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# Why large dependence on foreign aid yet only small detectable growth effects in low-income countries

Special Report

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## Executive Summary

Many Africa's aid dependent countries, many of whom in the COMESA region, have implemented public expenditure and revenue management reforms since the early 1990s, aiming to improve budget planning and, in part, aligning aid with fiscal priorities.

In this special report, we bring together available evidence on how foreign aid receipts have interacted with recipient governments fiscal aggregates (government expenditure, tax revenue and domestic borrowing). Evidence overwhelmingly reveals that foreign aid is a fundamental component of public sector fiscal behaviour, is associated with increased tax effort and public spending and that it reduces domestic borrowing. This is not surprising, in part because fiscal reforms have improved both aid and expenditure management, contributing in a significant way to improvements in fiscal performance. Continued efforts by donors to coordinate aid delivery systems, make aid more transparent and support the improvement in government fiscal statistics would all contribute to enhance effectiveness of foreign aid. Moreover, the Chinese model of aid and assorted financing and economic and trade cooperation zones is improving connectivity and easing logistical bottlenecks, which, over the medium- to long- term is bound to boost Africa's export capacity and competitiveness.

## Introduction

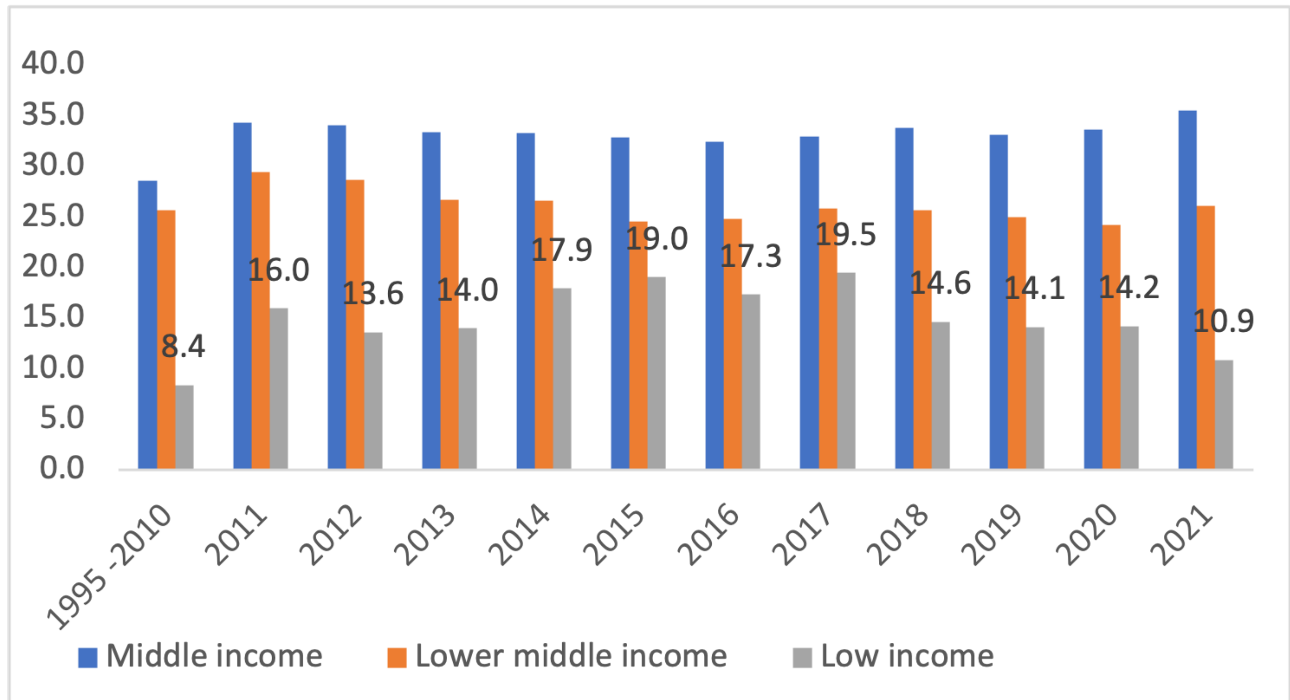
Low Income Countries (LICs), since their respective independences, have hugely depended on foreign aid to plug their fiscal gaps. Despite of this windfall, we can discern, if any, only small detectable evidence that aid has enhanced growth in the recipient countries, generating public debate as to its usefulness. In the subsequent sections, I summarize what is so far known about aid-growth interaction, then, put in context how foreign aid should ideally be mediated—if it were to enhance growth but has sadly been largely ignored in the aid effectiveness debate. I then review a few, largely COMESA country's evidence on how foreign aid has disrupted fiscal aggregates of public spending, tax efforts and domestic financing. Finally, I piece together a few lessons on how foreign aid effectiveness may be enhanced.

