EVALUATING THE IMPACT OF FOREIGN AID ON GROWTH: A CASE OF KENYA

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Abstract

There is no consensus on aid effectiveness and the resulting policy recommendations have been conflicting. Foreign aid to developing countries is a subject of heated debate among politicians, economists, and development specialists. Over the past 50 years Kenya has received several billions of foreign aid, the equivalent of several Marshall Plans. Some of this has been extremely useful: Treatments for HIV/AIDs, food to prevent starvation, and support for immunization programs. A large amount of the literature on foreign aid on economic development in Kenya is based on cross-country analysis and therefore simply yields some patterns that hold on average. The goal of this paper is to evaluate the role of World Bank aid in economic development in Kenya. We find that World Bank aid has strong beneficial effects on per capita income in Kenya. We established a very strong statistical association between sound economic policies and the performance of the World Bank aid in Kenya in our period of study. The study has presented ample evidence that with sound track record of macroeconomic policy management that is by keeping inflation modest, prudent fiscal policy and good financial policy World Bank aid can spur economic growth. The implication for policy is that in order for Kenya to foster and sustain growth, closer attention should be given to increase of World Bank aid, stable macroeconomic stability and sectors where the aid is directed.

Key words: *Foreign aid, Official Development aid, inflation, public expenditure, economic growth.*

Introduction

The inability of Kenya to wean itself from foreign aid and duplicate the Asian miracle has puzzled many policy makers. Above all, Kenya has lagged other developing regions in attracting foreign direct investment (FDI) and competitively participating in international trade, the two major drivers of long term economic growth. Therefore foreign aid persists to be a contentious issue to date. This study will assess the effect of foreign aid on economic growth. Most aid does indeed work, but this does not imply either that it works in every country or in all situations (Cassen and Associates, 1994). Overseas development assistance (ODA) or foreign aid, remain the largest source of external financing of the development of least developed countries (LDCs). At the recent 2011 United Nations (UN) conference on LDCs, a renewed call was made for increased foreign aid flows to LDCs (targeted at approximately 0.15% to 0.20% of gross national income for development assistance committee members). There is little conclusive empirical evidence exists in support of growth enhancing effects from foreign aid.

Adam Smith (1776) argued that capital accumulation is the key requirement for sustainable economic growth. The American Marshall plan and other growth models opined that capital accumulation is the basic determinant of economic growth. When a large sum of funds is given to less Kenya it is expected to have positive impact in the reduction of poverty. The inability of Kenya to wean itself from foreign aid and duplicate the Asian miracle has puzzled many policy makers however critiques have been swift to fault both the donors (for crippling interference in Kenya's development policies and in some cases, for not providing the accurate quantity and quality of aid) and the 'corrupt' government agencies in some of the recipient countries (Shah, 2012). Over the past 50 years Kenya has received several billions of foreign aid, the equivalent of several Marshall Plans. Some of this has been extremely useful: Treatments for HIV/AIDs, food to prevent starvation, and support for immunization programs, for example, have saved lives and enhanced our universal humanity.

The Harrod Domar (1947) and Rostow (1953) influenced the public policy on foreign aid and its objective to boost the economies of the LDCs to self-sustainable growth rates. Rosenstein (1961) argued that the objective of aid is to accelerate the economic development up to a level where a

satisfactory rate of growth can be achieved on a self-sustaining basis. When this level is achieved by the developing countries they can substitute external aid by local saving.

Chenery and Strout (1966) outlined three phases of development, during the first phase, due to the shortage of financial resources, investment levels are below the rate required to achieve targeted growth. Aid can be used to fill up the gap between available savings and investment required to meet the targeted growth. During the second phase, a trade gap appears, as export earnings are insufficient to finance required imports of capital equipment and raw materials. During the third phase, although the savings–investment gap would disappear, due to structural rigidities the foreign exchange gap would continue requiring aid to finance imports. Because of aid's role in filling the savings– investment and exports–imports gaps, the model developed by Chenery and Strout has come to be known as the two-gap model. It is concluded that the inflow of foreign capital, which is scarce in less developed countries, is the engine of growth and development. The role of foreign aid where the World Bank is the highest contributor we believe springs logically from this analysis.

