

UDC: 338.121:339.727.22]:303.725.3(100-773)

Review

Empirics of Financial Aid and Growth

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Abstract

In the way to reach millennium goals it was argued that aid should reduce poverty and help countries achieve targets. Aid, growth and good policy relate to distinguished debate for policymakers especially for developing countries (aid receivers) as aid is expected to generate growth. Objective of foreign financial aid is promotion of development and welfare. The study on effectiveness of aid on growth is numerous but with ambiguous results. Why ambiguous empirical results? Is it econometrics? The aim of this study is to examine the effectiveness of aid on growth empirically. Different results namely finding positive, negative or no effect of aid on growth, result because of lack of data and econometrics specifically model specification problems and endogeneity. Different theoretical definitions as well as different estimation techniques may not result with robust results. On grounds of ambiguous theoretical framework, inappropriate econometrics policy conclusions and recommendations are questionable.

Keywords: financial aid, empirics, endogeneity

Introduction

Aid is given as a treatment to address poverty in order to generate growth. Aid- growth nexus encouraged a large body of theoretical and empirical evidence between researches as well as a debate between policymakers both in developing and developed countries. It is expected that aid induces growth and is responsive to ameliorating inequality. Aid effectiveness literature addresses theoretical foundations on the nexus aid and growth but the conclusions both theoretically and empirically are ambiguous. Data, specification of the model and estimation techniques may attribute to the differences in the results. Concluding instrumental techniques positive relation aid-growth while non instrumental variables negative relation; causal effect should be taken account; endogeneity problem is addressed using instrumental variables; within industry analysis may result with simultaneity bias. Nevertheless, the open question remains to be addressed: Does aid promote growth? So far aid refers to grants excluding loans. What if using different definition of aid, policy and growth?

Foreign Aid – Economic Growth Nexus

In the way to reach millennium goals it was argued that aid may reduce poverty and help countries achieve the targets. Aid, growth and good policy relate to distinguished debate for policymakers of both developing and developed countries. Objective of foreign aid is promotion of development and welfare. The study on effectiveness of aid on growth is numerous but

ambiguous. Foreign aid is important for developing countries. Aid is given as a treatment to address poverty in order to generate growth.

Aid effectiveness literature generally is focused on two main strands; the first strand group researches focus on Growth direct, accumulation (Doucouliagos and Paldam (2006), while the second group of researchers focus their research that growth is conditional (Doucouliagos and Paldam (2005a). The point that makes difference between these strands is whether aid finances consumption or investment.

Accordingly, the research concluding on positive relationship between aid and growth is based on micro evidence while zero coefficients is known as micro-macro paradox. Namely different theoretical definitions may not result with robust estimation. The two opposing views are illustrated in the figure below:

