

This work is licensed under a
Creative Commons Attribution-NonCommercial-
NoDerivs 3.0 Licence.

To view a copy of the licence please see:
<http://creativecommons.org/licenses/by-nc-nd/3.0/>

(832) 3.95
RESERVE

TIED AID, INDUSTRIAL DEPENDENCE AND NEW
TACTICS FOR NEGOTIATIONS: OBSERVATIONS
FROM KENYA

INSTITUTE OF
17 JAN 1989
DEVELOPMENT STUDIES
LIBRARY

By

PETER COUGHLIN
GEOFFREY MWAU
GREGORY BEGUMISA

WORKING PAPER NO. 457

INSTITUTE FOR DEVELOPMENT STUDIES
UNIVERSITY OF NAIROBI
P. O. BOX 30197
NAIROBI, KENYA.

April, 1988

Views expressed in this paper are those of the author. They should not be interpreted as reflecting the views of the Institute for Development Studies or of the University of Nairobi.

This paper is not for quotation without permission of the author, as specified in the Copyright Act, Cap. 130 of the Laws of Kenya.

TIED AID, INDUSTRIAL DEPENDENCE AND NEW
TACTICS FOR NEGOTIATIONS: OBSERVATIONS
FROM KENYA

Peter Coughlin
Geoffrey Mwau
Gregory Begumisa

Abstract

Kenya receives much foreign aid especially for agriculture and infrastructure. Despite this, many opportunities are missed for localizing the sources of inputs for these projects. The country has skills and installed capacity to manufacture many of these imported inputs locally but does not do so partly because much of the aid is tied to purchases from the donor countries. In this study, the authors selectively review the literature on the impact of tied aid on the economic structures of recipient countries. Illustrations are given of how more flexible and detailed negotiations for aid could improve the demand for the outputs of some industries. The authors also propose specific ways of improving Kenya's negotiating ability and tactics that may well be applicable to other developing countries.

INTRODUCTION

Kenya receives much foreign aid, especially for agriculture and infrastructure (1). Despite this, many opportunities are missed for localizing the sources of inputs for those projects. Though the skills and installed capacity exist locally to manufacture many of these imported inputs most are still imported, partly because much of the aid is tied to purchases from the donor countries. This study selectively reviews the literature on the impact of tied aid on the economic structures of recipient countries, though the broad issues of the social and political/economic repercussions of aid and the long-term strategies needed to reduce dependency and accelerate development are not considered here. The way the Kenya Government negotiates for aid is examined. Then four case studies are presented to illustrate how more flexible and detailed negotiations for aid could improve the demand for certain industries' output. The article proposes specific ways to improve Kenya's negotiating ability and advocates new negotiating tactics that may well be applicable to other developing countries.

THE IMPACT OF TIED AID ON THE ECONOMIC STRUCTURES OF THIRD WORLD COUNTRIES

More than half of all development assistance (i.e. aid) is tied and must be used mostly to purchase goods and services from donor countries (OECD 1982: 192). This practice imposes two special problems upon Third World countries: extra costs and lower local production. Nevertheless, donor countries tie the source of inputs and services purchased with foreign aid for the following reasons (2).

- to minimize the negative impact on the balance of payments in the donor country;
- to counter the practices of other donor countries who also tie aid;
- to utilize excess industrial capacity in the donor country and to dispose of surpluses;
- to generate employment in the donor country;
- to initiate or to sustain the penetration of the recipient country's market by the donor country's corporations;
- to minimize the cost of giving aid -- irrespective of what it costs the recipient country to receive the aid.

The United States of America started tying aid in the 1950s and 1960s in an effort to reduce the balance-of-payments drain on its gold reserves. Subsequently, other countries followed suit to promote exports or to prevent the pre-emption of export markets by the aid-tying practices of rivals (Wightman 1971: 50).

Despite the extra costs of tied aid for recipient countries, bilateral aid is usually tied. As of 1978, only ten of the Development Assistance Committee countries -- Australia, Denmark, West Germany, Italy, Japan, Netherlands, Norway, Sweden, Switzerland and United States of America -- had untied bilateral development loans to permit at least some procurement in developing countries (Kappagoda 1978: 8-9). In 1981, 54.7% of grants and 72.4% of loans from the United States were tied; another 17% and 13.2% were "partially tied". Britain tied 78.3% of its grants and 72.4% of its loans, another 1.4% and 2.8% was "partially tied" (OECD 1982: 192). About 60% of Canadian aid is bilateral; of this about 80% is tied (Carty and Smith, 1981: 36).

Business interests in the donor countries are keen to stave off concessions from the principle of tied aid. For instance:

Ottawa

In 1975, / announced that Canadian aid would be untied immediately for bidding by Third World countries. The Development Aid committee of the Canadian Export Association expressed loud dismay at this minor concession to recipient nations Government spokesmen soon became equivocal in their statements on the change ... By the end of 1977, they had stopped mentioning it (Carty and Smith 1981: 43)

The United Kingdom, which loosened conditions for tied aid in 1975, only allowed aid recipients to buy from countries that had a per capita income below US\$200 (Kappagoda 1978: 8-9). Yet, poor countries usually lack the capacity to produce goods or the capability to design and build factories and processing plants. Hence, in most cases, the aid from the United Kingdom is still tied. The rules penalize potential suppliers in Third World countries (Hamilton 1976: 1-21). Moreover, a developing country may not purchase inputs or capital from another developing country without special permission from the Overseas Development Ministry. On the other hand, Sweden and Norway do allow aid recipients to spend all their bilateral aid on local costs.

When aid -- especially subsidized loans -- is tied, the recipient country often pays more than world prices because the donor is a high-cost producer or the shipping and insurance is also tied to high-cost donor sources (Kappagoda 1978:8). Suppliers from donor countries can often charge monopolistic prices when aid is tied since competition from other suppliers world-wide is excluded. For instance, in 20 projects in Pakistan analysed by Mahbub ul Haq (1967: 327), the average costs were 51% higher than they would have been with competitive bidding. Yassin (1982: 164) also found that the average excess cost of aid tying in Sudan was 92.6% for the projects examined.