The moral imperative behind aid is reflected in many value based systems, in Islam Zakat, an obligation to give to those in need is one of the pillars of the religion. The Christian tradition of the jubilee calls on creditors to write off debt. Whether motivated by human rights, religious values or economic reasons World Bank aid or foreign aid in general has played a crucial role in eliminating mass poverty in LDCs. Between 1961 and 2011, 36 countries worldwide graduated from eligibility for the most concessional aid from DAC donors to middle-income status. But eight of these subsequently reversed and are now eligible again for the most concessional form of aid. Perhaps the most celebrated graduate is South Korea. As recently as 1960 it was receiving 10% of GDP in aid (not counting an even larger share of non-aid military support from the US). In 2010, South Korea completed the transition from recipient to donor and became a member of the DAC group of donors.

Statement of the problem

With billions of dollars poured into Africa over the past fifty years and the continent still unable to feed or look after itself without help, the controversial subject of 'Aid' is increasingly under the

spotlight. What good has it done, how effective is it. More than 50 years after independence in 1964, poverty continues to haunt Kenyans. The World Bank's mission statement is "to reduce poverty and improve living standards by promoting sustainable growth and investment in people". In a developing country like Kenya, where rapid economic growth has taken centre stage, such studies analyzing the effect and performance of the foreign aid assume a vital significance not only for politicians and policy makers in Kenya, but also the donor community at large. World Bank (2010) found 52% of the population in Kenya living on an income below two dollars a day.

Having the above economic and poverty scenario of Kenya calls us to find out whether the financing of past programmes and projects by the foreign aid through the Government of Kenya do reach the vulnerable section of the society. Many studies take Africa as homogenous continent which is erroneous. Africa is made up of 55 independent countries following various ideologies and economic policies, all of which influence the efficacy of foreign aid. It will give vital information about the development and eradication of poverty in Kenya by the World Bank.

Objectives of the study

1. To determine whether the foreign aid has spurred growth in Kenya
2. To find out whether the foreign aid contributes in the rise of welfare in Kenya
3. To establish whether the foreign aid has positive impact on economic growth when there is sound macroeconomic policy in Kenya

Hypotheses of the study

1. Foreign aid has spurred growth and economic development in Kenya
2. Foreign aid contributes to increasing aggregate welfare in Kenya
3. Foreign aid has positive impact on economic growth when there is a sound macroeconomic policy in Kenya

Research methodology and data collection

This research has proceeded through descriptive and quantitative analysis. We have used secondary data collected from reports by the World Bank and the International Monetary Fund. The ordinary least square (OLS) regression method has been used. The variables used are the GDP per capita, Official Development Assistance (ODA) the World Bank Aid, total national population, money supply, inflation, Infant mortality, and total government expenditure. Our study has adopted the recent empirical studies which have been carried out by Burnside and Dollar (1997) and the basic model of Chenery and Strout (1966).

Limitations of the study

The study is limited to the performance of the foreign aid in economic development of Kenya; the findings will not be applied universally to all countries. Level of democracy influences economic development of the country but due to complexity in its quantification it was not taken into consideration.

Literature review

Chenery and Strout (1966) found that due to the shortage of financial resources investment levels are below the rate required to achieve targeted growth. The trade gap and foreign exchange gap can be filled by aid. The study established a positive relationship between aid and growth and therefore justified aid for two reasons: to fill the savings–investment gap and the foreign exchange gap.E. Mason and R. Asher (1973) the study attempted to trace the history of the World Bank and assessed the World Bank as a development agency and a guide to a development policy. The study revealed that the World Bank successfully negotiated the short transition from lending exclusively for reconstruction in Europe to lending for development in the less developed world. The foreign aid has had a substantial and generally beneficial impact on the areas in which it has concentrated its lending.

These countries have low savings rate, undiversified tax-base, and limited access to international capital markets and despite liberalizing their capital accounts, their domestic financial markets are weak and in some cases, missing. A combination of weak or underdeveloped financial markets and capital account liberalization can have dire consequences in terms of increasing a country's vulnerability to financial volatility, deterring long term FDI (Hermes and Lensink,

2003; UNCTAD, 1996b) and even attracting short term capital that has unfavorable growth effects (Lensink and Morrissey, 2002).

Heller, P.S. (1975) developed a cross-sectional time series model to analyze the behavior of the public sector to foreign aid flow in eleven African countries where Kenya was included in the period of 1960-71 particularly it was concerned whether aid resulted in increased investment needed to spur growth and development. The study established that aid not only increases investment but also simultaneously facilitates a reduction a level of domestic taxes and borrowing.

