The fiscal management of foreign aid in sub-Saharan Africa

Foreign aid is managed by governments whose countries are in need. Their decisions on how that money is managed greatly affect countries' subsequent economic performance. Loujaina Abdelwahed, Assistant Professor in Economics at The Cooper Union, argues that whether aid is received permanently or temporarily is an overlooked determinant of how a recipient country's fiscal performance reacts. She focuses her research on foreign aid received by countries in sub-Saharan Africa between the years 1990 and 2016.

Foreign aid is mostly managed by the public sector in recipient governments. The decisions that these governments make concerning aid received from other countries can greatly affect the subsequent economic performance of their own countries. Loujaina Abdelwahed, Assistant Professor in Economics at The Cooper Union, argues that whether aid received from donor countries is permanent or temporary is a key determinant in how a recipient country's fiscal performance reacts.

Abdelwahed believes that this facet of the management of foreign aid is often overlooked. Her research therefore attempts to bridge the gaps in improving foreign aid policies. She focuses on foreign aid granted to countries in sub-Saharan Africa between the years 1990 and 2016. By separating temporary and permanent aid grants during this time, Abdelwahed shows that the fiscal responses generated by the two distinct types of aid are meaningfully different. She goes on to provide important policy implications that should be taken into consideration during the designing of aid programmes to foreign countries.

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Most of the research on foreign aid has focused on how governments adjust their budgets in response to large amounts of aid received. These studies highlight that aid is largely used to finance government spending on both consumption and investment, and that there are no robust effects on taxation policy. Other studies have attempted to differentiate between specific types of aid. For instance, one study found that project aid (which is directed to specific projects in specific sectors) increased public investment. In contrast, programme aid (which is more flexible for recipient governments) leads to higher rates of government consumption.

An overlooked determinant of fiscal responses in prior studies, however, is whether aid monies received are permanent or temporary. Overlooking this facet of foreign aid results in misleading estimates of the governmental fiscal responses. In her research, Abdelwahed separates the fiscal effects of temporary and permanent foreign aid, and assesses how each affects both recipient governments' financing choices (choice between taxation and debt issuance), and their responses in terms of recurrent spending, public investment, tax collection, and domestic borrowing.

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This allows for a relaxation of the restriction imposed by most of the prior literature that insists that both temporary and permanent foreign aid have the same fiscal effects.

THE CHOICE BETWEEN TAXATION AND DEBT ISSUANCE

Abdelwahed argues that because foreign aid is considered an additional source of financing government operations, it ultimately affects the subsequent governmental choices concerning other sources of funding: namely, taxation and debt issuance.

Abdelwahed's methodology is comprised of a theoretical framework that shows that the impact of foreign aid on the aforementioned financing choices depends on whether aid received is permanent or temporary.

By testing the predictions of the theoretical framework on data from 26 sub–Saharan African countries over the period 1990–2016, the research shows that foreign aid received on a permanent basis is mostly associated with an increase in debt issuance (increasing the fiscal deficit). As Abdelwahed explains, 'debt issuance –increasing the stock of debt – is equivalent to increasing the fiscal deficit'. In contrast, foreign aid of the same size but received in a temporary form, more commonly leads to a decrease in fiscal deficit. What is revealed most clearly from this analysis is how the response of the fiscal deficit to aid inflows is directly linked to the response of government spending. A permanent aid 'shock' leads to increasing the government spending by more than the amount of aid received, which leads to an increase in the fiscal deficit. Yet a temporary aid shock tends to increase the government spending by less than the aid received, thus leaving funds to reduce the existing deficit.

Abdelwahed argues that whether aid is received permanently or temporarily is an overlooked determinant in how a recipient country's fiscal performance reacts.

FISCAL RESPONSES TO FOREIGN AID

Abdelwahed also assesses the response of the government fiscal operations to permanent versus temporary inflows of foreign aid. From this, she generates four results:

First, separating foreign aid grants into permanent and temporary components leads to different fiscal responses. Thus, failing to acknowledge these differences imposes false constraints on the estimated fiscal effects of a given recipient country's economy.

Temporary aid may be more useful in supporting fiscal adjustment programmes in aid recipient countries in need of financial assistance.

