Foreign Aid, Public Expenditure And Economic Growth: The Nigerian Case

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ABSTRACT

Foreign aid represents an important source of finance in most countries in Sub-Sahara Africa (SSA), including Nigeria, where it supplements low savings, narrow export earnings and thin tax bases. In fact, foreign aid is considered to be a major supplement to government expenditure in Nigeria. As a result, foreign aid can have positive effect on economic growth, through public expenditure if properly channeled to the productive sectors of the economy. This paper therefore seeks to investigate the impact of foreign aid and public expenditure on economic growth in Nigeria. It reveals that foreign aid and public expenditure impact positively on the economic growth in Nigeria, with foreign aid indicating a very significant impact on growth.

Keywords: Foreign Aid; Public Expenditure and Economic Growth

1.   INTRODUCTION

There is growing international awareness that poverty anywhere is dangerous to prosperity everywhere and prosperity anywhere must be shared everywhere. In the past, especially in the Cold War environment, foreign aid was at times used to "buy" elites and thus influence affairs in third world countries. Effects of development were viewed as secondary. This approach is no longer acceptable because developing nations' importance to global security has risen significantly in recent years. For instance, several developing countries in Asia and Africa have served as staging points for worldwide terrorist attacks. Also, industrialized countries have realized the need for a close cooperation with the government of developing countries to ensure global security. They have also begun to understand that persistent poverty makes developing countries vulnerable to insecurity and other threats (Krueger, 1997).

Consequently, donor countries have begun to mobilize additional resources for the needs of developing countries. Several donors have pledged to reach the United Nation's target level (0.7 percent of donor's gross national income) for ODA[1] over the next decade and others have begun to significantly increase their commitment for development assistance. Based on new pledges and greater commitments to development assistance from donor nations, there is a possibility of significant scaling of foreign aid resources far beyond the current and past levels (Heller, 2005). However, from the donors' perspective, the commitment to increase aid flows to developing countries is only the starting point. But donors have to ascertain that aid flows are allocated among recipients and various sectors efficiently to ensure that resources will promote economic growth in recipient countries.

The amount of foreign aid received by the country and the trend has witnessed both increase and decrease in the past. For instance, there was gradual reduction in the amount Nigeria received as aid between 1970 and 1979 (from $590.47million to $28.92million), and it later rose to $473.63million in 1989. Between 1990 and 2004, there was no specific direction in which the amount received as aid by the country moves. By 2005, Nigeria experienced a sharp increase in the amount she received as aid. The value rose from $360.78million in 2004 $6799.81million in 2005. The following year (2006) also witnessed almost the double amount of the amount she received in 2005; it rose to $11781.51million but later fell to $1385.2million in 2007. Despite the increased foreign assistance to

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[1] Official Development Assistance

Nigeria, macroeconomic performance has remained weak (OECD[2], 2007). The expectation is that aid should induce the growth of the recipient nation, however it has been unrealistic. The explanation is that aid largely goes to consumption rather than productive activities which crowd-out domestic savings and investment. The country occupies most of the bottom places in income per capita with large percentage of the population living in poverty and the economy is characterized by low life expectancy, high AIDS prevalence, low level of literacy, infant mortality, (Eregha, 2009). For instance, the percentage of population that live on less than $1 stood at 70.8% as at 2008,(compared to 70.2% in 2000), the national poverty rate of the country is given as 34.1% as at 2000.

The study intends to analyze the impact of net disbursement of foreign aid, via the official development assistance to the country, on economic growth viz-a-viz the impact of government expenditure on the growth of the economy. Given the facts presented above, it is therefore pertinent to ask whether and to what extent has foreign aid during the same period may have caused or contributed to economic growth. The remaining part of this paper is structured into four sections. Section two presents some salient issues about foreign aid, public expenditure and economic growth in Nigeria. The empirical literature review is presented in section three while section four is on the methodology used in the study, sources of data, analysis and presentation of results. The conclusion is presented in the last section.