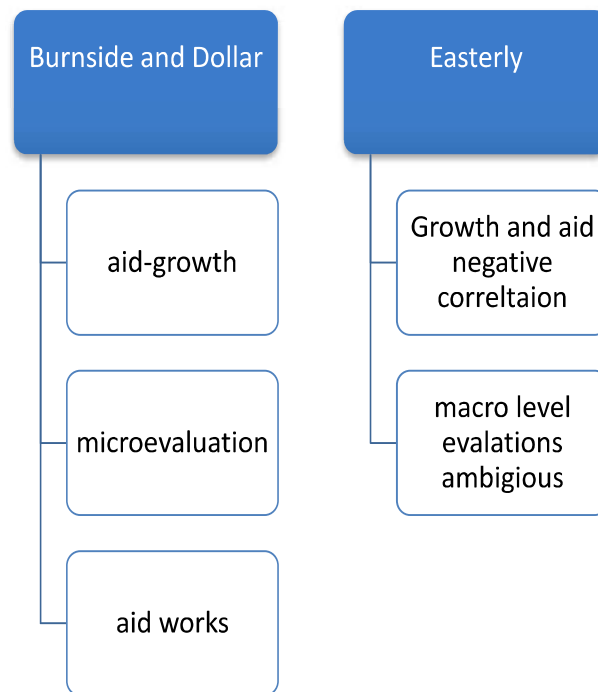


Figure 1. Literature review

A Systematic Review of Empirical Evidence

Pre-Data and specification of the model may attribute to the differences in the results namely differences result due to models and estimation techniques. Gomanee et al (2005) use pooled panel data and find positive effect of aid on growth also Bruckner (2013) use instrumental variables and find positive effect of aid on growth. Endogeneity problem is addressed using instrumental variables. Instrumental techniques positive correlation aid-growth while non-instrumental variables negative correlation. Easterly finds no positive relationship between aid and growth but causal effect should be taken lysis still may result with simultaneity bias because of reverse causal effect that growth has on aid. Doucouliagos (2006) meta-analysis finds that the effect of aid on growth is not significantly different from zero.

Trade liberalization was less effective than post-trade liberalization because policy reform is endogenously included after trade liberalization (Durbarry, Gemmell and Greenaway (1998)). They find robust evidence; foreign aids have positive effect on LDC growth with condition of stable macroeconomic policy also that too low and too high level of aid does not promote growth respectively the optimum level is at 40-45%.

Burnside and Dollar (2000) investigate relationship between foreign aid, economic policy and GDP per capita growth rate. Aid had little impact on growth but.; significant positive relationship b/w interaction term of foreign aid and good macroeconomic policy; Implying aid has positive impact on growth in countries that have good policies and government committed to improve social welfare, infrastructure as well as eliminate corruption.; Results also indicate robust positive correlation between bilateral aid and government consumption, supporting why aid does not have strong positive effect on growth, (Burnside and Dollar (2000)).

Hansen and Tarp (2001) introduce countries' specific effects in the regression e.g. natural endowments, cultural and socioeconomic characteristics. Contrarily to Burnside and Dollar aid increases growth rate unconditional to good policy.

Aid impacts on growth via investment; aid has significant positive impact on productivity but it is not a panacea for poverty reduction (Dalgard et al. (2004)). Their result indicates insignificant interaction between aid and policy but result indicate that aid have been less effective in tropical areas therefore suggesting further study on i interaction b/w aid and climate.

Brückner (2013) use instrumental variables and find positive effect of aid on growth. His main conclusion is in line with cross country stylized facts that as countries grow richer, they get less aid on grounds such as inappropriate econometrics, problematic definition of the 'policy' variable, inappropriate specification of the empirical model, endogeneity issues, etc.

