

## The Effectiveness of Aid and their Fiscal Response in Sub-Saharan Africa: Theoretical and Empirical Evidence

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### Abstract

This study primary target is to examine the effects of aid on fiscal responses in Sub-Saharan Africa. The significant of capital accumulation for economic development and growth was broadly recognized long time ago. However, most developing nations- particularly Sub-Saharan African nations, are still trapped in ‘vicious circle of poverty’ and have failed to fund most of the desired level of investment from their own domestic savings. Previous studies of development debated that these nations would come out of stagnation only if they received support from developed countries (Rodan 1961, and Chenery and Strout 1966). Based on this observation donors from developed countries are concerned about how their aid is been used in various recipient countries, especially how it affects the fiscal responses by the receiving countries government. Aid may be given to governments; but the effectiveness will hinge on their fiscal behavior from diverse recipient government. The preponderance evidence from theoretical and empirical literature on the effectiveness of aid proposes that external finance has not had a remarkable influence on development in most Sub-Saharan Africa nations. However, there are certain evidences that aid has had certain major impacts on growth in most favorable policy environments.

This survey reviews the current proof on the effects of external finance on government tax and expenditure effort in diverse receiving nations-especially in Sub-Saharan Africa, ending with a discussion of when budget support is a fiscally effective aid modality. Severe data shortcomings restrict inferences on the association between expenditure and aid, particular as most regimes are not aware of all the available aid to fund the provision of public goods. Three generalities are allowed by the proof: aid fund government expenditure; the degree to which external finance is fungible is over-stated and even where it is fungible this does not seem to make the external finance less effective; and there is no systematic effect of aid on tax effort. Beyond these conclusions the fiscal effect of external finance are nation-specific.

**Keywords:** Aid, Fiscal response, fungibility, Government expenditure, taxation

### 1.0 Introduction

Sub-Saharan African<sup>1</sup> (SSA) countries have been classified among those recipients’ countries who have been receiving hundreds of billions of dollars of foreign aid since the creation of post-war financial system at Bretton Woods (Moyo and Ferguson, 2010). Most of the aid flow to Sub-Saharan Africa countries represent significant inflows of money, particularly as it concern poorer Sub-Saharan Africa countries. According to Glennie (2008) suggestion, such aid has had double purpose: the first purpose is to look into the short-term humanitarian need and to create long-term strength in the social and economic institutions of Sub-Saharan Africa countries.

Sub-Saharan Africa continues to present important challenges to the international donors’ community. There was a significant reduction in aid in 1990s; partly for the reason that donors argued that aid was not successfully attaining the anticipated objectives (Lancaster, 2007). For example, these donors were frustrated based on the fact that they noticed that there was no correlation between the strengthening of social and economic institutions and foreign aid in Sub-Saharan African (Fengler and Kharas, 2010). Even though most donors noticed this, they have not stopped pouring aid to Sub-Saharan Africa. In recent years, several nations like Sweden and other European economies in particular, have started becoming bigger foreign aid donors to the region (Robinson, 2011). India and China, with their significant position in the world economy today, have also increased their interest in the region as prominent donors to the region (Noman, Botchwey and Stein, 2012). There have been a serious and continuous augment in the academic community creating the case for and against the effectiveness of aid in Sub-Saharan Africa with two broad divisions emerging: on one side consist of commentators who argued that foreign aid is helpful and on the other side comprises of scholars who argued that the aid that is been channeled to recipient countries bring about inefficiencies and so has failed to meet up with the expectation and objectives of “institution-strengthening” (Van Deer Veen, 2011). Particularly, the anti-foreign aid arguments is that the inflow of aid money feeds an incompetent bureaucracy, and is siphoned off by corruption and creates distortion in the markets which tend to prevent recipient nations from creating rational and resilient institutions of their own (Mavrotas, 2010). Additionally, most aid that are given to Sub-Saharan Africa countries are not effective because most recipient governments implement “pocket policy”— a policy that is design to benefit

<sup>1</sup> *Sub-Saharan Africa*: The United Nations defines Sub-Saharan Africa as every country in Africa but Algeria, Egypt, Libya, Morocco, South Sudan, Sudan, Tunisia and Western Sahara; that is as every African country that is not a part of Arab Northern Africa (United Nations, 2011).

those in power and not the general public (Ehizuelen Michael, 2014). Aid has to be allocated to those countries pursuing good policies and not those countries pursuing “pocket policies”, to a larger extent; it is argued, than is already the case.

On the other hand, the argument of the pro-foreign aid is that, despite the fact that foreign aid might be misused in several ways, it makes the recipient nations better off than they would have been without it (Lehman, 2011). Recently, analysts have used statistical and empirical models to test pro-foreign and anti-foreign aid arguments (Palmer and Morgan, 2011). Economic development is the fundamental problem of nearly all countries and capital accumulation is a focal point of economic growth - particularly in less developed nations. Even though the significance of capital accumulation was recognized long ago (check Lewis 1954, Harrod 1939 and Domar 1946), less developed nations have usually failed to fund the desired level of investment out of their personal resources (i.e. savings). This situation called for external finance as an optimal means to break out from the ‘vicious circle of poverty’ experienced by these poor nations and fasten the reform procedures. The purpose of this study is to theoretically and empirically survey the influence of foreign aid inflows on ‘recipient governments’ revenue collection and expenditure behaviors with evidence from Sub-Saharan Africa.

The organization of this paper follows this order: The first section deals with the introduction of the paper. The second section looks at the theoretical and empirical literature review of aid effectiveness and their fiscal responses. The third section deals with aid and government expenditure. The fourth section will be concentrating on the fungibility and sector expenditure. The fifth section will look at aid and public expenditure. The sixth section will cover the fiscal effects of aid, fiscal response as well as aid and taxation. The seventh section will conclude the paper.

## 2.0 Literature Review of Aid Effectiveness: Theoretical and Empirical Evidence

For many years now there has been enormous outburst of studies on the effectiveness of aid and their fiscal response, much of this research has been dominated by both empirical and theoretical examination. The topic has been a central and recurring subject with which several economists, subscribing to different paradigms of development thinking, have grappled. Questions like whether aid works or not has been approached from diverse ideological and methodological perspectives. In the next section we will be able to look at some of the theoretical and empirical literatures on aid effectiveness. The theoretical foundation for the empirics started from the two-gap model of Chenery and Bruno (1962) and Chenery and Strout (1966): developing nations have deficient level of domestic savings to fund diverse level of investment essential to attain a desired rate of economic development, and limited foreign exchange reserves to acquire imported capital goods. These foreign exchange and savings gaps constraint growth, and foreign aid can be one vital instrument donors can use to help various recipient countries fill these gaps.

