Impact of foreign aid on the economic growth of nigeria

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Foreign aid can be simply put to be a flow of assistance which can take the form of funds, infrastructure, trade openness from high income countries to low income countries. The debate till date has been centred around the significance of this aid on the economic growth of these countries. To a large extent, several researches have shown a positive impact of foreign aid on the economic growth of LDCs with the exception of a few factors which may affect this positive impact on growth, while some others have shown a negative impact on economic growth of these LDCs.

According to Burnside and Dollar (1997), the positive impact of foreign aid on growth in LDCs is subject to the country having good fiscal, monetary and trade policies, thus, the introduction of economic policies into their economic equation. This was included, to see if aid was allocated to these countries in favour of good policies. Durbarry et al (1998) argue that ‘ an important limitation of much of this literature is the incompleteness of the underlying growth models’, according to them, irrespective of the fact that Burnside and Dollar were among the first to take into account economic policies, they have not been able to examine the impact of aid in general including only aggregate savings and investment variables.

Most of these researches have based the framework of their research on the neoclassical growth model such as the Solow growth model and the Ramsey-cass-koopmans growth model which ‘ suggests that poor countries should have a high return to capital and a fast growth rate in transition to the steady state’ (Burnside and Dollar, 1997). According to Chenery and Strout (1966), in the case of a country seeking a transformation of its existing economy and hoping not to rely on more advanced countries (i. e. foreign

aid), such a country must be able to meet the necessary demands for her rapid growth from either her own resources or from her net exports.

The case of foreign aid and economic growth has proven to be a continuous learning process, in that, while some studies base their findings on macroeconomic factors such as economic policies, others have recommended the use of human well being factors such as infant mortality, literacy, life expectancy and employment level (Burnside and Dollar 1997; Fayissa and El-Kaissy 1999). While the results of Durbarry et al (1998) supports the results of Burnside and Dollar (1997) which shows foreign aid to have a positive impact on growth where there is a good macroeconomic policy environment, but with some exceptions which were based on income level, levels of aid allocation and geographical location.

According to him, aid has been tested econometrically based on a macro and micro level, the results of some these tests by some researchers show that aid works at the micro level while at the macro level the results as ambiguous (Durbarry et al, 1998). So far, most research have dwelt on macroeconomic factors as well as physical factors which in their opinions either shows that growth is fostered positively by aid or negatively by aid. One interesting contribution to the subject matter in question is the contribution by Douglas C. Dacy, which looked at foreign aid and economic growth from a totally different point of view, his paper aimed showing the possibility of an aid receiving country having its post-aid growth rate to be lower than it would have been in a situation of not receiving aid under certain conditions.

According to Dacy (1975), his paper viewed the subject of foreign aid and economic growth with respect to consumption on the side of the government as well as domestic savings. Contrary to other researches, Dacy in his paper viewed foreign aid as a substitute for domestic savings, saying that there would not be an increase in total savings by the full amount of foreign savings. Thus, LDCs will increase consumption as well as investment if foreign aid is made available.

Papanek (1973) in his paper, studied the relationship between aid, savings, foreign investment and growth in thirty-four LDCs for the 1950s and fifty-one LDCs for the 1960s, applying cross-country regression analysis. Treating each of these components as separate explanatory variables, he found out that over a third of GDP growth is explained b y domestic savings and foreign inflows. Also the effect foreign aid has relative to other variables is considerably higher, his results also suggests no inverse relationship between aid and foreign private investment as well as showing a non-correlation between growth and factors such as; exports, education, country size or per capita income. Unlike Chenery and Strout's result which showed that Country's size and per capita income has a positive relationship with growth, Papanek's result did not show such positive relationship as said earlier. This is because Papanek's work had savings as one of the independent variables and this was seen to be significantly correlated with per capita income.

Concluding his paper, Papanek (1973), suggests from his results that foreign aid is distributed disproportionately to LDCs experiencing low savings rates as well as severe balance of payments problems. And that this

disproportionate aid has a more positive effect on growth than domestic savings and other sources of foreign inflows. Chenery and Strout's results are criticised by Papanek as not being very stable and also in his results, foreign source of inflows are not disaggregated compared to the results of Papanek.

