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Impact of Foreign Aid on Economic Development in Pakistan [1960-2002]

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“IMPACT OF FOREIGN AID ON ECONOMIC DEVELOPMENT IN PAKISTAN (1960-2002)”

By: Ghulam Mohey-ud-din

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“IMPACT OF FOREIGN AID ON ECONOMIC DEVELOPMENT IN PAKISTAN (1960-2002)”

Ghulam Mohey-ud-din *

ABSTRACT

The Two-Gap Model suggests that the Poor countries have to rely on the foreign resources to fill the two Gaps: Import-Export Gap and the Savings-Investment Gap. There are many forms of the foreign resources like FDI (Foreign Direct Investment), External loans & Credit, technical assistance, Project & non-project aid etc. But UDC's (including Pakistan) don't have the investment friendly policies. So, they have to rely on the Foreign aid and Debt rather than FDI and portfolio investments. The role of these external resources always remains questionable.

This paper analyzes the trends and structure of the foreign aid in Pakistan during 1960-2002 and its role and effectiveness in the economic development in Pakistan.

KEY WORDS

Foreign capital inflows (FCI), Foreign Aid, Economic Development, Foreign Economic Assistance, Official Development Assistance (ODA), Foreign Debt Burden, Aid and Growth, Trends and Structure of Aid, Aid Effectiveness.

I - INTRODUCTION

“A country is Poor because she is Poor” is an oft-quoted maxim, i.e. poverty is not only the cause but also the consequence of poverty. Consequently, the underdeveloped countries (UDC) like Pakistan are entrapped in a “Vicious Circle of Poverty”. Because of low incomes, the saving ratios also remain low, resulting in low investment levels. At the same time, due to low income the taxable capacity remains lower, i.e. government earnings also remain low. In such situations, the UDCs have to face saving-investment deficit as well as the deficit in balance of payments (BOP). The *Two-Gap Model* suggests that developing countries have to rely on the foreign capital inflows (FCI) to fill these two gaps: the import-export gap and the saving-investment gap.

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There are many forms of the FCIs, which includes the grants, loans, foreign direct investment (FDI), export credit, project/non-project assistance, technical assistance and emergency relief etc. Regardless of the fact that all the UDCs need FCIs for their development, the amount and the form of the foreign economic assistance (or FCI) differs from country to country. The country size and the economic circumstances of the country are the major determinants of the volume and the form of the FCI. For instance, the LDCs (Least Developed Countries) of the Africa have been relying on the foreign aid, while the developing countries of the East-Asia are largest beneficiary of the Foreign Direct Investment (FDI).

In case of Pakistan, the foreign aid is a major form of the foreign capital inflow and has a significant role for the country's economic development. The trends and the patterns have shown that the FDI, portfolio investment and borrowing through private sources have also increased sharply. But Pakistan is still unable to attract such FCIs. Pakistan lacks physical, financial & human capital as well as political & macroeconomic stability. So, it has to rely on foreign aid or foreign debt.

The need of foreign aid can be justified on the following grounds: Firstly, the main argument is "*Two-Gap Model*", that is, deficits in BOP and deficit in savings is major argument in favour of foreign aid, as described earlier. Secondly, the external assistance is also assumed to facilitate and accelerate the process of development by generating additional domestic savings as a result of the higher growth rates (that is presumed to induce by the accurate utilization of foreign aid). Eventually, it is hoped that the need for the concessional aid will disappear as local resources become able to make development self-sustaining.

Thirdly, the financial assistance needs to be supplemented by the technical assistance in the form of high-level worker transfer to ensure that the aided funds are utilized most efficiently to generate economic growth.

This *Labor-Gap-Filling* process is thus becomes analogous to the *Financial-Gap-Filling* process.

Finally, the amount of aid should be determined by the recipient country's *Absorptive Capacity*.¹ Typically the donor countries decide which LDC is to receive the aid, how much, in what form, for what purpose and under what conditions on the basis of the their donor countries' assessment of LDC's absorptive capacity.

The main objective of this paper is the analysis of the effectiveness of the foreign aid in economic development of Pakistan. The organization of this paper follows as: a detailed survey of the related literature on this topic is presented in next section (Section – II). The section – III deals with the trends and composition of foreign aid in Pakistan. The impacts of the foreign aid in Pakistan are analyzed in Section – IV, while the last section – V gives the conclusion and the policy recommendations.

II – REVIEW OF LITERATURE

The role of foreign economic assistance in economic development and growth remains contentious in economic literature. Some studies proved its positive impact on the economic development empirically, while some studies highlighted its negative effects as well. As Chenery and Strout (1966) concluded, on the basis of empirical evidence from LDCs, that foreign capital has a positive effect on the economic growth. Afterwards some other studies also argued that foreign economic assistance stimulate the economic growth.

