roles in detail.

The Two Gaps

One of the most frequently used models in traditional development finance theory is the so-called "two-gap" growth model formulated by Hollis Chenery, Alan Strout and Ronald McKinnon in the mid-1960s (Chenery and Strout 1965). This model holds that

there is a need for development assistance because developing countries need to overcome structural and other weaknesses in order to close the gap with developed countries. Specifically, the recipient countries need to fill two financial gaps: the "savings gap" and the "foreign exchange gap." Based on this theory, the purpose of development assistance is to supplement low domestic savings and foreign exchange earnings.

The two-gap model starts with the argument that in order to achieve equilibrium income in a model of economic growth, the level of planned savings has to be equal to or more than projected investment requirements. In poor countries, the domestic savings rate is usually lower than the level that is required for investment to meet the output growth target, creating a savings gap. Therefore, foreign investments, especially development finance on concessional terms including grants, are useful to help these countries fund the necessary investment (Chenery and Stout 1966). According to the two-gap model, the role of development finance is to fill these capital "gaps," and the savings gap is the first one that development assistance has to fill.

Even if the domestic savings rate is high enough, the economic growth of a developing country may still be constrained if there are not enough foreign exchange reserves or export earnings to finance the necessary imports. Developing countries, most of which do not themselves have hard currencies, may be in need of financial resources that enable them to fund the imports. Therefore, in addition to the investment-savings gap, there is a level of imports that needs to be funded in order to achieve the equilibrium level of income in an open economy. These imports could include both producers' durable goods, such as machinery and equipment for production, and consumer goods. This constraint would be removed if developing countries could receive hard currencies to pay for these

imports of both capital and consumer goods, and therefore fill the "foreign exchange," or "import-export" gap (McKinnon 1964). This is the second gap development finance has to fill according to this model.

Under the two-gap theory, development assistance is provided to a developing country in order to remove both the domestic savings gap and the foreign exchange gap, so that the recipient countries can achieve optimal economic growth. Assistance gives them the external funds to achieve rapid economic success by buying more and better imported equipment and financing bigger, better and more investment projects. So under the role of aid as filling the gap, it is assumed that higher levels of assistance would be directly associated with faster economic development and improvement of living standards. However, by focusing on the volume of development assistance, the two-gap model generally ignored the policy environment and other factors that are related to the efficient use of resources. In such a theoretical framework, the country policy environments do not play a significant role in determining the effectiveness of development aid.

Macroeconomic Management

The magnitude of the debt crisis and the imbalances, both internally and externally, faced by most developing countries, means an adjustment is a necessary for a resumption of development. The debt service obligation (the total debt was estimated at $1 trillion towards the end of the 1980s) became large enough to reverse the net flow (from developing to the developed countries) reaching $15 billion annually during 1987-1989 (Brown 1990:132).

In response, the development strategy of the 1960s and 70s had to be adjusted. The main policy objective of many multilateral aid institutions became macroeconomic stability, and consisted of a set of policies to reduce developing countries' two main deficits: balance-of-payments and budget. The World Bank lending policy shifted to the so-called Structural Adjustment Programs (SAP). A typical adjustment package consisted of measures such as devaluation, removal of artificial price distortions, trade liberalization and institutional changes at the sector level. (Thorbecke 2002)

The rise in the oil prices in the late 1970s and the past decades of accumulated debt changed the role of aid in a fundamental way. The aid purpose became twofold: 1) stop-gap measures to keep the international financial system afloat and 2) imposed conditionalities to promote the implementation of the adjustment policies.

This view gained dominance in the 1980s in the development literature. It became widely accepted that macroeconomic factors, especially whether a developing country had a stable macroeconomic framework and conducive economic environment for development, play an important role in the economic growth of a country. Corden (1991) documented, for both Mexico and Chile, respectable growth associated their macroeconomic reform. Among the reforms were lowering the inflation and reducing the budget deficit. On the other hand, the growth crisis Brazil faced in the late 1980s and early 90s was attributed to macroeconomic instability. In supporting this view, Fisher (1993) summarized the factors should be looked at to appraise a macroeconomic management framework. A favorable macroeconomic framework can be represented by low inflation, appropriate real interest rates, stable and sustainable fiscal policy, competitive and predictable exchange rates, and a viable balance of payments situation.

According to Fisher, the best single indicator of whether macroeconomic policies facilitate growth is the inflation rate. Because there are few arguments in favor of high inflation, the overall ability of the government to manage a country's economy can be reflected through whether the inflation is high. Fisher's study indicated that low inflation, small budget deficits, and relatively efficient foreign exchange markets are conducive to growth.

Bringing development assistance into the equation, in studying aid, policy and growth in Africa, Hadjimichale (1995) concluded that soundness of the economic policy is a major factor in increasing the impact of development assistance on economic growth. The same result was reached by Burnside and Dollar (1997) and Tsikata (1998). On the other hand, Guillamont and Chauvet (1999) reached even stronger result when they found, independent of aid, that growth is positively influenced by conducive macroeconomic policy.

Few papers have addressed the question of *what kind of aid* produces growth. Sawada, Kohama, and Kono (2004) find that grant on average has no effect on growth, but loans to a country with good policies are associated with faster growth. Similar results were reached by Djankov, Montalvo, and Reynal-Querol (2004).

Institutional Building and Governance Gap

Until the mid-1990s, the structural adjustment program was the dominant role for aid. However, the overall situation of LDCs was stagnant largely due to poor governance in Sub-Saharan Africa and most transitional economies in Eastern Europe (Thorbecke,

2000).   A World Bank (1998) report[16] attracted a lot of attention with its blunt

proposition that aid is only beneficial when there are sound economic policies and good

governance, and is typically ineffective in countries with highly distorted economic

policies and bad governance. However, the report and other research (Burnside and

Dollar (1997), Collier and Dollar (2001a) and World Bank (1998)) supporting it came

under criticism on methodological ground (e.g. Lensink and White (2000), Hansen and

Tarp (2000, 2001), and Dalgard and Hansen (2001). However, elements of governance,

such as corruption, have been extensively studied. Using Business International (BI)

corruption indices (now part of the Economist Intelligence Unit), Mauro (1995) showed

evidence that corruption is negatively correlated with the level of investment and

economic growth, and that countries with negative political risk factors tend to have

slower growth. Keefer and Knack (1994) supported Mauro's conclusions by using ICRG

(International Country Risk Group) as a proxy for political risk.

According to Wenli Lu (2002), an improvement in BI corruption indices may increase

investments by 5 percent of GDP and 0.5 percent increase in per capita GDP.

From the donor's side, there was a new agenda toward placing more weight on

good governance by western donors. As noted by Selbervik (1997: 7), there has been a

"wave of policy announcements by Western donors in the 1990s postulating that good

governance will occupy a central place on the aid agenda." There seems to be a general

agreement on what constitutes the most fundamental aspects of good governance:

political freedom and democracy, human rights, the rule of law, the quality of public

sector management, the control of corruption and the reduction of "excessive" military

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[16] Assessing Aid: What Works, What Doesn't, and Why.

expenditures (OECD-DAC 1994). . The World Bank report (1998) documents the effect of Good Governance and good institutions on the success and failure at the project level. For example, there were 68 percent success rates for rural water supply project with high beneficiary participation compared with low participation.