Papanek (1973) and Burnside & Dollar (2000) share similar opinions on the allocation of foreign aid to low income countries. As Papanek is of the view that foreign aid is disproportionately distributed to low income countries who are experiencing low savings rate. While Burnside and Dollar is of the view that though this is allocated to low income countries, it is also influenced by population, i. e. aid donors tend to allocate more aid to smaller countries in size within the Low Income Countries, and also there are variables that reflect their own strategies.

Generally speaking, from researches done so far, it is evident that foreign aid has a positive relationship (or impact) on economic growth in LDCs. But this could show a different result when the countries are sampled individually, such that, though aid may be positively related to economic growth based on some macroeconomic factors, it may also a negative relationship influenced by some other factors.

According to Levy (1988), his paper aimed at showing some level of quantitative evidence on the impact of foreign aid on economic growth. This he showed using a sample of 22 Low Income Countries in Sub-Saharan Africa with the exception of a few African countries which to him had their level of development similar to that of middle income countries. Using time series

data for his analysis, Levy found two important things; which is a positively significant relationship between aid, investment and economic growth in Africa. The second important finding is that there is a significant contribution by fixed capital formation to the rate of economic growth.

Although the exclusion of some African countries which he classified as similar to middle income countries from his analysis seems questionable, Levy's contribution to the subject matter is very significant. According to Burnside and Dollar (1997), most researches such as that of Levy (1988) and a few others who made an attempt to measure the impact of aid on domestic savings, investment and growth in developing countries, have had results which faced several econometric difficulties.

Taking another close look at the work of Dacy (1975) which questioned the desirability of aid, according to him, " even if aid is used in a way that contributes to a decline in the long term growth rate, it will almost always be true that the capital stock income and consumption will be higher at the end of the period of aid, and for a number of years afterward, than it would have been without aid". To this end he agrees with Papanek (1973) view which argues that the inverse relationship shown in most statistical research between domestic savings and foreign aid might be greatly misleading. This view is due to Papanek's objections from his observations from previous studies, thus, Papanek's results which show that there is a positive relationship between aid and economic growth as well as aid having an inverse relationship with domestic savings is largely accepted by Dacy.

Durbarry et al (1998) in their paper made reference to the work of Hadjimicheal et al (1995) as being a more advanced piece of research compared to most of the researches before it. This is because of their effort to show the potential secondary effect of foreign aid such as the “ Dutch Disease” as well as other policy related variables that are speculated to have an effect on growth.

Ekanayake and chatrna (2010) in their paper, criticised the work of Karras (2006) which concluded that there is a positive statistically significant and permanent impact of foreign aid on economic growth. In which they gave a statistical analysis by per person result as well as the growth rate of real GDP per capita, but in all this, they did not take into consideration the effect of policies. According to the research carried out by Ekanayake and Chatrna (2010), their results showed mixed effects of foreign aid on economic growth in LDCs, their research was carried out using annual data on a group of 85 developing countries cutting across continents. The models that were specified in their work were estimated using panel least squares estimation method.

Malik (2008) described the poverty of people in the poorest African Countries to be on the increase despite the many years of development assistance. According to him, there has remained a stagnant or declining real per capita income since the 1960s, thus the disturbing question is “ why could these countries not break the poverty trap despite receiving large inflows of foreign aid?”. This question he sought to answer using the co-integration analysis for six poorest African Countries, the results from this analysis showed the existence of a long run relationship between real GDP, aid and

investment as a percentage of GP and trade openness. But showing the effect of foreign aid on growth, the result indicated a long run negative relationship for most of these countries.

Easterly (2003) went ahead in his paper to discuss the historical research on the relationship between foreign aid and Economic growth. This he did, citing the work of Burnside and Dollar as being an early research that was widely accepted by the World Bank and economies of the world, and thus, created the platform for further research. According to Easterly (2003), data availability was one of the main limitations to having a conclusive and reasonable literature on the subject matter i. e. foreign aid and economic growth in the 1960s and onwards, as well as the reasonable arguments on the specific factors and ways through which foreign aid can affect growth.