Similarly, the Indian newspaper Business Standard (15 Sept. 1981 reported that a World Bank Loan of US\$450 million for rural electrification had been cancelled because the Bank had insisted that the government should accept a Canadian loan offer tied to the purchase of aluminium rods from Canada; the government had rejected this on grounds that the cost of the rods was 45% above the ruling market price and that it would therefore be cheaper for India to buy on the open market with Eurodollar finance; the World Bank had called off the project, saying that its foreign aid requirements were not properly tied up (Hayter and Watson 1985: 86).

Aid recipients are usually aware of the problems of aid tying, but they accept it because they need foreign exchange for projects. In fact, aid recipients can sometimes even increase the amount of aid by agreeing to increase the value of the imported components of a project. Since mobilizing local finances for public expenditure is often difficult.

....local financing often becomes the bottleneck of the project: it is easier for the developing country to use imported goods and services than those that can be bought locally Projects with high "development effect" and low import content are replaced by projects with lower "development effect" and higher import content ... (Hamilton 1976: 1: 40).

This introduces a bias in favour of imported content and against local sourcing. Moreover,

...even if donors allow some of their aid to be used for local costs, the bias is not necessarily removed. The World Bank's practice, for instance, is to specify that some fixed percentage of a loan may be used for local costs, giving the recipient free foreign exchange to cover the indirect addition to import demand generated by expenditure on the project. This means that it is still the size of the import component that determines the size of the loan, and the implicit bias remains ... (White 1974: 172).

Tendler (1975: 58-68) discusses an example of American aid to Brazil for construction of a hydroelectric power plant. Brazil originally planned to build a 250 megawatt hydroelectric power plant in two 125 megawatt phases of seven years each. According to Tendler, American aid influenced Brazil to build the 250 megawatt plant in one phase in five years even though that capacity was not needed immediately. Brazil was also required to buy turbines from the USA though both turbines and generators could have been produced in Brazil. She concluded that the decision to import deprived the nation of an opportunity to strengthen its technological capacities and gain experience. Also,

... the 250 megawatt, five-year decision meant a greater cost, economically and institutionally. It involved a meddling by assistance entities in recipient-country decision making and increased skepticism about the use of analytical techniques in project selection (Tendler 1975:68).

The limited availability of aid to finance the use of local consultants, skilled labourers and locally produced goods hinders the development of diverse economic sectors in Third World countries (Gray 1971a; 1971b). This is especially so if aid displaces locally-made competing products. Aid can also impede development by enticing an aid receiver to postpone plans to generate alternative local supplies. As an example of this latter problem Hayter and Watson (1985:256) quote an Indian official:

In fertilizers, for example, we have the capacity to manufacture them ourselves, but this is stultified by several people who were brought up by the World Bank, ... when the World Bank goes for an international tender, they go for the best technology in the world, which necessarily means imports; we lose the will, energy, and desire to produce our own ... our failure to raise resources internally, which is a political failure, implies that we go to the World Bank, in the process we receive imports which are tied to specific technologies. These are developed adopted to use of India raw materials ... we lose the will to develop on our own, even though we have the technicians and the machines.

Indeed, two Indian fertilizer projects financed by the World Bank had at least 25% more import content than one built with tied supplier credits and bilateral loans even though these "are at least 30% more expensive than normal loans" (Menon 1980: 1441).

111 - conceived aid can depress both local agricultural and industrial output. For example, Sri Lanka's staple food is rice. Since the yield of rice depends greatly on water supply, Sri Lanka's rice harvests vary according to the rainfall. To avert potential famine due to drought, the government of Sri Lanka encouraged the production of sorghum, maize, cassava and yams as substitutes for rice (Kappagoda 1978: 14-15). However, during the harvest of these substitute foods in 1975, Sri Lanka received "rice aid" from the USA. This diverted demand from domestic rice substitutes to "rice aid". Sri Lanka farmers -- who had been motivated to grow substitutes for rice -- could not sell their crops. They became discouraged and quit growing the substitutes. According to Kappagoda (1978: 14-15):

A major extension effort by the (Sri Lanka) Agricultural Department received a set-back as the farmers required considerable persuasion to grow these other crops and the country's long-term development prospects were seriously damaged.

m An economic study of American food aid to India in the 1960s also revealed that for every three units of food aid received, the local production of food dropped by one unit (Mann 1967).

Third World countries need to be alert to the possibility that aid may hinder the growth of local industry. Aid is sometimes used to penetrate local markets and divert demand away from local firms and towards corporations from the donor country.

If the aid had not been available in the first place, the materials and skills might, in many cases, have been provided from local sources. A foreign firm's bid may be supported by offers of aid. Thus the Financial Times (28 May 1984) reported that Bharat Heavy Electrical (BHEL) India's state-owned power station contractor, was overtaken by General Electric company ... backed by the UK government ... the fact that a substantial proportion of the cost of imported equipment will be covered by grants reduced the power of BHEL's arguments (Hayter and Watson 1965: 242).

When widely practiced, aid tying can also have large adverse macroeconomic repercussions for a developing country. For instance, Ndulu (1986:19), in an excellent article on Tanzania, examined how, real capital investment grew by 51% between 1978 and 1981, while manufacturing declined 39.5% . Moreover,

... the share of industrial capital imports in total industrial imports increased from an average 17.3% between 1972 and 1975 to an average 48% between 1975 and 1980. This was made possible by a substantial inflow of external assistance tied to projects, given the absolute decline of real export earnings (Ndulu 1986: 19).

From 1975 to 1980, foreign aid averaged 34% of total imports; this rose to 51.6% in 1982. During this period about two-thirds of the aid was in the form of grants, many of which were tied. Thus aid contributed to the inordinate build-up of underused capital, worsening labour productivity and consequent inflation. In addition, the Tanzanian currency became more overvalued, thus discouraging the exports needed to finance imported industrial inputs and spares (Skarstein and Wangwe 1986: 213). Earlier errors in the selection of highly import-dependent technologies and products compounded the problems. Thus despite the large external resource inflows,

... The inflexibility of their allocation due to tying them up to capital goods content of development projects constrained their effectiveness. Indeed, flexibility in their use for current operational requirements could have substantially reduced the loss in growth, even in the face of poor export performance registered during the period (Ndulu 1986:22).