Debt Relief Benefits

As was mentioned earlier, many of these countries became heavily indebted and repayment had become a constraint on economic development. Thus, several developing countries--particularly in Latin America--faced severe debt crises and, in the mid-1990s, both the IMF and the World Bank started the Heavily Indebted Poor Countries (HIPC) Initiative to bring down the debt of low-income countries to sustainable levels. According to many economists, such large accumulation of debt has led to the creation of the so-called "debt overhang" for the majority of borrowing countries. According to Claessens (Claessens et al., 1996), debt overhang occurs when debt service exceeds a country's repayment ability and expected debt service is likely to be an increasing function of the country's level of output. Sachs (1990) demonstrated that external debt overhang plays an important role in heavily indebted countries. They asserted that debt overhang is the main reason for slowing economic growth in indebted countries. In such circumstances, Greene and Khan (1990) argued that income return from public investment outflows from the domestic economy to the existing foreign creditors, creating little incentive for local government to foster further growth. Not only will new investment by domestic and foreign creditors be discouraged, but a disincentive effect of investment, in general, will be created. The debtor country will only share partially in any increase in output and exports, as a higher proportion of the increase will be used to service the debt.

Figure 3: Debt Laffer Curve
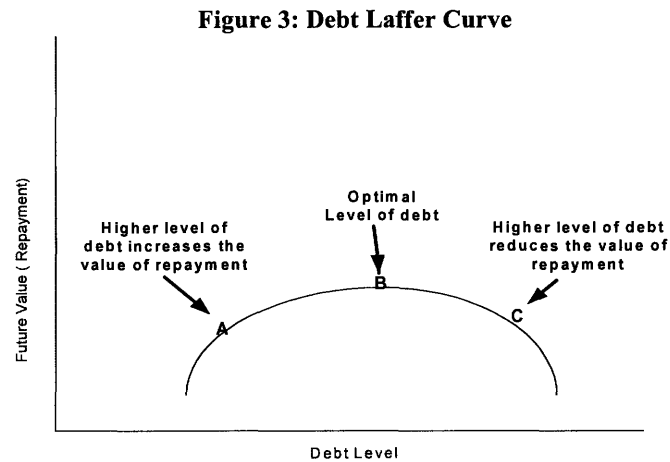
The theoretical basis underpinning the increase in grants or conversion of loans to grants is related to the benefits of debt relief for both the donor and recipient. Krugman (1991) argued that reduction of debt can be beneficial for both debtors and creditors. He demonstrated that whether the benefit will accrue depends on the level of the indebtedness and the timing of relief. This is best illustrated using the Laffer curve (shown in Figure 3 above). When a country has a low level of debt (Point A), less income will be required for debt service and loans will be directed to fund productive projects that will help the country in repaying the existing debt stock. As debt increases (moving from point B to C) and marginal benefits of capital decrease, the benefits of growth will go to the creditors, leaving little incentive for growth. In this case, the debtor is said to be on the "wrong side" of the debt Laffer curve. Beyond point B, the curve implies that there is a limit at which debt accumulation stimulates growth and that there is a threshold at which more aid is detrimental to growth (Lensink and White 2000). If countries are unlikely to repay loans, Krugman's debt Laffer curve hypothesis suggests that grants will be more useful in maintaining incentives for growth and development in the recipient nation.

As shown in this section, through debt relief, it is hoped that HIPCs will graduate from their poor stage and start their economies growing. It is the objective of this debt relief to reduce the transfer of benefits of the expected growth to the donors and help increase the incentive to the borrowers by letting more benefit be accrued. Or, as Krugman argued, lowering the interest rate on new lending (higher grant element) can increase the incentive for a heavily indebted country to "adjust its policy" toward more productive investment.

In early 2000, to reduce the debt burden on LDCs' economies, a new debate centered on increasing the concessionality in the already concessional loans extended to the developing countries. This debate arose after the US administration proposed that the aid community convert 50 percent of its loans into grants. This argument is based on the fact that current concessional loans already have a large grant component and thus switching to grants allows resource transfer without the debt build-up that is currently handicapping many recipient countries and eventually will reduce the debt overhang effect. Furthermore, they argued that increasing the grant component would provide the aid institutions greater leverage in how funds are allocated.[17] Alan Meltzer, the commission's chairman, argued: "Grants can provide the same amount of aid, make every dollar more effective, provide a permanent exit from debt for the poorest countries, protect donor contributions from risk loss--all without diminishing the funding pool or asking for more money from the taxpayers of the industrialized nations" (Lerrick 2001).

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[17] There are many types of grants: outright grants as lump sum or as annual, technical or grants embedded in a loan. Our research deals with the latter type.

The majority of development aid institutions are less supportive to the proposal. They argued that by increasing the grants, the supply of funds would diminish over time, therefore reducing future development lending activities.

III.4 Grant element Analytics

External assistance is comprised of aid or concessional finance, also known as "official development assistance" (ODA), and market-related or non-concessional finance. For many LDCs, aid-flows account for the majority of external assistance for development purposes. However, many developing countries also use export credits and other types of non-concessional funding.

Development aid is comprised of grants, which are transfers that do not have to be repaid, and loans, which qualify as ODA to developing countries. Three conditions must be present in any loan in order to be classified as ODA or concessional loan:

- The loan is made by the official public sector – that is by any government or a government's institution;

- Its objective is to promote economic development and welfare; and

- It has a grant element of at least 25%.

Loans, which are lent by the public sector (institution or state) but do not qualify as ODA because they are not primarily aimed at development or are not concessional, are known as other official flows (OOF). These include export credits extended by donor governments or guaranteed by them. Military grants and loans are also classified as OOF.

In this section, we start by stating the confusions surrounding the concessionality, followed its measurement. Then, we present the necessary conditions for loan concessionality and advance our argument in favor of using donor's cost of funds as the appropriate discounting future cash flow repayment in determining the grant element. We conclude by re-estimating KFAED's concessionality using our new discount rate.

Concessionality

The confusion surrounding the grant element is twofold. The first is caused by the OECD Development Assistance Committee's commonly accepted practice of assuming only one discount rate: 10 percent. Operationally, the confusion is exacerbated by a failure to adjust the discount rate over time in line with changing market interest rate conditions to reflect more accurately the cost of capital (Leipziger 1983. p330). The second confusion is related to whom the discount rate, used to discount the loan repayment, should refer to? In other words, should the grant element reflect a donor's costs or a recipient's benefits?

Surprisingly, given the widely published aid statistics, grant element calculation has not attracted more detailed analysis. Moreover, the use of the 10 percent discount rate and the assumptions underlying its use has not been challenged in the literature.

Among the existing research that has been published, some have made confusing claims regarding the 10 percent discount rate used to discount the future repayment of the loan in measuring its concessionality: the grant element. It is not that this 10 percent is

arbitrary only, but, more importantly; it became apparent that some researchers[18] () have

assumed this 10 percent to be the recipient's alternative cost of financing. We offer a

rationale for using the donor's cost of funds as the discount rate to calculate the grant

element, and not the recipient's alternative cost of financing.[19]

GE Measurement

The grant element is measured as the difference between the loan's face value and

the present value of the future cash inflow (both the principle and interest) discounted at

an appropriate discount rate divided by the loan face value.

$$GE(\%) = \frac{(Loan\ amount - \mathrm{Pr}\,esent\ value) \times 100}{(Loan\ amount)}$$

The above reflects the loan terms at the time of commitment, when the loan is agreed

upon. The present value is the discounted stream of future debt service payments

assuming the loan is fully disbursed on the date of contract. In other words, the

calculation of future interest payments is on the total loan amount and does not take into

account that disbursements can take place over a number of years.