However, some other economists like Leff (1969) and Griffin (1970) have analyzed its negative impacts on growth. They argued that the Foreign aid could adversely affect the economic growth by substituting the domestic savings. So, the literature on effectiveness of foreign aid shows both, positive as well as the negative effects, of foreign aid on the economic development. Hansen and Tarp (2000) run a regression between aid and the growth. It is shown that aid increases the growth rate, and this result is not conditional on

¹The term '*Absorptive Capacity*' is defined as "the ability of a country to absorb the foreign assistance to use the funds in a wisely and productive manners" (Todaro, 2001)

'good' policy. There are, however, decreasing returns to aid, and the estimated effectiveness of aid is highly sensitive to the choice of estimator and the set of control variables. When investment and human capital are controlled for, no positive effect of aid is found. Yet, aid continues to impact on growth via investment. We conclude by stressing the need for more theoretical work before this kind of cross-country regressions are used for policy purposes.

Burnside and Dollar have constructed an index of three policies (on fiscal surplus, inflation, and trade openness), interact it with foreign aid, and instrument for both aid and aid interacted with policies. They find that aid has a positive impact on growth in developing countries with good fiscal, monetary, and trade policies. In the presence of poor policies, on the other hand, aid has no positive effect on growth.

The role of foreign aid varies from country to country. Pakistan has been relying on the foreign aid to support its development programs since independence. And the aid still has a larger proportion in the foreign capital inflows to Pakistan. In Pakistan, several economists have tried to find out the role of foreign aid in economic development of Pakistan. As, Shabbir & Mahmood (1992) and Khan & Rahim (1993) concluded that the aid has accelerated the rate of growth of GDP. Aslam (1987) examined that the public FCI did not affect the domestic investment significantly, while the private FCI covered the domestic saving-investment gap.

Some other studies were carried out to analyze the impact of aid on savings in Pakistan. Khan, Hasan and Malik (1992) estimated that the FCI caused to decline national savings in Pakistan during the period of 1959-60 to 1987-88. Shabbir and Mahmood (1992) also found the negative impact of foreign capital on the national savings in Pakistan for the same period. Mahmood (1997) found that country may caught in a sever debt problems due to macroeconomic mismanagement, misutilization of aid and inappropriate policies.

Khan (1993) concluded that foreign aid has played an extremely important role in influencing the pace of development, especially investments and imports have to a large extent depended upon the amount of foreign aid. However, this dependence on foreign aid, on the other hand, has led to the emergence of rising debt burden.

In short, we can conclude on the review of the above literature on the aid effectiveness in Pakistan that foreign aid has stimulated the economic growth on one hand and has substituted the domestic savings on the other hand. And it caused a severe debt serving problems in Pakistan. Accordingly, aid has a positive impact on growth in developing countries with good policies. In the presence of poor policies, on the other hand, aid has no positive effect on growth.

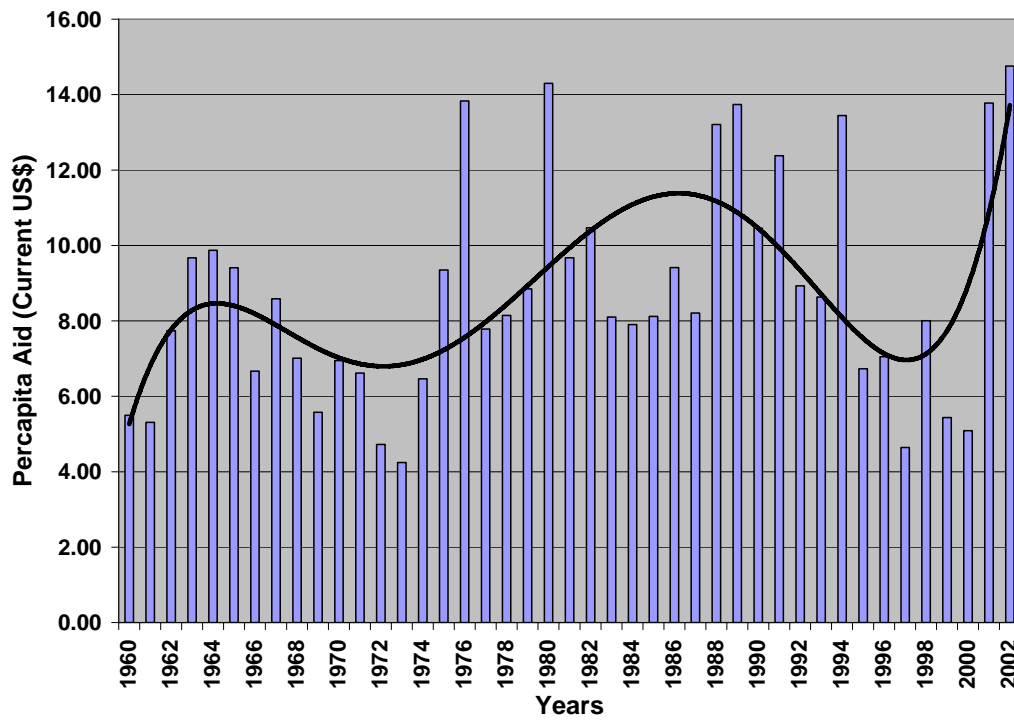
III - TRENDS AND COMPOSITION OF AID

TRENDS AND PATTERNS OF FOREIGN AID IN PAKISTAN

In Pakistan almost the earliest dispute, in the cabinet of the first Prime Minister (Liaquat Ali), was over the principle of foreign aid. Three times in 1950 the Government of Pakistan refused the proposed American Assistance. The cabinet also split in the same year over the question of going to World Bank for loans. Ultimately it is the influence of Chaudhri Mohammad Ali which persuaded the decision in the favour of taking aid and loans. The Common Wealth aid, promised through the Colombo Plan, was however accepted. (Hasan: 1999)

