Does Foreign Aid Still Have a Role in the Global Marketplace?

From 1990 to 1999, private capital flowing into developing countries grew significantly, from $43 billion to $239 billion. As a result, some policymakers have suggested reducing foreign aid to developing countries. An even more radical opinion holds that bilateral and multinational organizations such as the World Bank and the International Monetary Fund should be abolished, since “the market” will direct the flow of capital appropriately.

UIUC Professor of Economics Anne Villamil and former UIUC Ph.D. student Elizabeth Asiedu, now of the University of Kansas, have examined the role of foreign aid when there is no international body that can enforce private contracts, and less investment is made in response to the lack of enforcement. One of the crucial problems in international lending is the fact that there is no supra-national entity empowered to enforce repayment of private debt across borders. As a result, borrowers may simply choose not to repay the debt. Because the establishment of such an international body is unlikely any time soon, Villamil and Asiedu consider various policies that might mitigate the problem of under investment due to the possibility of default.

Villamil and Asiedu constructed an economic model with which to study the effects of foreign aid policies. They considered a two-country model in which a “rich” country lends to a “poor” country. In addition, the rich country can provide aid to the poor country. If the poor country defaults on the loan, it loses both access to foreign capital and the foreign aid. When they looked at how foreign aid affects the behavior of the debtors, they found a non-altruistic rationale for the aid.

Their model shows that foreign aid reduces default risk, thereby stimulating private investment and improving the welfare of both the donor and recipient countries. Furthermore, their research indicates that it may be more efficient to have one organization — a multilateral agency — coordinate aid disbursement. In this sense, multilateral agencies serve as an enforcement mechanism in an international setting, providing a rationale for the existence of such organizations. They studied the effects of two different kinds of developmental assistance programs, loan subsidies and technical assistance. Technical assistance is free to the recipient and directly affects productivity. The model suggests that technical assistance may be a better policy, enhancing investment flows into developing countries. There has, in fact, been an increase in the proportion of aid in the form of technical assistance in recent years. The share of developmental finance spent on technical assistance has risen from 47 percent from 1988–1991 to 60 percent from 1992–1998. The researchers feel that this trend should enhance the flow of private investment into developing countries to the benefit of the world economy.

The Villamil/Asiedu model offers several implications for policy decisions. It might seem at first glance that such multinational
economic investment agencies reward countries with inefficient institutions, giving such countries no incentive to improve. In fact, a country must improve its institutions in order to reap the full benefits of the aid received. The analysis shows that a country’s welfare, measured by the present discounted value of GDP, depends, in part, on the quality of its institutions. This is consistent with work done by other researchers who found that aid induces growth only in countries with good institutions. The model thus provides an explanation for why a number of countries, for example, many countries in Sub-Saharan Africa, have not experienced significant growth in spite of receiving large amounts of aid. Indeed, the inability of aid to stimulate growth is one of the main criticisms of such agencies as the World Bank.

The model further suggests that multinational agencies should be selective in their lending. If a country’s institutions are sufficiently poor or the level of aid is sufficiently small, the country will repudiate debts. This suggests that agencies must tailor their lending policies to fit the conditions in a country. This contrasts with the policies of the World Bank, which has been criticized for a “one size fits all” approach. The model also suggests that multilateral assistance may have some inherent advantages over bilateral government assistance. Interestingly, this is a trend already observable in the world economy. In recent years there has been a shift from lending from one single country to another, to multilateral lending.

When it is not possible to enforce private contracts across borders, Villamil and Asiedu show that foreign aid is beneficial for both the recipient and the donor. By offering foreign aid, the donor changes the recipient’s payoff for default, providing it an incentive to repay its debt. Thus, foreign aid serves as a proxy for the missing direct enforcement mechanism (e.g., a court with international jurisdiction). When enforcement is imperfect, foreign aid can play an important role in the global marketplace. Indeed, private capital will not flow, or under investment will occur, unless countries have an incentive to honor their contracts.

The complete version of this study will appear as “Imperfect Enforcement, Foreign Investment and Foreign Aid,” in Macroeconomic Dynamics. Anne P. Villamil is a professor of economics at the University of Illinois at Urbana-Champaign. Former UIUC Ph. D. student Elizabeth Asiedu is an assistant professor of economics at the University of Kansas. For further information on this research, you can contact her at avillami@uiuc.edu.
Recent research by Associate Professor Madhu Viswanathan and graduate student James Harris sheds light on the buying habits of a group of neglected consumers, the functionally illiterate. Functionally illiterate adults lack the skills necessary to understand labels or signs and cannot easily add or subtract. Surprisingly, one–fifth or more of the adult U.S. population is, to some extent, functionally illiterate. Viswanathan and Harris studied how functionally illiterate consumers negotiate the marketplace and have developed coping strategies necessary to act as consumers.

