Does Aid Spur Economic Growth?

MusaTalba JIBIR,1 Salamatu Idris ISAH2 & Bello A. IBRAHIM3

1 Department of Economics, Ahmadu Bello University, Zaria, Nigeria, Email: mtdjibir@gmail.com
2 Department of Economics, Ahmadu Bello University, Zaria, Nigeria, Email: sisah71@yahoo.com
3 Department of Economics, University of Maiduguri Pmb 1069 Maiduguri, Nigeria

Development Assistance is based on the idea that Rich Countries can and should help Poor countries to find the path to sustainable economic growth and poverty reduction—especially those that lack sources of capital. The paper began by reviewing the various sources and composition of net capital flows to developing countries and examined the respective roles of private and public flows in social program it further discussed the arguments and evidence on both sides of the question of whether aid is effective in promoting economic growth. The evidence of a direct effect on growth is inconclusive. Does this mean that aid should be cut back? Not necessarily. The impact of Aid should be evaluated not only in relation to its direct effects, but also in terms of its role in improving governance and economic management, and its contribution to social amenities such as basic education, health care facilities and access, water and infant mortality.

Key words: Economic Aid, Economic Growth, Development Assistance

INTRODUCTION

Many studies have examined the relationship between aid and growth, with mixed findings. Some have found that aid has no effect on growth and may actually undermine it (for example, Easterly, 2001); others have suggested that, on average, aid has a positive relationship to growth, although not in every country and with diminishing returns. Still others find that aid has a conditional relationship to growth, accelerating it only under certain circumstances (Radelet, Clemens, and Bhavnani, 2005). Rajan and Subramanian (2005) find no clear effect at all, positive or negative. Their finding holds across time periods, regardless of the donor or type of aid, and regardless of the characteristics of the recipient country.

“AID HOBBLES GROWTH”

Empirically, some evidence suggests that aid may distort or weaken private sector incentives. Large amounts of aid may also cause a currency to appreciate, thus making the country’s traded goods less competitive—an effect known as —Dutch disease —about which we will say more below. It has also been asserted that food aid can reduce agricultural prices in the recipient country and adversely affect farmers’ income if not effectively managed. In addition, there is also evidence that revenue collections are lower in highly aid recipient countries.
Aid can stunt growth through three channels. First, by stimulating demand, it pushes up the price of goods and services and inflates salaries, such as those of aid managers; the engineers who work on roads, power, and school buildings; doctors and nurses; and building contractors.

As wages rise, the non-tradable sector will increase prices to maintain profitability. The tradable sector lacks this flexibility, however, because it faces external competition that limits the prices it can charge. Producers of tradables face a choice between forgoing profits and losing their competitive edge. Pushing up wages of certain goods and services, aid puts pressure on all other sectors to increase wages, leading to a generalized rise in wages throughout the country.

Second, in a flexible exchange rate regime, aid inflows will push up the nominal exchange rate of the recipient nation’s currency, thereby further reducing the tradable sector’s competitiveness. To counter this, aid inflows should be spent in ways that benefit the tradable sector (imported capital and machinery, intermediate goods, and so on).

Third, aid inflows weaken incentives for a country to improve tax collection and administration, and to operate efficiently and transparently. With free money flowing in, the government may be better able to avoid accounting for what it spends. “Yes, Aid promotes Growth”.

Other studies point to a positive relationship between aid and growth. Most do not conclude that more aid leads to more growth but suggest instead that —higher aid flows have been associated with higher growth (Radelet, Clemens, and Bhavnani, 2005).

Some scholars have found that although a scaling up of aid promotes the transfer of real resources from rich to poor countries, beyond a certain threshold (of about 5 percent of GDP per year), a surge in aid poses macroeconomic problems and can have a negative impact on growth in the long term, particularly if most of the aid is channeled toward consumption rather than Investment. During the 1990s, economists began to ask whether returns on aid flows would diminish as the share of aid in GDP rose. Working along these lines, (Clemens et all, 2004) finds diminishing returns once total aid reaches about 17 percent of GDP (or once the subset of aid aimed directly at growth reaches 8 percent of GDP).

Dollar and Burnside (2000) argued that aid positively influences long-term growth in countries that maintain good policies. This is intuitively satisfying, whereby building schools, hospitals, roads, and power plants are good things. But the new school will do little good unless it is filled with teachers who are paid well enough to show up regularly to teach and students who are well-fed to learn. Hospitals cannot improve health care with trained personnel, adequate supplies, reliable power, and clean water.