### 2.1 Theoretical Literature

The literature review in this paper proposes that experts from varying theoretical orientations (Bangura, 2000; Hudson, 2005; Moyo and Ferguson, 2010; Silberfein, 2004) agree that foreign aid to Sub-Saharan Africa has been ineffective but there is little consensus on why the aid has been ineffective or how the ineffectiveness can be quantified. There was a seminal study that was conducted by Brautigam and Knack (2004) on the correlation between aid and the quality of governmental institutions in Sub-Saharan Africa. Both of them found out that there was a significant negative correlation between the various variables of government quality and foreign aid to Sub-Saharan Africa. This discovery was highly significant for the reason that it proposes that the correlation between aid and social indicators or between aid and economic indicators is strongly moderated by the quality of government. Despite the fact that most of the empirical studies on aid-growth relation produced some contradictory results, early development model supported the idea that foreign aid promotes growth in beneficiary nations by supplementing little domestic savings and easing foreign exchange shortage. Looking on the fiscal response however, there were no such well-developed theories, which forecast the influence of foreign aid inflow on recipient government’s revenue collection, spending and borrowing behavior. Based on the revenue part, aid may possibly upsurge government tax collection efforts particularly when the aid is tied to certain project and the government obligation will be to mobilize domestic resources to cover part of the cost of the project. The domestic resources in relation to aid could chiefly come if there is an increase in domestic taxation. Most papers that have been written on fiscal response, however, hypothesized that financial inflow may lessen the government’s tax collection effort (Griffin and Enos, 1970, Heller, 1975 and Mosley et al., 1987). This observation can be seen particularly in a system that has weak regime with weak institutional set up. This may possibly have the tendency of shrinking their tax collection efforts most particularly when they have access to acquire certain foreign resource like grant (Griffin and Enos, 1970), for the reason that foreign resources are seen as an addition for the government when it comes to funding its expenditures.

Based on this situation, foreign resources are driving domestic resources down whose result is anticipated to retard growth (Griffin and Enos 1970, Weisskoff, 1972). According to Rodan argument (1961), the author thinks

that domestic efforts have being the principal element in the transition. This implies that if inflows of foreign resources create a disincentive-like effect in decreasing the effort of collecting tax by the government, it rather turn out to be inimical to growth. This is the reason why most research works that observed aid decreasing domestic savings argue that aid retards growth (Griffin, 1970, Weisskoff, 1972). According to World Bank (1998) argument, when aid reduces tax, it misguided policies, encourages corruption, creates incompetence within the government of that receiving country and later hinders growth. Looking at that part of expenditure, you will notice that aid certainly upsurges government spending for the clear reason that it upsurges the availability of resources that assist government in funding its expenditures supposing the fall in tax does not offset the inflow of aid. On the other hand, the kind of expenditure, which upsurges aid flow, may possibly be dissimilar from nation to nation. There is an assumption that most regimes in the beneficiary nations regularly employ the available resource in funding consumption like military expenditure, increasing salary of civil servant etc. (Heller, 1975). Others may possibly employ their available resources to fund developmental projects like dams, irrigation schemes construction etc. (Gang and Khan, 1991). The growth outcome of foreign resources when employed for developmental issues is clearly dissimilar, for the reason that the results of foreign resources rely on how it is employed and its influence on most régime tax revenue. A debate is still going on as to whether decrease in tax and upsurge in consumption rather than investment has low growth payoff.

Numerous research studies have shown that the effects of diverse kinds of aid on both expenditures and revenues of government of recipient nation differ. The assumption is that grants may possibly be channel to consumption while loans tend to be used in productive areas of capital expenditures. The dissimilarity is that the first one is not paid while the latter one is paid back indicating the presence of incentive problem. The assumptions stated above are built on diverse hypothesis about the behavior of the government in the receiving nation. Thus, it will be an empirical issue to examine which one of the above assumptions is valid. One of the early model in the fiscal response literature was the Heller's (1975) model, which was generally employed in the literature area (See evidence from, Gupta et al., 2003; Franco-Rodriguez et al., 1998; Alemayehu, 1996, 2002; Otim, 1996; Khan, 1998; Khan and Hoshino, 1992; Gang and Khan, 1991; Mosley et al., 1987 and White, 1993, 1994.

According to Heller (1975) specification, the recipient policymaker's utility function which is express in linear-quadratic form is written in deviation of the actual aim values of the choice variables (expenditures and government revenues). The utility function make best use of subject to funding constraints, which was disaggregated into two, where the accounting identity as well as the total receipts was equal to the total expenditures, this assumption holds. The utility function specified exhibits diminishing marginal utility and it upsurges with spending and drops with domestic resources. (Re-construct this statement). Despite the fact that government attempt to minimize the deviations from the target values, it is symmetric for the reason that the government placed the same weight to overshooting and undershooting of the choice variables involved. Even though Heller's model was seen as the first and employed as the starting point for the rising literature in the area of fiscal response, there were attempts from various scholars, which modified the theoretical settings by adjusting certain hypothesis that was applied by Heller (1975) and some other authors like Mosley et al., 1987; White, 1994; Gang and Khan, 1999; Khan 1998 and Franco-Rodriguez et al., 1998. Furthermore, to some modifications of the Heller model, it was seen that Mosley et al. (1987) stretched the fiscal response analysis a step forward to examine the overall influence of overseas capital on output growth that goes via public and private investment. Therefore, the private function was specified in such a way that it captures the effect of aid that runs through change in price. On the other hand, output was specified as a function of private and public capital stock so that the indirect effect of aid that runs through public and private investment is captured.

Even though Gang and Khan (1991) adopted the Heller's model specification in their latter study that was conducted in 1999, (Gang and Khan, 1999) where they put forward an argument that the previous model specification by Heller was impractical as it assumes that government attached the same weights to over and undershooting the target variables. Therefore, both authors proposed a 'quadratic-ratio loss function' rather than in deviation form. Looking at both situation (the previous model specification in 'linear-quadratic function in deviation form' and the latter 'quadraticratio') it was now assumed that policymaker's attempts to minimize the deviation from target values but over and undershooting were differently weighted. The second specification, which is the 'quadratic-ratio function' established by Gang and Khan (1999) permit them to estimate the fiscal response of diverse kinds of policymakers who are not the same by the weight they attach to over and undershooting of target values of diverse choice variables ( check Gang and Khan, 1999 and Khan, 1998). Lastly, there was some selection among the policymakers employing Akaike information criteria and personal observation. To examine the fiscal response behavior of three Southeast Asian nations Khan (1998) also applied similar technique. It was a different side of the story from Franco-Rodriguez et al. (1998). They treated aid as an endogenous variable in the quadratic utility function specification. In contrast to previous examinations, Franco-

Rodriguez et al. (1998) made mentioned of domestic borrowing as one instrument for funding consumption expenditures, which was previously restricted by other authors as an instrument for funding investment. In the budget constraint, these authors applied the system of inequalities, which is to some extent not the same from previous surveys.

