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The Effect of Foreign Aids on Economic Growth of Sri Lanka

Mayuri P. Madhusanka
Department of Economics, Faculty of Humanities and Social Sciences,
University of Sri Jayewardenepura, Sri Lanka

Abstract:- This paper study the impact of foreign aids on the economic growth of Sri Lanka. This study was conducted by focusing on the previous research done on the same topic for several developing countries and for several Asian countries. World Bank Data from 1989 to 2017 were used to conduct this study. Both descriptive and econometric tools were used to analyze data. OLS method was applied to analyze the impact of foreign aid on the economic growth. Based on the findings, there was a direct impact from foreign aid to the economic growth. As well as, proper policy implications, proper monitoring of fund utilization led to the boosting of the economic growth.

Keywords:- *Foreign Aids, Policy Implications, Proper monitoring.*

I. INTRODUCTION

Foreign Aid (FA) has been defined as the voluntary transfer of resources from one nation to another. These transfers occur in many ways. They can be in the form of grants or loans. One ways of transferring resources are flow of capital to developing countries. Usually, a developing country does not have enough industrial base and is characterized by low human development. Therefore, foreign aids have become a dominant strategy for reducing the poverty level in most developing countries. This paper is important because many developing countries claim for more and more foreign aids. But a very little economic growth being achieved. The paper analyses the effectiveness of the foreign aid on people's lives to change for the better.

Sri Lanka is also like other developing countries highly depending on FAs. Basically, for its development needs due to low domestic resource mobilization. The aid injection results to a rapid economic growth. But there are both positive and negative effects from the FAs. In one hand aids help to improve both physical and human capital and as well as the welfare of the society. On the other hand, aid receiving countries are spending these funds to debt servicing and for defenses expenditure rather than on the development activities. Additionally, political instability, frequent changes in the policies and inefficiency in institutions lower the effect of aids to the economic growth. In most of the developing countries, the normal trend that we can see is, wastage of most of the aids received from the foreign agents.

FA being a crucial topic under discussion by politicians, economists, and development specialists. Some argue that FA does not have any impact on the economic growth. Some express that, aids for developing countries lead to the reduction of poverty. Therefore, this paper focusing on analyzing how foreign aids have been affected to the economic growth in the Sri Lankan context. In this study, it was assumed that all the FAs have been allocated for investments and further economic development activities.

II. LITERATURE REVIEW

The results from various studies related to aids and economic growth provide both positive and negative results. An Aid should be given to a developing country with the aim of helping them rather than trapping them by giving a useless amount. The allocation of aids has the maximum effect on poverty based on the poverty level and the quality of policies. It was identified that; actual allocation of aid was radically different from the poverty efficient allocation in countries (Denton, 2020). In recent years most of the studies have been focusing on analyzing the effect of foreign aids on the economic growth (Ouattara, 2006). That is because the magnitude and the effectiveness of the aid measured in terms of how they have affected to the growth rate. The volatility of the aids also is becoming debatable topic among most of the economists and policy makers. Aid is not homogeneous. Therefore, it is important to investigate the growth impact of aid in terms of developing countries (Kilby, 2010). Further, different types of aids have several implications in the case of the growth rate of the recipient country (Neanidis and Varvarigos, 2009; Hudson and Mosley, 2008).

However, in some studies it was failed to identify a significant relationship between development aids and the economic growth. On the other hand, some studies have suggested there is a negative impact from foreign aid to the economic growth (Collierand Dollar, 2001). Clemens et al. (2004)classified aid into three categories namely, humanitarian aids, aids affect to the growth only after four years and aids affect to the growth within four years. Burnside and Dollar (2000), Hansen and Tarp (2000) and Tan (2009) argued that, aid is successful only when they are associated with good policies within the recipient country. But Tan (2009) emphasized that, good policies reduces the long run economic growth rate. By contrast, good policies are likely to reduce the growth effect of aid because they are

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acting as alternatives or substitutes during the growth process (Dalgaard and Hansen,2001). Moreover, the results indicate that developmental aids promote the long run economic growth when concerning on the growth impact of official development assistance to developing countries. The effect was significantly large and strengthening the different specifications and estimation techniques (Minoiuand Reddy, 2009).

