

# The Fiscal Impact of Aid Flows: Evidence from Ethiopia

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**Foreign aid flows** to developing countries have increased considerably in the last decade. This trend is driven mostly by the need to meet the resource gap in countries committed to fight poverty and achieve the Millennium Development Goals (MDGs).

In sub-Saharan Africa, where aid inflows account for a significant share of GDP, the fiscal impact of aid is fundamental to assessing its effectiveness. This One Pager seeks to contribute to the debate on aid by presenting results from a traditional fiscal response model estimated for Ethiopia.

The model focuses on the impact of foreign aid on government expenditure, revenue and domestic borrowing. Fiscal data for 1964-2005 were obtained from the IMF's International Financial Statistics (IFS) database and complemented by secondary sources.

A summary of the results is presented in the table, with aid disaggregated into its two main components, grants and loans. The coefficients denote foreign aid's total impact on the remaining fiscal variables, over the period under consideration.

The results suggest that foreign aid to Ethiopia has had a positive impact on government capital expenditure, but not a significant effect on recurrent spending (the coefficients are virtually zero). Moreover, aid loans seem to have had a stronger impact on government expenditure than grants, particularly on capital spending (with a coefficient of 0.30 for loans versus 0.06 for grants).

These findings are not entirely surprising since aid flows (especially loans) are often earmarked to specific investment projects, while governments are likely to use domestic tax revenues to pay for most recurrent costs.

Interestingly, both aid grants and loans have had a strong negative effect on domestic borrowing. This suggests that aid and domestic financing are close substitutes. There are two possible interpretations for this relationship. Since domestic borrowing is often an expensive last resort to balance the budget, an increase in aid flows could be used to reduce such a burden. Conversely, it might also be the case that, facing a shortfall in aid flows, the government seeks domestic finance to keep expenditure levels stable.

## The Fiscal Impact of Aid in Ethiopia, 1964-2005

	Capital Spending	Recurrent Spending	Domestic Revenue	Domestic Borrowing
Grants	0.06	0.00	-0.47	-0.44
Loans	0.30	0.03	-0.15	-0.46

Source: Martins (2007).<sup>1</sup>

The results also seem to support the hypothesis that aid displaces domestic revenue. Note the negative coefficient for loans (-0.15) but the even larger one for grants (-0.47). This raises concerns about how low-income countries, such as Ethiopia, can eventually overcome aid dependence.

However, these results might also be capturing some indirect effects, such as those due to aid conditionality. Aid flows to Ethiopia increased substantially from the early 1990s, roughly coinciding with the start of economic reforms that were designed to reduce public spending and reform the tax system (such as lowering rates). This might partly explain the apparent weak impact of aid on spending and the negative correlation with domestic revenue.

In conclusion, the results suggest that donors and recipients of aid should focus on ensuring greater 'aid additionality'. The priority should be on financing new capital spending, which can contribute not only to enhancing human development but also to expanding the economy's productive capacity.

While using foreign aid to pay off onerous domestic debt can serve a useful purpose at least in the short run, the medium-term purpose of aid should clearly be to expand MDG-related government spending.

Most troubling is the apparent displacement of domestic revenue by aid flows. One implication is that donors should channel more aid precisely into building up national capacities to mobilise domestic revenue. Otherwise, developing countries such as Ethiopia will have difficulty in graduating from heavy reliance on external aid.

### Reference:

1. Martins, Pedro M. G. (2007). 'The Impact of Foreign Aid on the Government Sector: The Case of Ethiopia', forthcoming IPC Working Paper, Brasilia.