Table 1

S/N	Country	Total ODA	Population	ODA Per Capita
1	Nigeria	18973.32	149,229,090	127.14
2	Congo DR	9947.67	11,862,740	144.81
3	Tanzania	7522.96	41,048,532	183.27
4	Mozambique	6581.21	21,669,278	303.71
5	Ethiopia	6364.89	85,237,338	74.67
6	Sudan	6158.86	41,087,825	149.9
7	Egypt	6151.36	78,866,635	78.00
8	Cameroun	5644.3	18,879,301	298.97
9	Uganda	4754.78	32,369,558	146.89
10	Zambia	4621.92	11,862,740	389.62
11	Ghana	4081.07	23,887,812	170.84
12	Kenya	3443.72	39,002,772	88.29
13	South Africa	3248.75	49,052,489	66.23
14	Senegal	2940.22	13,711,597	214.31
15	Morocco	2769.4	31,285,174	88.52
16	Mali	2391.94	13,443,225	177.93
17	Madagascar	2326.59	20,653,556	112.65
18	Burkina Faso	2183.95	15,306,252	138.7
19	Malawi	2159.03	15,028,757	143.66
20	Cote d 'Ivorie	1906.82	20,617,068	92.49
21	Rwanda	1754.65	10,746,311	163.28
22	Tunisia	1516.3	10,486,339	144.6
23	Niger	1500.44	15,306,252	98.03
24	Sierra Leone	1452.5	6,440,053	225.54
25	Zimbabwe	1411.55	11,392,629	123.9
26	Benin	1364.85	8,791,832	155.24
27	Algeria	1349.64	34,178,188	39.49
28	Burundi	1048.79	9,511,330	110.27
29	Eritrea	969.56	5,647,168	171.69
30	Chad	936.15	10,329,208	90.63
31	Guinea	911.62	10,057,975	90.64
32	Liberia	833.65	3,441,790	242.21
33	Namibia	733.82	2,108,665	348
34	San Tome & Principe	155.99	212,679	733.45

Source: http://stats.oecd.org/ and Authors' compilation

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[2] Organization for Economic Cooperation and development