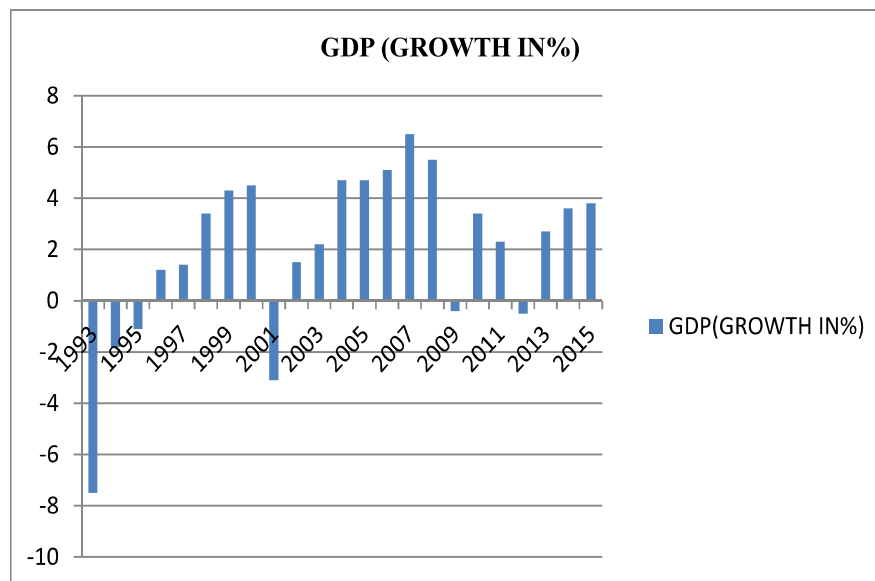


Figure 2. GDP Growth
Source: World Bank

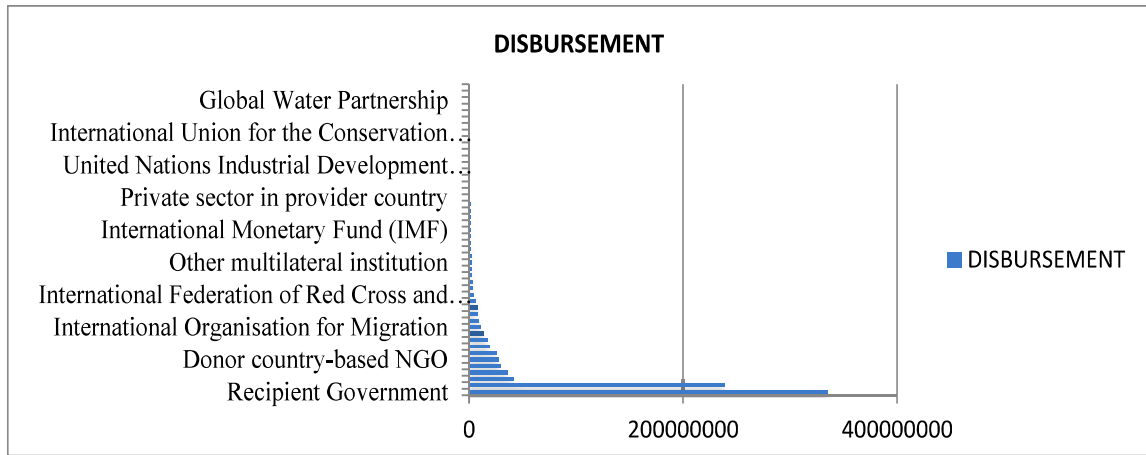


Figure 3. Disbursement (a)
 Source: <https://euaidexplorer.ec.europa.eu>

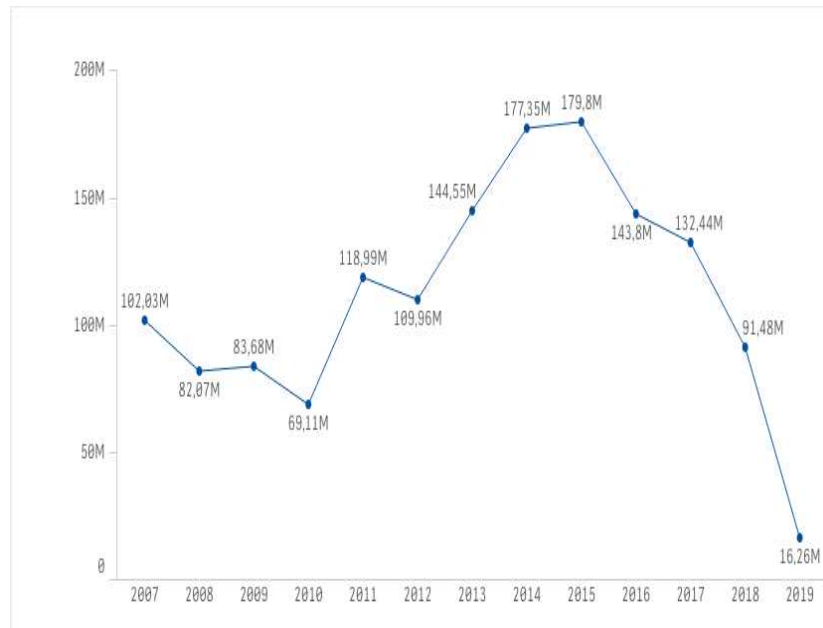


Figure 4. Disbursement (b)
 Source: <https://euaidexplorer.ec.europa.eu>

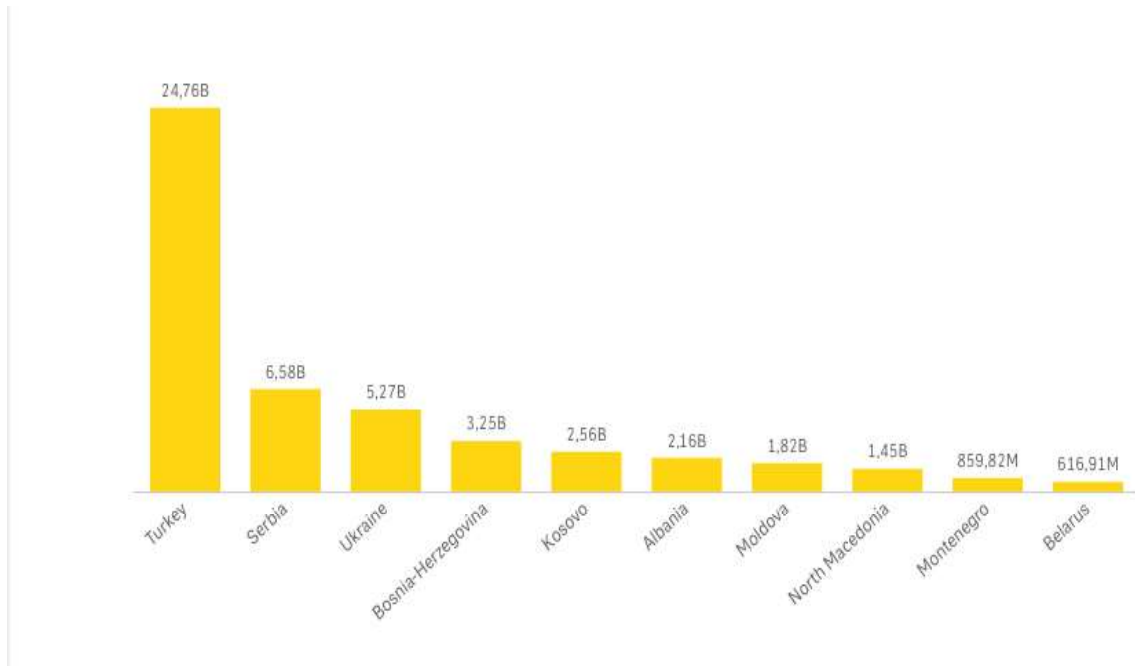


Figure 5. Disbursement (c)
 Source: <https://euaidexplorer.ec.europa.eu>

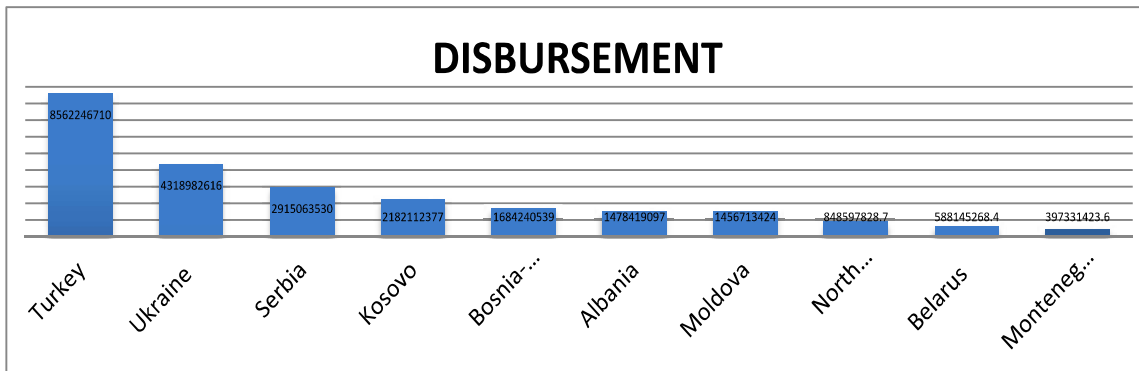


Figure 6. Disbursement (d)
 Source: <https://euaidexplorer.ec.europa.eu>

Conclusion

On grounds of such inappropriate econometrics, problematic definition of the ‘policy’ variable, inappropriate specification of the empirical model, endogeneity issues, etc. Different conclusions are as a result of lack of data and econometrics. Different results that find positive, negative or no effect of aid are on growth. Namely robust policy conclusions are questionable. The answer whether aid promotes growth may be ambiguous. Entrepreneurship initiatives promote growth!

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