A simple formula for the calculation of the grant element is:

$$GE(\%) = \frac{L - \sum_{t=1}^{n} \frac{R_t}{(1+d)^t}}{L} \qquad (1)$$

where:

---

[18] as in Mejren 2002

[19] It worth noting that the majority refer to the 10 percent as donor's cost of funds. However, no rationale is given (see Chang 1998).

GE : grant element

L : Face value of the loan at t=0.

R_t : Debt service payment (principal plus interest) in year t

d : The discount rate

n : The last year in which payments are due

To get an insight into the dynamics of variables determining the grant element, we need to re-examine the underlying theory of grant element using the following function:

$$GE = f(G, M, r, d)$$

(2)

Grant element (GE) is a function of grace period (G), maturity (M), loan interest rate (r) and discount rate (d).

Differentiating (2) with respect to each variable:

$$\frac{\partial GE}{\partial G} = f_1 > 0 \quad \frac{\partial GE}{\partial M} = f_2 > 0 \quad \frac{\partial GE}{\partial r} = f_3 < 0 \quad \frac{\partial GE}{\partial d} = f_4 > 0$$

(3)

From (3), the grant element will increase ceteris paribus, with longer grace period, longer loan maturity, lower loan interest rate and higher discount rate used in discounting loan repayment.

As stated earlier, the Development Assistance Committee (DAC) of the OECD defines concessional loans as having a grant element--calculated on the basis of a uniform 10 percent discount rate for all loans--of at least 25 percent. This is the current basis used for defining ODA. The difficulty with this definition is that at times of low interest rates, as will be shown later in this section, it is possible for a classified concessional loan from a development institution to be non-concessional or even profitable.

Loan Concessionality: Necessary Conditions

For the existence of a positive grant element, the interest on the loan I_L must not only be lower than the discount rate used to discount the future cash flow repayment, but must be low enough to produce the 25 percent grant element, one of the conditions for classifying a loan as ODA. So the question posed here is: to what shall the discount rate used refer?

In order to answer the question, we need to explain the relationship among the three costs: loan interest I_L, donor's cost of funds I_D, and the recipient cost of funds I_R.

First, donor's cost of funds, I_D is always lower than recipient's cost of funds, I_R. This is based on economic grounds: a donor country possesses certain economic and financial characteristics that are not found in recipient countries. A common one is that donors are all classified as rich nations by the World Bank, with higher per capita income compared to recipient countries. It can be argued that this higher per capita income acts to reduce the risk of default and thus lowers the cost of funds facing these "rich nations" compared to poorer nations. Furthermore, this higher per capita income is a result of a well-developed economy and financial system, as is the case with western donors and Japan, or is a result of excess liquidity[20]. It is not surprising that all donor countries have higher sovereign debt ranking than all recipient countries[21].

In notation,

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[20] As is the case in oil producing countries like Kuwait Saudi Arabia and UAE.
[21] According to Moody Investor Services' Global Credit Research ranking 2003.

$$I_R \succ I_D \text{ (4)}$$

Secondly, we argue that loan cost[22] I_L must be lower than the recipient's cost of funds I_R (alternative cost of financing) for the loan to be concessional.

In notation,

$$I_R \succ I_L \text{ (5)}$$

From (4) and (5), we have;

$$I_R \succ I_D, I_L \text{ (6)}$$

Both the donor's costs and loan costs are less than that of the recipient, for the loan to be concessional. The question is then what is the relation between the loan cost and donor's costs?

In case the donors lend below their cost of funds, then with time it is expected that their budget will dry up and less funds will be available for re-lending.[23] Therefore, donors, like KFAED, will lend above their cost of funds.

In notation,

$$I_R \succ I_L \succ I_D \text{ (7)}$$

In both the development finance literature and the aid publications, it has been assumed that the discount rate used to calculate the present value of the future repayment is equal to 10 percent. While few argue that this discount must reflect the recipient's alternative financing (e.g., Al-Mejren 2005), the majority assume it correspond to the donor's opportunity cost (e.g., Chang 1998).

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[22] We use loan cost and interest interchangeably. For simplicity, we assume no grace period throughout the paper.

[23] This is the same argument that many of the IFIs used to oppose Meltzer's recommendations in increasing the grant elements.

While the use of 10 percent might be correct if the term of the concessional loan is comparable to that of the commercial loan which the grant element equation is assuming, in reality, the concessional loan term, like the one extended by KFAED, is a sovereign debt. A sovereign debt entails seniority above all other claims and debts, rendering it facing lower default risk than commercial loans. Therefore, the assumption that the donor can lend the loan at 10 percent in the market is exaggerated. Therefore, there is a need to adjust the discount rate used in calculating the grant element to reflect the decrease in default risk that was created because of the "sovereignty" attached to the concessional loan.

In case of Kuwait, according to Moody Investors Service, its government bonds rating averaged A2 [24] ratings. To calculate the spread above KFAED's rating to reflect the "risk" of its recipients that must be added to reflect the newly adjusted discount rate, which at the same time reflects the actual alternative cost of financing available for the recipient, we obtained the average of equally weighted sovereign debt ratings for KFEAD's recipient, which is the midpoint between Baa3 and Ba1. From Figure 4 below, there is an average spread of 100 basis points between Kuwait ratings and the average rating for KFAED's recipients. We add this spread to KFAED's cost of funds to arrive at our adjusted discount rate.

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[24] The rating ranges between A1 and A2.

Figure 4 Ratings and Credit Spread
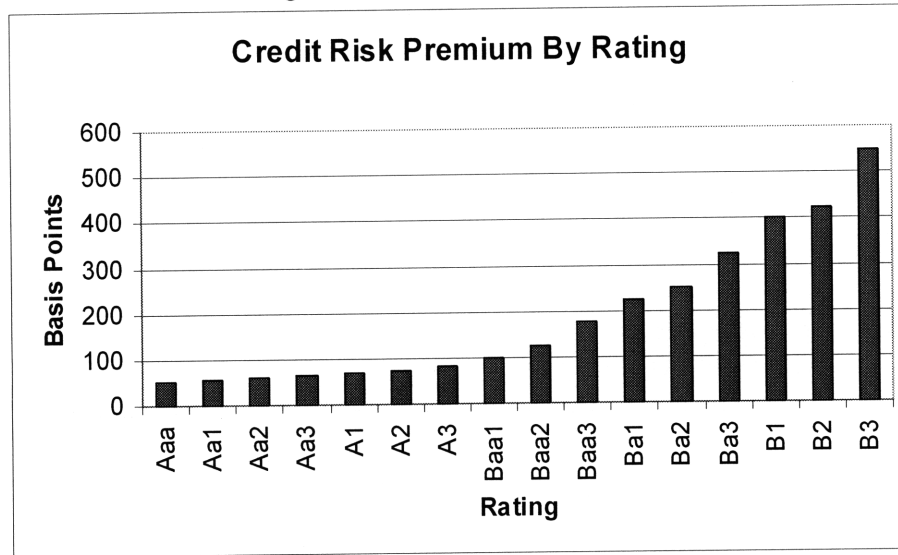
GE Re-estimation: The Case of the KFAED

In this section, we review the characteristics that KFAED's concessional loans possess. Then we proceed to re-estimate the grant element embedded in KFAED's concessional loans using the newly adjusted discount rate.

KFAED's Loans Terms

Unlike many concessional development loans, KFAED loans are set in Kuwaiti Dinar[25] (KD) equivalent and not in US dollars as in the case of many bilateral institutions and the World Bank or some universal monetary units (i.e., SDR or Arab Dinar). The interest charged on all the loans is fixed during the duration of the loan. Given that the interest rate on the loans is already low, it is a position KFAED took to fix such a rate so

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[25] Thus no foreign exchange risk facing KFAED.

as not to create an added future burden on the recipient in case of rising interest rates. Furthermore, KFAED has been traditionally extending its loans with semi-annual repayments.