## Aid and Growth

Scaling up investment—a cornerstone for growth in LICs remains largely constrained by two gaps: insufficient savings and foreign exchange earnings1. For almost three decades, gross domestic savings, in LICs, as shown in Figure 1, have averaged about 13% of GDP, compared to 26% and 32% for lower middle income and middle-income country categories, respectively (World Bank, World Development Indicators, 2022). Such low level of savings is insufficient to provide the resources needed to finance the level of investment required to achieve these countries target growth rates.

1 Akin to the two-gap model of Chenery and Strout (1966), from which the underlying economic rationale for aid to developing countries can be traced.

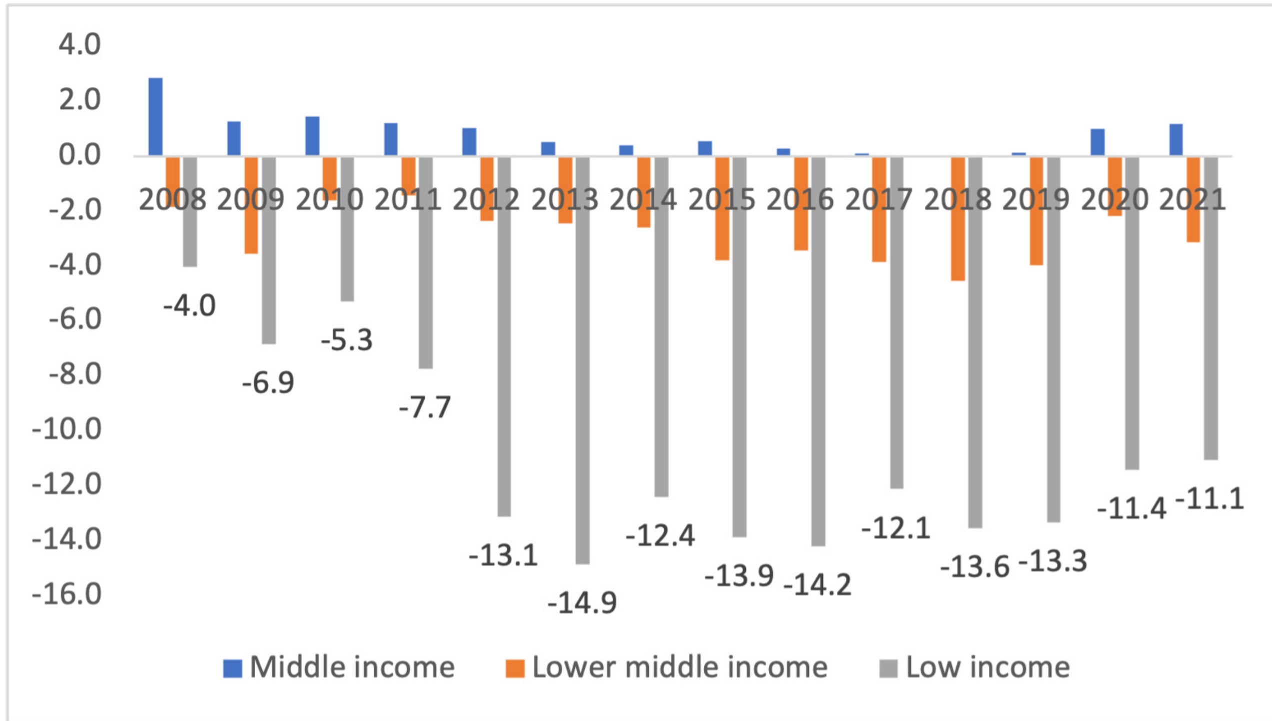
**FIGURE 1:**
**Gross domestic savings (% of GDP)**




Source: World Bank, World Development Indicators (2022)

Similarly, because LICs are unlikely to have sufficient export earnings, earnings in foreign exchange are insufficient to finance capital imports. Indeed, historical data, in Figure 2, suggests there is no year in which exports from LICs has matched their import needs, the magnitude of the mismatch being highest relative to the closest comparator, Lower Middle Income country category.