‘CONDITION UNDER WHICH AID STIMULATES GROWTH”

The conditional view of development assistance suggests a positive impact on economic growth depending on certain variables—for example, the characteristics of aid recipients or the efficacy of certain donor practices. World Bank research conducted in the mid-1990s showed higher returns from aid in countries with stronger civil liberties (Isham, Kaufmann, and Pritchett, 1995), good policies(Burnside, Craig, and Dollar, 2000), and effective institutions. Further, recipient-country characteristics—such as vulnerability to trade shocks, climate, institutional quality, political conflict, and geography—have all been studied as conditional variables affecting the aid—growth relationship, although Radelet, Clemens, and Bhavnani (2005) raise doubts about the statistical robustness of such findings. Nevertheless, the view that aid works best in countries with
sound policies and institutions is widely accepted among donors, including multilateral development banks. (That view is the rationale behind the U.S. Millennium Challenge Account.)

Reflecting the acknowledged importance of host-country conditions, recipient countries have had a greater say in recent years in setting priorities and designing programs in cooperation with donors and civil society. Greater —country ownership of aid goals and broader participation in the formulation of those goals and in the implementation of aid projects are believed to increase the efficacy of aid. The effect on growth of various donor practices has received very little systematic research, although many opinions can be found. Multilateral aid is generally considered more effective than bilateral aid, for example (because it is less likely to be politically motivated or to carry burdensome conditions), and aid that is not earmarked for specific purposes is widely believed to generate higher returns than is aid limited to prescribed uses.

Recent research into the connection between growth and aid also suggests that type of aid—in substance and timing—matters. The pioneering work of Clemens, Radelet, and Bhavnani(2004) focuses on aid aimed primarily at economic growth. They revealed that most scholars of aid and growth have examined the relationship of total development assistance to growth, even though, only a portion of assistance is designed to stimulate growth. Humanitarian and food aid, for example, are not aimed at spurring growth. Nor is aid for purposes such as educational material or judicial reform. The same authors also note that most studies used cross-sectional data at intervals of four years—too short a period to capture the impact of aid on growth. (On the other hand, the authors acknowledge that problems of causality arise if the time period is too long.)

Based on their hypothesis that —not all aid is alike,— Clemens, Radelet, and Bhavnani (2004) examined the effects of (i) humanitarian aid, (ii) early-impact aid, and (iii) late-impact aid on economic growth. Their results show that (i) and (iii) have very little or no effect on growth (On the other hand, early-impact aid—aid to build infrastructure and support productive sectors and budgets, which accounts for about half of total aid—has a positive relationship to growth over a four-year period.

Among the findings on the effect of early-impact aid on economic growth are these:

- The positive effect of early-impact aid on economic growth is not reversed over time.
- Each dollar in early-impact aid yields $1.64 in increased income in the recipient country in net present value terms, or a project level return of 13 percent per country.
- The relationship between early-impact aid and economic growth is stronger for countries with good policies and institutions.
- Typically, the maximum growth rate a country can achieve occurs when early-impact aid represents 8 to 9 percent of GDP.
- Development assistance is partially fungible—aid flows intended for different purposes have significantly different relationships to economic growth.

Aid has multiple objectives, not often directly related to economic growth. Development aid goals include peacekeeping, fighting terrorism, and drug trafficking, disaster relief, and the strategic political and diplomatic support of friendly governments. For example, a large part of development aid received by Egypt and Israel is devoted to supporting the Middle East peace process. Aid to conflict-ridden Cote d’Ivoire, for example, would be found ineffective if judged only by growth performance indices. A large fraction of aid to many countries is also designed to support the fight against terrorism, in these situations, there is no immediate effect of aid on growth, but in the long term, these objectives translate into a more stable economic environment.
that leads to growth and poverty alleviation. This goes to show that, aid effectiveness must be understood in a larger multidimensional framework. It also leads us to conclude that paradoxical results of the effect of aid on growth and poverty reduction are inevitable in a multiple-objective development aid framework.

**CORRELATION BETWEEN AID AND GROWTH**

There have been increases in official aid in recent years to help developing countries reach, by 2015, the Millennium Development Goals promulgated in the Millennium Declaration of September 2000 signed by 189 countries. The MDGs are a set of eight objectives for poverty reduction; improvement in indicators of well-being (health, education, and infant mortality); and the promotion of sustainable development. They represent the international communities commitments to narrowing the gap between rich and poor countries. That commitment has been reaffirmed in successive international meetings, and public aid flows have significantly increased—though still not to the promised levels. It is safe to say, however, that poverty reduction is now firmly back on the global policy agenda, this time with specific targets and deadlines. Rich countries have been committed to boosting development aid, canceling debts, and promoting trade access for developing countries.