The researchers worked primarily with an adult education center. They conducted interviews and observed functionally illiterate adults in training programs and in shopping situations, and they interviewed the teachers to confirm their impressions. The adult education facility divided their functionally illiterate clients into two groups, those with reading levels of grades 0-4 and those at levels of grades 5-12. None of the participants was considered to have developmental difficulties.

Perhaps the most striking facet of decision-making by functionally illiterate adults was their difficulty with abstractions. The informants in this study are able to process a piece of information such as price, but often have difficulty in relating that information to other information such as package size. The informants showed a tendency to process a single concrete piece of information without deriving abstractions such as trade-offs between attributes, price and one or more product attributes, or price and size. Such concepts as value or unit price are largely outside their ability to judge. Other problems are related. Informants were often dependent on oral and visual information and intuitive processing. They used numbers as concrete information, lacked planning ability, and depended upon familiar contexts.

Dependence on oral and visual sources is a natural consequence of having difficulty with written material. The informants reported depending upon television advertising as an important source of product information. Brand names and recognizable product labels were also extremely important. As one informant said, “even if you can’t read the words Kentucky Fried Chicken, you . . . see the colonel and the big old chicken box up there.” They depended upon information from others — family, friends, and even friendly store clerks — to help them choose products. As might be expected, dependence upon others was much stronger in the group whose reading abilities were grade 0-4 rather than 5-12. Some of the former group report that they never shop or go to restaurants without a family member with them to handle the details. To compensate for lack of knowledge, some informants may use an intuitive sense of product quality such as looking for products that “look good”; looking for fresh foods; consuming fruits and vegetables; trying to avoid fat, salt, and sugar; and consuming more proteins and vitamins.

The informants used numbers as a way to make concrete decisions. Overall, the amount of information used to make decisions is small, but a large proportion of the information used is numerical. This follows from an almost exclusive concentration on price and the necessities of handling money. They possess the basic skill of picking the larger or smaller of two numbers to make decisions, but they mostly focus on the price. They often look at two different sizes of an item and make a buying decision based solely on which costs less. Most seemed to have difficulty relating price to size in order to grasp value or unit price. The informants also had trouble planning and budgeting, and they often made impulse purchases. Some did, however, have simple strategies to compensate. They would divide their income and keep some money aside to last for a certain period of time.

Context was central to the informants’ processing of numerical or other information. Teachers reported finding it easier to teach low-level math students in terms of money. “Seven take away three” was hard, but “I give you $7, and you spend three of them,” made a lot more sense to them. Students were also familiar with dollar denominations to use in different situations, for example, $5 in a fast food outlet. Contextual learning can lead to store loyalty (where staff are friendly, helpful, and respectful) and brand loyalty as a means of maintaining stable and familiar contexts.
Informants use a number of coping strategies to navigate the consumer environment. They depend on networks of friends and relatives to provide everything from actual decisions about purchases to information about products, brands, or stores. They also depend on word-of-mouth, advertising, and store loyalty. Another theme that emerged from the interviews was effort to maintain self-esteem by purchasing specific brands and through encounters with service personnel in various shops. They look for friendliness in their interactions and resent being viewed with suspicion, disrespect, and unfriendliness. It appears that functionally illiterate consumers bypass or expend minimal effort in steps such as pre-purchase search and evaluation of alternatives. They sometimes bypass the entire decision-making process by mimicking others or delegating someone else to make decisions for them. Consumers at lower levels of functional literacy engage in several defensive practices. Some carry only a certain amount of money and buy one item at a time from a menu to avoid the embarrassment of not having enough money, and they pay with all the money they have and hope for the correct change. One student claimed that he only carried a $20 bill at all times to avoid being taken advantage of, and many said they often bought less to protect themselves—presumably to minimize the loss if they were cheated.

Several differences emerge when comparing the grade 0-4 level informants with the grade 5-12 group. Level 0-4 students have less computing ability, leading to problems with such tasks as reading prices, finding the price of two or more units, or computing discounts like “1/2 off.” Concrete thinking was even more evident. Dependence on others appears to be greater. The 0-4 level group seemed more aware of their constraints; through caution, they developed more rudimentary coping strategies as a defense. The 5-12 level group can function better and, thus, are less aware of their inabilities. In most cases, they are able to estimate closely enough to provide a satisfactory outcome.