2.   SOME STYLIZED FACTS ABOUT FOREIGN AID AND GROWTH IN NIGERIA

Nigeria ranks first in Africa in terms of total aid received by countries over the years. Although, in per capita terms, it is not on the top of the list, and this could not be far-fetched from the fact that it has the largest population in Africa. Presented below are tables showing the comparison between Nigeria and some other African countries; it shows their ranks in terms of total aid received as well as in terms of their per capita ODA. The table shows that Nigeria ranks the first in Africa in terms of total aid received (from 2001 to 2007), it was ranked as the 21st in terms of its per capita ODA, (total ODA divided by the country's population).
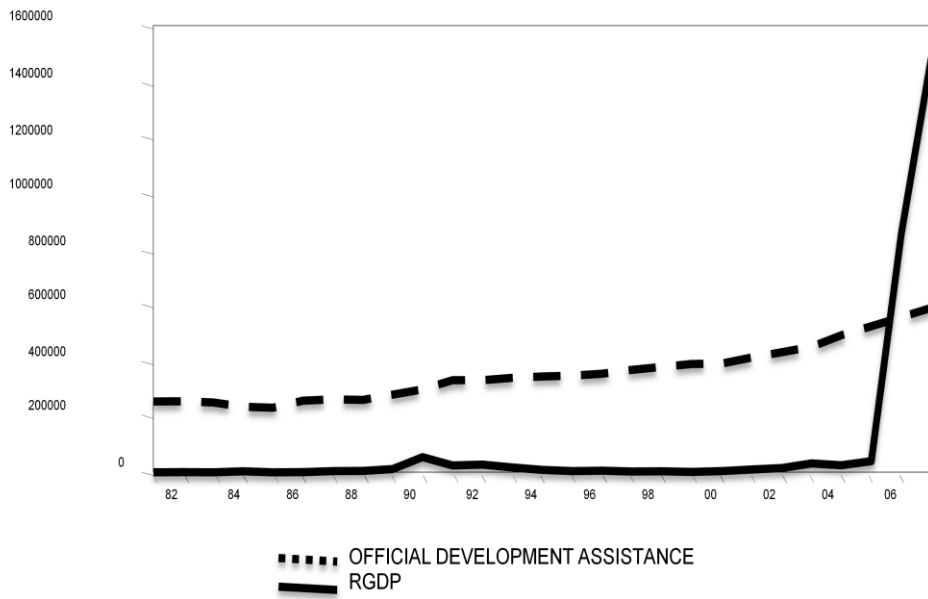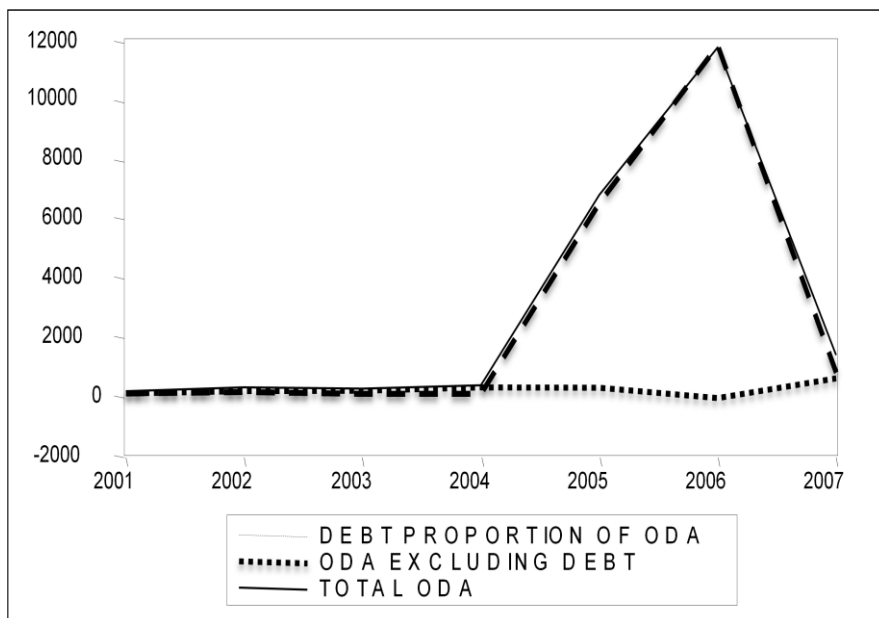
Fig. 1

Fig. 2

The examination of the growth of the Nigerian economy vis-à-vis foreign aid in Nigeria exerts a positive relationship. Fig 1 shows aid flows into the country (per capita). It indicates a relative constant trend, except from 2004 upward when a sharp increase was witnessed. The impact of foreign aid in Nigeria cannot be over-emphasized especially in the aspect of financing capital expenditures of the nation which most times require huge initial capital. Several developmental projects in the country were mostly financed through aid.

Figure 2 also reveals the relationship among between total ODA, debt proportion of ODA and the non-debt ODA. It reveals that debt carries the larger percentage of foreign aid to Nigeria. The sharp fall in the line (total ODA and debt proportion of ODA), indicates the impact of the debt relief enjoyed by the country in 2006.

3.   REVIEW OF EMPIRICAL LITERATURE

Many of the literature on the foreign aid and its impact on development in the recipient countries focus on the relationship between aid and economic growth and uses international cross section statistical investigations rather than individual country case study (Riddell, 1987; Mosley et al 1987). The results of the cross-section studies usually depend on the countries and periods of study chosen. Such studies face numerous problems of measurement and interpretation and often ignore the stylized structural features of individual countries. For example, foreign aid was once associated with reduced domestic savings, but comprehensive surveys on individual recipient countries have proved otherwise. Foreign aid can influence, either positively or negatively, the expenditure patterns and economic development of the recipient countries.