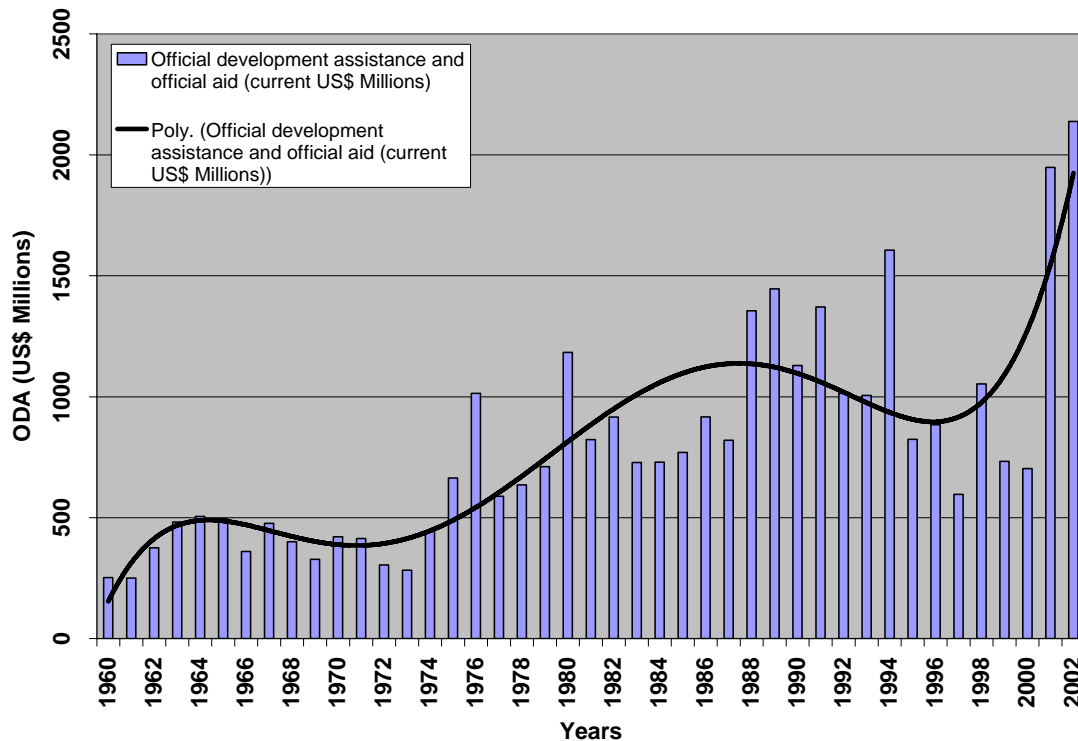
Accordingly for the first time, Pakistan accepted the Common Wealth Aid under the Colombo Plan in 1950's. And then in sixties, there was the emergence of the so called *Growth Man-ship*, which suggests that there should be a high growth rate (minimum double of the population growth rate). In most of UDCs, (including Pakistan) the population growth rate was about 3%. Thus the growth rate of 6% was assumed as a target for the rapid economic development. And according to the *Harrod-Domar Growth Model*, to achieve the target of 6% growth rate the savings (investments) must be equal to the 18-20%.

Figure 1: Per Capita Aid to Pakistan (1960-2002)