As a control, Viswanathan and Harris also studied a group of students of English as a Second Language (ESL) at the same adult education center. Students from various countries had English reading levels varying from second to sixth grade. The most striking differences between these students and the functionally illiterate was their ability to engage in abstract thinking such as evaluating multiple attributes, size, and price information, and reaching global judgments. However, informants reported avoiding menus by ordering from specials and buffets (which sidestep the menu). The underlying motive of preserving self-esteem is strikingly similar to that of the functionally illiterate.

The other control group, the functionally literate poor, interviewed at a homeless shelter, was included to exclude the effects of poverty as a reason for the problems of the functionally illiterate. There was a wide range of background and education among the group. They differed considerably from the functionally illiterate group, most strikingly in their ability to engage in abstract thinking, such as evaluating multiple attributes and size and price information, and to reach global judgments. This group most resembled the functionally illiterate in their efforts to maintain self-esteem in the marketplace. They showed extreme sensitivity to being regarded with suspicion and disdain because of their economic status, their dress or appearance, and their use of government aid such as food stamps.

The most practical conclusions of the authors suggest that retailers think about various groups of consumers who do not fit the normal middle class mold. Perhaps they might have more service personnel available and train the personnel to distinguish between functional illiteracy, low English language ability, and simple poverty to meet the needs of the various groups better. Most important, retailers should insist that personnel treat all potential customers with a friendly, helpful attitude, and with respect. These practices will build customer loyalty with a not inconsiderable group of consumers.

Madhu Viswanathan, an associate professor of marketing at the University of Illinois, directs the Consumer Literacy Project, which researches and disseminates knowledge to improve the effectiveness of business and government in serving the needs of functionally illiterate consumers. This article is based on research conducted with doctoral student, James Harris. For further information on this research, email Professor Viswanathan at mviswana@ux1.cso.uiuc.edu.
Is Land Reform the Only Hope for Less-Developed Countries?

Throughout history, land has been the primary asset, and arguments over the distribution of land can be traced for centuries, if not millennia. Throughout the twentieth century, land reform was one of the most contentious issues in dealing with the worldwide Depression, wars and their aftermath, “the communist menace,” and most other woes of poor people around the world. What is land reform? Generally it involves the breaking up of huge tracts of land belonging to wealthy and powerful families or individuals and redistributing it to the landless people who have worked it for the landowner.

During the twentieth century, it was almost axiomatic that land reform was essential in order to bring about the economic development of poor and developing countries, many of which were largely agricultural societies. UI Professor of Economics Salim Rashid has reviewed the theoretical literature on land reform and the historical cases of developing economies in the last hundred years and has come up with a view that challenges the common assumption that there should be a general policy presumption in favor of land reform.

This presumption probably follows from another, that land reform furthers economic growth most effectively. Land reform is nearly unique as a policy since it is a form of expropriation that so many defenders of the “market” approve of. Even a president of the World Bank, that well-known bastion of faith in the market, once called land reform, “the whole basis of development.” Rashid suggests that this belief may depend on the questionable premise that small farms are more productive per acre. Even if we accept this as fact, it is not clear why efficient small farmers will not be able to buy land from inefficient large landlords? This market-friendly solution is superior to confiscatory land reform.

Rashid found — even in the literature that most strongly supported land reform in the twentieth century — indications that land reform alone could not solve the problems of poor countries. Other factors such as industrial development and economic support from the government or from donor nations were required to pull such countries as post-war Italy and the Uttar Pradesh of India out of abject poverty.

If, he concluded, the most compelling demands for land reform are political rather than strictly economic, why not implement the desired political reforms directly. If the owners of large tracks of land are wealthy and, thus, have too much influence over the judiciary, why not improve the independence of the judiciary rather than approach the problem obliquely through land reform? If the major problem of poor nations is an excess of population and a shortage of food to feed them, why not look for more direct ways to increase the well-being of the “peasantry” and, thus, avoid the endless calls for land reform to provide food and jobs to the poorest groups? If aid and the development of industry to provide jobs and income for the poor are, as we are told, necessary adjuncts to land reform in raising the standard of living of the poor, why not simply provide aid and investment to bring about industrial development?