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Whether aid is received on a permanent or temporary basis does not seem to impact a recipient government's tax-collection policy.

Second, temporary aid is associated with fiscal adjustments, such as lower domestic borrowing and increasing recurrent expenditure, while permanent aid is associated with higher public investments.

Third, even though foreign aid leads to a recipient government increasing its spending on both consumption and investment, the response of investment expenditure (ie, acquiring fixed assets) is stronger and more persistent when

Abdelwahed's results have important implications for future policymakers on the design of aid programmes to developing countries.

compared to the response of recurrent expenditure (ie, spending that does not result in acquiring fixed assets). For example, if a country spends on building a hospital (ie, investment) then the recurrent expenditure will be the subsequent costs of running the hospital. So the increased recurrent expenditure is in fact, complementary to investment expenditure.

Furthermore, the response of public expenditure to permanent aid is larger and more persistent when compared to the response to temporary aid. This suggests that stabilising aid flows can lead to less volatility in public investments and generate stronger economic growth.

Fourth, whether aid is received on a permanent or temporary basis does not seem to impact a recipient government's tax-collection policy. Temporary aid is associated with a slight, temporary increase in tax collection, while permanent aid is not associated with any changes.

Abdelwahed's findings have some important implications. Merely estimating how a government chooses to respond to received foreign aid (ie, grants versus loans versus debt relief) would be misleading, as the *frequency* of these types of aid would affect the recipient government's decision.

Understanding how foreign aid received on either a temporary or permanent basis is allocated to specific budgetary uses will elucidate how that aid will affect the economic performance of the recipient country.

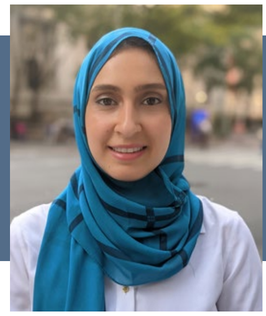
Abdelwahed's results have further important implications for future policymakers on the design of aid programmes to developing countries. First is the fact that stabilising foreign aid flows, although leading to higher fiscal deficit and borrowing in recipient countries, actually promotes an increase in public spending. Although permanent aid leads to higher borrowing, it generates more persistent effects on public investments. This might be a channel for economic growth and the alleviation of poverty.

Stabilising foreign aid flows, though leading to an initial higher fiscal deficit in recipient countries, promotes an increase in public spending.

This is compliant with existing literature which claims that a stabilised and consistent flow of received aid helps developing countries with economic growth.

Equally important is the fact that temporary foreign aid helps to reduce a recipient country's fiscal deficit, which makes it suitable and advantageous to countries seeking a fiscal adjustment programme. Temporary aid motivates fiscal adjustments, such as a reduction in domestic borrowing, and therefore may be more useful in improving fiscal circumstances in countries in need of economic assistance.

However, in countries where public spending increases by more in response to foreign aid than to other methods of income, such as taxation, policymakers must develop economic conditions and foreign aid programmes that ensure aid is an effective means of development, rather than merely enabling government financial operations.



Behind the Research

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Research Objectives

Loujaina Abdelwahed's research focuses on foreign aid and natural resources and their impact on fiscal decisions and economic inequalities.

Detail

Bio
Loujaina Abdelwahed is Assistant Professor of Economics at the Faculty of Humanities and Social Sciences at The Cooper Union. She received her PhD in Economics from the University of Illinois at Chicago. Prior to that, she worked as an economist at the Macro Fiscal Policy Unit in the Egyptian Ministry of Finance.

References

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Personal Response

Could you provide us with a case study of where either permanent or temporary aid was a great success in improving the fiscal conditions of a recipient country?

An example of temporary aid that can help countries improve their fiscal conditions are IMF-supported programmes. When countries borrow from the IMF, they agree to adjust their economic policies according to the conditions imposed by the IMF, which typically include targets on the government budget balance. An example for a sub-Saharan African country that benefited from such a programme is Ghana, which in 2015 took a $918 million loan to stabilise the economy. The budget deficit decreased from 13% of GDP in 2014 to about 5% of GDP in 2018. (source: www.imf.org/en/Countries/GHA/ghana-lending-case-study).