Fiscal analysts and the donor communities are convinced that the aid process is undermined by the ability of the recipient governments to alter their spending patterns to subvert the sectoral distribution of expenditure for designated projects. Empirical literature of the impact on foreign aid and government expenditure is also inconclusive. A few studies (Heller, 1975; Khilji and Zampelli, 1991; 1994; Pack and Pack, 1993) have supported the theoretical proposition that developing countries have been rendering foreign aid fungible by transferring resources from the donor-aid sectors to non-donor aided sectors. According to the World Bank's 1998 report, assessing aid, countries with good monetary, fiscal and trade policies (i.e. good policy environment) registered high positive effect of aid. Such good policy environment depends on the donor or recipient country. These reasons underlie the impact of aid on the recipient expenditure pattern. However, of great importance is whether recipient countries spend donor funds on intended purposes. Studies using time series data in individual countries (Levy, 1987; McGuire, 1978, 1987; Gang and Khan, 1990; Pack and Pack, 1990) found no significant diversion and all agree that countries spend foreign aid funds on the designated purposes. The results are interesting. These reasons influence the impact of aid on the recipient expenditure pattern.

A study by Feyzioglu et al (1998) using cross country data from fourteen developing countries found that aid is not fungible at aggregate levels in smaller samples, but that increasing the number of countries make aid fungible. At sectoral levels, the study found that aid is fungible on earmarked concessional loans for agriculture, education and energy, but not for transport and communication sectors. Aid money increased government expenditure on a roughly one to one basis for the smaller samples. Increasing the samples to 37 countries changed the results; a dollar's worth of aid led to a significantly less than a dollar worth of government expenditure (a weaker fly paper effect). These results contrast with those of Cashel-Cardo and Craig (1990) who found out that categorical grant (bilateral loans) are least fungible with fly paper effect. On the other hand, Pack and Pack (1990, 1993) concur with Feyzioglu et al (in the case of Indonesia and Sri Lanka) that strong fly paper effect do occur on concessional loans (but the results differ with data on the Dominican Republic). The evidence that aid money increases government expenditure means that the recipient governments do use the increased resources as they choose to increase spending, cut taxes or reduce fiscal deficits. Devarajan et al (1998), in the study "what aid does to Africa finance?" found that most aid (about 90%) boosted   government expenditure with no significant evidence of tax relief. About half the aid was used to finance external debt service payments; one quarter to finance investments and the other quarter to offset current account deficits. At sectoral level, aid was highly fungible in health, industry and agriculture. Aid to the energy, transport and communication sectors was partially fungible, while that to education was least fungible. On the other hand, Swaroop et al (2000), focusing on the effects of foreign aid on expenditure decisions of central government of India, found that foreign aid merely substitute for already earmarked government spending; the central government spends funds obtained through aid on non-development activities. This means that government choices are unaffected by external sources of finance.

A prominent strand of the literature focuses on the effect of government expenditure on growth of the economy.   While the relationship between public expenditure and economic performance is "complex" and "important", economic studies have hardly produced conclusive results. Some studies have reported positive results (Aschauer 1989). For these studies, the effects of public expenditure on economic and social services are important for enhancing productivity , generating employment, promoting output growth and improving the economic and social conditions of living of the people. Other studies have indicated contrasting effect of public expenditure on economic infrastructure. It has a negative effect on economic growth and it has no significant effect on output of the private sector (Devarajan, Swaroop and Zou 1996).

The turning point in the aid growth empirics was a study by Burnside and Dollar in 2000. One of the key conclusions by Burnside and Dollar (2000) is that aids work better in countries with sound policy regimes and more precisely that ….. 'Aid has a positive impact on growth in developing countries with good fiscal, monetary, and trade policies but has little effect with the pressure of poor policies'. However, in a recent critique, Easterly, Levine and Roodman (2004) convincingly showed, by adding four more years (1994-97) to the original dataset, that aid policy interaction was not robust. Thus casting serious doubts on the policy implications emanating from the Burnside and Dollar study.

Finally, empirical literature using both panel and time series data supports the notion that aid increases government expenditure. The main question is, if an aid increase leads to increased government spending, what happens during the periods of declines in the flow of aid? Studies by Corden (1984), Killick (1991), Nyoni (1997), and Cassen et al (1994) have confirmed that huge receipts of foreign aid by developing countries do have effects on growth similar to those of the discovery of natural resources. On the other hand, Bevan et al (1993) noted that the effects of increased financial resources depend on the type of expenditure the boom (aid) finances.