Among the main findings of Fasanya and Onakoya (2012), FAs and real gross domestic products have a negative relationship, and aid policy interactive term has a direct relationship with the real gross domestic product. In Nigeria, Aid flows had a significant impact on the economic growth. In that case, foreign aids lead to the development of Nigerian economy with the increment of domestic investment level. McGillivray et al. (2006) found that, effectiveness of aids and link between aid and economic growth. Based on the literature, they reached to the conclusion, that in the absence of aids recipient's countries growth would be lower. It was also found that development aids have a positive, large and robust effect of growth. Non-development aids are largely growth neutral and occasionally negatively affect to the economic growth.

If aids were used to settle the debts and fulfill the consumption needs rather than on investments it was found that the connection between aids and growth will be weak (McGillivray and Ouattara, 2005 and Arellano et al.,2008). Rajan and Subramanian (2005) argued that, aid could lower the growth rate as it reduces the competitiveness of the traded goods sector by reallocating resources to the non-traded goods sector. Mbaku (193) tested the relationship between FA and economic growthand suggested that domestic resources have a stronger impact on economic growth than do foreign resources.

As the conclusion of the literature review of the above on the topic of effectiveness of foreign aid on the economic growth of Sri Lanka, on one hand aids have stimulated the economic growth in the presence of good policies. On the other hand, it has no positive effect on economic growth. Further, it has led to the sever debt problems in the country.

III. METHODOLOGY

To conduct this study, researcher has taken World Bank data of Sri Lanka from year 1989 to 2017. By considering the previous studies, Real Gross Domestic Product ($RGDP_t$)in Sri Lanka at Year t has taken as the dependent variable and Ration of Real Investment (INV) to $RGDP_t$, Population Growth (POPUGROWTH), the ration of the Official Developmental Assistance and Aid received by country in year t (AID) to $RGDP_t$ and Inflation Rate(INF) in year t has taken as independent variables for the study. The conceptual framework for the study was designed to easily identify the independent variables and the dependent variable of the phenomenon being studied.

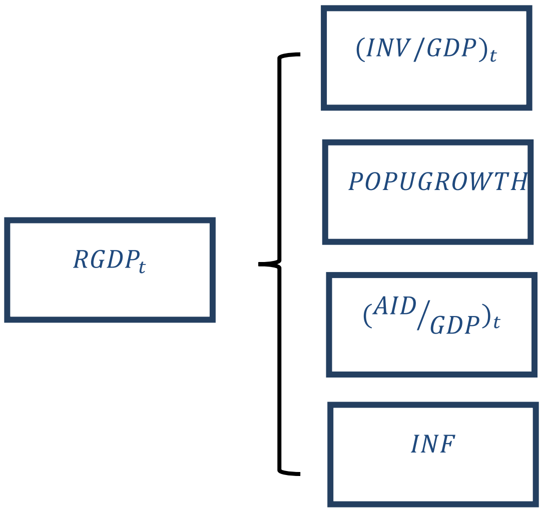


Figure 1 : Conceptual Framework

The regression model has been developed as,

$$RGDP_t = \beta_0 + \beta_1 (INV/GDP)_t + \beta_2 POPUGROWTH_t + \beta_3 (^{AID}/_{GDP})_t + \beta_4 INF + \mu$$

Where,

$RGDP_t$= Real Gross Domestic Product in Sri Lanka at Year t
$(INV/GDP)_t$ =Ration of Real Investment to Real Gross Domestic Product in Sri Lanka at Year t

$POPUGROWTH_t$= Population Growth at Year t
$(^{AID}/_{GDP})_t$ =Ration of the Official Developmental Assistance and Aid received by country in year t to Real Gross Domestic Product.

INF = Inflation Rate at Year t

To identify the impact of FA to Economic Growth of Sri Lanka both descriptive statistical methods and econometric tools have been used. Therefore, Ordinary Least Square Method has been applied to identify the impact of FA to Economic Growth.