## 2.2 Empirical Literature

Let's look at the empirical literature by considering the empirical study of Heller's (1975) who considered the influence of diverse kinds of aid (loan, grant, bilateral and multilateral) on numerous categories of public expenditure (socio-economic consumption in the public sector, public spending for developmental purposes and civil consumption in public sector.), domestic borrowing and government revenue. According to Heller (1975) examination, the author employed data from eleven African nations categorized as French and English speaking. The author concluded that aid upsurges both consumption and government investment and reduce domestic borrowing and taxes. It upsurges total government spending for the reason that aid flows upsurges the availability of resource for funding government expenditures. By way of decomposing aid into loan and grant, Heller (1975) noticed that grant has a stronger and bias pro-consumption whereas concessional loan has stronger bias pro-investment. For that reason, grant indirectly contributes to private consumption by reducing taxes and directly augmented public consumption. He was able to estimate the equation by pooling cross-section and time series data. According to Heller (1975) Two-Stage Least Squares (2SLS) estimation surveys results, the author found that both samples (English and French speaking) government investment takes about 63-76 percent of total loans in contrast to about 41-53 percent of official grant, displaying that the debate about loan having a bias pro-investment and grant having a bias pro-consumption is true. The fact that Heller (1975) observes loan to be more pro-investment bias and grant to be more pro-consumption bias fortify the uncertainty that diverse kinds of aid have dissimilar macroeconomic consequences. The empirical study by Levy (1997) also revealed that there is dissimilarity in utilization of expected and unexpected aid. The outcome from the estimation of consumption function of various sample nations revealed that unexpected aid is completely consumed but over 40 percent of expected aid is invested.

The influence of foreign aid influx on growth was not explicitly captured in Heller's model. This was picked up by Mosley et al. (1987) where Heller's model was extended and the influence of aid on output growth was assessed. According to Heller's original model, the target level of public investment was assumed as a function of lagged output and private investment. On the other hand, Mosley et al. (1987) states that the private investment is extended to include price effects (by way of dividing it into tradable and non-tradable sectors) of financial inflows and secondly, output was further redefined as an aggregate production function of government and private capital and labor. Mosley et al (1987) empirical results from both cross sectional and time series data displays that aid does not have a demonstrable influence on the economic development of most receiving nations in the 1960's and 1970's. Based on Heller's (1975) model, two other authors namely, Gang and Khan's (1991) empirically investigate the fiscal response of the Indian government to foreign financial inflows by employing time series data. These authors proposed a two-step technique, to enable them examine the correlation between aid and growth. The first step focuses on the fiscal responses aspect of foreign aid while the other step deals with the influence of public investment and consumption on developmental variables such as growth and income distribution (Gang and Khan, 1991). Even though they applied the framework developed by Heller (1975), they were able to come up with estimation employing the non-linear three-stage least square (3SLS) estimation procedure. In actual fact, both Gang and Khan (1991) results confirm Heller's original findings on the tax side but contradict other earlier findings on the part of expenditure. The parameters that display the proportion of tax revenues, loan and grant spent on recurrent spending ( $G_c$  and  $G_s$ ) are 1.08, -0.79 and -0.03 respectively.

Knowing that the last two parameters were insignificant indicate that aid does not statistically influence government consumption but all tax revenues are used for funding consumption. The empirical results of Gang and Khan (1991) which states that aid (both loans and grants) are employed for funding investment is dissimilar from the results of Heller (1975) which stated that about 63-73 percent of the total loans and about 41-53 percent of official grants goes to public investment. Contrary to the results of Heller, there is no statistically dissimilarity between the two sources of aid (talking about bilateral and multilateral) their findings indicates that bilateral aid pulls resources out of government consumption while multilateral aid is employed for funding both consumption and investment expenditure. Other authors like Binh and McGillivray (1993) as well as White (1994) criticized the work of Gang and Khan (1991) based on theoretical and methodological aspects. White argument was based on the fact that Gang and Khan (1991) assumption about how aid had been employed for investment in Indian was a misinterpretation of their findings. The author concern was that the way Gang and Khan generated their

target values were not only inconsistent with budget constraint but also will not be significant when  $R^2$  from the regression is close to one or zero. Since such generated values cannot be good proxy variables for target values, set up by policymakers, based on economic growth objectives, the above critic put forward by White applies to all the studies that followed similar methodology.

There was another examination by Gang and Khan in 1999 to see whether different source of aid have dissimilar influence on government revenues and spending and the general fiscal behavior of Indian government employing slightly dissimilar method (asymmetric quadratic ratio utility function). The findings from their empirical study point out that just like previous study; bilateral aid is employed for funding investment than multilateral aid. This specification permitted them to estimate the equations for diverse kinds of policymakers<sup>1</sup> from which Gang and Khan (1999) selected non-developmental, fiscal conservative and non-statist based on Akaike's information criteria. According to Gang and Khan (1999) observation, they realized that about 40 percent of domestic revenue, about 83 percent of bilateral aid and about 91 percent of multilateral aid was employed for funding consumption (non-developmental) expenditures. The implication is that foreign aid is chiefly employed to fund non-developmental expenditures, which is contrary to Gang and Khan (1991) work from which both of them concluded that aid to India is directed to investment. Nevertheless, with regard to the influence of bilateral and multilateral aid, both Gang and Khan (1991) have been able to replicate their results by saying that bilateral aid finances developmental projects more than the multilateral aid. As a final point, both authors concluded that the observed movement from bilateral to multilateral aid in India is not desirable, for the reason that resource from multilateral sources tend to fund consumption instead of investment.