4.   METHODOLOGY AND DATA ESTIMATION

Several questions have been raised on why foreign aid has failed to contribute to economic development. It has generated a number of theories in trying to explain the micro-macro paradox i.e. how negative side effects can outweigh the positive contributions of aid-financed development, (Bjornskov, 2008). Development economists have argued that in order to achieve growth, good policy genuinely matters, at least in terms of aid effectiveness. The model used in this study is culled from a study by Durbarry et. al. and it's specified as;

Growth = a_0 + $\beta 1i$ FAIDOECD + $\beta 2i$ FAIDOECDSQ + $\beta 3i$ PRIV + $\beta 4i$ SAV + $\beta 5i$OTHERIFS + $\beta 6i$ TRADE + $\beta 7i$ MONEY + $\beta 8i$ BSUR + $\beta 9i$ INFSTD + $\beta 10i$ LAT + $\beta 11i$SSA + εI

However, in order to meet the objectives of this study in terms of its concentration, as well as a result of availability of data on the appropriate variables, the model is modified to become:

Growth = β_0 + β_1FAIDOECD + β_2 PRIV + β_3 SAV + β_4TRADE + β_5GOV + ε_i

- *Growth: Average* GDP growth
- *FAIDOECD*: Official Development Assistance (DAC) as defined by the Organisation for Economic Co-operation and Development (OECD) as a percentage of the gross domestic product (GDP).
- *PRIV*: Total net private capital flows as a percentage of GDP.
- *SAV*: Domestic savings as a percentage of GDP.
- *TRADE*: Openness to trade, which is defined as $(X + M)/GDP$. That is the addition of export and import divided by Gross Domestic Product.
- GOV represents the total amount of government expenditure as a percentage of GDP

Sources of Data and Analysis of Results

This study covers a period of twenty eight years ranging from 1981 to 2008. The data for the study were sourced from the Central Bank of Nigeria (CBN), National Bureau of Statistics (NBS) and the Organization for Economic Cooperation and Development (OECD) website

Non-stationarity of time series data has often been regarded as a problem in empirical analysis. Hence, the Augmented Dickey Fuller (ADF) test was used to test for stationarity time series economic data used for the study, and the result is presented in table 2:

Table 2: Augmented Dickey Fuller (ADF) Test Result

Variables	ADF Statistics @ Levels	ADF Statistics @ 1ST Difference	Order Of Integration [I(D)]
GROWTH	-3.4334	-	I(0)
FAIDOECD	-2.1034	-7.1553	I(1)
PRIV	-1.0433	-5.3911	I(1)
SAV	-1.5031	-4.6441	I(1)
TRADE	-3.3416*	-	I(0)
GOV	-3.7231	-	I(0)
Critical Values			
1%	-3.711457	-3.737853	
5%	-2.982038	-2.981876	
10%	-2.629906	-2.635542	

*Significant at 5% level of significant

The test result above reveals that some of the variables are stationary at their respective levels, I(O), variables such as growth, trade openness and government expenditure. Other variables in the model although exhibit unit roots at their levels, I(1), however, they are stationary at their first difference.

Cointegration Test and Result

The cointegration test is carried out through the Augmented Engle-Granger (AEG) test. With the AEG test, the presence of unit root in the residuals implies that cointegration exist among the variables. Table 3 showed that at 1% significance level, the residuals (ECT) exhibit stationarity and this is confirmed with MacKinnon one sided P-value which is less than 0.05. Therefore there exist a long run relationship between the endogenous variables, (GROWTH) and the incorporated exogenous variables- FAIDOECD, PRIV, SAV, TRADE, GOV.

Table 3: Augmented Engle Granger Cointegration test result

Variable	Tau statistics	No of lags*	Prob**
ECT***	-4.7061	0	0.0009
Critical values			
1%	-3.6999		
5%	-2.9763		
10%	-2.6274		

* The number of lags is automatically selected using the Schwarz Information Criterion
**MacKinnon(1996) one sided p-values.
*** ECT represents the generated residuals from the regression.