Thus, if the annual rate of growth in real capital investment had been decreased from 12.4% to 2.9% and the foreign exchange reallocated to import intermediate inputs instead of capital goods, then the annual growth of output would have been 5.2% instead of merely 0.7% between 1973 and 1981. The dismal macroeconomic performance can be blamed, at least in part, on aid-tying. This was especially so since foreign exchange earnings were falling and hence extra foreign exchange was not readily available to reallocate for purchasing imported intermediates and thereby overcome the constraints imposed by aid-tying. Under such circumstances, there was little room for manoeuvre. Being tied, the assistance was of help. The nation was bound to under-achievement and declining per capita income.

Though it is not our intention to paint the situation too negatively, these examples do illustrate that aid -- particularly tied aid -- can impede development. Thus a potential recipient country must carefully identify its own interests and negotiate to defend them.

AID NEGOTIATIONS IN KENYA

In Kenya negotiations for aid are centralized under the Department of External Aid in the Finance Ministry. As of 1984, this department was dealing with 48 donors, including 25 bilateral and eight multilateral donors. The bilateral donors accounted for nearly 60% and multilateral donors for 37% of all grants and loans (see Table 1). Thirty-eight per cent of the aid was given as grants, the rest as loans. Most grants were bilateral or from non-governmental organizations and the United Nations system.

Multinational organizations tended to lend rather than grant. Statistics are not available as to how much aid was "tied", though the documented international patterns of development assistance and extensive tying is probably applicable to the bilateral aid received by Kenya. Industry and the private sector received little aid directly -- only 4.5% of all grants and loans. Of course, some money spent on other categories of aid was used to purchase inputs and services from Kenyan industries.

Officially, Kenya aims to reject aid that promotes the economic or political dominance of the aiding country (Kenya Govt. 1965: par.25). Nevertheless, Holtham and Hazlewood (1976: 200) have concluded that:

... while donors, including Britain, are guilty of distorting government expenditures, it is only fair to say that they often seem to be pushing an open door and the Kenya government has its own appetite for the grandiose ...

Edwards (1968:11) and again Holtham and Hazlewood (1976:41) observed that projects were often tailored to donor requirements while projects and programmes essential for development were reduced or sacrificed when viewed unfavourably by donors. All these authors noted that Kenya tended "to accept aid for imported goods which could be produced domestically". Moreover, the amount of aid the Kenya Government receives is large, e.g. Kshs.2,040 million in mostly bilateral grants and a nearly like amount of loans in fiscal year 1985/86 (Kenya Govt. 1986:62). Thus significant opportunities to stimulate local industrialization are missed. Moreover, in some cases, overpricing and inappropriately designed factories and equipment have hamstrung projects for years after their initial commissioning. Various examples will illustrate these problems.

TABLE 1: Development Assistance to Kenya

	Number of organizations	Grants	Loans	Total	%
A: On-going aid commitments as of 30 June 1984 (millions of Kenya pounds)					
Bilateral	25	757.1	625.5	1,382.7	59.5
NGOs	3	16.4	.6	16.9	0.7
UN system	2	63.0	3.8	66.9	2.9
Multilateral	8	56.3	800.3	856.7	36.9
Total	48	892.9	1,430.2	2323.1	100.0
B: Aid commitments by sector (%)					
Agriculture	23.2	13.9		17.5	
Natural resources	2.5	3.6		3.2	
Health and population	10.7	4.8		7.1	
Energy	9.8	13.9		12.4	
Education, training and social services	13.4	5.8		8.7	
Industry and private	4.0	4.8		4.5	
Water and Urban	7.3	19.3		12.4	
Infrastructure	9.9	31.1		23.0	
Macro economic planning and research	7.1	2.4		4.2	
Multi-sector	12.0	.3		4.8	
Total	38.4	61.6		100.0	

Source: Kenya Govt. (1985a).

Tractors and a Sugar Factory

Aid-tying not only increases the cost of equipment, but a recipient can also be locked into ^{receiving} inappropriately designed equipment from donor suppliers. The increased costs and consequently inordinate finance charges, perhaps compounded by a bad choice of equipment, can cause a project to be long plagued by inadequate liquidity as well as numerous operational problems.

This is exactly what occurred to the French-assisted Nzoia Sugar Factory in Western Kenya (Coughlin 1986). Nearly all the equipment came from France, and much of the equipment (e.g. tractors and generator turbines) was highly overpriced. For instance, Fives Cail Babcock (FCB) charged Kshs. 5.6 million for a 1.3 megawatt turbine in 1978 (February). But when asked for its replacement value as a result of an insurance claim, FCB inadvertently revealed the overpricing when it reported that a replacement in 1984 would only cost Kshs. 2.1 million despite the intervening inflation and devaluation of the Kenya shilling. Similarly, Nzoia's management reported that , "included in the French Buyers Credit Agreement were agricultural machinery which could have been negotiated at better prices and more than 50% of the cost saved". The high charges burdened the plant with unmanageable annual finance charges, even at the supposedly reduced interest charges (7.95%). These charges would chew up 35% of the expected annual sales revenue. The plant was immediately crippled with an insupportable financial drain. The continually acute liquidity crisis bred numerous secondary problems.

On top of these inordinate financial charges, the plant was also badly designed. The plant was supposed to be able to crush 2,000 tonnes of cane per day continuously. But according to all the engineers currently in the factory, the plant cannot and never could crush and process more than 1,600-1,700 tonnes per day on a continual basis. Significant imbalances between sections in the factory exist. But in order to pass the test for acceptance of the factory, the then French managers reportedly ran the crushing mills for 36 hours at that rate. Then just as the juice processing house was jammed full, they stopped the test and declared it to have been a successful demonstration of the plant's capacity! The mills would have had to stop anyway to allow the process house to clear. The middle level African managers (many of whom are today's managers) were not tricked, but they were unable to communicate the possibility of a fraud

to higher authorities. So the "test" allowed the French suppliers to gain official acceptance of the plant and the government's acknowledgement of the debt.

As time passed, other design deficiencies began to reveal themselves. Most key pieces of equipment lack the normal backups that can be used if the primary equipment breaks down (e.g. pumps, milling rollers, boilers, turbine generators, vacuum pans). Since the process is continuous, if a breakdown occurs in any one of these, the entire plant suffers a partial or complete shutdown. Moreover, compared to Kenya's other plants that are rated for 2,000 tonnes per day, this plant has the smallest capacity for most key pieces of equipment. As a result of these design deficiencies, as soon as the plant became older and more susceptible to breakdown, the critical failure to provide more backup equipment became evident in the increasing number of hours that the entire plant was shut due to breakdowns.

