An Empirical Analysis of the Determinants of Foreign Aid: A Panel Approach

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Abstract

This paper uses a panel approach to examine the determinants of foreign aid. It examines the extent to which taxes on international trade and the scope of government activities, ethnicity, private credit, and education determine foreign aid. The paper specifies and estimates a model that explains the allocation of foreign aid among 151 countries over the period 1975 to 1998. The key empirical finding suggests that Taxes on Trade increases foreign aid dependency. Moreover, trade, private credit, foreign direct investment, GDP per worker, and government consumption are important determinants of foreign aid. The factors that appear to decrease foreign aid include: Years of schooling, private credit, trade, and GDP per worker. The factors that appear to increase foreign aid include: Taxes on international trade, ethnicity, and government consumption. (JEL O11, O47, P51)

Introduction

The empirical analysis of why foreign aid failed to increase the well being of aid recipient countries is one of the hotly debated issues in the growth literature. Until recently, the growth literature didn’t adequately explain the determinants of foreign aid. The relevant analytical question is not to assess whether aid is harmful or beneficial but why different countries receive different amounts of foreign aid. In other words, what determines the dependence on foreign aid? This paper attempts to identify the determinants of foreign aid and examines the extent to which taxes on international trade and the scope of government activities, ethnicity, private credit, and education determine foreign aid. Using alternative equations the paper endogenizes government consumption, taxes on trade, GDP per worker, and trade to capture their interrelationships. It theoretically builds upon Bauer [1972], who stressed the lack of free trade among aid-recipient countries. It further examines empirically the relationship between protective trade policies and foreign aid and thus attempts to apply Bauer’s theoretical framework to the data.

The rest of the paper is organized as follows. The next section reviews the literature in a public choice perspective. The following section presents the empirical results of the determinants of foreign aid and the last section is a summary of key findings.
Foreign Aid: A Review of the Literature in a Public Choice Perspective

Poor countries receiving substantial amounts of foreign aid have consistently registered negative growth rates. The proponents of foreign aid fail to acknowledge the role of incentives in both private and public activities. While they recognized aid’s intrinsic fungibility, they have underestimated its consequences. Since most foreign aid is government-to-government, one must understand how rulers allocate foreign aid resources. Whether or not foreign aid is invested in productive or unproductive activities is important; foreign aid might lack the positive externalities that come from hard work and self-reliance.

The theory of public goods explains why markets cannot provide certain activities. People will demand certain kinds of government actions because they are productive. Potential sources of market failures include externalities, public goods, monopolies and information asymmetries. An additional source of market failure in developing countries appears to be a lack of capital resources for economic development. Foreign aid is supposed to fill this vacuum. However, foreign aid is often provided government-to-government. This means that the government assumes a commanding and controlling role in the ownership, organization, distribution, and allocation of foreign aid resources. Unfortunately, this process provides little opportunity for the enhancement and development of private enterprises.

Foreign aid’s inability to increase economic performance stems from its lack of market institutions with well-defined property rights that encourage people to use their resources and skills in the most efficient manner. Not only are people the residual claimants of their resources with market institutions, but they also have transferable rights for their capital, which allows them to capitalize on the value of their capital and labor. This leads to cooperation and social harmony, which ultimately benefits society at large.

North [1981] identified factors that have helped or hampered economic progress historically. He concludes that the lack of financial resources never prevented nations from growing, but the lack of proper institutions and policies hindered economic performance. North [1990] further postulated that economic development is a function of, among other things, institutional apparatus, which depends on incentive structures and the information available to society. He argued that the type and pattern of institutions in the development process determine the structure of property rights and, together with the standard constraints of economic theory, determine the opportunities available in a society. Foreign aid institutions lack the type, the pattern, the incentives, and information necessary for private individuals to engage in productive exchange. This creates a property rights structure based on distributive rent seeking and not wealth generation.

Rowley [1998] attempted to explain why some African countries are worse off economically today than they were before the onset of foreign aid. He suggested that many African rulers lack the entrepreneurial experience necessary for production, and the only avenue for wealth accumulation is the diversion of resources (often provided through multilateral agencies) from productive economic activity to bank accounts in foreign countries. This further supports the hypothesis that foreign aid is simply a transfer of wealth rather than a creation of wealth that can be quickly dissipated into distributive activities.

Foreign aid is inherently distributive and, therefore, bad for economic performance, especially under settings where efficient political and economic systems do not prevail. It should also be noted that foreign aid exacerbates the political bias toward short-run gains from foreign aid resources. Since no one expects to reap the future profitability of aid, in