As Solon Barraclough wrote in the Journal of Political Economy in 1970:

Large-scale reform generally is revolutionary in that it changes political structures.
Unless the groups pressing for agrarian reform can make their interests felt in the existing structure, reform cannot take place through the established political system. But if the political system has evolved sufficiently to make reform a possible “output,” it should be feasible to redirect other agricultural policies even without land reform.

Studies on such countries as Taiwan indicate that the role of non-agricultural activities is perhaps the most important factor in leading to prosperity. In fact, cases such as Indonesia, which has had to rebuild its non-agricultural sector almost totally to achieve the success it has attained, suggest that one of the most important of the myriad ill effects of colonialism was the decay of once thriving non-farm economic activity.

Studies of Latin America during its economic trials of the 1980s suggest a possible new role for agriculture. During that time the only sector to “prosper” was agriculture; in fact, agriculture continued growing and exceeded the growth rate of industry. This suggested a new strategy of using agriculture to bolster GNP. By drawing upon the generation of foreign exchange wealth created by selling agricultural products produced by large-scale farming operations, a country can provide employment on the farm and in the many agribusinesses required to carry on foreign trade and can broaden the domestic market for industry by linking it with new agricultural demand.

Rashid makes an exception for South Africa, which he considers a special case, but concludes,

the only remaining case for land reform then rests on the grounds that it is the only way to convert feudal society to capitalism. Does this mean that no action is warranted? By no means. A vast literature testifies to the unjustified advantages enjoyed by the rich — even in the USA. The government has a decided obligation to provide equal access to justice, to clear and unambiguous titles to land, to credit, and agricultural extension (technical support to agriculture). This constitutes a sufficiently wide scope for action for any government.

Salim Rashid, a native of Bangladesh, is a professor of economics at the University of Illinois at Urbana-Champaign. He is the author of many studies on economic development in the Third World from both the theoretical and practical perspectives. This article was developed from Professor Rashid’s article, “Is Land Reform Viable under Democratic Capitalism.” For further information on this or other research by Professor Rashid, send email to [srashid@ux1.cso.uiuc.edu].
Research News

This page highlights the recent research achievements of the faculty of the UIUC College of Commerce and Business Administration. To find out more about any of the projects mentioned, contact the editor, Janet Fitch, who can put you in touch with the appropriate faculty member.

Grants

**Ruth Aguilera**, Business Administration, has been named a Beckman Fellow at the Center for Advanced Study for Spring 2002. She will work on a project entitled “Have American Corporate Governance Practices Crossed the Atlantic? A Study of Corporate Governance Changes in Europe.”

**Kevin Hallock**, Economics and the Institute of Labor and Industrial Relations, has been awarded a two-year grant from the Alfred P. Sloan Foundation for a study of “When and Why Do Firms Make Layoffs?”

**Elizabeth Powers**, Economics and Institute of Government and Public Affairs, has recently received three grants: from the Retirement Research Consortium at the University of Michigan, $50,000 for “Multiple Program Use by Older Americans: Social Security Early Retirement and Supplemental Security Income” with colleague, David Neumark; from The Social Security Administration via UIUC Disability Research Institute, $5,000 for “The Characteristics of SSI Child Applicants and Beneficiaries”; from Partnership Illinois, $15,000 for “A Partnership with State Government to Improve Childcare in Illinois.”

Honors and Awards

The Office of Research presented its 2001 Awards for Excellence in research to **Narasimhan Jegadeesh**, Harry A. Brandt Distinguished Professor in Financial Markets and Options, and **Stephen L. Parente**, Associate Professor of Finance.

**Ruth Aguilera, Timothy Bablitt, John Denker, Ruth King**, Business Administration and J. Lawler, received a CIBER Research Award for their study, “Managing Information Technology Professionals in Multinational Corporations.”


**Ruth King**, Assistant Professor of Business Administration, and Weidong Xia received the Best Paper Award at the 2001 ACM SIGCPR Conference in April for “Retaining IS Talents in the New Millennium: Effects of Socialization on IS Professional’s Role Adjustment and Organizational Attachment.”

**Don Kleinmuntz**, Professor of Business Administration, has been named editor of a new journal, Decision Analysis, to be published by the Institute for Operations Research and Management Sciences. Publication is to begin in 2003.

Recent Publications


**Anil Bera** and Rahul Mukerjee co-edited a volume on Rao’s Score Test published as a special issue of the Journal of Statistical Planning and Inference, August 2001.