Grant Element Re-estimation

The Kuwait Fund's loan portfolio consists of more than 700 loans extended to more than 100 countries. As the largest government agency, in term of capital, it is not unrealistic to assume that the cost of fund facing KFAED is KIBOR[26] (Kuwaiti Inter-Bank Offer Rate). KIBOR was instated by Kuwait Central Bank in 1983. It is important to mention that the KD was pegged to a basket of major currencies[27] up until 2003. In 2003, the central bank of Kuwait dropped the basket and pegged the KD to a single currency: the US dollar.

We obtained the KIBOR from the Central Bank of Kuwait. The KIBOR data (shown in Table 12 below) covers the period from 1983, reducing our grant element data to start from 1983 instead of the fund's first loan in 1961.

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[26] Since there is no Bond Market in Kuwait, we used KIBOR as the proxy for KFAED's cost of funds.
[27] US Dollar, Japan Yen, German Mark, French Franc and UK Pound.

Table 13: Annual One Year KIBOR

Year	%	Year	%
		1993	7.4061
1983	7.4287	1994	6.3324
1984	9.2436	1995	7.707
1985	7.9791	1996	7.119
1986	7.5352	1997	7.225
1987	6.2582	1998	7.5563
1988	6.234	1999	6.6962
1989	8.6994	2000	7.134
1990	8.6958	2001	4.8392
1991[28]	-	2002	3.3218
1992	9.2901	2003	2.7949

Using the data in the above table, we construct the KIBOR's yield overtime for from

1983 until 2003 as in Figure 5 below

Figure 5 KIBOR Yield (1983-2003)
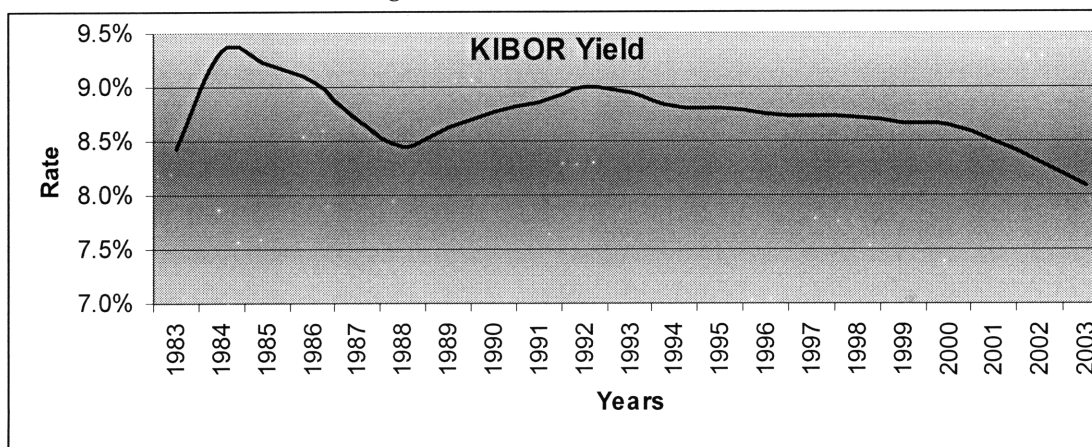
However, since the majority of KFAED loans are of longer maturities with an average of

22 years, it was necessary to determine a hypothetical KIBOR yield equivalent to match

the maturity

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[28] In 1991 Kuwait was occupied by Iraq. For the purpose of our calculations, we will assume the 1991 rate to be equal to the 1990 (pre-occupation) rate.

Given that the tying of the KD Dinar with the US dollar was instated in 2003, one way, and a reasonable one to extend the yield curve on KIBOR, is to use US T-Bill spreads as a proxy for the spread between the short term KIBOR rate and the long-maturity rate. We obtained the US Treasury-T-bill yield spread in 2005 as shown in Figure 6 below.

Figure 6 US T-Bill Yield 2005

	1	2	3	4	5	6	7
Yield	2.79%	3.10%	3.28%	3.64%	3.94%	4.23%	4.84%
Spread		0.31%	0.49%	0.85%	1.15%	1.44%	2.05%
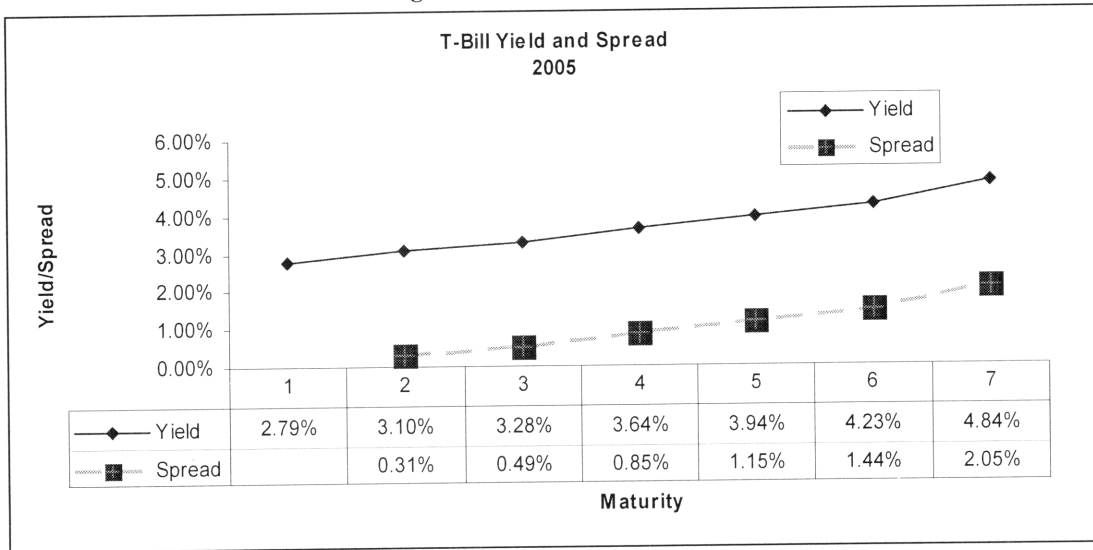
Therefore, we added the spread between the US T-bill and US treasury of the appropriate maturity over the existing KIBOR yield to arrive at a yield to maturity for each loan in KFAED loan portfolio.

Substituting the annual KIBOR plus 1 percent (to reflect the added risk of 100 basis points) into the following equation instead of the 10 percent discount uniformly used by KFAED in all of its loans results in overall significantly reduced estimates for the grant elements in KFAED's loan portfolio.

$$GE = 100 * \left(1 - \left(\frac{r}{d}\right)\right) * \left[1 - \left(\frac{1/(1+d)^G - 1/(1+d)^M}{d(M-G)}\right)\right]$$

where:

GE: grant element

G: grace period

r: contractual annual interest rate

M: loan maturity, including grace period

d: our new compounded discount rate for semiannual payment $\sqrt{(1+d)} - 1$

We re-estimated the new grant element using the adjusted discount rate. The findings are surprising and mixed. We ran Wilcoxon[29] signed-ranks test/two-tailed test for both samples of grant element (the original and the re-estimated). At 1 percent significance, the decision is to reject the null hypothesis that the samples are not different (Table 13). In other words, the difference between the two samples is significant.