The same technique was applied by Khan (1998) (asymmetric quadratic-ratio policymakers utility function) and was later employed by Gang and Khan (1999) to empirically look at the macroeconomic influence of aid in three Southeast Asian nations; Thailand, Malaysia and Indonesia. Created on the ground of Akaike's information criteria, the policymakers concluded that Indonesia was developmental, statist and fiscal liberal. According to a survey conducted by Khan, the author noticed that 50 percent of domestic revenue, 33 percent of bilateral aid and 54 percent of multilateral aid were channel to non-developmental expenditure respectively. The findings of Khan's (1998), as compared to Gang and Khan (1996), demonstrated the superiority of bilateral aid over multilateral aid because of the above reason. The final point of Khan studies concluded that similar results hold for both Malaysia and Thailand respectively. Both Khan and Hoshino (1992) also examined the fiscal response of recipient governments to foreign aid inflows by using five nations from South and Southeast Asia as example and by adopting the Heller (1975) model specification. Both authors applied the technique of nonlinear three-stage least square (3SLS) estimation procedure which displays that aid influence taxation, investment and consumption, this result was not dissimilar from Heller (1975) conclusion. Related to Heller's (1975) results, the parameters that shows the proportion of tax revenue, grants and loans spent on recurrent expenditures ( $G_c$  and  $G_s$ ) were 0.88, 0.48 and -0.21 respectively. This implies that tax is used for funding consumption while relatively grants are more pro-consumption and loans tend to pull non-loans resources from recurrent consumption to investment. The influences of loans and grants on tax efforts displays that grant have the tendency of reducing taxation while loans have the tendency of increasing taxation for the reason that policymakers in most receiving nations applied non-repayable money (grants) to cut tax burden (Khan and Hoshino, 1992).

That is the reason most poor nations tax collections have economic cost and political resistance (Heller, 1975 and Otim, 1996). Both Khan and Hoshino (1992) did not discover any differences between bilateral and multilateral aid in influencing investment. Both Khan and Hoshino findings were questioned by McGillivray due to the fact that critical hypothesis test and analysis making explicit the direct and indirect effects of aid in the model were missing. The author further argues that the parameters for the share of loans and grants assigned to consumption were statistically insignificant. This indicates that Khan and Hoshino (1992) conclusion that aid influences both investment and consumption and investment further pull resources away from consumption was

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<sup>1</sup> Gang and Khan (1999), and Khan (1998) estimated loss function for different 'type' of policymakers' who differ on the weight they attach to over-or undershooting the target level of the three choice variables; domestic revenues (R), developmental expenditures (D) and non-developmental expenditures (N). 'Developmentalist' gives more weight to undershooting developmental expenditure target than overshooting. The opposite being 'Non-Developmentalist' 'Fiscal liberal' gives more weight to overshooting revenue target than undershooting. The opposite is 'Fiscal conservative' 'Statist' gives more weight to undershooting non-developmental expenditure target than undershooting. The opposite is 'Non-statist'. By taking different combinations of this, they have estimated loss function for eight types of policymakers. Note that their objective function is minimization of the loss function.

not correct. McGillivray believes that if the indirect effects of aid are involved in the model then the influence of aid will be to lessen consumption and upsurge investments (McGillivray 1994). On the other hand, White (1993) also tested the influence of aid on government revenue and expenditures by involving feedback effects via higher income. Implicitly, White assumption was based on the fact that aid boosts growth as anticipated by previous development theories, which negate the results of Griffin (1970) and Weisskoff (1972). Furthermore, White (1993) argued that the study by Mosley et al (1987), which considered the influence of aid on growth via changes in fiscal behavior of the beneficiary government and price, did not look into the dynamic and multiplier aspects. By ways of including these effects, White (1993) displayed that there is a possibility that aid inflows upsurgers taxes supposing it is channel into private investment.

On the other hand, Otim (1996) also try to examine the fiscal behavior of three South Asian nations by applying the Heller (1975) model. Most of the results of Otim (1996) confirm the findings of Heller (1975), as well as Khan and Hoshino (1992) where they stated that loans are pro-investment and grants are pro-consumption (based on the fact that Otim got 18.7 percent of loans and 34.4 percent of grants finance consumption expenditures). However, the findings that inflow of aid upsurgers recipient nation's tax collection effort and the availability of aid tax help to pull resources out of consumption contrasts with previous findings. There was another noticeable observation from Otim study, the author did not believe that multilateral aid is more productive that bilateral aid, so he thinks this fact contradicts with the findings of Heller (1975), Khan and Hoshino (1992) who concluded that there is no dissimilarity between the two findings, and Gang and Khan (1991, 1996) and Khan (1998) who came up with a conclusion that bilateral aid is more productive. To sum up this discussion on empirics of fiscal response, let us deliberate on the subsequent table and briefly discuss the key outcomes and policy implications of fiscal response literature. The subsequent table shows the estimated values of parameters, which measure the proportion of domestic revenue (interpreted as tax) (E1), grants (E2) and loans (E3) allocated to consumption (recurrent) expenditures respectively.

Table 1: The summary results of some previous empirical studies

	Heller (1975) Pooled Sample	Gang and Khan (1991) [for India]	Khan and Hoshino (1992) Pooled sample	Otim (1996) Pooled Sample	Gang and Khan (1996) [ for India]	Franco-Rodriguez et al (1998) [for Pakistan]
$\rho^1$	0.83	1.08	0.88	-0.371	0.4563	0.85
$\rho^2$	0.38	-0.79	0.48	0.344	0.8323	0.51
$\rho^3$	-0.39	-0.03	-0.21	0.187	0.9153	0.54

Note:

- Based on the findings of Gang and Khan (1996), E2 and E3 present the proportion of bilateral and multilateral aid allocated to consumption spending.
- On the other hand, based on the findings of Franco-Rodriguez et al (1998), E2 and E3 present the proportion of foreign aid (loans plus grants) as well as domestic borrowing allocated to consumption spending

The table above shows certain mixed result of various authors, but certain general skeptical conclusions could be drawn out from it. Based on that we can see that the parameter which measure the proportion of tax allocated to consumption got positive value, which is nearer to one concept from Otim (1996) indicating that domestic revenue is chiefly employed to fund consumption expenditures. The proportional range of their findings was from 45 percent for Gang and Khan (1996) to 100 percent for Gang and Khan (1991). Several surveys also point out that loans were more pro-investment than grants as the government in the receiving nations tends to employ loans (on which repayment is expected) wisely than grants, which were free resources. The outcome was intuitive as loan has incentive element to use it resourcefully than free resources grant. Based on this fact, the policy implication is that donors should provide loans rather than grants to promote growth in developing nations. If this is the situation, there is a cost attached to it particularly when the resources are employed to fund consumption and inefficient investment projects from which repayment at complete scale is not anticipated. This create a rising problem of debt crunch from which most less developed nations are suffering from today. With this issue, the fiscal burden of debt accumulation may offset the private influence and discourages private investment.