Re-specification of the model

Having established the presence of cointegration among the variables, the cointegration equation could be re-specified as the Error Correction Model (ECM). Using the Engel Granger method, the ECM could be written as:

$$\Delta GROWTH_t = \alpha_0 + \alpha_1 \Delta FAIDOECD_t + \alpha_2 \Delta PRIV_t + \alpha_3 \Delta SAV_t + \alpha_4 \Delta TRADE_t + \alpha_5 \Delta GOV_t + \alpha_6 ECT_{t-1} + \varepsilon_t$$

Where Δ denotes the first difference operator, ε_t is a random error term, and ECT_{t-1} is the one period lagged value of the error from the cointegrating regression.

Table 4: Error Correction Model Result
Dependent Variable: D(Growth)
Sample: 1981 - 2008

Variables	Coefficients	STD. Error	T STAT	PROB.
INTERCEPT	0.0128	0.008217	1.557799	0.1377
D(GROWTH$_{-1}$)	0.096956	0.156668	0.618868	0.5442
D(FAIDOECD)	0.456589	0.168365	2.7119	0.0148
D(PRIV)	0.0048	0.533657	0.008994	0.9929
D(PRIV$_{-1}$)	-0.27325	0.529007	-0.51653	0.6121
D(SAV)	-0.15711	0.302274	-0.51977	0.6099
D(TRADE)	0.054939	0.028872	1.902803	0.0741
D(GOV)	0.1799	0.170815	1.053184	0.307
ECT(-1)	-0.8806	0.210599	-4.18138	0.0006

R-squared:	0.732024		Adj R-squared:	0.605918
Durbin-Watson stat:	1.569639		Schwarz criterion:	-2.908771
F-statistics:	5.804814		Prob. (F-stat):	0.001160

An inspection of the result in table 4 reveals that the coefficient of DGROWTH$_{-1}$, which is the one period lag of GROWTH, appears with a positive sign which implies that growth of GDP in the next period is positively influenced by the rate in the previous period. The coefficient of DFAIDOECD, i.e. foreign aid as defined by the Organization for Economic Cooperation and Development (OECD), does not only appear with a positive sign but also it is also significant at five per cent (5%) level. The observed coefficient of total net private capital flow (DPRIV) has a positive influence on the growth of the economy, while its one year lag , (i.e. DPRIV$_{-1}$) has a negative impact and both not significant. With respect to trade openness (DTRADE) and government expenditure (GOV), they appear with the expected sign but total domestic savings (SAV) on the other hand exhibit a wrong hypothesized sign, as it is expected that a positive relationship should exist between a nation's output growth and savings. This could have resulted from the investment by the economy into non-productive sector, or that the people save in order to meet other needs and not just for investment purposes. The negative sign of the coefficient of the one period lagged ECT indicates the short run equilibrium that exist between the variables is below the long run equilibrium, and in order to eliminate this discrepancies, the residuals needs to be increased by 88%. Besides, short run fluctuations in aid, expenditure and growth relationship are corrected in the long run. The value of the coefficient does not only conform to the a priori expectation, but it also exhibits significance at five per cent level, since its probability value (0.0006) is below 0.05.

The strong significance of the error correction model is an indication of long run relationship among economic growth, foreign aid, government expenditure and other factors as explained to affect growth, especially as they relate to foreign aid. The R^2 and adjusted R^2 (0.7320 and 0.6059 respectively) indicate goodness fit of the model. The overall significance of the model is confirmed with the probability of the F-statistics below 0.05, the significant level.

5.   CONCLUDING REMARKS

The effectiveness of foreign aid in Nigeria has been the core objective of this study. This is so because Nigeria has been a major beneficiary of official development assistance (ODA) from the OECD and other international donor agencies. While she is yet to come out of an age-long economic doldrum, with most of citizens still subjected to abject poverty, this study vividly reveals that foreign aid and government expenditure have contributed to economic growth in Nigeria, but the impact has not been qualitative on the welfare of the Nigerian populace. Consequently, foreign aid and government expenditure should be judiciously utilized in providing necessary socio-economic infrastructure (adequate power, roads etc), required to stimulate economic growth and development at a satisfactory pace.

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<u>**NOTES**</u>