Source: World Bank Online Database²

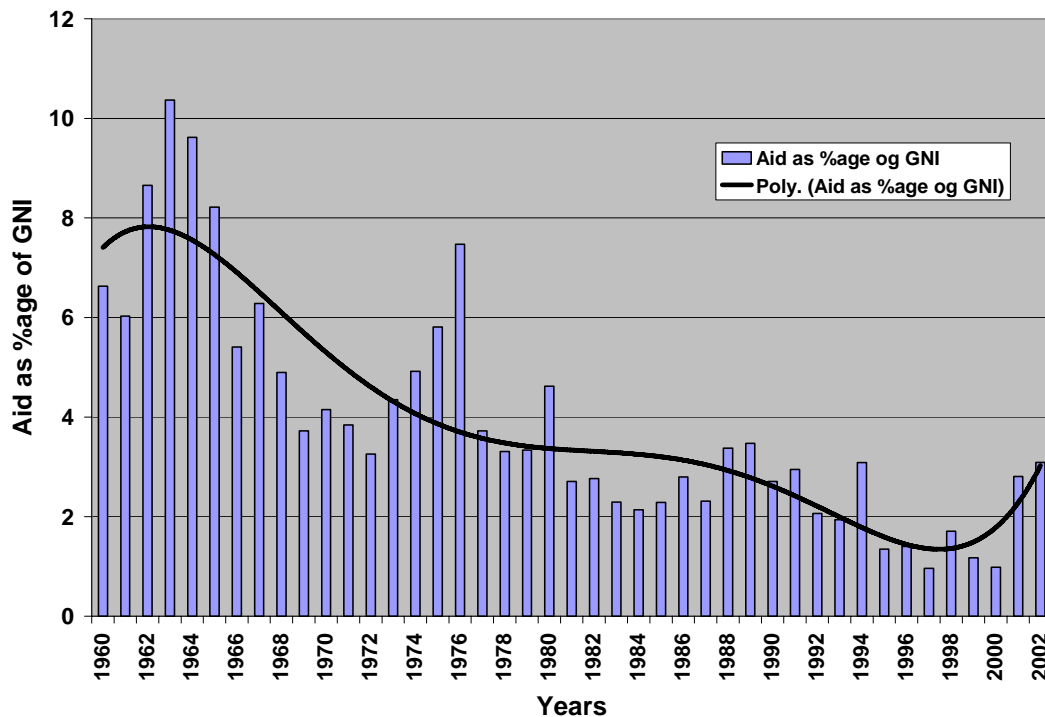
Figure 2: Pakistan: Official Development Assistance (ODA) and Official Aid (Current US\$ Millions)



Source: World Bank Online Database [<http://devdata.worldbank.org/wbquery>]

² Global Development Network (GDN) & World Bank Data Query Available on World Wide Web (WWW) at [<http://devdata.worldbank.org/wbquery>]

Figure 3: Aid as a %age of GNI in Pakistan (1960-2002)



Source: World Bank Online Database [<http://devdata.worldbank.org/wbquery>]

But all the UDCs were in the severe saving-investment deficit, so they had to rely on the foreign aids and loans to balance this saving-investment gap. Similarly, in 1960's Pakistan received the huge amount of foreign aid for second five year plan, as shown in the Fig: 01 and in the Fig: 02. The Fig: 01 shows the per capita aid (current US\$) received by Pakistan during 1960-2002, while the Fig: 02 shows the Official Development Assistance (ODA) and Official Aid (in Millions of Current US\$). In both Fig: (01 & 02)³ the actual data is shown in columns and a (5th order) polynomial trend line is drawn to analyze the trend of Per Capita Aid and ODA over the period of 1960-2002.

The figures (Fig: 01 and Fig: 02) depict an altering behavior of foreign aid over the time (1960-2002) in terms of both ODA as well as Per Capita Aid. From 1960 to 1966 there is an increase in Aid, during 1968-73 a declining trend and there is a rising trend in the era between 1978 to 1988. There is another period of decline in aid from 1990 to 1998, while there is swift increase in the

³ For the detailed data on the Per capita Aid and ODA and other variables during 1960-2002, See Appendix: Table: 03

aid after 2000 in terms of both ODA and Per Capita aid. But the over all trend of foreign aid in Pakistan (during 1960-2002) is increasing.

Although the net amount of ODA and per Capita Aid increased over this period, but the aid in proportion to GNI (Gross National Income) decreased. As depicted in the Fig: 03, there is overall declining trend in “Aid as %age of GNI”. Thus we can say foreign aid increased less proportionally to the Gross National Income in Pakistan. This analysis also depicts some interesting facts that during all the military regimes (1960-66, 1978-88 and 2000 to onwards) Pakistan received huge amounts as a foreign aid. So, it will be true to say that amount of aid depends on political considerations rather than economics considerations.

COMPOSITION AND STRUCTURE OF FOREIGN AID IN PAKISTAN

Foreign aid to Pakistan mainly distributed into two major types, that is project aid and non project aid, while non-project aid is further sub-divided into; food, non-food, BOP and relief aid. The Table No. 1 and Fig No.4 present the distribution of total foreign aid to Pakistan by types. It is very clear that share of the project aid remained higher during the period of 1952-53 to

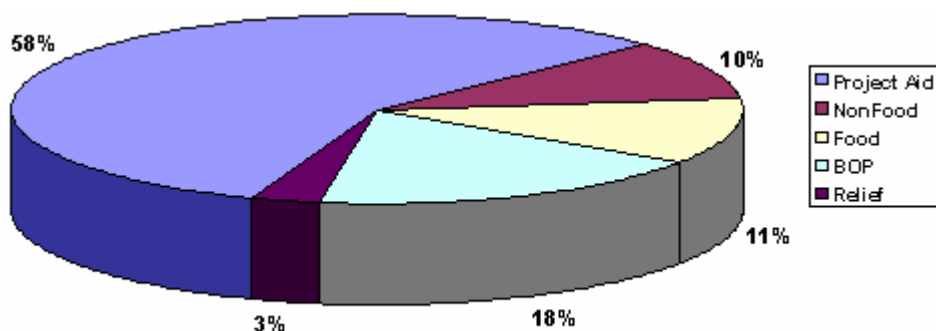
Table 1: Aid Disbursement to Pakistan by type (1952-2002)