World Bank (1976) asserted that there are significant benefits from improving the quality and quantity of village water supply as it directly contributes to improvement in public health. It was concluded that village water supply projects are vital in economic development.

Bereket Habte Selassie(1984) established that the Bank had become the leading multilateral international lending agency, with an expanding role covering a variety of sectors and involving billions of dollars' worth of loans to the less developed countries, on conditions that are not available from commercial banks. The World Bank operates within the framework of a system established at the close of Second World War at Bretton Woods, New Hampshire, guided by the United States of America.

Mahendra Pal (1985) –The Second World War had brought colossal destruction to Europe. The majority of ports in Europe and many in Asia had been wrecked, bridges had been blown up; railway locomotives had been vanished. Furthermore over 60 million dead, great cities reduced to rubble, families torn apart this made Europe to be economically exhausted after the war. Therefore the most important factor in assisting speedy economic recovery in the immediate post-war years was the injection of foreign aid into the European economy by the World Bank. After successful reconstruction of ravaged Europe, the World Bank turned its priority to long-term financing of development. The study asserts that economic policy may be linked to political policy and therefore World Bank considerations may also have some influence on the domestic affairs of the country. The study also established that the World Bank in the third plan of India financed eight loans for power projects which generated 8% of the total India's generating

capacity. The World Bank provided finance for irrigation, seeds, fisheries, weed control projects and telecommunication facilities.

Sanghvi (1985) the study revealed that the decline in the interest rates both in the donor countries as well as World Bank credits made the terms of foreign aid a little harsh. The study concluded that the role of bilateral aid was dwindling while the role of multilateral World Bank aid was steadily expanding. Rana (1987) found that foreign capital made a positive contribution to the growth of these Asian countries, and in general higher aid flows were associated with more productive investment.

Bhavnani and Bazzi, (2011) established that the quality of aid and the timing of aid has a significant effects on growth,, the study distinguishes between multilateral aid and bilateral aid and, further, separate development aid (non-geostrategic) from non-development aid (geostrategic). The study concludes that aid flows based on geostrategic factors have neutral effects on growth, while the non-geostrategic aid has growth enhancing effects. Timing of the aid impact also matters in determining the aid-growth relationship (Clemens et. al, 2011)

Karras (2006) examines the relationship between foreign aid and growth in per capita GDP using annual data from the 1960 to 1997 for a sample of 71 aid-receiving developing countries it concludes that the effect of foreign aid on economic growth is positive, permanent, and statistically significant. More specifically, a permanent increase in foreign aid by $20 per person results in a permanent increase in the growth rate of real GDP per capita by 0.16 percent. These results are obtained without considering the effects of policies.

Jonathan E Sanford (1989) the study revealed that the World Bank was doing better in reducing poverty than before. The Bank's current programme was more poverty-oriented than bilateral aid programmes financed by the United States and other key donor countries. The World Bank aid combined development programme and basic human needs which are firmly grounded on a concern about poverty. Bade Onimode (1989) says that World Bank aid alone will not be adequate; debt relief is also vital if the international community genuinely wants to stop millions of Africans who are at the verge of slipping to poverty of less than a dollar a day.

A study by Vyuptakesh Sharan (1991) revealed that transport, sanitation, and water supply were financed, as well infrastructure. For the sound project to accomplish its efficacy there should be administrative and managerial capabilities available. Collier and Dollar (2002), Aid should be directed to countries, which already have good policy environment and governance this implies that the foreign aid affect growth through its allocation and growth in turn will lead to poverty reduction only where there is a sound policy environment.

James Njeru (2004) found that there is a positive and statistically significant relationship between the share of government expenditure in GDP and the share of net disbursement of overseas development assistance (ODA). The study finds there are strong indications that the government renders aid fungible by financing recurrent expenditures. This means that the government substitutes the amount for development expenditure to finance the recurrent expenditure like salaries and maintaining the civil service when there is a financial crisis.

Stanley Fisher (2004) established that the World Bank plays a vital role in lending to member countries, coordinating aid, technical assistance and its research and policy analysis. Government spending has a positive long-term influence on growth, and there is no evidence that taxes retard this. The aid to Kenya could be more effective if given in form of grants, and associated with fiscal discipline. The government spending in its totality has spurred the per capita income and growth in Kenya.