Table 14: Wilcoxon Two-tailed Statistics (two paired sample)

T	436.000
T (expected value)	44205.000
T (variance)	6196066.500
Z (observed value)	-17.584
Z (critical value)	2.576
Two-tailed p-value	< 0.0001
Alpha	0.01

---

[29] In addition, we ran a parametric test (z and t test for paired sample) and reached a similar conclusion by rejecting the same hypothesis.

From Table 14, and shown in Figure 7, there is a strict overestimation of KFAED's grant element in all years, with an average of 10 percent difference. The total overestimation accounted for close to $1600 million since 1983, in 2003 dollars.

Table 15: GE Overestimation

Year	Original GE	Re-Estimated GE	Difference
1983	41.79%	31.26%	10.54%
1984	44.52%	32.29%	12.22%
1985	40.21%	32.89%	7.31%
1986	48.77%	41.00%	7.77%
1987	42.28%	34.61%	7.67%
1988	44.80%	37.05%	7.75%
1989	46.78%	38.04%	8.74%
1990	47.18%	38.11%	9.07%
1991	47.47%	38.10%	9.37%
1992	41.96%	32.24%	9.72%
1993	44.33%	34.59%	9.74%
1994	42.89%	33.17%	9.72%
1995	45.24%	34.49%	10.75%
1996	44.96%	34.02%	10.93%
1997	48.54%	36.94%	11.60%
1998	45.48%	33.82%	11.66%
1999	47.44%	35.32%	12.12%
2000	46.99%	34.52%	12.47%
2001	49.90%	37.02%	12.88%
2002	49.35%	35.99%	13.36%
2003	43.38%	30.32%	13.06%

Figure 7: GE: Differences between GE-Re-estimated GE
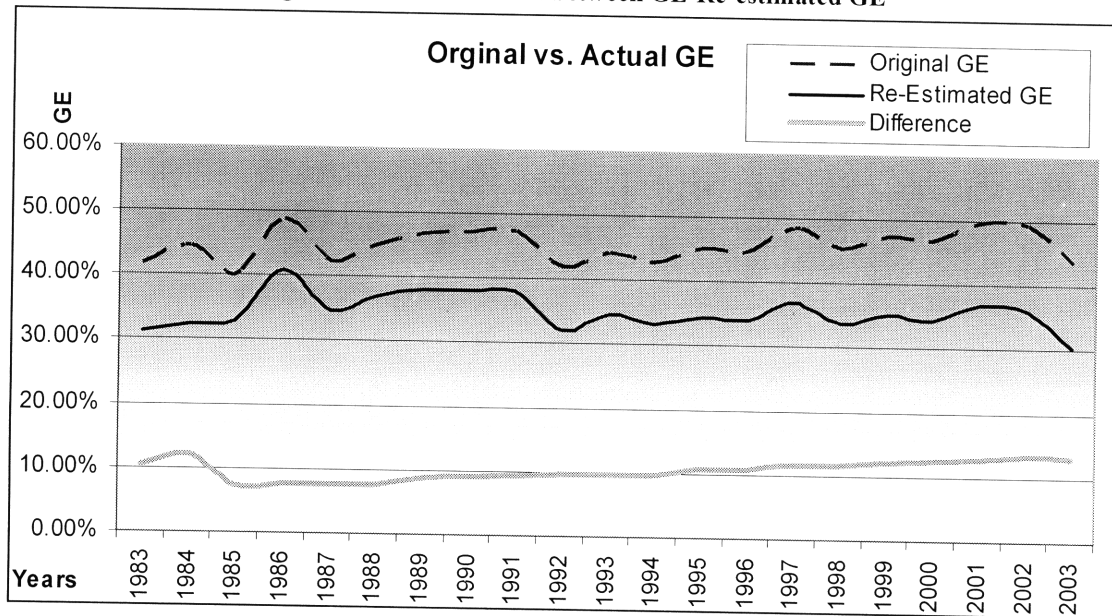
III.5 Grant Element Allocation: Empirical Testing

The purpose of this section is twofold: the first is statistically testing KFAED's stated vs. actual policy in its grant element allocations; the second is testing whether actual aid allocation policy is influenced by aid effectiveness criteria and roles as was suggested in the literature review section.

KFAED's Grant Element Policy: Stated vs. Actual KFAED Policy

Kuwait Fund established its grant element allocation based on two criteria: the recipient income and the sector being financed. It groups the recipients into three income classes while categorizing the sectors into four groups. Each set is assigned an average grant element, based on a range on which KFAED decided.

Data from 1983 to 2002 were obtained from KFAED. These include basic information for all projects, grants, countries and loans in its portfolio.

Grant Element: This variable is the percentage of grant component in all loans extended by KFAED since 1983.The grant element is the ratio of a loan's grant amount to the total value of the loan. The grant amount is equal to the loan's face value minus the present value of future repayments. These data were compiled from KFAED's database.

Sectors: KFAED classifies the sectors it finances into eight sectors: agriculture, transportation, energy, industry, water, sewage, communication and social (education and health). However, for its stated policy in grant element allocation, the classifications are reduced to four categories: social, agriculture, industry and the rest, which represents all other sectors.

GNI Per Capita: The single most common and most relevant indicator variable included in studies of aid allocation is a country's level of income. It represents the annual income of the average citizen. The lower this income is, the poorer on average a country is and therefore the more in need of aid. In its guidelines on developmental aid, KFAED states clearly that aid should be concentrated on the poorest countries. Data were taken from World Development Indicators. The per capita is taken as current and not constant prices to reflect KFAED's decision at the time of allocation.

KFAED's Stated Policy

According to KFAED's grant element allocation guidelines, Table 15 breaks down the sectors and recipients' income groups and their designated average grant element in percent.[30]

Table 16: KFAED's GE (%) Allocation Guidelines

Income Sector	Low Less than $760	Middle $761-$3,000	High More than $3,000
Health and education	65	60	47.5
Agriculture	57.5	50	37.5
The Rest (Transport, telecommunications, power, water supply and sewage)	52.5	42.5	35
Industry	45	40	32.5

Making a closer investigation of KFAED's concessional loan portfolio since 1984, we notice some deviations from its actual allocations compared to its stated grant element allocation policy, as shown below in Table 16. Some of those deviations were to the benefit of the recipients, while others were not.

Reconstructing the above table using KFAED actual grant allocation policy results in the following table.[31]

Table 17: KFAED's Grant Element Allocations (Declared vs. Actual) in Average %

Income Sector	Low	Middle	High
Agriculture	57.5 vs. 52	50 vs. 49	37.5 vs. 43
The rest	52.5 vs. 49	42.5 vs. 45	35 vs. 38
Industry	45 vs. 38	40 vs. 37	32.5 vs. 26

---

[30] The variations in the range in the above grant element table within each subset is due to other factors such as the project economic rate of return, relation to Kuwait, new government in the recipient country.
[31] KFAED had only recently started funding the health and education sector; therefore they are excluded.

The actual policy is noticeably different from the declared one. There is an "over-granting" for the higher income bracket within the recipients in both the agriculture and the rest of the sectors and an "under-granting" for the lower income bracket within the recipients in all sectors. For the middle-income group, the variations are mixed. These deviations become clearer when we investigate a sample of recipient countries that had been allocated grant element very differently than the stated average in KFAED's policy.

Deviations of Policy: Examples

We take the lowest income bracket for a country like Mozambique (Table 17) that had two agricultural projects that were financed by KFAED.