<i>Disbursed Aid to Pakistan (1952-2002) by Type (in US\$ millions)</i>						
Plan /Year	Project Aid	Non Project Aid				Total
		Non Food	Food	BOP	Relief	
Pre Plan (1952-55)	170	48	119	-	-	337
1st Plan (1956-60)	406	244	192	-	-	842
2nd Plan (1961-65)	1209	420	765	-	-	2394
3rd Plan (1966-70)	1811	763	469	-	-	3043
Non Plan (1971-78)	2543	1299	785	1090	-	5717
5th Plan (1979-83)	3363	950	36	531	643	5523
6th Plan (1984-88)	4882	791	776	-	734	7183
7th Plan (1989-93)	7643	1922	1558	413	545	12081
8th Plan (1994-98)	9564	61	1923	1139	61	12748
9th Plan (1999-03)	4991	-	502	8307	35	13835
Total	36582	6498	7125	11480	2018	63703

Source: Govt. of Pakistan, Statistical Supplement: Economic Survey of Pakistan (2002-03)

2002-03 i.e. 58%, while the shares of the food, non-food, and BOP and relief aid are 10%, 11%, 18% and 3% respectively.

Figure 4: Distribution of Total Aid Disbursed during (1952-2002)



Source: Govt. of Pakistan, Statistical Supplement: Economic Survey of Pakistan (2002-03)

The data of ODA (official development assistance) received during the year 2002-03, shown in Table No. 2. The list of the top ten donor of aid (ODA)

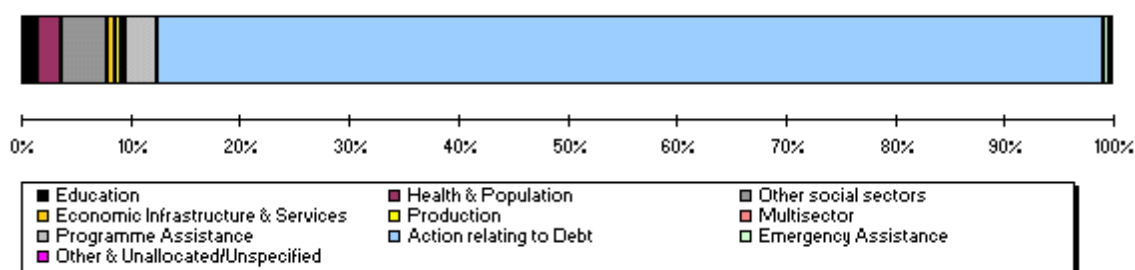
Table 2: Pakistan: Official Development Assistance (2001-20003)

Receipts	2001	2002	2003
Net ODA (USD million)	1 948	2 138	1 068
Bilateral share (gross ODA)	53%	33%	71%
Net ODA / GNI	3.4%	3.6%	1.5%
Net Private flows (USD million)	- 153	- 288	- 398

For reference	2001	2002	2003
Population (million)	141.5	144.9	148.4
GNI per capita (Atlas USD)	420	420	470

Top Ten Donors of gross ODA (2002-03 average) (USD m)		
1	United States	656
2	IDA	523
3	SAF & ESAF (IMF)	408
4	Japan	284
5	France	250
6	AsDF	186
7	United Kingdom	106
8	Germany	58
9	EC	38
10	Arab Countries	22

Bilateral ODA by Sector (2002-03)



Source: OECD Website ⁴

⁴ Organization for Economic Co-operation & Development (OECD)'s website [<http://www.oecd.org>]

to Pakistan is shown in the upper-right corner of the Table No. 2 that USA remained the major donor to Pakistan and provided the 656 million US\$ to Pakistan in 2002-03. The other top donors are shown in the table. After analyzing the top ten donor list it becomes clear that Pakistan is highly dependent upon the USA, IDA, IMF and Japan, as they are the top 4 donors to Pakistan in 2002-03.

The lower portion of Table No. 2 depicts the sector-wise allocation of the ODA received by the Pakistan in 2002-03. It is clear that the major share of the bilateral ODA is goes to the “action related to debt”, whereas the share of the education, infrastructure & services, health & population and the other social sectors remained very low.

Hence, the above analysis depicts that Pakistan’s economy is heavily dependent upon the USA, Japan and IMF for the foreign aid. And the major portion of the foreign economic assistance goes back to the repayment of the loans and the debt servicing.