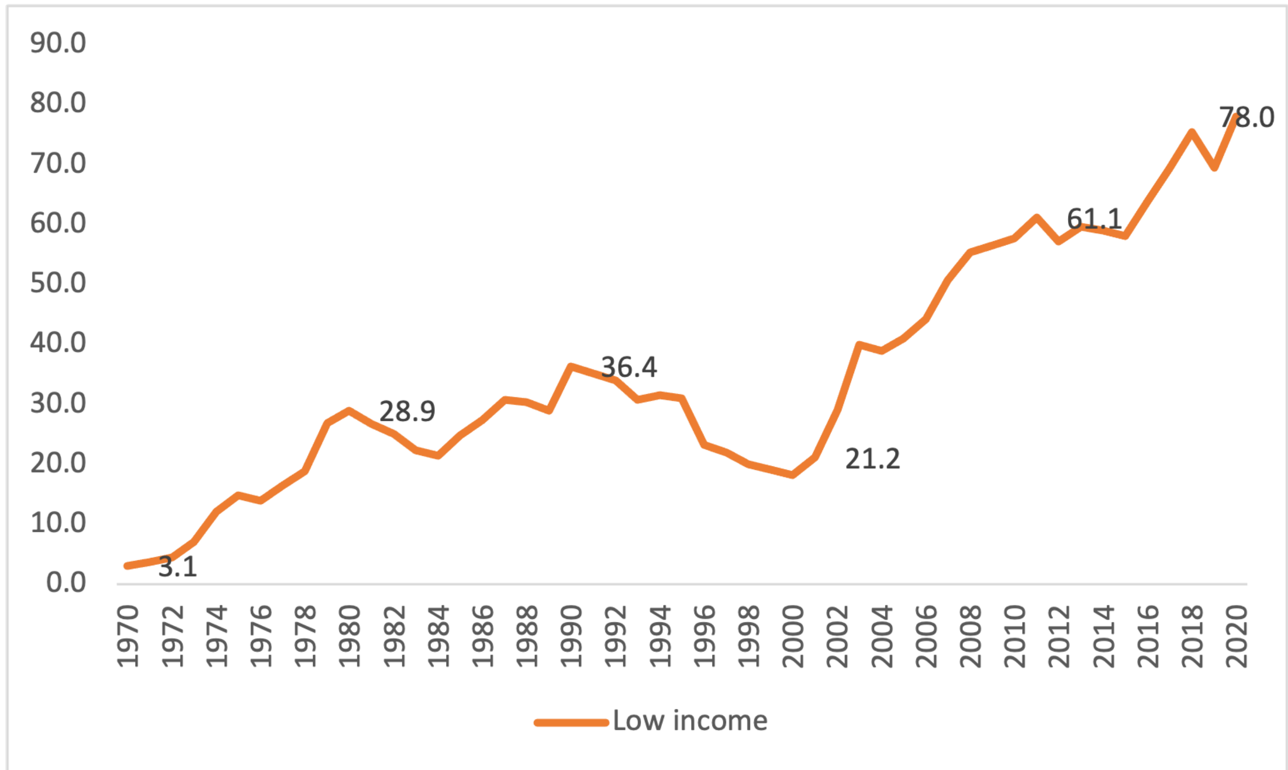
**FIGURE 2:**
**Trade balance (% of GDP)**




Source: World Bank, World Development Indicators (2022).

In such an environment of savings and foreign exchange earnings gap, capital flows—of which foreign aid is one form, becomes an important source of development finance as it relaxes the savings and foreign exchange constraints. Perhaps for this reason, LICs, as shown in Figure 3, have remained dependent on aid for many years.

**FIGURE 3:**
**Net ODA received per capita (% of GDP)**




Source: World Bank, World Development Indicators (2022).

Even if aid is now a less important source of revenue for some LICs than it was in the 1990s and has changed form with the aggressive entry of China, the debate as to whether aid is effective, judged in terms of its growth enhancing effect in recipient countries, rages on as it was over two decades ago. This is particularly in light of the World Bank (1998) landmark publication dubbed "Assessing Aid: What Works, What Doesn't and Why". A recent study summarizing aid-growth studies published since 2008 almost establishes a stylized fact, a collective evidence that aid leads to a small and hard-to detect long-run increase in growth (Arndt, Jones and Tarp, 2016).