### 3.0 Aid and Government Expenditure

Numerous surveys on external finance and government expenditure in most recipient countries-especially Sub-Saharan Africa center on fungibility, i.e. whether aid is spent by donor on the intended purpose or not. Actually, this was one of the exact emphases by the World Bank (1998) where fungibility was interpreted as the diversion of aid away from its intended purpose for investment and development, this issue was offered as a factor for restraining aid effectiveness in promoting development in Sub-Saharan Africa countries. However, most of the literature on aid effectiveness in Sub-Saharan Africa center on whether aid is fungible offers little analysis of the effect on the total expenditure. According to a study conducted by McGillivray and Morrissey (2004), these authors came up with three significant distinctions --- sector fungibility, additionality and general fungibility. Their investigation was center on whether aid in general was fungible; on the consumption that aid is anticipated to fund public investment, the question asked is how much of the external finance is 'diverted' to fund government consumption expenditure under the supposition that such diversion lessens the effectiveness of aid (e.g. World Bank, 1998). This is confusing as government consumption comprises of expenditures to maintain and operate investment projects; public investment expenditure is mostly construction costs (for instance, building a hospital), while the essential recurrent costs for productive investment (for instance wages for doctors, nurses and medicines) are contained within as consumption. Therefore, Sub-Saharan Africa governments should see consumption (or recurrent) spending is a vital complement to investment and should be seen as human capital investment. In this case, the argument that fungibility lessens the effectiveness of aid is commonly misguided (McGillivray and Morrissey, 2000)

Even though most Sub-Saharan Africa countries spend the aid on the intended sector (i.e. not fungible) which may possibly create a complete addition, but in real sense does the government spending on the sector upsurge completely by the amount of aid received? There was a study that was carried out by McGillivray and Morrissey (2001), these authors demonstrate that additionality is hard to establish, which may possibly be one motive for the dearth of empirical proof (McGillivray and Morrissey 2004). For instance, givers of aid could make sure the aid is spent as envisioned by undertaking the spending themselves, such as building hospital, school and good road via a donor project. However, the receiving countries may possibly answer back by decreasing the amount of its personal resources (domestic revenue or tax) allocated to spending in that sector, as a result, sector spending does not upsurge completely by the amount of the aid (sometime it may not upsurge at all). It is as well likely that sector spending upsurges by more than the aid; even though certain sector aid is fungible (let's say a donor builds a hospital that produces a claim on future government recurrent expenditure). These concerns are addressed in some fiscal effects studies of aid that address wider effects of aid as well as the dynamics of the fiscal association; even though aid in a specific year is not completely allocated as givers intended, expenditure in the areas favoured by givers may possibly upsurge over time by at least the amount of aid.

### 4.0 Fungibility and Sector Expenditure

According to the survey done by McGillivray and Morrissey (2004), both authors discuss the limitations associated with the literature on aid fungibility. To begin with, the underlying theoretical model posits two distinct kinds of spending sector, one to which aid is distributed and another to which aid is not allocated, and that these are divisible in the government's utility function so that only fungible aid affects the expenditure allocation (Feyzioglu et al. 1998:34) Therefore, the model does not permit aid to affect expenditure distribution across all sector. Secondly, there is also the problem of lack of appropriate data to estimate the model as one must be familiar with how much aid the donors anticipated to spend on each expenditure sector. Thirdly, the econometric methods employed in most surveys are assume to be lacking the components of government expenditure which are determined independently (assuming that they are divisible); in reality the components are together determined and this should be permitted for in the estimation. Fourthly, which is the most significant; no effort is made to permit for the dynamics of the wider fiscal effects of aid, on borrowing, the evaluation of spending on specific sectors and taxation. Both the second and third issue will be addressed in the fiscal response part below.

The drawback explains the reason why most of the examinations provide such mixed proof of the influence of aid on expenditure: in some circumstances total expenditure upsurges by more (or falls by less) than non-developmental expenditure. Certain unwarranted end have been drawn, notably that fungibility 'assist clarify why large amounts of aid had no long-term effect in highly distorted settings' (World Bank, 1998:82) The ineffectiveness of Aid can be possible as a result of low productivity of public spending or aid-funded investment as to aid being channel to unintended purposes. Numerous surveys find that even where aid is fungible this does not seems to lessen the effectiveness. Both McGillivray and Morrissey (2000) argued that fungibility simply reflects the actuality that donors and receiving countries have dissimilar preferences concerning the allocation of public expenditure. Receiving countries want aid to be maintained as well as recognize givers' wishes for policy and expenditure allocation, even though these vary from what the receiving countries consider suitable. Based on this, the spending allocation result will be somewhere between the two preferences, relying on respective bargaining powers and the ability of recipients to efficiently implement

spending strategies. In further analysis, McGillivray and Morrissey (2001) argue that the fungibility issue is confusing; so the relevant matter is how aid affects dynamic fiscal behavior and how undecided strategies are executed. Both authors propose 'aid illusion' such that the officials executing spending strategies misperceive the purposes of the policy officials and donors who set spending strategies. The necessary fact for such misperception to arise is not there, because the public expenditure management system and information flows are weak. These authors studies show that even though the receiving nations intend to employ aid in a fungible way the outcome may not be that spending on the items donors want to support will upsurge by less than the value of the aid. The authors also demonstrate situations of unintended fungibility of the appearance of fungibility (for the reason that only spending allocations rather than the budgetary process are witnessed). However, the fungibility examination may possibly be informative concerning the influence of aid on the composition of government expenditure, at least in the short-term. This issue can be considering in the context of current surveys by assessing the effect of aid on sector expenditure.

Current fungibility examination consider if aid to a specific sector is actually spent on that sector. For instance, if the donor intention for given aid was to solve the educational or health problem but later diverted to other unintended purpose, then the intended purpose is not actualized. This is the reason why most analysts are concern and asking what is actually happening to the aid that is been sent to these recipient countries? The problem this study is facing on this topic is in constructing sufficient data on sector aid. Based on this fact, the basic source is the aid statistics and the Creditor Reporting System (CRS) delivered by the Development Assistance Committee (DAC) of the OECD on sector aid for giver-receiver pairs. On the other hand, Pettersson (2007) delivers a comprehensive examination of sector aid fungibility employing two sectors, social and other, assuming that total aid disbursement can be distributed to sectors according to the sector allocation commitments. Other authors like Wagstaff (2011) reaches the same conclusion by examining two health projects in Vietnam: the sector (i.e. health) aid seems to be fungible but this does not noticeably lessen the influence of the projects. In the author analysis, he emphasis that there may even be fungibility within projects or sectors; for example van de Walle and Mu (2007) noticed that certain aid that was intended to fund road building in one province seemed to support roads building in another province in Vietnam. The implication is that fungibility may possibly be existing but need not lessen the effectiveness of aid. Even though these authors do not address if aid is fungible, authors like Michaelowa and Weber notice certain weak proof that aid to the educational sector is related with augmented primary school enrolment and completion rates; this shows that there is an element of effectiveness even if it is fungible.

