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INEQUALITY, AID AND GROWTH: MACROECONOMIC IMPACT OF AID GRANTS AND LOANS IN LATIN AMERICA AND THE CARIBBEAN

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Aid effectiveness in Latin America and the Caribbean (LAC) has been little studied, despite the fact that it is the developing region receiving foreign aid with the highest per capita income and inequality levels. This paper uses a growth regression model to analyze the impact of Official Development Assistance (ODA) in LAC. We evaluate ODA effectiveness in relation to the growth rate of an 'inequality-adjusted GDP per capita' in order to precisely define the desired impact of aid in a region with high levels of inequality. The estimation produces three main results: aid is effective, in aggregated terms, once we deal with the effect of income inequalities; the impact of concessional loans seems to be greater than the impact of grants; and, aid may be more effective in less corrupt countries.

JEL classification codes: F35, O19, I30, C5
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I. Introduction

Economic research has paid significant attention to the connection between foreign aid for development and economic growth. Since the 1960s several development economists, starting with Paul Rosenstein-Rodan and Hollis Chenery, have claimed that the effectiveness of public international development policies — so-

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called Official Development Assistance, ODA — should be evaluated in terms of the stimulus finally exerted on the developing countries' growth rate of per capita income. Nevertheless, after more than 50 years of research it is still debatable to conclude that ODA stimulates growth in aggregate terms. In contrast with previous studies, this paper deals with three issues that have been insufficiently considered in the aid effectiveness literature:

Firstly, the majority of aid-effectiveness studies have analyzed the whole group of developing countries, paying limited attention to the analysis of regional experiences. Specifically, aid impact in Latin America and the Caribbean (LAC) — the developing region with the highest per capita income, but also with the highest inequality levels among those which receive aid — has been little studied, and it has only been pointed out that this region is an outlier in the general models of aid effectiveness.[1]

Secondly, preceding studies have analyzed the impact of aid on recipient countries' GDP per capita growth rate. However, this method involves a 'target problem', which has not been previously considered in the literature: it is not possible to distinguish if aid benefits the income growth of the relatively richer or poorer citizens, precisely when the latter citizens are, indeed, the target population of aid policies.[2] In this context, the intra-national distribution of foreign aid should help to reduce income inequalities. This is the reason why we evaluate aid-effectiveness in terms of the growth rate of the GDP per capita for the population with lower incomes, which we call the 'inequality-adjusted GDP per capita'.

Thirdly, previous studies have analyzed the aggregate ODA impact, thus neglecting the fact that different aid modalities may have dissimilar impacts on growth. In contrast, we disaggregate into ODA grants and ODA loans, and analyze the financial characteristics and productive incentives that may affect their potential impact on growth.

All in all, this article aims to analyze the impacts of ODA grants and loans on the inequality-adjusted rate of growth of LAC countries' income per capita during

[1] In practice, numerous studies include regional dummies (frequently LAC and Sub-Saharan Africa) as a control for their lack of fit to the general model (such as Lensink and White 2001; Kosack 2002; Burnside and Dollar 2004; and Ekanayake and Chatrna 2010). Few studies have run regressions for the restricted sample of LAC countries (e.g., Griffin and Enos 1970; and Campbell 1999).

[2] This distinction is particularly relevant for LAC countries, which register the highest levels of inequality among developing countries. According to the World Bank's (2005) *World Development Report on Equity and Development*, LAC's Gini coefficient was estimated to be around 53, well above the coefficients of Sub-Saharan Africa (45), East Asia and the Pacific (39), North Africa and the Middle East (39), South Asia (39), and Europe and Central Asia (34).