I argue, however, that overt concerns with the growth effect of aid could have distracted attention from how aid affects the economy through the broader fiscal dimension. For a fact, most of the foreign aid that fiscal authorities deploy is given primarily to the government, inform of budget support. Therefore, any associated effect of aid on the economy can only be mediated by the public sector fiscal behaviour, i.e., the effect on government spending, tax revenue effort and domestic borrowing.

## The context as to how foreign aid is expected to interact with the recipient's domestic fiscal tools

In general, foreign aid donors are concerned with how recipient countries use their aid (McGillivray and Morrissey, 2000, 2004). That they hope that their efforts will contribute to the development of the target country and provide the necessary resources to fill gaps in the sectors seen as relevant (ibid). However, because foreign aid will often be distributed through the state, understanding its effects on the fiscal behaviour of governments is a necessary condition for its effective and successful deployment. The new incentives and conditions created by the addition of aid to the venue mobilization actions of any one state will disrupt how it disposes of the fiscal tools of tax revenues, expenditure and public debt in uncertain ways.

Aid packages come with strong pressures to spend (O'Connell, Adam and Buffie, 2008). So, aid packages are expected to be associated with a direct and significant effect on public spending. Beyond spending, aid packages may affect tax revenue either because of influences on tax effort or because reforms linked to aid conditionality affect tax rates or the tax base (Morrissey, 2015b). Moreover, aid may be associated with lower domestic financing especially where this is an element of donor conditionality. Notwithstanding these donor expectations that aid will increase spending, raise tax revenue and decrease borrowing, on the side of recipients, these, clearly are too general expectations to always hold true.

In fact, while, Eifert and Gelb (2005) observe that recipients may face a suspension of aid if donors do not observe that aid increases spending, spending may not increase by the full amount of the aid. This is either because some aid is directed to other uses such as interest payment or accumulation of reserves or because tax receipts decline or some of the aid "leaks" (the old age cancer of corruption or inefficiency). On the other hand, spending can increase by more than the aid, i.e., aid illusion—if, for example, governments have to match aid revenue or aid-financed government spending generates subsequent claims on future spending (that may need to be financed by domestic resources), such as the recurrent costs required to maintain an investment. In the case of aid illusion, officials misperceive and

overestimate how much aid will be received and therefore spend in excess of the budget constraint (McGillivray and Morrissey 2001) — a similar outcome could be observed if actual aid disbursements are less than anticipated.

Similarly, addressing the tax effect associated with aid tends to be difficult as there can be many effects in opposing directions (Morrissey, 2015b). For example, the conditionality on aid for trade may reduce tax revenue, at least in the short run, while on the other hand, donors who recognize this may actually increase aid to compensate for and/or encourage tariff reductions. Moreover, tax effort may reduce if recipient governments use the extra fiscal space provided by aid to keep taxes low or reduce tax-induced distortions, which may be desirable to crowd-in private investment. Relatedly, governments may treat aid as an alternative to domestic borrowing if concerned that the latter may deter private investment (by increasing interest rates and/or reducing domestically available credit), while in some cases multilateral institutions, such as the IMF may give aid to support conditionality to reduce domestic borrowing.

Foreign aid accounted for almost a third of government spending on average in low-income or sub-Saharan African countries and over 100 percent in some countries, some in the COMESA jurisdiction inclusive, in 1997 (Bwire et al, 2017). On average, during the 1990s, aid amounted to over 100 percent of government spending in Burundi and Ethiopia, and over 100 percent in Zambia and 20 percent in Kenya during 2001-07 (Morrissey, 2015b). Since 2015, Uganda has received an annual total of somewhere between 40 percent and 50 percent of the corresponding year's budget in net overseas development assistance (ODA) (The World Bank, World Development indicators 2021b, Isabelle 2021). In the earlier years, Uganda had received, on average, foreign aid worth 11 percent of its GDP between 1990 and 2006, having risen from a low of about 1 percent in 1980 to about 5 percent in 1986, hitting highs of about 19 percent in 1992 (Brownbridge, 2010). Experiences elsewhere suggest even higher predominance of aid in recipient country fiscal aggregates (Bwire et al, 2017). Thus, given that governments have counted on foreign aid when planning their budgets and policies, arguably, effectiveness of foreign aid is best ensured by transparent, reliable and predictable aid contributions.