Handpumps

Foreign aid is the major source of handpumps in Kenya. Sometimes donors drill holes and supply and install pumps. Other times they just supply pumps. According to the Ministry of Water Development, the major donors of handpumps are (i) the Swedish International Development Agency (Coast Province); (ii) the World Bank (Coast Province); (iii) the Kenya Finland Corporation (KENFINCO) (Western Kenya), and (iv) various religious agencies throughout Kenya. (3) Donors import many makes of handpumps from diverse producers. As a result, the users usually do not know who the manufacturers are and how and where to obtain spare parts. Also, the local manufacture of spares on a one-off basis is often expensive or impractical. Hence, many of the donated pumps remain unrepaired and the boreholes are idle until, perhaps, a new donated pump arrives. The activities of KENFINCO in western Kenya are outlined below to illustrate how the receipt of pipes and pumps given as "aids" actually underdevelops Kenya's productive capacity for handpumps and water pipes.

Finland is a major donor of water handpumps to Kenya. It supplies pumps under a 1981 agreement for the "Rural Water Supply Development Project in Western Province of Kenya". KENFINCO, a joint venture, was established to execute the project. (4) KENFINCO's project area covers 28 locations in four districts in the Western and South Nyanza provinces of Kenya. As of October 1984, KENFINCO had completed 220 shallow wells and . deep borehole wells. Two of the latter were high-yield boreholes for piped water supply schemes. KENFINCO had also completed 160 spring protections and was about to complete the rehabilitation of water supply systems for the towns Kakamega and Shikusa.

The KENFINCO project is financed by a Finnish grant tied both as to procurement and end use. Finnish International Development Assistance (FINNIDA) finances the local cost of the water supply project, brings in Finnish experts to supervise Kenyan casual workers, and imports Finnish water pipes and nearly all the cylinders for handpumps.

KENFINCO uses three makes of handpumps: the NIRA AF-76, the Indian Mark II (with 2" Demster cylinder); and the Malawi Pumps (AFRIDEVE). The NIRA AF-76 is imported from Sweden and used in shallow wells. The Indian Mark II is made locally by Western College in Kakamega. It is used in deep wells. Its cylinder retails for Kshs.3,915. The well-heads for the three handpumps are made locally at Western College, Kakamega. According to the project manager, the cylinder constitutes about 20% of the total cost of a shallow well. The cylinders for shallow wells are imported; those for deep well are made locally. (5) Most of the cylinders are imported since about 80% of the wells are shallow. Half of the spares are manufactured at Western College; half are imported.

Though the local demand for handpumps is small -- only a few hundreds per annum -- Kenya does have the skills and installed capacity to make handpumps locally. (6) Two firms actually make handpumps and at least five foundries in Kenya are technically competent to cast handpump cylinders. Various machine shops could finish them. One study revealed that if the current demand for handpumps were satisfied by potential local producers, the pumps would even cost less than comparable commercial imports (Begumisa and Coughlin 1986: 12).

Though Kenya has the proper equipment and skills to produce handpumps locally, very few are produced. The major reason is that foreign donors supply imported pumps as "aid" instead of buying locally made ones to donate. The commercial demand alone is insufficient to allow reasonable economies of scale. Instead of assisting Kenya to become self-reliant by encouraging local industries, the donations perpetuate dependence on imported pumps and subsequently needed spare parts. Thus, "aid" has kept the Kenyan handpumps industry underdeveloped.

Steel

When Kenya negotiated the contract with China to erect the large new sports stadium and complex in anticipation of the All-Africa Games, it was initially agreed that all materials, even cement, should be purchased from China. In practice, however, numerous items (e.g. cement, plastic pipes, electrical conduits, galvanized roofing sheets and timber) have been obtained locally. But still, many locally producible items were imported, (e.g. 5,000 tonnes of steel reinforcing rods, ceramic wash basins and toilets). The reinforcing rods were mostly 25 mm to 28 mm threaded rods which are not made in Kenya. But for such a large order (i.e. roughly Kshs.2.5 million), equivalent to two months' production in most local mills, the existing local steel mills -- three of which are brand new -- could easily groove the rolls needed to make those rods. Moreover, if worried about the quality of the steel, the Chinese builders could have imported steel billets of assured quality and commissioned the hot-rolling locally. Kenya imports steel billets in any event, so Chinese imports of billets would not have hurt the local scrap steel melters (Coughlin 1985a).

Electrical Cables and Conduits

Kenya also imports many electrical cables as part of aid packages, even though the country could make many of those cables locally. The justification for this is that these cables are paid for by grants or subsidized loans. Nevertheless, significant opportunities to use local productive capacities are lost because of the government's failure to negotiate with aid donors to obtain raw materials instead of finished electrical cables and conductors.

The government has embarked on large programmes to increase electrical-power generating capacity, rural electrification and telephone services. These efforts are financed by foreign loans and grants from Canada, Britain, West Germany, Denmark, Yugoslavia and others. Except for some domestic expenditures on labour, energy, cement and minor inputs, the bulk of the purchases are tied to sources in the donor countries.

In addition to technical issues, the government and the power and telecommunications companies evaluate the price, financial conditions and the grant or grant equivalent (due to subsidized finance charges) for any tender to supply equipment or materials. The grant or grant-equivalent is a key consideration; low bids are often rejected if their grant element is small. Since Kenyan companies obviously cannot offer "aid" or subsidize finances, it is futile for them to bid for these contracts. As a result, Kenya imports much equipment and materials which the country has the installed capacity and ability to produce locally at competitive prices. Due to "aid", local companies were unable to bid for the Kshs120 million double circuit line between Mombasa and Nairobi; the Nyeri-Thompson Falls-Nakuru-Kisumu line; low voltage conductors and internal wiring for Kiambere Dam; and the Kshs.50 million per annum rural electrification projects. Both the corporate planning manager for Kenya Power and Lighting (KP&L) and E.A. Cables' management agreed that 70-80% of the materials for the rural electrification programme could be made locally. (7) But due to the grants and zero-interest loans available from Finland and Denmark for this programme, all the distribution transformers, insulators, conductors and cables will be imported instead of being made locally. Moreover, from this experience, KP&L planning manager anticipates that local supplies would be economically priced. The managing director of E.A. Cables also confidently maintains, "we would like to be able to bid head-on against them because we think we can compete". And, indeed, they have won various internationally bid supply contracts for Kenya and Tanzania.