Table 18: Mozambique Agricultural Sector GE Allocation

Per Capita income	Year	GE
$150	1997	38.01%
$310	1987	60.10%

Mozambique's per capita income more than halved in one decade, from $310 in 1987 to $150 in 1997, yet the grant element decreased from 60 percent to 38 percent. This is contrary to KFAED's stated policy in its grant element allocations.

As illustrated in Table 18, Egypt, a country that had "graduated" from a lower class of income, received higher grant element for financing a project in the same sector as agriculture, industry and the rest. The average grant elements in all sectors had increased at the same time its income increased.

Table 19: Egypt GE-Income-Sector Comparison

Transport, telecommunication, power and water supply		
Income bracket	Year	Average GE
Low income group	1978	38%
Middle income group	2002	53%

Agriculture sector		
Income bracket	Year	Average GE
Low income group	1987	41%
Middle income group	1990	55%

Industry sector		
Income bracket	Year	Average GE
Low income group	1977	36%
Middle income group	1989	42%

The above examples do suggest the presence of anomalies in KFAED's actual policy grant element allocation, which necessitates a more thorough statistical analysis.

Modeling Policies Differences: General Linear Model (GLM)

In this section, we resort to testing both KFAED's declared policy and actual policy by using more sophisticated statistical techniques. Since our objective is comparing two policies with categorical factors--sector and income group--an appropriate method is running GLM of the variables specified in KFAED's declared policy as having the only weight in the grant element allocation decision policy: sector financed and recipient income. Since we are dealing with more than one dependent variable--declared and actual grant element allocation, and categorical independent variables--the choice of

the GLM is best suited in our case. Table 19 shows the within subjects and between

subjects for our GLM model, repeated measure.

Table 20: Within-Subjects and Between-Subjects Factors

Within-Subjects Factors

Policy	Dependent Variable
1	GE-Actual
2	GE-Declared

Between-Subjects Factors

Factors		Group	Cases (N)
Income	1	Low	183
	2	Mid	122
	3	High	55
Sector	1	Agriculture	51
	2	Industry	26
	3	Rest	283

Running both policies as dependent variables (within subjects factors) and both sectors

and income as between subjects factors, we gained the immediate result that there are

significant variations between the policies.

Table 21: Multivariate Results (Income-Sector – main effect)

Multivariate Results - Income - Sector[b]

Effect		Value	F-Stat	Siginifcance	Partial Eta Squared
policy	Pillai's Trace	.008	2.881[a]	.090	.008
	Wilks' Lambda	.992	2.881[a]	.090	.008
	Hotelling's Trace	.008	2.881[a]	.090	.008
	Roy's Largest Root	.008	2.881[a]	.090	.008
policy * Sector	Pillai's Trace	.029	5.229[a]	.006	.029
	Wilks' Lambda	.971	5.229[a]	.006	.029
	Hotelling's Trace	.029	5.229[a]	.006	.029
	Roy's Largest Root	.029	5.229[a]	.006	.029
policy * Income	Pillai's Trace	.104	20.578[a]	.000	.104
	Wilks' Lambda	.896	20.578[a]	.000	.104
	Hotelling's Trace	.116	20.578[a]	.000	.104
	Roy's Largest Root	.116	20.578[a]	.000	.104

[a]. Interactions effect were not signinficant. and were not reported

[b]. Eta squared denoted amount of variation accounted for by the model effect, to a maximum of 1.

Including both sectors and income as between subjects, as stated in KFAED's declared policy, does give the result that the significant differences in the two policies vary significantly over different income groups and over different sectors. Table 20 shows the multivariate results for both the income and sector groups, entered as main effect. Both effects are significant at 1 percent for income and 5 percent for the sector.

The Eta associated with both factors, which represents the size effect of each subject on the model, is relatively small and does indeed direct us to further investigate other possible factors that might explain the policies' differences.

The usual suspects for sources in such differences of policies are "political" reasons. One of the candidates that can best represent such sources is a country's specific factor(s).

This factor can capture and encompass a variety of unique and specific attributes, such as

ethnic, religious, economic and political, that are considered specific to the country.

Taking the above into consideration, and adding country factor, as fixed effect, as

between subject[32] enables us to capture some of sources of the differences between the

two policies. The country factor appears to be not only significant but its size effect of

.478 (Table 21) is higher than the combined effect size of both income and sectors

together: the same two variables that KFAED contend in its declared policy are the two

main factors that influence the grant element allocations.

Table 22: Multivariate Result (Country-Income-Sector--main effect)

Multivariate: Country-Sector-Income [b]

Effect		Value	F	Sig.	Partial Eta Squared
Policy	Pillai's Trace	.002	.466[a]	.495	.002
	Wilks' Lambda	.998	.466[a]	.495	.002
	Hotelling's Trace	.002	.466[a]	.495	.002
	Roy's Largest Root	.002	.466[a]	.495	.002
policy * Country	Pillai's Trace	.478	2.782[a]	.000	.478
	Wilks' Lambda	.522	2.782[a]	.000	.478
	Hotelling's Trace	.917	2.782[a]	.000	.478
	Roy's Largest Root	.917	2.782[a]	.000	.478
policy * Sector	Pillai's Trace	.054	7.600[a]	.001	.054
	Wilks' Lambda	.946	7.600[a]	.001	.054
	Hotelling's Trace	.057	7.600[a]	.001	.054
	Roy's Largest Root	.057	7.600[a]	.001	.054
policy * Income	Pillai's Trace	.142	22.045[a]	.000	.142
	Wilks' Lambda	.858	22.045[a]	.000	.142
	Hotelling's Trace	.165	22.045[a]	.000	.142
	Roy's Largest Root	.165	22.045[a]	.000	.142

a. Exact statistic

b.

Design: Intercept+Country+SectorRank+Incomec
Within Subjects Design: policy

As was documented in the second chapter, the country factor does play a role in the

allocation process in KFAED's decision making. Here, the grant element allocation

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[32] Political alliance proxy: The UN similarity/dissimilarity vote was tested. The result was not significant.

seems to be influenced by some of the recipients' attributes that are not related to economic or development factors. Running country as dummy failed to indicate any significant result, which led us, in the next section, to test the impact of certain recipients' attributes on the allocation of grant element.

GE Determination Stage

In our previous GLM result, we limited our analysis to comparing the stated vs. actual policy of KFAED's grant element allocations. In this stage, we investigate the factors that influence the distribution of grant element that were obtained in our GLM testing, namely, what attributes, which are unique to recipient countries, influence the KFAED's grant element allocation.

Model Specifications

An ordinary least square (OLS) regression with all time-varying explanatory variables enter the regressions with a one-year lag to mimic the data situation facing KFAED at the time of decision-making.

Testing GE Determinants

In this model, we are interested in uncovering the factor(s) that are related to the "Country" effect that accounted for the major reason for the difference between declared and actual policy analyzed before.

Four attributes that represent country uniqueness were selected that are expected to have the potential of capturing the factors influencing the allocation. These four attributes are:

Ethnicity: To check for potential bias towards Arab countries, a dummy variable was used. An Arab dummy variable was set to 1 for Arab and 0 for non-Arab. This dummy covers all countries with a majority Arab population.

Religious: There is a potential for a bias toward Muslims recipients in KFAED allocation; therefore, an Islamic dummy was set to 1 for all countries with a majority of Muslims, other than Arab countries.

Political: A control variable to measuring the similarity of policy positions. Gartzke, Jo and Tucker [1999] use this measure to provide estimates of the similarity of policy positions as revealed by the voting behavior in the UN General Assembly. We take the similarity of policy positions between aid recipient countries and Kuwait.