The existing body of research on the fiscal response to aid suggests that because in principle most of the aid that is spent in a country goes to or through the government, or finances the provision of public goods and services that would otherwise place demands on the budget, aid is a fundamental component of public sector fiscal behaviour. To this end, country-based evidence seems to the only way to reliably explore these interactions as experiences between countries vary due to their different institutional foundations. We turn to country experiences in what follows.

## What does the Regional Experiences reveal?

The relationship between aid and recipient's fiscal behaviour has been explored in several of the COMESA region countries. In Zambia, donor aid has been reported to discourage efforts at tax collection and to increase government borrowing (Fägernas and Roberts (2004c). This has not been the case in past studies of Malawi and Uganda where aid was found to raise government expenditure and revenues with negligible effects on borrowing (ibid). A similarly negligible effect of aid on tax revenues was found for Kenya (Morrissey et al., 2007), where aid does seem to have increased public spending. In the case of Ethiopia, aid is not fungible, increases development expenditure specifically that intended by donors but not general recurrent government spending and does not have an effect on tax efforts, although borrowing increases due to unexpected decreases in aid revenue (Martins, 2010).

In the most recent study on Uganda (Bwire et al, 2017), aid has been shown to have a stable relationship with tax revenues, government expenditure and borrowing. Over the last thirty years, the Ugandan government seems to have incorporated aid into its fiscal planning; ostensibly planning to fund its expenditure via tax revenue, aid and domestic borrowing, in that order—internalization of aid that rejects the donors overly rated opposite case, known as 'aid exogeneity'. Other findings suggest that although the authority runs a budget constraint, of which aid is a component, it does not use aid to balance its budget and it is dependent on further borrowing to meet its obligations. In other words, instead of aid, tax revenues and government spending adjust to each other's movements to bring about a balanced budget. So, to speak, budget-spending plans adjust to tax revenues. Outside of the COMESA jurisdiction, aid in Ghana has been found to increase the tax base, facilitates higher revenues and thus allows the government to increase spending without needing to borrow more (Osei et al., 2005).

As stated earlier, critics have often argued that aid flows can lead to 'revenue displacement', a phenomenon where aid deters from efforts at tax collection. The evidence adduced above, based on most recent data, does not seem to lend credence to this word of mouth narrative. On the contrary, aid appears to have increased efforts at tax collection essentially due to the conditions attached by aid donors that require efforts to ensure sustainability of tax revenues. Furthermore, although aid is found to stimulate government spending, the movements are not equivalent or one-to-one, as the theory of 'aid additionality' would suggest.

In almost all country experiences, less than two-thirds of aid contributed to spending, which is consistent with aid being fully additional if at least one-third of the donor measure was not recorded in the budget. Most of these evidence are based on the Development Assistance Committee (DAC) data on aid. However, we also know that the measure overstates not only the amount of aid actually spent in the recipient (some technical cooperation is spent in the donor

country) but also the amount delivered through the budget (aid that does not go through the government cannot appear as government spending). Moreover, aid is not monolithic. Rather, it is given by a number of different donors whose coordination may be imperfect. Furthermore, aid appears to decrease costly domestic borrowing, which is consistent with the view that the latter is often triggered by unpredictability and volatility in aid. However, the evidence does not support a one-to-one 'perfect' substitution between the two either.

This said, the dynamics of aid seems to be changing remarkably with China's aggressive entry in Africa, under pinned by the natural resource intensity in China's economic growth and sub-Saharan Africa's (SSA) natural resources abundance. Most SSA countries seem to be shifting away from traditional sources of ODA, such as the Paris club and multilateral donors as these sources have become more constrained. China has proved to be liquid and has been providing financing which is easy to access with less stringent terms, making it a welcome competitor as it provides Africa the advantage over traditional donors. Importantly, China addresses the structural imbalances of the international economic system within which many African states are facing marginalization.

## Lessons for enhancing aid effectiveness from the existing country experiences

An overwhelming lesson worthwhile drawing from the country evidences is that introduction of better expenditure management through the Medium Term Expenditure Frameworks (MTEF) and associated measures in addition to better recording of aid inflows that finance public goods and services has been associated with improvement in budget management. Although aid is now a less important source of revenue than it was in the 1990s, it remains a significant component of country's budgets. There is therefore evident scope to improve further the accuracy of recording aid in the budget and increasing donor coordination to ensure that aid disbursements are predictable. Unpredictable revenues, aid or tax, remain a challenge because 'the reality of budgeting in our countries is that there is very little flexibility in the budget to reallocate funds to meet strategic priorities or accommodate fiscal shocks.