#### 5.0 Aid and Public Expenditure

Surprisingly, it may seem that there is very little specific proof for the effect of aid on expenditure. This can be possible for the reason that present surveys focused on diverse questions: fungibility examination center on where the aid is channel to while fiscal response surveys consider the wider fiscal association. Where the latter do comprise of the effect of aid on expenditure, it is usually positive though seldom completely additional (not for the reason that aid is fungible, although it may possibly be, but for the reason that aid supports reductions in borrowing---- more emphasis below). According to Remmer (2004), the author specifically addressed the effect of external finance on government expenditure with cross-country data over the period of 1970-1999, in the framework of the literature on growth of government size (which is measured as government spending/GDP ratio) and notice that aid is an important determinant of spending/GDP growth in the middle and low income nations. Even though the examination is econometrically accomplished, as the focus is on the effect of aid on long-run adjustments in spending/GDP in a model containing determinants of government size, there are drawbacks. To start with, the author analysis does not completely permit for the fact that aid itself is contained within government expenditure that is to say accounting terms is a significant part of aid provided to a nation which is included in the measure of government expenditure (the examination should attempt to permit for this 'double counting'). Secondly, aid may possibly affect or even be part of (in accounting measurement terms) certain other explanatory variables, like import/GDP and tax/GDP ratios, and these inter-related effects are not permitted for. On the other hand, the examination establishes the anticipated effect of aid on total expenditure for a period of time.

In a study conducted by Morressey et al. (2011), they analyse the effect of aid on expenditure for an unbalanced panel of annual data for fifty-eight nations between the period of 1990-2008; nearly all the nations has certain missing annual observations (particularly on government revenue and spending), and certain nations has data for sub-period like the 1990s or 2000s only. For the complete sample (fifty-eight nations), on average total expenditure is similar to the amount of aid and tax revenue but it is notably less than by summing the total aid and revenue. This issue can be clarified by observing the donor aid, measure by overstating what is received by the receiving regime, even if it is also possible that total revenue may possibly consist of elements not significant to the measure of government expenditure (let's say the local government revenue or taxes related with publicly owned businesses). For the complete sample over the whole period average government expenditure has been reliably between 22-27 percent of GDP, with a small but obvious upward trend (most especially since the early



2000s). The tax revenue as a percentage of GDP was reliable at 15 percent on average until the late 2000s (it augmented to nearly 20 percent by 2008). Most of the spending on health and education are quite low and education is more than twice the level of health spending on average (14.5 percent and 6 percent of total expenditure on average). Aid is a percentage of receiving countries GDP for there have been a huge decline from an average of eight percent over the 1990s to about six percent after 2002. Looking at the measure of aid, it is equal to 30 percent of total expenditure on average, but as with other variables there is considerable variability, across nations and for some period of time (with a significant drop, from over 35 percent at the beginning to less than 25 percent by the end). Relatively, richer developing nations get less aid, typically much less, than poor nations; for fourteen of fifty-eight nations, aid is less than five percent of government expenditure in (nearly) all years and for an additional eight it fell below five percent in the 2000s.

#### 6.0 Fiscal Effects of Aid

The dearth of fungibility approach to the effect of external finance on expenditure is that it does not permit for wider fiscal influences of aid for a period of time, particularly on revenue, borrowing and tax. In addition, obvious concern with fungibility may possibly serve to distract attention away from the more fundamental subject of how external finance influences on receiving countries fiscal response in general, together with the interaction of revenue and spending variables. Most Studies that examine the fiscal effects of aid addresses the components of the budget by bearing in mind the correlation between government spending, (and sometimes borrowing), aid, and domestic revenue (taxes).

#### 6.1 Fiscal Response

In an examination from Lloyd et al. (2009), they applied a general country-specific fiscal response study to a sample of 19 nations. Their key finding was that aid is an important element of the fiscal association for variety of developing nations (comprising of numerous middle income nations for which aid is a relatively small share of expenditure), that is to say they confirm that aid does impact budgetary behavior. For most recipient nations, aid is weakly exogenous (that is to say, donors do not answer back to fiscal imbalances in determining their allocation, but aid has effects on the other fiscal variables) and is positively related with expenditure (both recurrent and capital). However, these authors did not elaborate on the effect of aid on expenditure, that is to say they do not deliver any estimates of the magnitude of the effect of aid on expenditure, nor do the authors provide estimates of the degree of the effect of aid on expenditure, nor do Lloyd et al. (2009), also provide any conversation of the effect of aid on the composition of dynamic of government expenditure.

Numerous surveys has be conducted on the fiscal effects of aid, but even though these display that the effect differ on consumption (recurrent) as likened to investment expenditure, in this case, few estimate the degree of the effects on total expenditure. There was an early applications of fiscal models (FRMs) that was conducted by McGillivray and Morrissey (2004) where they employed the structural econometric (3SLS) estimation techniques and notice numerous limitations: the authors realized that they are notoriously hard to estimate and very sensitive to (and demanding of) the data, often producing inconsistent estimates of core parameters; it is essential to estimate budget targets but there is no accepted theory concerning how governments form spending and revenue targets; the theoretical context does not deliver a good picture of government behavior (and is not directly derived from a utility optimizing context); and the behavioural association being estimated is assumed fixed over time (that is to say, the models do not permit for dynamics).

