

Effect of foreign aid on economic growth in developing areas



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The Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) defines foreign aid as financial flows, technical support, and goods that are intended to encourage economic growth and wellbeing. Foreign aid is generally linked with authorized development support which in turn is a division of the official development finance, and usually given to the poorest countries (World Bank, 1998) (TAB 1).

Various debates about the usefulness of foreign aid dates back decades. Milton Friedman, Peter Bauer, and William Easterly are critics that have given tough reviews, ranging from the decreased impact aid has on government bureaucracies, propagated bad governments, enriched the selected few in poor countries, or wasted. They lay emphasis on extensive poverty in Africa and South Asia despite over thirty years of aid directed to these countries still having a devastating record, e. g. the Democratic Republic of the Congo, Guinea, and Somalia. In their opinion aid programs should be significantly transformed, considerably managed, or eradicated (PAPER 1).

Other researchers oppose these arguments, although partly correct but over emphasised. Jeffrey Sachs, Joseph Stiglitz, Nicholas Stern and others have argued that even though aid has from time to time failed, it has reduced poverty and enhanced growth in some countries and discouraged worse outcome in other countries. They consider the weaknesses of aid to be linked with donors rather than receivers, and identified a couple of successful countries that have received significant aid such as Botswana, Indonesia, Korea, and, more recently, Tanzania and Mozambique, together with thriving

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ideas such as the Green Revolution, the crusade against river blindness, and the introduction of oral rehydration therapy (PAPER 1).

Review by Papanek (1973) disagreed with the negative outcome of Griffin and Enos (1970) that by not adding capital flow to foreign aid and other inflows, a significantly positive aid coefficient can be achieved. In contrast, using a sample of 22 Less Developed Countries 1956-1968, Voivodas (1973) achieved an insignificant negative aid impact on growth. This early periods can be characterised with poor quality of data thereby causing ambiguity in their results(TAB 5). More recently, Knack (2000) debates that an increase in foreign aid increases corruption, rent-seeking and corrodes institutional quality thus having an adverse effect on growth.

However, with better data, Dowling and Hiemenz (1983) used the pooled data for 13 Asian countries to test for impact of aid on growth and discovered a significantly positive relationship. In their research, they controlled for certain policy variables like government intervention and trade. While Levy (1988) considered Sub-Saharan Africa and also achieved a significantly positive correlation haven used a regression model with income per capita and aid as a ratio of GDP for 1968-1982(TAB 5). Using 41 countries 1986-1992, Hadjimichael et al. (1995) discovered a positive aid-growth relationship. More recently, Burnside and Dollar (1997) used a model with various policy variables and learnt that aid alone does not directly influence growth in LDCs but when policy variables interact with aid will have a significant impact on economic growth (World Bank, 1998) (TAB 1). The potential side effects of foreign aid as well as certain policy variables were

captured in the above mentioned models thus making them slightly more sophisticated than previous research.

These studies can be criticised in many ways. Boone (1996) disagrees with the positive aid-growth relationship, stating that aid has no effect on both investment and income growth in LDCs (tab 5). While Easterly, Levine and Roodman (2003) used a higher sample size to reanalyse Burnside and Dollar's review, thereby finding that the coefficients of the result is not as significant (TAB 1).

Similarly, the most mentioned criticism is the poorly defined growth model where researcher's growth model may ignore certain economic activities that would have enabled a more sophisticated empirical growth model in which aid would be a reliable growth factor (TAB 5). An example is Gupta (1975) and Gupta and Islam (1983) who discovered that the negative effect of foreign capital can be reversed if indirect effects were incorporated. On the other hand, Mosley (1980) found a negative (although not significant) correlation in aid and growth haven used a simultaneous equation model. He however, found a positive correlation in the case of LDCs in his sample but in total concludes that his analysis is incomplete.

A major shortcoming of the previous research is the deficiency in the growth models. Most of which identify capital accumulation alone as a growth factor but others have thoroughly considered the problem of sufficient model requirement. Mosley (1987) and Dowling and Hiemenz (1983) considered variables representing trade and government activities, while Burnside and Dollar (1997) and Hadjimichael et al. (1995) used macroeconomic variables

in their growth model. In contrast, reviews on determinants of growth in LDCs do not consider the effect of aid rather it includes only variables of total savings and investment (Fischer, 1991, 1993; Easterly, 1993; Barro and Sala-i-Martin, 1995) (TAB 5).

On the whole, the aid-growth relationship can be considered to be full of loopholes and should be further researched. Sample countries' regions should be considered as it influences economic growth but has been ignored in economic growth analysis (Gallup, Sachs and Mellinger, 1999)(TAB 1). This study will revolve round impact of aid on growth in intensification on the growth model: the 'Fischer-Easterly model' (Fischer, 1991, 1993; Easterly, 1993). The model will concentrate on macroeconomic policies which encompass the total framework of the aid-growth relationship as argued earlier that aid only increases growth in the presence of sound economic policies in recipient countries (TAB 5). The model specification will be further broken down to include policy variables as well as all key investment sources (domestic savings, foreign aid, private and other inflows) (TAB 5). This study will also strive to surmount past criticism of aid-growth models by applying a cross-section econometric technique to a large sample size(50 developing countries) over a long period (1980-2005) (TAB 5).

RESEARCH QUESTIONS:

Does foreign aid have a positive impact on economic growth across developing countries?

Does foreign aid have a diminishing return as volume of aid increases?

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To test for Hypothesis:

H0: that foreign aid induces economic growth

H1: that foreign aid does not induce economic growth

RESEARCH STRATEGY & METHODOLOGY:

The research will be highly empirical with the use of secondary data obtained from the World Bank and the International Monetary Fund database. The use of Cross Section techniques and the Augmented Fischer-Easterly model in order to control for macroeconomic stability/instability and policy distortions.

DATA COLLECTION AND ANALYSIS:

The data trend in foreign capital flow to 50 developing countries (number of countries may reduce due to unavailability of data) between 1980- 2005 will be analysed. These figures will be in nominal rates to avoid appropriate deflator problems.

MODEL SPECIFICATION:

Cross section techniques will be used to examine the impact of the data averaging through 1980-2005 and for comparism with previous research.

The model will take the form:

The study is aimed at making a major contribution to the empirical argument on the capability of foreign aid to induce economic growth in developing countries. The Augmented Fischer-Easterly growth model will be used where macroeconomic variables and foreign aid as well as other financial investment sources are considered in calculating economic growth. (TAB 5).