Despite the existence of local technical capacity to increase substantially the local content in aid projects, neither the government nor the telecommunications and electrical power companies have sought to depackage the aid below the level of components and thereby enable

Kenya to obtain raw materials (e.g. copper and aluminium rods, polyvinylchloride plastic) needed to manufacture cables and conductors locally. The KP&L Corporate Planning Manager states that:

Because we have no equity (in the cable manufacturing firm), we have not negotiated to de-package aid supplies.

This failure can have dire economic consequences. For instance, E.A. Cables, which used to supply most of the aluminium conductors for the Rural Electrification Programme, lost half and anticipated losing two-thirds of its previous Kshs.50 million market for these conductors because they were being received as a grant for the Rural Electrification Programme.

Water Pipes

The Greater Nakuru / ^{water} Supply Project is financed with French aid and executed by a French contractor for Kenya's Ministry of Water Development. The water pipes for the project are imported from a manufacturer in France and shipped to Mombasa by French transport firms in chartered French-registered ships. (8) As mentioned, KENFINCO also imports water pipes for its rural water supply projects. Yet Kenya has several factories with the capacity to manufacture both plastic and steel pipes. Moreover, the local plastic pipe manufacturers are running at merely 35% capacity utilization (Mwangi 1984) and the steel pipe manufacturers use merely 13% of their capacity (Coughlin 1985a: 25). Kenya would benefit more if the pipes were produced locally and just the steel or polyvinylchloride (pvc) inputs required to make the pipes were tied to French suppliers.

TOWARD MORE EFFECTIVE NEGOTIATIONS

The Finance Ministry's Department of External Aid does not frequently or consistently seek to receive raw materials instead of finished products from aid organizations even though this would increase local value added. The Department recognizes the need to "link aid to Kenya's own industrialization" by further increasing local content. (9) Toward this end, in 1982, the Cabinet also decided that Kenya should accept tenders for projects on an open (component) basis, rather than for "turnkey" projects.

Nevertheless, "the implementation of that decision still has to be articulated". (10) But the Department of External Aid has no regular or institutionalized links to industry; nor does it have economists well versed about Kenyan industries on its staff. Intermittent liaison with economists in other departments within the Ministry is insufficient; the task requires a full-time economist whose main responsibility is to increase the local content in aid projects. Lacking such contacts and information about what can be produced locally, the Department is ill-positioned to know how to negotiate so as to increase local content. Moreover, Kenya exploits only a small portion of its potential manoeuvrability in negotiating to increase local sourcing for inputs for aid projects.

A considerable margin sometimes exists for a sharp negotiator to align apparently conflicting interests, especially if the scope of the negotiations is widened and the recipient adopts a flexible approach. In some cases a donor may be amenable to untying the cables, steel or other component of a ^{project} or programme grant or loan. For instance, recently Tanzania successfully negotiated with Norwegian donors to import the raw materials to manufacture cables instead of importing the cables funded by aid for use in the local factory making transformers.

(11) Aid donors to Kenya have also shown some flexibility when requested to source locally, e.g. for electrical towers, railway-engine components, cement and electrical cables. Opportunities exist. Moreover, various competing sources for aid for particular projects often exist; and each source imposes different conditions concerning the source from which the recipient may obtain inputs for the projects. By diversifying the sources of aid, a developing country can reduce the burden of tied aid. Triangularization of tied aid has also been suggested whereby aid from the donor is used to pay for needed inputs from a third country (Mahbub ul Haq 1967: 335). The third country would then proceed to use the credits to make purchases from the original donor.

Often the bilateral donor's main interest is to ensure that most of the funds are spent on products from the donor country. Though pressure from special interest may exist, the donor country's government may not have strong preferences about exactly which products are purchased from it. If astute and armed with adequate information about the motivations and political situations of various donors, a Third World country's negotiators can take advantage of this indifference to assist local manufacturers.

A NEW NEGOTIATING TACTIC

The key idea proposed here is a tactic for use during negotiations for aid so as to increase local sourcing of inputs needed for aided projects. It involves persuading the donor to permit the aid receiving country to divert project aid funds to purchase different product -- perhaps not related to the project -- from the donor country. The recipient country would choose to import items from the donor that the recipient does not produce and must import anyway. Hence, the recipient would divert trade from established sources, and, by choosing from a wider range of the donor's products, select only items available at fairly competitive prices. Being financed by aid, these imports would free foreign exchange that would have been used to buy them from the previous sources. That foreign exchange would -- as per agreement -- have to be used to finance the local production costs plus the cost of the foreign materials or inputs needed to produce locally the items needed for the project. Thus the aid would become partly untied as to commodity and source but remain tied to a specific project. This approach would be a restrictive variant of aid tied to imports in general.

An example would help illustrate the approach. Kenya, say, is negotiating with West Germany for electrical cables for the Rural Electrification Programme though they are locally producible. If Germany produces exportable quantities of pvc but not aluminium rods, Kenya might agree to import pvc plus some totally unrelated product (e.g. steel billets) instead of finished cables. With the foreign exchange Kenya had been using to import steel billets from elsewhere, Kenya could