The next section discusses the impact of scaling up aid on government budgets, national competitiveness, and the macroeconomic situation of a country receiving aid. The section concludes with an examination of initiatives now in place to achieve aid effectiveness in 2010.

**AID AND THE GOVERNMENT BUDGET**

A scaling up of development aid may facilitate a greater expansion in public services, but increase in flows will also bring challenges in managing and delivering that extra aid. This is because Aid flows are volatile and may not arrive on schedule, and this can create serious budgetary challenges in the respective individual ministries. When the volume and duration of development aid are not clear and when questions surround the manner and timing of disbursements, government ministries are hard-pressed to produce accurate, sustainable budgets. Celasun and Walliser (2008) found that about 30 percent of development assistance to a sample of 13 countries between 1992 and 2007 did not arrive on time, leading to budgetary shortfalls in countries that had projected these inflows in budget estimates. A 2008 survey by the OECD showed that for the average country just 45 percent of aid arrives on time. The World Bank reports shows the wide gaps that exist between the levels of aid scheduled by donors for disbursement and the actual amounts received in five countries (Raj. Breda, 2011).

When development aid is targeted to sectors and projects, the challenge facing the sector or a particular ministry is how to achieve stability and sustainability in the sector. Thus, Aid spikes may exceed the absorptive capacity of a sector. For example, higher flows to health and education may encounter shortages of staff and personnel because in many of the developing countries, public financial management systems are ill-equipped to meet the challenges of substantial increases in aid. A 2005 World Bank–IMF study of semi-autonomous agencies and extra budgetary funds, found weak budget formulation; weak classification systems; poor commitment controls; and inadequate cash management, budget reporting, auditing and regulatory capacity (Heller, 2005).

A scaling up of aid may also present organizational challenges. As noted by Heller (2005), a department that functions well on one scale may not be able to make the transition to a large-scale.
ENSURING THAT AID DOES NOT COMPROMISE COMPETITIVENESS

As noted earlier, an increase in development aid flows may generate a —Dutch disease effect, whereby the increased inflow of foreign currency boosts demand in both the non-traded and traded goods sectors, pushing up prices, while causing the domestic currency to appreciate and thus, compromising the competitiveness of the recipient country’s exports. While increased demand for traded goods can be met by increased imports, this is not the case for non-traded goods, such as housing. We have already noted that excess demand here can lead to production bottlenecks and higher wages, increasing inflation and the real exchange rate. A higher real exchange rate may adversely impact a country’s international competitiveness, thus hampering its gains from international trade and its capacity for growth and investment. Heller (2005) identifies three questions a government should ask if an appreciation of the exchange rate is likely:

□ Does development assistance induces higher productivity in the non-traded goods sector to offset the effect of a currency appreciation?
□ Can the effect on exchange rates be moderated by pursuing macroeconomic and microeconomic policies?
□ Taking into account adverse effects, will aid’s net effect on growth and poverty reduction still be positive?

A nation’s central bank may try to keep the pressure off the nominal exchange rate by intervening in the foreign exchange market (buying foreign exchange) and offsetting the monetary impact of increased currency flows by conducting so-called open market operations.

However, the capacity of developing countries’ central banks to absorb liquidity may be limited by a lack of suitable monetary policy instruments. These policies may then result in an appreciation of the real exchange rate through the channel of domestic inflation. Tight monetary policies may also lead to higher interest rates and a crowding out of private investment activities. Fiscal policy may also be tightened to keep domestic inflation in check.

In their attempts to ward off a —Dutch disease effect, governments may take advantage of resource transfers. As such, the governments may introduce policies that affect the demand for imports. In particular, if resource transfers facilitate the removal of bottlenecks, productivity in then on-traded sector may increase. Furthermore, increasing the supply of non-traded goods in the economy may curtail price pressures and even expand investment and growth in the economy, with the increased supply of non-tradable leading to investments in physical infrastructure and human capital.

Heller (2005) argues that it may be sensible for a low-income country to accept some loss in competitiveness by implementing policies that lead to a real transfer of resources from the traded to non-traded sector. Furthermore, Heller suggests that if increased development assistance is successful in achieving the MDGs, the resulting economic environment will be better placed to increase productivity and competitiveness. But Heller cautions that uncertainty regarding the continuity of aid may make accepting the loss in competitiveness a risky venture. Thus, governments need to choose their exchange rate policy in full cognizance of the possibility of future changes, up or down, the volume of development assistance.