In his paper, Easterly (2003) cited the paper by Boone (1996) as being noted for its aim to address the issues of reverse causality through the introduction of political factors that determine aid, and thus, using them as instruments in addressing these problems. He also discussed the paper by Burnside and Dollar (2000) as being well known for addressing the disbelief shown by Boone and also the lack of agreement from previous studies.

In another paper by Papanek (1972) titled ” The Effect of Aid and other Resource Transfers on Savings and Growth in Less Developed Countries”, he analysed the recent challenge to past assumptions with respect to aid, savings and growth, where he termed some past literatures as “ Revisionists”. His concern is based on their argument that the contribution to economic growth by foreign aid is little or insignificant, in which a number of

factors were taken into consideration to support this claim. He went further to expand their argument saying " Aid may ease the lot of the recipient country's citizens by permitting higher consumption which is considered desirable if the analyst's humanitarian instincts outweigh his Calvinist conviction that people should struggle for their economic salvation, but does little for growth" (Papanek, 1972).

Amongst these, are other literatures done by several researchers in which different methods were implemented such as the Autoregressive Distributed lag (ARDL) model used by Gounder (2001), in which his results showed a positive relationship between foreign aid and economic growth in Fiji. There has been other literatures that have also tried to show this relationship in individual countries, some have found a positive relationship but a long- run negative relationship using the Co-integration and error correction analysis, while others found a co-integration between saving rate, real gross domestic product and aid therefore showing a long-run positive effects (Murty et al, 1994; Nyoni, 1998).

Taking a closer look at the problem of causality which Boone tried to address, Dacy (1975) concurs that the issue of causality is a tough knot to tie. He also suggests that the debate on if foreign aid contributes largely to economic growth is one that cannot be fully decided, as there would be a need to take into consideration the response of individuals as well as groups. Such consideration includes checking if these individuals or groups behave in a certain way where there is an increase in aid compared to where there is no aid.

From the above literatures and many more, it is obvious that the issue of foreign aid and its impact on economic growth is inconclusive and is also a continuous learning process. Depending on the different types of data and methodology used in previous studies, several results have been achieved; some depict positive and significant relationship while others indicate negative long-run relationships based on different factors. This paper in the next section would be using time series data and applying the Ordinary Least Squares method (OLS) as well as the co-integration method to see what impact foreign aid has on the economic growth of Nigeria.

Section 3. Data and Methodology

In testing for the impact of foreign aid on the economic growth of Nigeria, I am using annual time series data which has its period from 1960 – 2009 and which is gotten from World Bank World Development Indicators. Thus, the focus of this analysis is on Nigeria as a developing country and a recipient of aid from advanced countries which are known as donors. Due to the limited availability of data with respect to the proposed variables, the observations are 49 running from 1960-2009. The table below shows the variables that are included in this study as well as the source they were gotten from:

Table 1:

Variable

Unit

source

Gross Domestic product

Growth Rate

World Bank

Foreign Direct Investment

Percentage of GDP

World Bank

Trade(Openness; exports plus imports as a percentage of GDP

Percentage of GDP

World Bank

Population Growth

Per Cent (%)

World Bank

Net ODA per capita

Current US$

World Bank

Most of my variables were gotten from the work of Ekanayake and Chatrna (2010), where he used things like investment as proxy for growth rate of capital stock and also population growth as proxy for labour force. This study also uses population growth as a proxy for labour force as well as including trade to represent openness which as shown in the table above is made up of exports plus imports as a percentage of GDP. Net ODA per capita is a

proxy for aid alongside Foreign Direct Investment, as earlier said, this study would be adopting the use of Ordinary Least Squares method (OLS) for its analysis. To ensure that the study is academically robust, I will also be employing the use of co-integration tests, to check the long run relationship between Foreign aid and Economic growth in Nigeria.