In other to address these drawbacks as well as estimating the FRMs, there were certain surveys that were undertaken in respect to series of econometric techniques that have two exact benefits in this context. To start with , having established the fiscal aggregates (borrowing, spending and revenue) which is exhibited by a long run equilibrium (cointegrating) association (and that aid is part of this) the data can then be permitted to estimate which of the variables drive the association and how the variables answer back to each other; it is essential to impose a structural relationship and how the variables respond to each other; it is not necessary to impose a structural association or estimate targets. Secondly, the technique allows a distinction in estimating the long run (equilibrium) and short run (change to the equilibrium) associations between the variables, comprising of aid. The initial survey to adopt this approach was Osei et al. (2005) for Ghana; these authors demonstrates how the fiscal response and fungibility approaches can produce contradictory interferences and show that the fiscal response is more trustworthy. Particularly, they display that the external finance to Ghana from the 1980s was connected with reduced domestic borrowing (for the reason that reducing domestic borrowing was a requirement imposed by the IMF) and augmented tax revenue (for the reason that reforms in the cocoa sector promoted by the World Bank).<sup>1</sup> Furthermore, as borrowing is more closely associated with investment expenditure, while tax revenue is distributed to recurrent expenditure, recurrent expenditure rose more than investment expenditure following the upsurges in aid. This proposes prima facie that external finance was fungible (investment expenditure rose by less than the aid and by less than recurrent expenditure) but it is actually for the reason that

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<sup>1</sup> It is not the amount of aid that generates effects on borrowing or tax revenue but specific policies (that were implemented) associated with the aid, i.e. the effects can be interpreted as due to conditionality rather than the aid itself.

the aid was employed to lessen borrowing. Therefore, even though the econometric study displays that aid did not directly determine spending growth, the upsurge in aid joined with the increasing tax revenue allowed expenditure to increase whereas borrowing was reduced. As a result, aid facilitated improved fiscal management even if it seemed fungible.

Another author Ouattara (2006) obtains the same outcome for Senegal (employing a structural FRM rather than time series method): the author feels that aid had no significant effect on total expenditure but did cut borrowing. Even though it is not explicitly specified it is likely that multilateral donors (the IMF) required drops in borrowing as a quid pro quo for augmented aid so that the aid could not (all) be employed to support expenditure. Notably, fungibility surveys omit controls for borrowing and revenue and assume that the aid that is given is intended to fund specific expenditures; this may possibly lead to incorrect inferences on whether external finance is fungible. Ghana and Senegal situation display that donors linked aid to reducing borrowing so that additionality could not be achieved (in the case of Ghana, total expenditure augmented for the reason that tax revenue rose). More significantly, the study on FRM display that just looking at spending and aid can result in missing the big picture—expenditure decisions are made within a fiscal (budget) context in which external finance is only one component.

In another investigation done by Morrissey et al. (2007), they extend the time series FRM method with official Kenyan data for 1964-2004 (that is to say, the aid was reported by the government, which is much less than declared by donors to Kenya), to differentiate the fiscal effects of loans and grants and consider the influence of aid on growth (within a fiscal context). The outcomes varied for the two kinds of aid: grants were linked with augmented expenditure and that government expenditure had a positive effect on growth (grants as well had a small positive relationship with growth); loans, however, were a response to unexpected deficits, that is to say if expenditure surpassed revenue (grants and tax) the government required loans to fund the deficit (in periods of budget surplus the loans were reimbursed). Hence, aid loans and fiscal deficits have a negative relationship with output. Another interesting outcome is that tax revenue was weakly exogenous, that is to say, the regime was not able to upsurge tax revenue in the short-term to change the budget disequilibrium (deficits). It follows that because grants and tax revenue were not amenable to short-term adjustment by the receiving government (in effect there were not policy tools), borrowing (loans) changed to expenditure disequilibrium.

Looking at the current application of the time series method, Martins (2010) delivers a comprehensive examination of the fiscal effects of aid in Ethiopia by employing a unique quarterly data set for the period 1993-2008. Contrary to the surveys of Kenya and Ghana, aid grants changes to the level of development expenditure, that is to say, donors to Ethiopia seems to delivers additional grants if development expenditure is upsurge. In addition, there is proof for a long run positive association between development expenditure and aid but not between recurrent spending and aid (hence no proof that aid is fungible). Based on other situation, domestic borrowing upsurgers in response to shortages in revenue (grants and tax) and there is no proof of a long run fellowship between tax revenue and aid (that is to say no proof that aid affects tax effort).

## 6.2 Aid and Taxation

Addressing the aid and tax issue, it is necessary to know that within the research tradition on determinants of cross-country variations in tax/GDP ratios, where the ratio is fundamentally clarified by a tax structure equation (to proxy the tax base times the tax rate), the few surveys conducted including aid providing no solid proof that aid is a systematic determinant of tax ratios, that is to say no proof that aid has a behavioural effect on tax effort. Two authors Teera and Hudson (2004) carried out an investigation and discover that the coefficient on aid is trivial in their estimates of tax performance in developing nations. Most of the Empirical surveys of the fiscal effects of aid do not support the final result that aid lessens tax effort, but all these suggestions are country-specific (Section 3.1). There are some current studies that provide certain proof that in the past 15-22 years low-income aid receiving countries have managed to upsurge tax ratios; this positive relationship between tax and aid ratios proposes that in most aid receiving countries, the policies that is related with aid have supported the growing tax/GDP ratios (Clist and Morrissey, 2011). Furthermore, there is also some evidence that the connection between augmented tax ratios and aid may possibly be connected to the aspects of governance (Brun et al.2009).

There is a specific concern that aid may possibly discourage tax effort, particularly if given a pure grant that creates no repayment obligations, but there is a little proof to this suggestion. Based on Gupta et al. (2004) surveys, the authors find that aid grants have a negative effect on tax effort, but that loans are positively associated to tax revenue; the authors conclude that grant induce lower tax effort but loans encourage tax effort to meet repayments. In a study conducted for Kenya that differentiates grants and loans, Morrissey et al. (2007) discover no evidence for an effect of aid on tax effort. Actually, the general outcomes propose that Kenya has limited ability to alter tax revenue (more general arguments in Keen and Simone 2004). On the other hand, Cist and Morrissey (2011) address the effect of grants and aid loans on tax effort by employing data for eighty-two developing nations from 1970-2005 and discover no strong proof for a negative effect of aid grants on the tax/GDP ratio. The authors propose that one should expect a contemporaneous relationship for the reason that

most of the poorest nations have lower tax/GDP ratios, partly for this motive, these countries tend to receive additional aid in the form of grants. Permitting this with moderately long lags on aid (let's say five years in a panel context) removes the aid effect.

The authors also notice that aid loans have a fairly reliable positive influence, particularly in the medium-term. They further noticed that grants are trivial over the full period but positive and significant over the medium-term. Additionally, the significant negative short-term effect of contemporaneous grants over the entire period is reliable with most poor nations that have lower tax revenue, as well as nations that are receiving more grants; there was no effect like this between the periods of 1985-2005. The outcomes propose that external finance does assist nations to upsurge their tax revenue over the medium term. It may possibly be that the external finance is related with conditions involving measure to upsurge tax revenue, which could be taken to mean as a positive influence of conditionality. Most analysts believe that tax effort stand for a structural association, this make most authors to think that the tax/GDP ratio is determined by the tax rate which is applied to the tax base (which is aggregated over all taxes), given tax collection effectiveness. In fact, aid itself is not part of this structural association: aid may possibly have a behavioural effect (on rates, bases or collection effectiveness) or policies related with external finance (conditionality). In this effect, the controls involved the proxy for the tax base (such as industry and agriculture shares in the economy, imports, exports and GDP) which can partially capture the indirect behavioural or policy effects.