Aiyar, Berg, and Hussain (2005) examine the macroeconomic challenges of five African countries—Ethiopia, Ghana, Mozambique, Tanzania, and Uganda—that experienced a large increase in development assistance. All five countries are considered good performers with strong
institutions and have benefited from the general rise in aid and from the Heavily Indebted Poor Countries Initiative (HIPC), which allowed them to greatly reduce their debt burden.

Broadly speaking, there are four possible responses to an aid surge in the short to medium term: (i) absorb and spend, (ii) neither absorb nor spend, (iii) absorb but do not spend, and (iv) spend but do not absorb. In their analysis, Aiyar, Berg, and Hussain (2005) look at how the five countries in their sample performed according to these categories.

Absorb and spend. The government spends the new aid on domestic goods, and the fiscal deficit increases. The central bank then sells foreign exchange to sterilize the local currency spent by the government (that is, to prevent the new spending from causing inflation). In this way, the foreign exchange pays for a widening of the current-account deficit, as the aid is absorbed by the economy. A key point here is that some appreciation of the real exchange rate appreciation may be appropriate because, if aid is used to increase net imports, higher aggregate demand and/or appreciation of the real exchange rate is needed.

But Aiyar, Berg, and Hussain (2005) found that the absorb-and-spend strategy was surprisingly rare. No country in their sample fully absorbed and spent the incremental aid it received during a surge of assistance. In four of the five countries, less than one-third of the incremental aid was absorbed.

Neither absorbs nor spends. In this case, the government does not spend the aid but keeps it in the central bank. Governments may choose this option because they want to build up international reserves from a low level or smooth volatile aid flows. In two of the sample countries—Ethiopia and Ghana—absorption and spending were both very low. Both countries entered the aid-surge period with a low level of reserves—2.2 months of imports in Ethiopia and 1.3 months of imports in Ghana—and used the incremental aid to increase their import coverage. The reserve buildup meant that aid was effectively not available to finance increased domestic spending. But neither was the surge accompanied by a significant widening of the fiscal deficit or an increase in inflation.

Absorb but do not spend. This response substitutes aid for domestic financing of the government deficit. The government keeps expenditures steady, and the money supply shrinks as the central bank sterilizes liquidity through sales of foreign exchange. Such an approach can help stabilize the economy where domestically financed deficit spending is too high. No country in the sample chose this approach for the entire surge period, but it was used for particular episodes, including, for example, in Ethiopia in 2001, when the strategy helped hold liquidity in check and avoided an inflation surge. This approach can also be used to reduce domestic public debt and—crowd in (an increase in private consumption or investment due to the government’s action on spending or taxation) the private sector if the central bank uses the proceeds from its foreign exchange sales to buy back government debt.

Spend but do not absorb. This is a suboptimal response, often reflecting inadequate coordination of monetary and fiscal policy. Unfortunately, it is all too common. Under this approach, the government increases expenditures, but keeps aid dollars in the central bank as reserves. This response is similar to fiscal stimulus in the absence of aid because the increase in government spending must be financed domestically since there is no real resource transfer, (net imports do not increase). This can lead to increases in the money supply and in inflation, unless sterilization is undertaken by sales of government paper (instead of foreign exchange).
Aiyar, Berg, and Hussain (2005) find that Uganda, Mozambique, and Tanzania adopted this suboptimal approach. In all three countries, concerns about the negative impact of a real appreciation of competitiveness dictated the pattern of aid absorption and the monetary response (foreign exchange sales being held in check to rein in upward pressure on the domestic currency, with sterilization instead being undertaken by sales of government paper).

In these three countries, unlike in Ethiopia and Ghana, the level of import coverage afforded by gross reserves was quite high, with reserves accumulating steadily. A more suitable response to increased aid inflows might have been to combine a widening fiscal deficit with sterilization through sales of foreign exchange. In Uganda and Tanzania, such a strategy would have relaxed the need for open-market operations and a sharp rise in interest rates. In Mozambique, it would have reduced inflation by reining in base money and limiting nominal depreciation.