Development Need: We have added PLQI to take into account any development backwardness that was not captured in the GNI per capita income.

Sectors were entered as dummy, as classified by KFAED's guidelines. As concerns explanatory variables, the GNI per capita, PLQI, to proxy the development need, were logged in order to allow an elasticity interpretation of their coefficients. If both the dependent and the explanatory variables are in logged form, then the respective coefficient can be interpreted as stating by how many percent the dependent variable is increasing or decreasing given a 1 percent increase in the explanatory variable. An elasticity interpretation makes perfect sense for the income and development needs variables, for which percent increases carry substantive meaning.

The ordinary least square (OLS) is in the following form:

$$Ln\ \%Grant\,Element_t = \alpha_0 + \beta_1 Arab + \beta_2 Musl + \beta_3 UN_{t-1} + $$
$$+ \beta_4 LnPLQI_{t-1} + +\beta_5 Ln\ PerCapita_{t-1} + \beta_6 Sector$$

The summary statistics of the above are in Table 22.

Table 23: OLS Summary Statistics and Coefficients--Country Factor

Independent variable	Value	t	Pr > t
Agriculture	0.008	-0.292	0.772
Arab	0.035	1.24	0.223
Muslim	0.017	0.702	0.487
LOG PLQI	-0.023	-0.737	0.466
LOG GNI per capita	-0.078	-2.703	**0.01**
UN Vote	0.458	2.054	**0.047**
R2	0.238		

Neither sector type nor recipient ethnicity nor religion is statically significant in influencing the grant element level. Both the per capita income and the similarity of votes, as represented by the similarity of UN vote are significant at the 1 and 5 percent level, respectively, with the expected sign. A higher per capita for recipient will yield a lower grant element level by 8 percent.

The way the UN voting variable is constructed makes it more difficult to provide a useful interpretation of its coefficient. However, one can say that a country with voting identical to Kuwait is estimated to receive a grant element that is about 58 percent higher than a country whose voting similarity value is equal to the sample mean.[33] Such significance of the voting pattern, we believe, is the main effect that contributed to the difference between KFAED's actual and stated grant element allocation.

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[33] See Neumayer 2003.

The insignificance of PLQI should not be surprising. More often, donors place more weight on such visible and easily understood variables as per capita income and not on indicators like PLQI.

Testing the Role of Aid

In this section we test whether the strategies and roles of aid, as were reviewed in the literature review, have any influence on KFAED's grant allocation policy.

The dependent variable, grant element, was logged to render its distribution less skewed.

Hypotheses

The Two Gaps: Under the traditional framework, development assistance should be allocated to where there are substantial financial gaps, regardless of the political, economic and financial environment of recipient countries. In its extreme but not uncommon form this uses the per capita level as the sole or primary criteria in deciding the level of grant element that should be allocated to a certain country. In a simplified framework, the poorer a country is, the wider the financial gaps are, and the more per capita assistance the country deserves. To an extent, major multilateral development institutions are still under the influence of this line of thinking. For example, in determining whether a country is eligible for its funds under concessional terms, the first criterion the World Bank uses is per capita GNP. If a country has a per capita GNP higher than its cutoff threshold, this theory holds that the financial gaps are not large enough to justify the allocation of concessional resources, no matter how good the policy environment is in this country. Therefore, the lower level of per capita income of the recipient, the higher grant element allocated by KFAED.

Macroeconomic Management: As was suggested before, macroeconomic policy management has a profound effect on a country's overall development. The World Bank shifted toward accomplishing this strategy through structural adjustment programs in the 1980s until the mid-1990s. Through these programs, varieties of conditionality were

attached to the aid, the majority of them dealing with fiscal and external imbalances. Stanley Fisher suggested using inflation as a proxy for such an indicator. Consistent with other studies, this research will test whether KFAED's development assistance is allocated to countries that are implementing good economic policies. However, this factor is not expected to have any significance on KFAED's policy due to the fact that the fund only finances projects, and not programs, and thus no conditionality is imposed on the recipient.

Governance[34]: This variable is included to determine whether the quality of a country's institutional framework explains its tendency to receive higher grant element. The Meltzer Report argues in favor of supporting countries with good policies. There are many proxies that were used in the empirical literature: PLQI and GDP per capita growth to name two. The Index of Economic Freedom, published by the Heritage Foundation, is a measure of a policy's performance. The Index rates each country on the basis of 50 economic variables divided into 10 major sections. The ratings are on a scale from 1 to 5, with 1 representing the most "free" economies. However, when using the index, our sample shrinks by two-thirds due to the absence of data prior to 1995.

Testing the above roles on KFAED's policy by running the following regression:

$$Ln\ \%GrantElement_t = \alpha_0 + \beta_1 LnInflation_{t-1} + \beta_2 LnGovernance_{t-1} + \beta_3 Ln\ GNIPerCapita_{t-1}$$

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[34] As suggested by Neumayer (2003).

Table 24: OLS Role of Aid

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	Ln GNI percapita	-.062	.023	-.393	-2.638	.010
	Ln Inflation	-.002	.011	-.017	-.159	.874
	Ln Governance	-.224	.153	-.216	-1.462	.147

a. Dependent Variable: Ln GE

The result, in Table 23, shows only income per capita as significant, suggesting that the two-gap model is still alive in KFAED's allocation process. Neither inflation nor governance coefficient were significant. This is expected, as KFAED does not impose conditionalities nor favor such ones on recipient countries.

We further tested the allocations for the debt overhang hypothesis as suggested by the literature: by adding debt service as percentage of GNI. The result is trivial and not reported.

III.6 Conclusions

The main thrust of the research was directed toward studying two aspects of grant element: estimation and allocation. Investigating both, and subsequently, testing both yielded a significant results that affect both the way grant element is currently estimated and the way allocation policy is being implemented. The main results and conclusions are as follows:

The results in the grant element re-estimation do shed light on the consistent over-estimation of published data on grant element. Using an ad hoc discount rate of 10 percent over the last 40 years not only overestimated the grant element of the majority of

concessional loans, but also compounded the problem by creating a misclassification issue. Concessional loans classified in many published aid statistics turn out to be non-concessional loans when we adjust the discount rate to reflect the donor's cost of funds.

The overestimation and misclassification give a distorted picture even when a donor is determined to allocate aid effectively. Such allocation might turn out to be allocated ineffectively once the donor's cost of aid is used. This issue is not specific to the Kuwaiti Fund, but it applies to all published aid statistics.

As the development community is debating increasing the concessionality, or grant element, in development aid, this research adds to the debate an angle that was not investigated systematically in the literature.

Our rationale for using donor's cost of funds is clear. Only the owner can concede, not the recipient of the concession or grant. When an agent offers a concession or a grant, he/she is conceding the benefit that might otherwise accrue to him/her. Therefore, to measure concessionality or grant, one must use the owner's forgone benefit as the proxy for such a cost.

KFAED's stated and actual grant element policies differ significantly. While KFAED's guidelines state that only income and sector are the main determinants of grant allocation, the results show otherwise. Not only did income of the recipient and sector financed play a role in the differences, but country specific factor played an even more important role in the actual policy of allocation. The main factor is the country specific factors, as represented by both trade volume between Kuwait and the recipients and the authenticity of recipients: as being an Arab. However, there may exist other politically related factors (such as a high official from the recipient country visiting Kuwait or a new government

taking office in the recipient country) that influence such deviation of policies. However, proxies to emulate such factors are hard to construct.

