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What Determines Exit from Aid-dependence?

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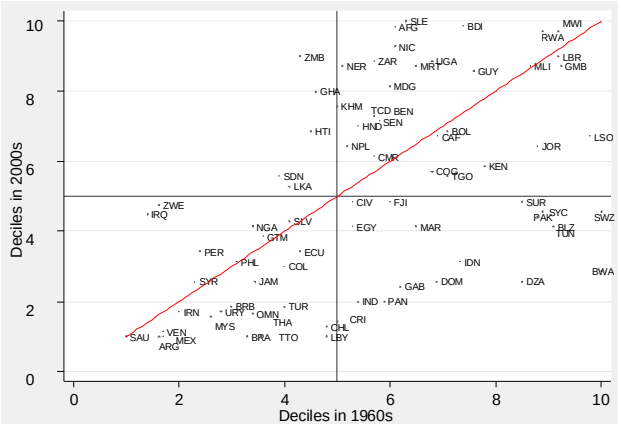
At the Fourth High Level Forum on Aid Effectiveness, the African Union stated that "the post-Busan agenda for Africa is in essence a programme to reduce aid dependency and ultimately exit aid" (AU, 2011: 11). This One Pager sketches out the attributes of an aid exit strategy to inform such an agenda.

We ranked 132 countries based on their aid-to-GDP ratio and grouped them into deciles for the past five decades. The Figure plots the deciles for the 1960s relative to the 2000s. The additional horizontal and vertical lines correspond to the 5th deciles as a threshold for higher and lower degrees of aid-dependence. The 45° line is the locus of countries that have experienced no change in their ranking of aid-dependence between the decades.

Changes in Deciles of Aid/GDP



Countries below the 45° line have experienced a reduction in their aid-dependence. For example, Botswana was in the 10th decile in the 1960s but reduced its aid-to-GDP ratio to be ranked below the 3rd decile in the 2000s. Conversely, countries positioned above the 45° line became aid-dependent in the 2000s relative to their position in the 1960s. For instance, Ghana was ranked below the 5th decile in the 1960s but joined the 8th decile in the 2000s.

In the upper right quadrant are countries with persistent aid-dependence (they were above the 5th decile in both decades). The majority in this quadrant are located above the 45° line, which means they became even **more** aid-dependent. In this group are Afghanistan, Benin, Cambodia, Guyana, Honduras, Madagascar, Malawi, Nepal, Nicaragua, Uganda and others.

The lower left quadrant contains countries with low aid-dependence. The majority of them moved below the 45° line. They reduced even the small aid-dependence they started with. These include Barbados, Brazil, Chile, Iran, Malaysia, Mexico, Oman, Thailand, Trinidad and Tobago, Turkey and others. Those with a low initial aid-to-GDP ratio are thus unlikely to become aid-dependent.

The countries in the lower right quadrant started with high aid-dependence in the 1960s but reduced it in the ensuing decades (they were below the 5th decile in the 2000s). These include Algeria, Belize, Botswana, Dominican Republic, Fiji, India, Indonesia, Morocco, Panama, Seychelles, Suriname, Tunisia and others. These are the aid-exiters.

The reverse is true for the countries in the upper left quadrant. They became aid-dependent. They were above the 5th decile in the 2000s. These include Ghana, Haiti, Sri Lanka, Sudan and Zambia.

Macroeconomic determinants of exit from aid

We tested a linear probability model to estimate the probability of exiting from aid-dependence. The analysis shows that the likelihood of exiting from heavy reliance on aid increases significantly with the rate of investment (see Table). While economic growth seems to contribute to graduation from aid dependence, its effect is not statistically significant. We find a statistically significant negative effect of inflation and a growing saving-investment gap on the chances of exiting from aid-dependence. The results also suggest that expansion of manufacturing is relatively more important than the export share of GDP in reducing aid-dependence.

We checked the robustness of the preceding results with a sensitivity analysis. We tested the extent to which the findings could have been driven by the composition of countries and by the starting period. We repeated the exercise using the 1970s and 1980s as starting decades. The results remain intact (see Hailu and Shiferaw, 2011).

Policy implications

Strengthening policies and institutions that promote public and private investment is a reliable path to exiting from aid-dependence. Increasing the flow of aid alone does not in itself lead countries out of aid-dependence if it is not accompanied by capital accumulation.

A functional and well-developed financial system that could support a high level of investment is equally important. A widening saving–investment gap is more than likely to delay graduation from aid-dependence. Donors and recipient countries should, therefore, watch out for aid flows not to inadvertently stifle domestic savings even when levels of investment are high.

Managing inflation is crucial, since it has been shown to reinforce persistent aid-dependence if it remains unchecked. This calls for fiscal and monetary policies that will avoid high and destabilising inflation rates.

We found that even a small increase in the share of manufacturing in GDP has a potential to facilitate an exit from aid-dependence. While the exact nature of policies will differ across countries, a clear industrial policy is a prerequisite for an aid-exit strategy.

If donors and recipients collaborate to support the above-mentioned policy objectives, then aid could be a development tool with diminishing importance.

Probability of Exiting Aid-dependence (n=46)

% of GDP	Coefficients	T-Stat
Investment	0.31	3.11
Saving–investment gap	-0.17	-2.66
GDP growth	0.26	0.47
Inflation	-0.07	-2.58
Exports	0.05	0.57
Manufacturing	0.28	2.15
Constant	0.46	1.04

Sources: Authors' calculations based on OECD and World Bank data.

Notes: Dependent variable is a dummy (=1 if a country reduced its aid-dependence; =0 if a country stays above the 5th decile).

References:

AU (2011). 'African Consensus and Position on Development Effectiveness', Fourth High Level Forum on Aid Effectiveness, Busan. African Union and New Partnership for Africa's Development (*NEPAD*).

Hailu, D. and A. Shiferaw (2011). 'Macroeconomic Determinants of Exit from Aid-Dependence', *IPC-IG Working Paper No. 90*. Brasilia, IPC-IG.

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