Country experiences reviewed reveal that recipient countries have shown ability to integrate aid into improved budget and expenditure management, so they remain deserving candidates for budget support as this makes it easier for the fiscal authorities to pool resources and plan accordingly. Continued efforts by donors to coordinate aid delivery systems, make aid more transparent and support the improvement in government fiscal statistics would all contribute to improving fiscal planning. Recipients need to know how much aid is available to finance spending and how this is delivered through donor projects or government budgets.

The evidence suggests that donors need not be concerned that aid reduces tax effort. Mobilising domestic revenue

remains a challenge because of the low tax base. The main distortionary taxes—majorly tariffs on imports and export taxes reduced significantly under trade liberalization since the mid-1990s. At first, as would be expected, this should have reduced tax/GDP ratios (given initial high dependence on trade taxes). However, over time, revenues could increase because of either a trade response (such as increased imports with lower evasion so revenue rises) or substitution with other taxes. The slow growth of the private sector, and especially wage employment, has limited growth in the effective income tax base. Donors can assist with tax administration reforms to improve collection efficiency, but if COMESA countries are to reduce aid dependence, growth in private sector incomes and employment is essential to facilitate an increase in tax revenue.

Bound together by intricate financial arrangements under China's Export Import Bank (Exim bank), the department of Commerce and China International Development Cooperation Agency (CIDCA), China is now not only the largest individual trading partner for SSA but also a major source of foreign direct investment (FDI) and foreign aid. China's financing commitment to SSA, mainly in form of preferential financing—provision of low-interest and interest-free loans and grants, debt cancellations, and establishment of economic and trade cooperation zones, has increased from USD 5 billion in 2006 to USD 60 billion in 2015 (FOCAC2, 2018). China's aid, unlike the DAC donors, is increasingly on quasi-barter basis, i.e., large-scale infrastructure projects (hydropower generation, railway and highways) for commodities. Recipient countries – largely those rich in natural resources, receive funding directly from say CIDCA and/or Exim bank through the Chinese companies (mostly construction and engineering) engaged in infrastructure development, which they agree to repay over several years, but in commodity terms, say minerals whose production and marketing may be facilitated by the construction project itself.

According to Deloitte insights3, since 2012, China's state-owned firms have financed one in five and built one in three projects in Africa in construction alone—making her the single largest player in African infrastructure. Overall, Chinese lenders are also Africa's single biggest creditor, holding roughly 21 percent of the continent's debt (Nantulya, 2021). In Figure 4 is the Nairobi-Mombasa railway, one of the many activities in the transport, shipping and port sectors intended to ease logistical bottlenecks, which opened in June 2017 as part of a broader regional integration scheme supporting the ambitions of the East African Community (EAC) activity by Chinese financiers and builders in East Africa. Similar Chinese-financed infrastructure developments include the Addis-Djibouti railway, the Suez Canal corridor in Egypt, which is underway, among others.

2 Forum on China-Africa Co-operation
3 China's role in African infrastructure and capital projects | Deloitte Insights, accessed March 7, 2023 at 8:26 AM (EAT)

**FIGURE 4:**
**A platform at the Nairobi Terminus of the SGR**

Photo: Macabe5387, The Forum on China-Africa Cooperation at 21: Where to Next? – Africa Center for Strategic Studies accessed on 3/6/2023, 8:22 AM (EAT).

## Conclusion

In the context of Chinese model of aid, aid could have a direct effect on growth. The infrastructural investment is assisting Africa to overcome the time age binding infrastructural constraint. Notwithstanding the concerns about the nature of China's financing relationship and increasing indebtedness of African economies, by improving connectivity and easing logistical bottlenecks and establishing economic and trade cooperation zones, Africa's export capacity could be boosted and African countries could be helped to integrate more fully into global value chain. However, in the context of aid from the traditional DAC donors, focusing on the growth outcomes of aid deflects parties from the real issue of how aid affects the economy, which in principle is mediated through the broader fiscal dimension. Crucially, the long-term need for foreign aid causes governments to incorporate this fund injection into their fiscal plans, alongside public expenditure, tax revenues and public borrowing. In this context, harnessing the desired effects of aid on African economies crucially calls for donors to increase the reliability and predictability of aid, co-ordinate aid delivery systems and make aid more transparent.

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