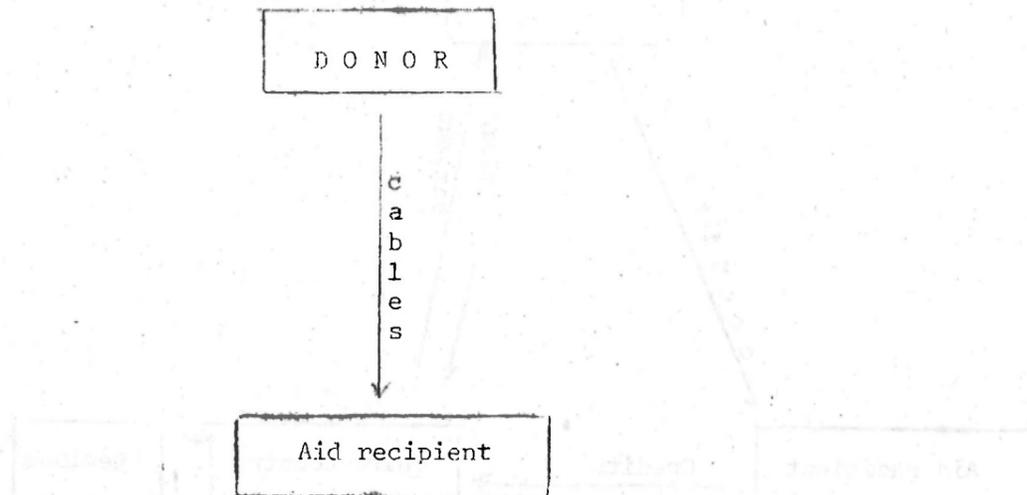
then purchase aluminium rods from any cheap source and still have extra foreign exchange. With the pvc and aluminium rods, a local manufacturer could be requested to make electrical cables, and be paid with the local equivalent of the extra foreign exchange released by the aid-financed steel billets.

The developing country would gain; the donor would not lose. So long as the trade diversion did not imply much higher prices, and the domestic resource cost ratio -- after considering the usually low opportunity cost of using local labour and the often underused local manufacturing capacities -- were favourable, the developing country would earn foreign exchange as well as create jobs in local enterprises. If the donor negotiated to ensure that the items purchased from it with the aid funds would really imply new imports, then it would not lose foreign exchange by permitting flexibility.

This proposed tactic differs from Mahbub ul Haq's triangularized aid credits. He only proposed triangularized credits to decrease the cost of tied aid (see Figure 1B). But triangularization could also be used to stimulate local production (e.g. of cables) by buying raw materials with the credits provided as aid instead of buying the final product from a third country (see Figure 1C). The tactic proposed here differs from even this revised variant of Mahbub ul Haq's triangularized aid in that the trade diversion is immediate. Moreover, it would not involve a donor in the extra-complicated negotiations with a third country needed to ensure that the transferred credits would be used for new imports (see Figure 1D) as might be variant in Figure 1C.

Figure 1: Aid Flows Under Alternative Approaches to Tied Aid

A: Tied aid and negated local production



B: Triangularized tied aid and indirect trade diversion without local production

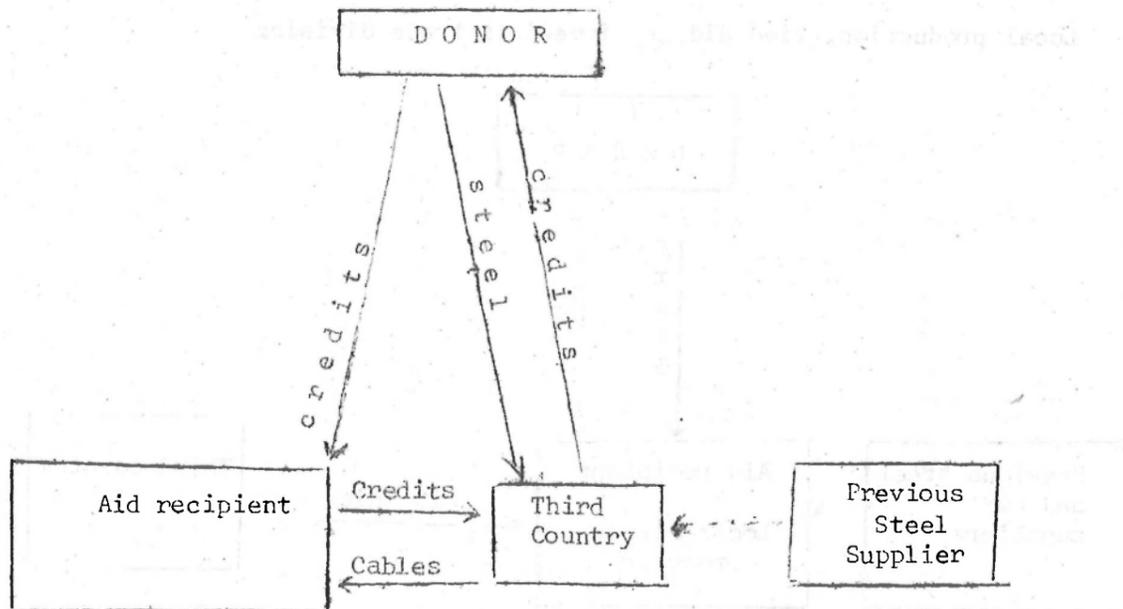
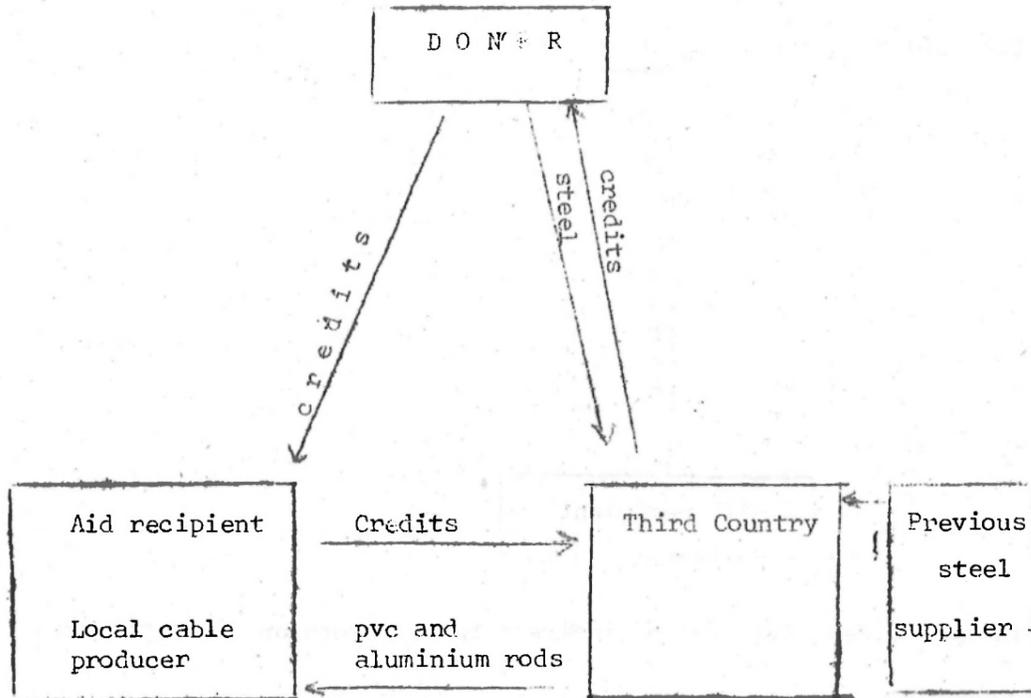
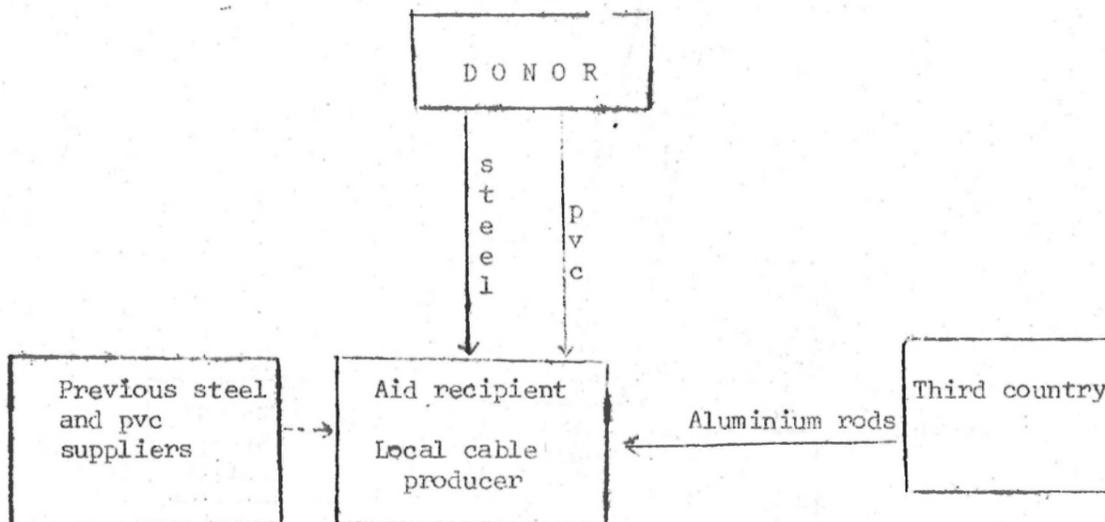


