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How sustainable is the macroeconomic impact of foreign aid?☆

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Abstract

This paper examines how long the impact of foreign aid on growth lasts in recipient countries. An econometric technique is adopted which recognises that the impact of aid in the current year is a function not just of the current aid received but also of the aid received in previous years. Results indicate that foreign aid has a half-life of two years. In other words, half of the total impact of aid on growth is experienced within two years of its disbursement. Aid loans are found to have longer half-lives than their grant counterparts. Policy implications are discussed.

Keywords: Foreign aid; Sustainability; Economic growth

1. Introduction

Evaluating the impact of foreign aid is becoming an increasingly pertinent issue. In efforts to achieve the United Nations' Millennium Development Goals (MDGs) by 2015, donors have scaled up their aid programmes to record levels. Official Development Assistance (ODA) (the

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most commonly used measure of aid) increased to a record high of US$128.7 billion in 2010, before falling slightly in 2011 due to the Global Economic Crisis (GEC) (OECD, 2012).

Importantly, there are widespread concerns that the impacts of foreign aid are not sustainable, perpetuating the need for further foreign aid (Easterly, 2006; Riddell, 2007). Sustainability is concerned with measuring whether the benefits of an activity are likely to continue after donor funding has been withdrawn (OECD/DAC, 2010). If impacts of foreign aid are not sustained they are less likely to break poverty cycles and high levels of assistance will need to continue beyond the 2015 deadline for MDG achievement. Riddell (2007) argues that “the benefits of much official aid have been predominantly due to its success in addressing short-term, gap-filling needs. There have often been major difficulties in achieving longer-term sustainability for many aid-funded projects and programmes. Similarly, while a large number of projects and programmes have achieved their stated short-term objectives, far fewer have been successful in achieving or contributing to broader goals and outcomes in a lasting way” (Riddell, 2007, pp. 253–254).

This view is supported by many ex-post evaluations undertaken by the independent evaluation departments of major international donors. These evaluations often indicate that sustainability remains a significant challenge for donors with sometimes less that 50 per cent of projects being deemed as sustainable (see for example, ADB, 2010; UNDP, 2003; World Bank, 1985, 1990). However, the issue of impact sustainability at a macroeconomic level has not yet been examined despite an explosion of recent, largely favourable, evaluations of foreign aid.

While poverty reduction is the ultimate objective of most foreign aid programmes, a lack of reliable data measuring poverty in its many forms have implied that the vast majority of aid effectiveness studies examine the relationship between aid and growth. It is now one of the most heavily scrutinised relationships in the discipline of economics. There are a few notable studies which have failed to find any statistically significant relationship between aid and growth. However, the extensive literature examining the impact of aid on growth conducted over the past 15 years suggest a positive association and that growth rates in recipient countries would, on average, be lower in the absence of aid. A further finding from this literature is that there are diminishing returns to foreign aid. After a certain level of aid, its impact starts to tail-off with donors getting less ‘bang for their buck’. Most studies which test for diminishing returns to aid confirm the existence of this relationship.[1] Explanations for diminishing returns to aid include diminishing returns to capital/investment which aid often funds, poor donor practices (including the proliferation and fragmentation of projects and programmes), and aid induced ‘Dutch Disease’ impacts and real exchange rate appreciation.

The approach of aid growth studies typically involves the econometric analysis of panel data for developing countries, averaged over a four or five year time period. The analysis of the aid growth relationship is therefore usually restricted to a relatively short time period with studies providing very little insight into the dynamics of the impact of aid. Foreign aid can have a medium or long term impact in a recipient if, for example, it assists in enhancing a recipient’s infrastructure

[1] See Mekasha and Tarp (2011); Arndt et al. (2010); McGillivray et al. (2006) and Clemens et al. (2004) for reviews of the recent literature. The few studies which fail to find any relationship between aid and growth include Easterly, Levine, and Roodman (2003) and Rajan and Subramanian (2008). Studies which confirm diminishing returns to foreign aid include Hansen and Tarp (2000, 2001); Lensink and White (2001); Dalgaard and Hansen (2001); Hudson and Mosley (2001); Dalgaard et al. (2004) and Clemens et al. (2004). The literature also points to a number of disputes regarding which conditions are most conducive for aid effectiveness including the importance of the policy environment (Burnside and Dollar, 2000), the degree of structural vulnerability (Guillaumont and Chauvet, 2001) being in a post conflict period (Collier and Hoeffler, 2004) and being located outside of the tropics (Dalgaard et al., 2004).