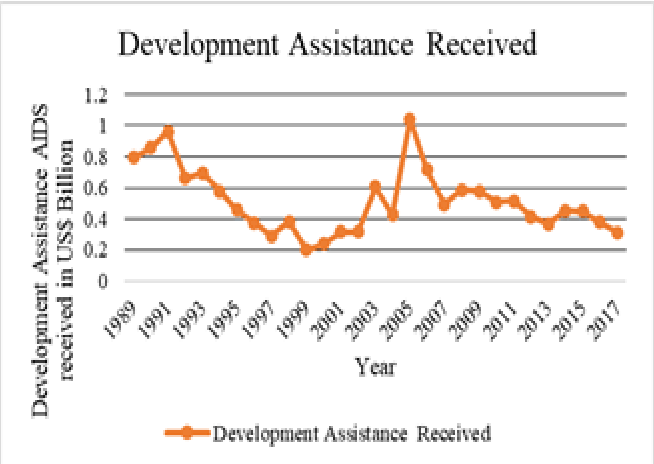
Hypothesis:

H_0 = FA do not have positive impact on economic growth.
H_1 = FA has positive impact on economic growth

IV. RESULTS AND DISCUSSIONS

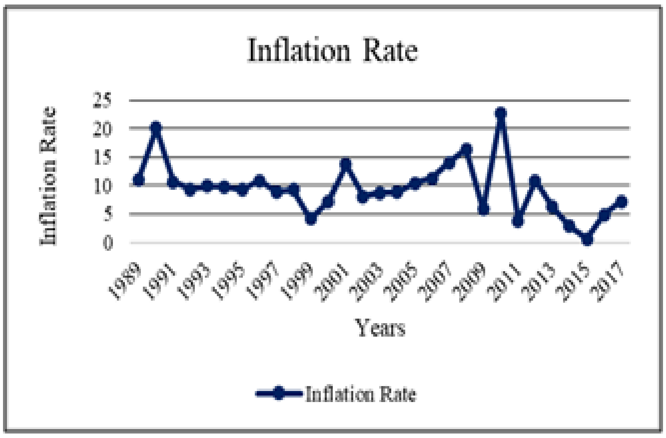
Source: World Bank data from 1989-2017
Figure 2 : Real GDP Growth

The figure shows the Real GDP growth from year 1989 to 2017 based on World Bank data. From the data it can be identified that real GDP has increased over the years. In year 1989 the real GDP was around US$20 Billion. When it comes to year 2017, real GDP has grown up to US$ 83 Billion. Over the years real GDP has grown from nearly US$63 Billion.



Source: World Bank data from 1989-2017
Figure 3 : Development Assistance Received in US$ Billion

Based on the figure it can be identified that, receipt of aids from other nations have fluctuated throughout the concerned period. In year 1989, Sri Lanka has received 0.795 US$ Billions of Development Assistance. The highest rate of Development Assistance received in year 2005 and as a value it was 1.04 US$ Billion. But after 2005, receipts of assistance from developed nations reduced gradually till year 2013. After 2013 we can again identify fluctuations in the receival of assistance from developed nations.



Source: World Bank data from 1989-2017
Figure 4 : Inflation Rate

The Figure 4 depicts the inflation rate of Sri Lanka from 1989 to 2017. We can identify that, inflation rate has fluctuated over the period and in year 2010, it was recorded the highest inflation rate in the country. It was 22.799. The lowest inflation rate was recorded in 2015. It was 0.649.

Source: World Bank data from 1989-2017
Figure 5: Real Investment Level

Based on World Bank data Figure 5 has designed using the real investment data of Sri Lanka during the period of 1989 to 2017. With compared to 1989, we can identify a huge increment in the level of investment in the country when it comes to year 2017. But there are number of fluctuations within that period. By year 2017, real investment level has recorded as 21.694 US$ billion.

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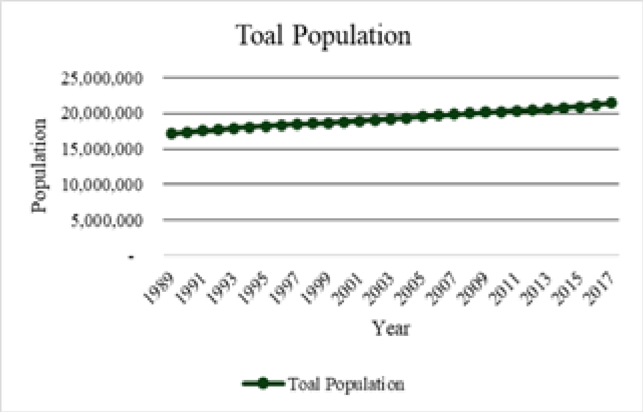

Source: World Bank data from 1989-2017
Figure 6: Total Population of Sri Lanka

According to Figure 6, there is an increasing trend in the total population of Sri Lanka. In year 1989, the total population of Sri Lanka is nearly 17.1 Million. It was increased up to 21.44 Million by year 2017. The gap of increment of population is nearly 4.3 Million.