INTERNATIONAL INITIATIVES TO IMPROVE THE EFFECTIVENESS OF AID

Presently, lack of aid predictability, lack of coordination, and aid fragmentation further constrain aid effectiveness. Deutscher and Fyson (2008) identify more than —280 bilateral donor agencies, 242 multilateral programs, 24 development banks, and about 40 United Nations agencies working in the development business. Added to that, are the increasing number of private foundations, Non-Governmental Organizations (NGOs), and —an estimated 340,000 development projects around the world. The fragmentation of aid means that (some) countries receive small amounts of aid from a plethora of donors, all requiring adherence to differing procedures and standards. A 2008 OECD survey found that during 2005 to 2006, 38 developing countries received aid from 25 or more DAC and multilateral donors (Deutscher and Fyson, 2008). Similarly, a 2006 OECD survey found that government authorities in Vietnam in 2005 received 791 visits from donors, while health workers in Tanzania spent a quarter of their working days writing reports for donors. Conversely, some countries are ignored altogether. A series of four high level meetings since 2002 have produced a promising plan to make aid more effective by 2010. The following year, high-level representatives from the major multilateral and bilateral donor institutions met in Rome with representatives of aid recipients to continue the discussion of how to improve the effectiveness of aid. The resulting Rome Declaration on Harmonization articulated the following goals:

- To ensure that harmonization efforts are adapted to the country context and that donor assistance is aligned with the recipient’s priorities.
- To expand country-led efforts to streamline donor procedures and practices.
- To review and identify ways to adapt institutions’ and countries’ policies, procedures, and practices to facilitate harmonization.
- To implement the good practices, principles, and standards formulated by the development community as the foundation for harmonization.

The same set of participants met again in Paris in early 2005. The Paris Declaration on Aid effectiveness committed the parties to specific actions that would promote the effective use of aid funds. The Paris Declaration is grounded on five mutually reinforcing principles and 12 indicators by which progress is to be assessed. Targets for 11 of those indicators were set for 2010. The five principles (and associated indicators) are as follows:

- Ownership. Partner countries exercise effective leadership over their development policies and strategies, and coordinate development actions. (Indicator 1)
Alignment. Donors base their overall support on partner countries’ national development strategies, institutions, and procedures. (Indicators 2–8)

Harmonization. Donors’ actions are more harmonized, transparent, and collectively effective. (Indicators 9 and 10)

Managing for results. Managing resources and improving decision making for development results. (Indicator 11)

Mutual accountability. Donors and partners are accountable for development results. (Indicator 12)

A first round of monitoring took place in 2006 based on activities undertaken in 2005 in 34 countries where some progress was noted but significant efforts were still needed. A second round of monitoring took place in 56 countries in 2008 prior to the Third High Level Forum on Aid Effectiveness in Accra.

The Accra Agenda for Action noted that despite the progress made on reducing poverty, much more needed to be done if the Millennium Development Goals were to be met. Similarly, much more needed to be done to improve the effectiveness of aid. A 2008 survey conducted by OECD prior to the Accra meeting examined progress in 33 countries toward the 2010 targets set forth in the Paris Declaration.

A number of policy recommendations aimed at accelerating progress and transforming the aid relationship into a full partnership between the donors and the country recipients: (i) step-up efforts to use and strengthen country systems as a way of reinforcing country ownership; (ii) strengthen accountability for development resources; and (iii) make aid management more cost-effective.

Deutscher and Fyson (2008) highlight the challenges in meeting these recommendations. Achieving country ownership is difficult in an environment where a country’s strategic vision is not linked to a specific fiscal policy or budget process, or where capacity is lacking. Even where frameworks for accountability exist, they are often weak. Finally, transparency on how public finances are spent, how contracts are procured, and how results are monitored—all prerequisites for cost-effective aid management—is a scarce commodity nearly everywhere in the developing world. The same authors suggest the following pathways for meeting the targets on aid effectiveness:

Focus on results, not on getting credit. Donors like to be acknowledged for the aid they provide, but this must not distract the objective of making aid more effective.

Encourage political leaders in the developing world to demand aid effectiveness and help reduce the fragmentation of aid, even if this means refusing aid that is not aligned with their development agenda.

Stem the proliferation of aid agencies—aid effectiveness is compromised by too many donors with too many conflicting systems.

Increase communication and accountability between donors and the public, and between donors and their recipient countries.

CONCLUSION

Development assistance is based on the idea that rich countries can and should help poor countries to find the path to sustainable economic growth and poverty reduction—especially those that lack other sources of capital. The chapter began by identifying the sources and composition of net
capital flows to developing countries—highlighting the respective roles of private and public flows. We then discussed the arguments and evidence on both sides of the burning question of whether aid is effective in promoting economic growth. The evidence of a direct effect on growth is not conclusive. Does this mean that aid should be cut back? Not necessarily. The impact of aid should be evaluated not only in relation to its direct effects, but also in terms of its role in improving governance and economic management, and its contribution to social objectives—notably education, health, and infant immortality.

REFERENCES