IV - IMPACTS OF FOREIGN AID

Different types of studies were under taken in order to understand the impacts of foreign capital inflows (FCIs) on the economic development. And the different methods and variables were used to analyze the role of foreign aid in economic development. Some studies focused on the study of aid’s impacts on the domestic savings, investments and capital formation, while some other researcher paid much attention to study the role aid on the debt burden, GDP growth etc. Some other studies focused upon the impact of aid on the different sectors of the economy like the agricultural sector, energy and the industrial sectors, social sectors (like health and education etc.).

It is difficult to analyze the effect of foreign aid on all the sectors and variables, as described above, in a single paper. Therefore, I narrow down my analysis to only two variables that are, GDP growth and the Debt burden. Here I have tried to analyze the impacts of foreign aid on GDP and the overall Debt Burden.

THE AID AND GROWTH OF GDP

Many studies were carried out to analyze the impact of the foreign aid on the GDP growth rate, as discussed in the literature review of section of this paper. In order to analyze the impact of foreign aid on GDP in Pakistan, the data on the ODA and the GDP (measured at the constant prices of 2000) is used.⁵ The quadratic regression model is fitted to the data. The quadratic model is given as:

$$\text{GDP} = \alpha + \beta_1 \text{ODA} + \beta_2 \text{ODA}^2$$

The results of the estimated model are given as:

$$\text{GDP} = -4371.2492 + 64.4 \text{ODA} - 0.014 \text{ODA}^2$$

Coefficient Data:

Overall Significance of model (F - Statistic) = 24.92458606177 *

$\alpha = -4371.2492$

$\beta_1 = 64.402631$ (t statistic = 3.48)*

$\beta_2 = -0.013780676$ (t statistic = -1.69)**

R squared = 0.579068 = 58%

Standard Error = 14794.9028265

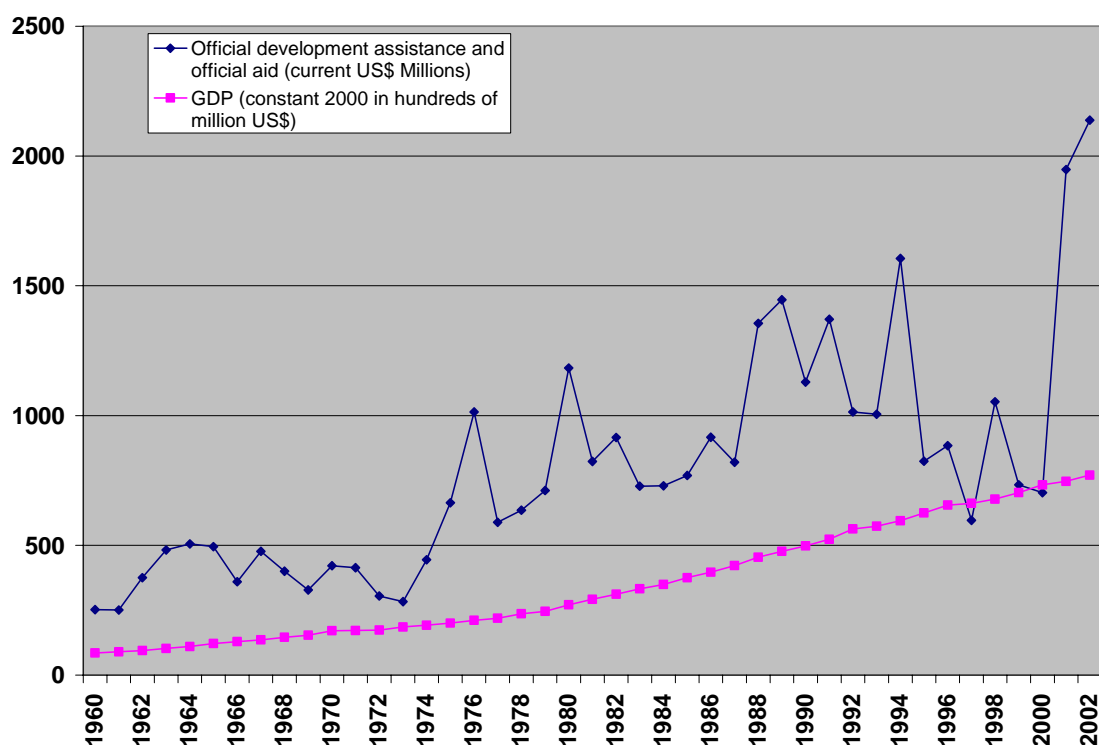
Correlation Coefficient (r) = 0.7609605 = 76%

The result depicts the positive effect of aid on the GDP in Pakistan (during 1960-2002) as the “ β_1 ” (the coefficient of regression) has a positive sign. But the “ β_2 ” has negative sign showing that the GDP increases as the ODA increases but at the decreasing rate. All the coefficients are significant. The value of R-Squared is 58%, that is, it explains that the 58% variations in GDP explained with the help of the ODA. And there is 76% correlation among the ODA and GDP in Pakistan. This positive correlation between GDP and ODA is also depicted in the Fig No. 5:

⁵ See Table No. 4 in Appendix for data on GDP and ODA

* Significant at 1% level of significance

** Significant at 10% level of significance

Figure 5: Official Development Assistance and the GDP

Source: World Bank Online Database [<http://devdata.worldbank.org/wbquery>]

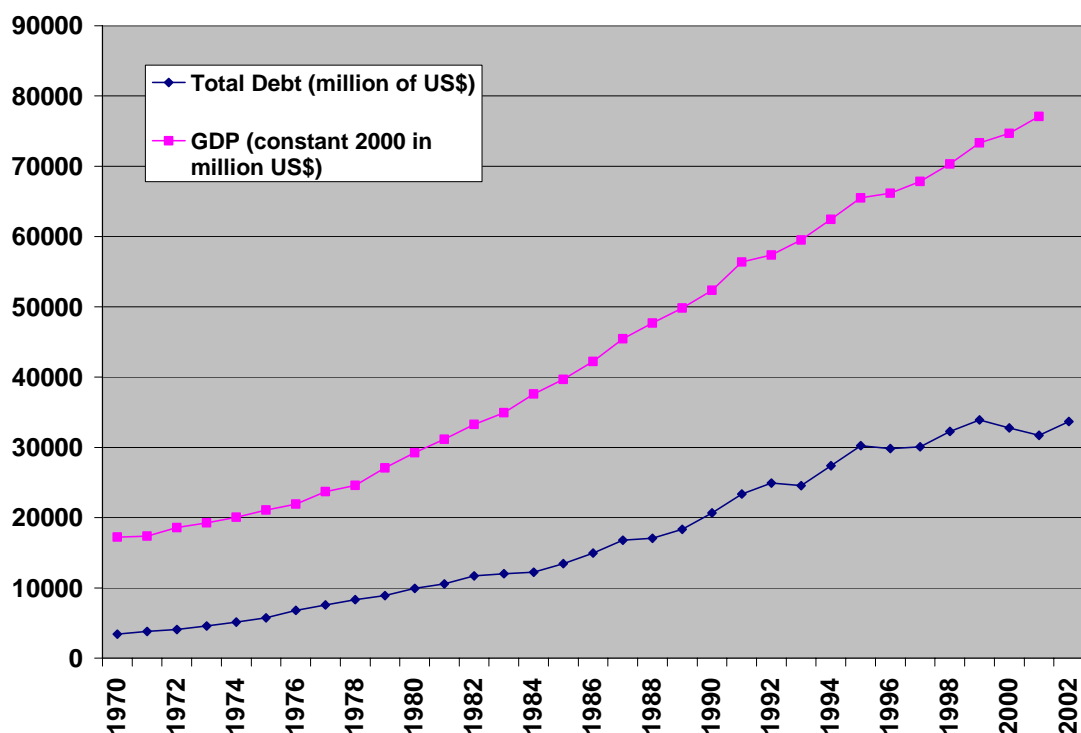
Thus, we can conclude that there is a positive relation between the GDP and the ODA in Pakistan. GDP increases at the declining rate with the increase in the flow of the ODA.

AID AND DEBT BURDEN

The burden of excessive dependence on the foreign aid has been caused by the: firstly, the shift in the composition of foreign aid from grants to hard loans has, over the time, taken up a relatively large share of the gross aid for debt servicing thereby reducing the amount of net aid available for financing the imports and investments. Secondly, the terms and conditions attached to tied credits have imposed both economic as well as political costs on the country (Khan, 1993).

The increased debt burden in Pakistan can be depicted by the Fig. No.6. It shows that the amount of external debt rises over the period of the 1970-2002 in Pakistan. It is clear that the overall debt burden also rises as the flow of foreign capital also increased over the same period.

Figure 6: The Total External Debt to Pakistan (1970-2002) in Millions US\$



Source: World Bank Online Database [<http://devdata.worldbank.org/wbquery>]

V - CONCLUSION

The current study shows both positive as well as the negative effects of foreign aid on the economic development. Foreign aid, on positive side, has helped in boosting the GDP Growth through structural transformation of the economy, laid foundations of the industrial and agricultural sectors, provided technical assistance, policy advice and modern technology, assisted in overcoming the budget deficits and the BOP deficits and has also funded the projects for the social sector development projects. As the regression analysis of the GDP and the ODA confirms the positive affect of Official Development Assistance (ODA) on the GDP. GDP increases at the decreasing rate, as the flow of foreign capital increases. Thus, the overall impact of the aid on the economic development is positive.

But on the negative side, aid seemed to have substituted for domestic savings, increase debt burden. As the various debt indicators depicts that Pakistan's debt burden increased over time and the country may caught in severe debt servicing problem if the macroeconomic management, foreign trade and domestic saving policies are not designed and implemented appropriately.

The policies are also important in the effectiveness of foreign aid, as the aid has a more positive impact on growth in with good fiscal, monetary, and trade policies. In the presence of poor policies, on the other hand, aid has no positive effect on growth. Accordingly, there is a need of not only good policies but also the implementation of these policies as well as the proper monitoring of the aid-utilizing projects is necessary in order to avoid the misutilization and the mismanagement of the foreign capital resources.