It is more challenging to address the tax effect of policy reforms that is related with conditionality as there can be numerous effects in opposing direction. Certain policies that are related with external finance in most recipient countries tend to decrease tax revenue. This situation occurred for the reason that economic liberalization has been an element of conditional lending (aid upsurges) and such reform episodes are commonly related with tax revenue reductions. In a study conducted by Aizenman and Jinjark (2006, 2009) both authors result shows that reforms like trade liberalization erode the revenue from 'easy to collect' taxes like tariffs (which tend to be very significant for poorer nations). Poor nations have difficulty in replacing the lost revenue via 'hard to collect' taxes, like VAT or income taxes, which require important investment in tax collection and resources for enforcement and monitoring, whereas the relatively small size of the formal sector implies a low tax base. Therefore, periods of economic policy reform in most developing nations tend to be related with decreases in the tax/GDP ratio, particularly for the poorest nations (Baunsgaard and Keen 2005), but most times they might as well tend to be related with aid episodes. In this manner, aid conditionality may really create a negative relationship between tax/GDP and aid/GDP ratios in the short-run. This assistance clarifies why one notices a negative association between tax and aid ratios, but it is not due to a behavioural effect of aid decreasing tax effort.

In fact, it is the poorest nations (also likely to be the main aid receivers) that face the highest challenges in increasing tax revenue (Keen and Simone 2004; Teera and Hudson 2004), that is to say the low tax/GDP is due to features related with low income rather than implying low tax effort. Given the tax base these nations are gathering as much as can be anticipated. In an examination carried out by Mkandawire (2010), the author argues that the nature of their colonial experience established institutional features that continue to assist and clarify why certain African nations have higher tax revenue than others. Changing tax/GDP ratios is a sluggish procedure. Actually, certain policy conditions will have the purpose of increasing incomes (the tax base) and tax collection effectiveness, and maybe even increasing tax rates (like consumption taxes); these effects may possibly be observed over the medium-term, and there is proof to support this positive association since the mid-1980s.

## 7.0 Conclusion

Even though the significant of capital accumulation for economic growth was broadly recognized long time ago, most developing nations- particularly Sub-Saharan African nations, are still trapped in 'vicious circle of poverty' and the region have failed to fund most of the desired level of investment from their own domestic savings. Previous models of development made known that these nations would come out of stagnation only if they received support from developed countries. Based on the two-gap model instituted by Chenery and Strout (1966) which displayed that these nations are constrained with little foreign exchange earnings and domestic savings. The prediction from the model states that external finance is an optimal means to break out from the 'vicious circle of poverty' and find ways to solve the two gaps issues simultaneously. Even though it seems convincing and interesting, most of the empirical examination on the effectiveness of aid came up with mixed outcomes. These mixed results made different experts to come up with diverse critics about the empirical study on the effectiveness of aid. The first critics to the 'optimist' view of 1950s and 1960s came from Griffin and Enos (1970). Both authors argued that aid rather contributes negatively to growth, as it is substituted for domestic saving by increasing consumption and decreasing government revenue collection effort. Following that observation, numerous empirical surveys were conducted on aid-growth relation but they were with inconclusive outcomes. The key problem with single equation based aid-growth or aid-saving/investment studies, is that it has

serious problems for the reason that they fail to recognize that aid is chiefly diverted via the public sector and its net effect relies on how it is employed in this sector and how this sector responds to the inflow of foreign aid. Various donors are concerned about how their aid is been employed in recipient countries, especially how it affects the fiscal behavior of the receiving regimes. Most of the analyses done on the fiscal effects of aid were motivated by the observation that most aid spent in any nation either goes via the budget or has an indirect effect on the budget by funding the provision of public goods and services. This paper examined the current evidence on the effects of aid on government expenditure and tax revenue as well as the fiscal response of the receiving governments to the inflow of foreign aid in Sub-Saharan African. There have been severe data limitations restricting the interferences on the association between expenditure and aid. Expenditure may not upsurge by the complete amount of aid, either for the reason that the aid is employed to lessens borrowing or is not actually reflected in the budget (that is to say, when making budget decisions the government is not aware of all the aid available to fund the provision of public goods). In other to assess the effects of aid on expenditure it is essential to survey the evolution of spending, in total and across specific sectors. Analysis like this is made known by fiscal response studies, displays that aid does not contribute to upsurges spending in total and in the sectors which are favored by donors. External finance affects the composition and evolution of government expenditure; this is supported by limited analysis of the cross-country effect of aid on expenditure. The few examinations that have been conducted on this matter specifically account for the effect of aid via which government expenditure discover positive aid effectiveness.

According to Gomanee et al. (2005b) examinations, the authors display that aid-funding investment contributes immensely to growth in Sub-Saharan Africa, also, Gomanee et al. (2005a) display that the aid that fund government social sector expenditure contributes to the upsurge in aggregate welfare of the recipient countries (see Mosley et al., 2004). Furthermore, this literature indicates that the kind of aid and the sectors to which it is distributed to, rather than simply the amount of aid, determines the effect on government expenditure and hence the influence of aid. Aid funding has the right potential to leverage upsurge social expenditure (particularly sanitation, health and education) which produces benefits (Morrissey, 2010). Initially, social expenditure contributes to human development and funds the provision of public goods. On the second note, it is the kind of government spending most possible to upsurge aggregate welfare and benefit the poor. There are other components of external finance that can be targeted on investment to contribute to growth. Based on combination, external finance can assist complementary elements of expenditure to contribute to human development and growth, hence to sustainable poverty reduction. It is vital that donors' aid policies for the future should be based on the most current proof, which is more encouraging that studies based on previous data. Numerous positive effect of external finance can be identified in areas of fiscal procedures, government expenditure and revenue mobilization. It is necessary for donors to avail themselves of these improvements in receiving countries systems so that it can help to provide aid in a more transparent way. If this transparency is put in place it will help to enhance the fiscal as well as the overall effectiveness of aid that is been channel to various recipient countries -- especially to Sub-Saharan Africa. Hence, in other for aid to be effective, the donor and recipient government will have to cooperate in a constructive way in the foreseeable future.

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