Basic model

The basic model, which will be tested, will be:

$$\text{Log}(Y) = a + b_0 \log x + b_1 \log x + b_2 \log x + b_3 \log x + b_4 \log x + b_5 \log x + b_6 \log x + u$$

Log (Y) refers to the per capita income.
a is a constant.
ODA refers to the official development assistance ratio of GDP.
EXPG refers to the total government expenditure ratio of GDP.
M2 refers to the money supply ratio of GDP an indicator for macroeconomic stability and financial deepening Kenya.
POP refers to the population of Kenya.
INFL refers to the inflation rate of Kenya.
MRT refers to the infant mortality of Kenya.

Low mortality rates and high life expectancy are good indicators of overall health conditions. High mortality rates are associated with other unfavorable human development indicators.

Regression results

$$\text{Log}(Y) = a + b_0 \log x + b_1 \log x + b_2 \log x + b_3 \log x + b_{4\log} x + b_5 \log x + b_6 \log x + u$$

$$\text{Ln(GDP)} = 3.38 + 0.01(\text{ODA}) + 0.005(\text{WBA}) - 0.105(\text{EXPG}) + 0.07(\text{M2}) - 0.204(\text{POP}) - 0.0003(\text{INFL}) - 0.001(\text{MRT})$$

(1.69) 0.5) (0.14) (-1.89) (2.01) (-1.68) (-0.66) (0.02)

$R^2 = 0.99$ D.W =2.6 F-statistic =974

GDP refers to GDP per capital income of Kenya.
WBA refers to World Bank aid
EXP refers to government expenditure.
M2 refers to broad money supply each as a ratio of Gross Domestic Product in Kenya.
POP refers to population of Kenya
INFL refers to inflation
MRT refers to infant mortality rate

All the variables are in their log form.

The above results show that foreign aid has a positive sign thus positively correlated with economic growth in Kenya.

Government expenditure has negative sign and the t-value is significant, thus it is negatively correlated to economic development in Kenya. Money supply is a parameter for sound macroeconomic policy and financial deepening is positively and highly significant in economic development in Kenya.

Population has a negative impact on the per capita income in Kenya as predicted. Population growth is also often used as a proxy for the rate of growth of labor input in the production process. In studies on African economies, population growth, especially in urban areas, has been found to be a strong determinant of infrastructure development and other key

Conclusions and policy implications

We would like to emphasize that aid is even more effective in economic development when invested in human capital. Foreign helps in financing projects in family planning, early

childhood development, healthcare and providing facilities for education, hence leading to gender equity which acts as a powerful force for reducing child mortality rate. The empowerment of women by human development through projects funded by the foreign aid influences child wellbeing through enhanced control over fertility rate, greater use of health services and better knowledge of health interventions.

Thus it is evident from the coefficient of determination R2 and R-2 that the variables explain 99% of variation of the relationship of the independent variable and the explanatory variables in determining economic growth in Kenya. D.W is high, 2.6, implying that there is no autocorrelation between the independent variables. F-statistic is highly significant and determines goodness of fit of the whole regression equation.

We can conclude that sound economic policies are significant in the performance of the foreign aid in economic development of Kenya. Our results indicate that by raising population by one percentage point will decrease the per capita income by 21 cents. The study also concludes that good governance, political stability and well developed financial markets all provide conducive environment for economic growth.

A strong and reliable banking system is needed to bolster confidence in public financial management and enhance efficiency in the delivery of services to the urban as well as rural areas. The results show that when inflation increases by one percentage point it will decrease the per capita income by 0.14% points. All parameters are statistically significant.

The findings in this confirmed that foreign aid has spurred economic development of Kenya. We established a very strong statistical association between sound economic policies and the performance of the World Bank aid and foreign aid in Kenya in our period of study. The study has presented ample evidence that with a sound track record of macroeconomic policy management that is by keeping inflation modest, prudent fiscal policy and good financial policy foreign aid can spur economic growth. The question of whether aid is effective at promoting growth and development has been hotly contested for years. However, this research shows that over long-term aid disbursements have had positive effects on the economy of recipient countries. But growth is not the only aim of aid. Thus, the findings of this study are, for the most

part, consistent with findings of previous studies on the effects of foreign aid on economic growth. A policy implication which may be drawn from the study is that foreign capital inflow can have a beneficial effect by supplementing domestic savings rather than replacing them. There should be more empirical research from other countries to consolidate the evidence.

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