Figure 2:

C: Local production, triangularized tied aid and indirect trade division



D: Local production, tied aid and immediate trade division



CONCLUSIONS

Aid-tying has many pernicious effects upon manufacturing industries in developing countries. The often inflated costs of items so financed, the consequently inflated finance charges, plus the inappropriate choices of equipment sometimes obtained through tied aid can beleaguer or cripple an industry many years after its initial commissioning. Moreover, aid-tying can also have severely adverse macroeconomic implications for the entire manufacturing sector if there is not sufficient foreign exchange to import enough raw materials and spare parts to be able to properly use the industrial capacity being installed with the aid. Also, as illustrated by various examples from Kenya, aid-tying can directly cause a country to stifle some of its own local industries by importing locally producible items as part of aid-financed packages. To avert some of the more negative results of aid-tying, a developing country's aid negotiators need to be thoroughly informed of the industrial capabilities of their own country so as to know which components of an aid project are locally producible. They also require systematic information about the various donors' motivations and political circumstances that might influence their flexibility toward aid during negotiations.

By using flexible and better-informed negotiating tactics, astute Third World negotiators may well be able to decrease the cost of tied aid and stimulate more local production for aid projects. Toward this end, the article proposes an additional tactic for negotiating to receive raw materials instead of final goods and equipment financed by tied aid. The interests of the donor country to seeing its aid funds spent on its own products may be reconcilable with the recipient's desire to promote its industries -- if some creative flexibility is shown by both sides.

ENDNOTES

1. This article contains significant portions adapted from Mwau and Coughlin (1985) and Bagumisa and Coughlin (1986).
2. For reference see: Kappagoda 1978: 7-8; Payer 1974; Miksell 1986: 246-7; Mattrick 1967: 97-99; Wightman 1971.
3. A legitimate question -- outside the scope of this paper -- is, "Who is aiding who?" Whole aid programmes have been turned on or off in order to stabilize, intimidate or unseat regimes (e.g. Israel, Ethiopia, Somalia, Zimbabwe, Nicaragua, El Salvador, Chile) seen as friendly or antagonistic to the donors. For instance, as shown statistically, the concerns of power politics have been much more important in the allocation of US aid than "the economic and political structure and performance" of developing countries (McKinlay and Mughan 1984: 247). Moreover, despite aid, the net resource flows are overwhelmingly toward the developed countries (the donors) after one counts the large repatriations of interest, dividends, royalties and fees, and the massive outflows of funds and resources from developing countries as a result of transfer pricing and the brain-drain. This resource drain inspires questions about whether "aid" and aid personnel are sometimes provided to buttress friendly political forces within developing countries so as to continue the net extraction of resources. Advocates of this view, of course, recognize that some donors do not have such manipulative purposes, others are quite inconsistent in their goals, and most of the aid personnel are well-intentioned even though they sometimes unwittingly serve the grander designs of realpolitik. On the other hand, by ignoring many well-documented cases to the contrary, Mosley (1987: 43-44), for example, discounts the importance of donor efforts to impose policy conditions; and he rejects the claim that "aid ... has returned to the function of sustaining colonial structures and relationships".
4. Ministry of Water Development, Borehole Registry, Drilling, Legal and Water Bailiff Sections (Interviews, 20 May 1982, 8 June 1982, August 1983, May-June 1984, and 7 December 1984).
5. According to Mr. Timo Vuori (Project Manager), KENFINCO was established by the two Finnish multinationals of YIT Limited (general engineering and contracting company) and Finnin Consult (Consulting Engineers).
6. Timo Vuori, Project Manager, Interview, 22 March 1985.