In testing KFAED allocation policy against the hypotheses presented in the literature review: the two gap model, macro-policy management and institutional and governance, the results were not surprising. It is the policy of Kuwait Fund, since inception, to use per capita income as one of the major yardsticks in its allocation of aid. Therefore, the two-gap model has been always part of the policy of the Fund. As to the other two roles of aid, macro-management and institutional and governance, neither have an effect on KFAED's allocation policy. Kuwait Fund shunned imposing conditionality in its operation and focused only on financing projects.

The role of aid, as shown in the empirical literature review, is multifaceted and complementary of different roles. Extending aid without monitoring, or without attaching conditions relating to performance, and bad governance all make the aid a burden on the recipient rather than a benefit. If KFAED's policy is not to impose conditionality, then allocating grant based on certain proxies of performance is feasible. The same applies to institutional strengthening and governance.

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IV. CONCLUSIONS AND RECOMMENDATION

We have described the trajectory of the KFAED program against the trajectory of development policies of the IFIs both to give our analysis a context and to underline the real function played by a South-South development aid fund. Our results should be of interest to the KFAED management to consider in any future revamping of their aid policy. Since the absolute amount of aid disbursed by KFAED is trivial compared to that of all Western donors (of which fact perspective recipients are naturally aware), the expected "aid effectiveness" is also relatively trivial. On the other hand, the global effect of KFAED aid can be amplified in two ways: it can generate models that will influence the behavior of other South-South development aid institutions, and it can form alliances with other South-South development aid institutions. Given the explosive growth of China, India, and the Southeast Asian states, it is reasonable to expect that South-South developmental aid will probably grow as a share of the aid sector in the coming decades, if not in terms of autonomous and separate agencies, then as a share of the funds allocated by IFIs. KFAED will no doubt be studied closely by other potential South-South donors for useful departures from the IFI and Western multilateral norms.

In one way, KFAED will remain unusual. Since Kuwait does not seek economic complementarities that would supplant or align with its primary product export orientation, and has even inscribed its "disinterestedness" in the "branding" of the KFAED programs, KFAED does have the opportunity of offering a "clean" kind of aid, not attached to the suspicion of self-interest that has often guided Western aid. At the

same time, as we have pointed out, the criticism of development aid as an instrument of the Western economies' self-interests is based on the mistaken assumption that economic self-interest is a zero-sum game.

The temptation to which KFAED should not succumb is the use of aid for purely security-seeking reasons, which can lead to KFAED becoming the counterweight to reform – the donor of last resort for stagnant statist regimes, resistant to IFI-suggested market reforms. KFAED is going to have to negotiate its traditional preference for regional stability and its willingness to adapt to significant change in a Middle Eastern environment encountering a marked turbulence, and enter an era in which the demands on the human welfare infrastructure (education, health, and the environment) are bound to increase dramatically.

KFAED, as the first South-South institution in 1960s, was under considerable pressure to allocate aid with some nationalistic, religious and political flavor. Given the Cold War atmosphere in which development aid was always granted in the context of political gains or losses to the major contending sides, it is understandable that political factors would also underlie KFAED's activities. Kuwait's own position in the international nation-state system has to be seen as occupying different places in different nestings: on one level, Kuwait and the other Gulf States were and are the strongest allies of the West; on another level, Kuwait and the Middle Eastern states were allies in the local conflict with Israel, putting them on the other side from the United States; on still another level, Kuwait exists within the local Gulf State system, and has had to balance

threats from states such as Iraq and Iran as it can. Given these sometimes inconsistent situations, Kuwait's aid, while not being a simple function of the security-seeking mandate of the state, has been pulled in different directions depending on state responses to perceived threats. It is probably unrealistic to expect any donor nation to completely disregard its valid interests in security when considering aid disbursement, but those interests should be mediated by less partisan models of economic rationality.

KFAED needs to address the issue of aid effectiveness seriously. As a first step, KFAED should take measures to shore up its credibility by adjusting its grant element estimation using the model that we present or one like it. Such policy will not only benefit the recipients financially, but more importantly increase the credibility of KFAED as a donor within the international development aid landscape. This will lead to the further step of making aid more responsive to the recipient situation, using such instruments as a variable interest rate with a cap. Offering concessional loans without material, quantifiable performance measures is an invitation to rent seeking and counter-productive effects on the recipient. Transparency should always be the guideline here, especially as KFAED is small enough to be immune to the enlargement of the bureaucratic armature that transparency initiatives often incite among IFIs. Our modeling of real grant element is one example of producing better accounting measures to better understand the terms of concessional aid. Given the governance issues that are only going to increase in importance in the next decade, KFAED would do well to aim at being a precursor in the development of accountability instruments in the Middle East, since this is an area in which its small size could make it an unthreatening model.

CONCLUSIONS AND RECOMMENDATION

Reevaluating its target aid projects could also leverage KFAED's smaller scale. For instance, KFAED could specialize in a few sectors instead of considering the whole spectrum of sectors considered by the IFIs. It might well be that seeking aid from KFAED for certain kinds of projects in which the IFIs are dominant is a sign in itself of problems with the recipient's project. One option for KFAED is targeting the development of financing services. This would be a good matching of capability to need, given Kuwait's rich and singular history in the financial service sector. Whatever the portfolio of development projects KFAED takes on board, it must incorporate institution-building and governance as primary considerations in interacting with recipient countries. Kuwait is a perfect candidate to be a "broker" of governance reform. Brokers are commonly peripheral enough to span boundaries, but significant enough to operate as vectors for change. Kuwait has operated within the various nestings of the world system in just this way for decades. As a period of turbulence seems to be on the horizon in the Middle Eastern region, KFAED is positioned to enable large-scale changes in economic practice without posing the threats to sovereignty or identity posed by IFIs.

KFAED has an in-house advantage insofar as it has been in operation over decades. Its contacts and position, as well as its own variety of experts in the governance domain, are being underutilized by dysfunctional designs in the development projects that KFAED accepts, as well as insufficient monitoring of follow-through. If KFAED emphasized a narrower range of projects, with commonalities related to the core

competencies that are special to KFAED, its brokering position would situate it favorably to engage in pooling of aid projects.

A carrier structure (i.e., one designed to be supported by multiple donors), such as a regional development bank, would be one vehicle by which KFAED might increase the impact of its aid as it decreases the number of candidates for that aid. This can increase KFAED's leverage and exposure of its significant funding to these recipients. The framing question would be, of course, whether KFAED would dilute its power in these kinds of arrangements. This is pertinent insofar as Kuwait's interest in maintaining KFAED is essential for its continuing existence. KFAED, like any bilateral organization, must serve two constituencies – its recipient clients, and its domestic audience of policymakers and supporters. The decline of aid levels throughout the globe is, in part, a reflection of the neglect of domestic constituencies by aid agencies. If, however, KFAED takes its role as a broker seriously, it could ensure continuing support from its domestic constituency even as it catalyzes needed changes in the Middle Eastern region.

KFAED can establish a "smart concessional finance" policy that can help enable it to both distinguish itself from other donors and more effectively promote development. There are some sensible approaches that it can explore. One of these approaches is a continuous forgiveness. KFAED can establish a set of conditions, which, when met by the recipient, will enable the debt of that year to be forgiven. So in essence the loan is converted to a grant for that year. These conditions must be transparent and be monitored independently. Another approach is grant unbundling: KFAED can separate the cash

grant equivalent from the market-based part. A recipient, thus, is offered a grant with an

option to borrow the rest at market rate. That would leave the recipient free to take the

loan only if appropriate; it would have no need to borrow to get the subsidy.