Consequently we can say, the aid may be helpful in boosting economic growth only under the presence of appropriate monetary, fiscal and the trade policies.

APPENDIX: DATA AND STATISTICS

Table 3: Data showing Foreign Aid Trends and Patterns in Pakistan

Years	<i>Aid (% of central government expenditures)</i>	<i>Aid (% of GNI)</i>	<i>Aid (% of gross capital formation)</i>	<i>Aid (% of imports of goods and services)</i>	<i>Aid per capita (current US\$)</i>
1960	..	6.630544	58.86302	..	5.499771
1961	..	6.026101	36.66479	..	5.309186
1962	..	8.653854	48.84152	..	7.742896
1963	..	10.36798	50.87576	..	9.673129
1964	..	9.618161	48.03884	..	9.874679
1965	..	8.217436	39.15985	..	9.40908
1966	..	5.409806	34.88032	..	6.665194
1967	..	6.283821	38.55457	..	8.58583
1968	..	4.894044	27.48405	..	7.014392
1969	..	3.72502	25.76191	..	5.578901
1970	..	4.15307	26.59925	..	6.950022
1971	..	3.842998	24.96731	..	6.616287
1972	..	3.256564	23.10448	..	4.722751
1973	..	4.352538	34.58876	..	4.244139
1974	..	4.918707	37.91818	..	6.464308
1975	..	5.80789	36.08843	..	9.349175
1976	..	7.472723	44.08217	36.05414	13.83108
1977	..	3.724027	20.20004	18.30464	7.78537
1978	..	3.309863	19.9656	15.51175	8.147615
1979	..	3.336377	20.18548	13.13402	8.849579
1980	..	4.621305	27.02224	17.64009	14.3008
1981	..	2.708115	15.60128	11.79125	9.672253
1982	..	2.763463	15.46923	12.6166	10.4705
1983	..	2.28931	13.49384	10.12581	8.102468
1984	..	2.139483	12.8145	9.092813	7.903295
1985	..	2.285517	13.48767	9.885303	8.118409
1986	..	2.795182	15.3038	11.51779	9.414314
1987	..	2.312238	12.85213	9.671507	8.205538
1988	..	3.377564	19.55715	14.21463	13.20789
1989	..	3.473894	19.03757	14.14852	13.73872
1990	14.42912	2.705744	14.90538	9.917955	10.45843
1991	16.57111	2.947265	15.85465	11.18443	12.38004
1992	10.75443	2.063545	10.3031	7.303484	8.929486
1993	10.04679	1.938512	9.381165	7.377136	8.633924
1994	15.91664	3.086107	15.82893	11.70765	13.4472
1995	7.301299	1.3484	7.325476	5.050495	6.731525
1996	7.253874	1.400889	7.349579	4.960971	7.049366
1997	5.110678	0.9627382	5.329852	3.779949	4.641853
1998	9.213367	1.708757	9.560105	7.334169	8.002918
1999	6.500468	1.174072	7.47747	5.379303	5.43757
2000	5.733341	0.9843713	5.516449	4.852044	5.089586
2001	17.63112	2.809873	15.85268	13.6622	13.77326
2002	16.94498	3.090837	17.83099	14.17616	14.75607

Source: World Bank & GDN Online Database [<http://devdata.worldbank.org/wbquery>]

Table 4: Official Development Assistance and GDP Growth

<i>Years</i>	<i>Official development assistance and official aid (current US\$ Millions)</i>	<i>GDP (constant 2000 Million US\$)</i>
1960	252.17	8534.943
1961	250.7	9045.96
1962	375.91	9451.477
1963	482.38	10272.7
1964	505.62	11050.32
1965	494.72	12201.69
1966	360.01	12908.16
1967	476.71	13605.28
1968	400.66	14589.38
1969	328.11	15392.95
1970	421.22	17140.59
1971	413.78	17220.87
1972	304.89	17360.94
1973	282.88	18587.37
1974	444.83	19245.39
1975	664.1	20055.9
1976	1013.89	21090.02
1977	588.78	21922.59
1978	635.37	23687.03
1979	711.1	24577.3
1980	1183.11	27088.04
1981	823.07	29233.62
1982	915.5	31144.77
1983	727.86	33255.87
1984	729.35	34940.35
1985	769.58	37593.06
1986	916.52	39661.31
1987	820.17	42220.39
1988	1355.42	45439.81
1989	1446.27	47693.52
1990	1129.25	49819.98
1991	1371.09	52341.65
1992	1014.05	56375.04
1993	1005.37	57365.98
1994	1605.62	59509.98
1995	823.77	62463.23
1996	884.06	65490.56
1997	596.28	66154.89
1998	1053.04	67841.99
1999	732.93	70325.1
2000	702.77	73321.01
2001	1948.23	74684.78
2002	2138.19	77088.91

Source: World Bank & GDN Online Database [<http://devdata.worldbank.org/wbquery>]

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