7. A study of Kenya's water pumps industry in 1982 enumerated six manufacturers, ten assemblers, and seventeen large importers. Although the study focused on motor-driven centrifugal water pumps, it also revealed that 1,800 reciprocating pumps -- only some of which were handpumps -- were imported and sold in Kenya. Reciprocating pumps constituted 19% of all water pumps sold in 1980 (Begumisa 1982: 51-54).
8. Interview with Mr. Hinpai S. Jabal, Chief Planning Officer, Kenya Power and Lighting Company, 31 May 1985.
9. The Standard, Nairobi, Tuesday 27 December 1984, p.7.
10. Interview with Dr. Dang'ana, Director of External Aid, Ministry of Finance and Planning, 3 June 1985. Dr. Dang'ana had been appointed to this position only a few weeks before the time of this interview. Obviously, he is not accountable for the prior management of the department.
11. Ibid.
12. Interview on 7 August 1986 with Dr. Samuel Wangwe who served NORAD as a consultant with TANELEC Limited, a producer of electric transformers.

- Bacharach, S. and Lawler, E. (1981) Bargaining Power, Tactics and outcomes. San Francisco: Jossey-Bass Publishers.
- Begumisa, G. (1984) "Manufacture of Handpumps in Kenya: An Industrial Capacity Survey", Washington D.C., World Bank, Project No. UNDP INT/81/026.
- Begumisa, G. (1982) Machine Goods and Spareparts Industries: A Case Study of the Water Pumps Industry in Kenya, unpublished M.A. research paper, Economics Department, University of Nairobi.
- Begumisa, G. and Coughlin, P. (1986) "Aid and Technological Dependence: The Case of Handpumps in Kenya", Discussion Paper, Industrial Research Project, Economics Department.
- Brecher, I. and Abbas, S. A. (1972) Foreign Aid and Industrial Development in Pakistan. (Cambridge University Press).
- Carty, R., and Smith, V. (1981) Perpetuating Poverty: The Political Economy of Canadian Foreign Aid. Toronto: Between the Lines Press.
- Cohen, J., Merilees, S. and Walker, S. (1985) "Foreign Aid and Conditions Precedent: Political and Bureaucratic Dimensions", World Development, Vol.13, No.12, December.
- Coughlin P. (1983) "Converting Crisis to Boom for Kenyan Foundries and Metal Engineering Industries: Technical Possibilities versus Political and Bureaucratic Obstacles", Institute for Development Studies (Nairobi), Working Paper No.398.
- Coughlin, P. (1986c) "Decisions and Their Financial Implications at Nzoia Sugar Company", a paper presented to a Friedrich Ebert Foundation Seminar on the Kenya Sugar Industry and Sugarcane Outgrowers Organizations. Webuye, Kenya, 7-10 September.
- Coughlin, P. (1985a) The Kenyan Steel and Steel-Related Industries: A Programme for Domestic Reliance and Export Promotion. Monograph, Industrial Research Project, Economics Department, University of Nairobi.

- Edwards, E. O. (1968) "Development Planning in Kenya since Independence", East African Economic Review, Vol.4, No.2, December.
- Ghuri, P. N. (1983) Negotiating International Package Deals: Swedish Firms and Developing Countries, Doctoral Thesis, Uppsala University.
- Gray, C. S. (1971a) "The Impact of Foreign Aid for Local Costs on the Donor's International Receipts", East African Economic Review, Vol.3, No.1, June.
- Gray, C. S. (1971b) "Tied versus Local-Cost Foreign Aid in the Light of Aid Objectives", East Africa Economic Review, Vol.3, No.2, December.
- Halmilton, C. (1976) Economic Effects in Developing Countries of Donor-Imposed Conditions on Foreign Aid. Institute for International Studies, Fack, Stockholm, Seminar Paper No.58, June.
- Hayter, T. and Watson, C. (1985) Aid: Phetoric and Reality. London: Pluto Press.
- Heyer, J., Maitha, J. K. and Senga, W. M. (1976) Agricultural Development in Kenya: An Assessment. Nairobi: Oxford University Press.
- Holtham, G. and Hazlewood, A. (1976) Aid and Inequality in Kenya. London: Overseas Development Institute.
- Jones, D. (1983) "The Involvement of Aid Donors in Recipient Country Public Policy Processes", Paper presented at the Society for International Development Conference on Management for Development, March 1983, Nairobi.
- Kappagoda, N. (1976) The Cost of Foreign Aid to Development Countries. Ottawa: International Development Research Centre.
- Kenya Govt. (no date) Report on arid and semi-arid lands (ASAL), Development in Kenya: The Framework for Implementation, Programmed Planning and Evaluation. (mimeo).
- Kenya Govt. (1986) Economic Survey. Central Bureau of Statistics Nairobi: Kenya Government Printer.
- Kenya Govt. (1985) Compendium on Development Co-operation with Kenya as of 30th June, 1984. Ministry of Finance and Planning, Nairobi.

- Kenya Govt. (1985) Import Licensing Schedules. Nairobi: Government Printer.
- Kenya Govt. (1984) Development Plan 1984-1988, Nairobi: Government Printer.
- Kenya Govt. (1979) Development Plan 1979-1983, Ministry of Economic Planning and Development, Nairobi: Government Printer.
- Kenya Govt. (1965) Sessional Paper No.10 of 1965. Kenya National Assembly, Nairobi: Government Printer.
- Mahbub ul Haq (1976) "Tied Credits -- A quantitative Analysis". In: J. Adler and P. Kuznets (eds), Capital Movements and Economic Development. London. Macmillan.
- Maizels, A. (1982) "Towards a Political Economy of the New International Economic Order". In: For Good or Evil: Economic Theory and North-South Negotiations. Toronto: University of Toronto Press.
- Mann, J. S. (1967) "The Impact of Public Law 480 Imports on Prices and Domestic Supply of Cereals in India", Journal of Farm Economics, Vol.49, No.1, February.
- McKinlay, R. D. and Mughan, A. (1984) Aid and Arms to the Third World: An Analysis of the Distribution and Impact of US Official Transfers. London: Frances Printer.
- Mettrick, H. (1967) Aid in Uganda-Agriculture. London: Overseas Development Institute.
- Miksell, R. F. (1986) The Economics of Aid. London: Raymond F. Miksell.
- Memnon, U. (1980) "World Bank and Transfer of Technology: Case of Indian Fertilizer Industry", Economic and Political Weekly (Bombay), August 23, 1980, as quoted by Payer, 1982, p.143.
- Mosley, P. (1987) Overseas Aid: Its Defence and Reform. Sussex: Wheatsheaf Books.