Table 1 : Model Summary

Model Summary[b]								
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics: R Square Change	F Change	Sig. F Change	Durbin-Watson
1	.983[a]	.967	.961	4.0314807	.967	181.325	.000	.946
a. Predictors: (Constant), AID/GDP, Inflation, INV/GDP, Population								
b. Dependent Variable: Real GDP								

Source: Author's computation based on World Bank data from 1989 to 2017

According to Table 1, there is a strong positive correlation between independent variables and the dependent variable. It is 0.983 as a value. As well as independent variables AID/GDP_t, INV/GDP_t, Population and Inflation rate describes 96.7% of dispersion of the dependent variable Real GDP. With the Durbin Watson Value, it can be concluded that, there's serial correlation between variables.

Table 2 :ANOVA Table

ANOVA[a]						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	11788.17	4	2947.044	181.32	.000[b]
	Residual	406.321	25	16.253		
	Total	12194.49	29			
a. Dependent Variable: Real GDP						
b. Predictors: (Constant), AID/GDP, Inflation, INV/GDP, Population						

Source: Author's computation based on World Bank data from 1989 to 2017

The Table 2 depicts, statistical significance of the variables. Therefore, $P<0.05$ ($P=0.0001$) concludes that,AID/GDP, Inflation rate, INV/GDP, Population affect the growth of Real GDP. Therefore, we reject thenull hypothesis which mentions that, FA do not have positive impact on economic growth.

Table 3 : Coefficients Table

Model		Unstandardized Coefficients: B	Std. Error	Standardized Coefficients: Beta	t	Sig.
1	(Constant)	-307.174	25.403		-12.092	.000
	INV/GDP	37.595	60.674	.059	.620	.541
	Population	1.763	.000	1.096	10.013	.000
	Inflation	-.368	.173	-.085	-2.125	.044
	AID/GDP	475.187	113.142	.264	4.200	.000

Source: Author's computation based on World Bank data from 1989 to 2017

As per the coefficients table, regression equation can be expressed as follows,

$$RGDP_t = -307.174 + 37.595(INV/GDP)_t + 1.763POPUGROWTH_t + 475.183(^{AID}/_{GDP})_t - 0.368INF + \mu$$

At zero level of Foreign Aids GDP growth is -307.174 US$. When Ration of Real Investment to Real Gross Domestic Product in Sri Lanka increases by 1US$GDP will increase by 37.595 US$. Additionally, when Population increase by 1 personGDP will grow by 1.763 US$. As well as when inflation increases by 1 unit GDP reduces by 0.368US$.

Among all the independent variables population, inflation rate and ration of the Official Developmental Assistance and Aid received by country in year t to Real Gross Domestic Product has significant at 95% of confidence level.

V. CONCLUSION

Based on the findings, it implies that, foreign aids have been directly affected to Real GDP growth. But based on the findings there are many demerits as well. Fiscal imprudence and poor institutions turn foreign aid into a curse. Therefore, we can conclude that, there are both pros and cons of the foreign aids. The next most significant variable identified in the study is inflation rate. Real GDP and inflation rate have a negative relationship resulting when inflation rate increases GDP goes down and inflation rate decreases GDP increases. The results imply that domestic investments have made an important contribution to economic growth in Sri Lanka. The policies are also important in the effectiveness of the foreign aids. Because foreign aids have been a major contributor to the economic growth of Sri Lanka. Accordingly, there is a need of not only the effective policies but also proper monitoring of the aids-utilizing projects once they have implemented and there by avoid the mis-utilization of funds and mismanagement of the foreign resources. Consequently, foreign aids are highly useful in boosting the economic growth of a country. Our findings suggest that, sound monetary, fiscal, economic and trade policies help to achieve a positive impact of foreign aid on economic growth through minimizing budget deficits, lower the inflation rate and to achieve the trade openness.

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