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The Effect of Official Development Assistance Aid on Economic Growth and Domestic Savings in Kenya

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Abstract:

Purpose: *This study examines the effect of Official Development Assistance (ODA) on Kenya's economic Growth and Domestic savings from 1960-2019, using a simultaneous equation system in which growth and savings are jointly determined.*
Design/methodology/approach: *The model was estimated using the 2-Stage least square method to address the endogeneity problem.*
Findings: *The results show that government spending has the most positive impact on economic growth, however, the impact of ODA although positive was found to be statistically insignificant. The results further indicate that aid positively affects domestic savings during the study period.*
Practical implications: *Despite many developing countries benefitting from Official Development Assistance (ODA), only a few countries including Kenya have experienced significant positive changes in economic growth and domestic savings. Given that most developing countries have higher growth potential, ODA Aid is expected to affect economic growth and saving rates positively and significantly.*
Originality/Value: *The contribution of ODA in improving economic growth and augmenting domestic savings is still debated in the economics literature. Previous studies have not settled on a conclusive impact of ODA on domestic savings and economic growth, given the existence of conflicting findings.*

Keywords: *Official Development Assistance, growth, domestic savings, simultaneous equation, Kenya.*

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1. Introduction

While numerous reasons exist for giving foreign aid, the most compelling argument is to bridge the gap between domestic saving and domestic investment and therefore, to accelerate growth (Dowling and Hiemenz, 1983). A fundamental assumption made by the supporters of foreign aid is that it helps poor countries in achieving higher levels of economic growth. In the absence of such aid, the internal resources of the poor countries will not be able to take off.

Official Development Assistance (ODA) is an international support policy whose primary purpose is to stimulate economic growth in developing countries. Aid can be either a loan or a grant. Aid also can be bilateral: from one country to another - this accounted for about 70% of total aid in 2020; or multilateral from donor countries to international organizations. These organizations then distribute aid funds among developing countries.

The significance of ODA in funding economic growth and augmenting domestic savings has been debated in the economics literature. Some studies, for example, Durbary *et al.* (1998), Asteriou (2009). and Juselius *et al.* (2014), have shown that ODA impacts positively economic growth and domestic savings. Over the period 1974 to 1996, Hatemi-J and Manuchehr (2005) investigated the link between foreign aid and economic growth in a group of developing nations (Botswana, Ethiopia, India, Kenya, Sri Lanka, and Tanzania). They discovered that foreign aid had a beneficial and considerable impact on economic growth.

Mckee and Bells (2013) state that ODA has a remarkably positive impact on economic growth. Also, Refaei and Sameti (2015) state that foreign aid has a positive, statistically significant, and sizable impact on economic growth in the long run, implying that it is more productive than domestic resources and other capital inflows.

Some scholars have argued that ODA has a negative impact on growth. In *Dead Aid*, Dambisa Moyo (2009) states that development aid has a negative link to growth; she states that official aid is cheap money that encourages corruption and destroys nations, resulting in a culture of dependence and economic laziness. The development of government bureaucracies and unpredictable macroeconomic policies are to blame for this failure.

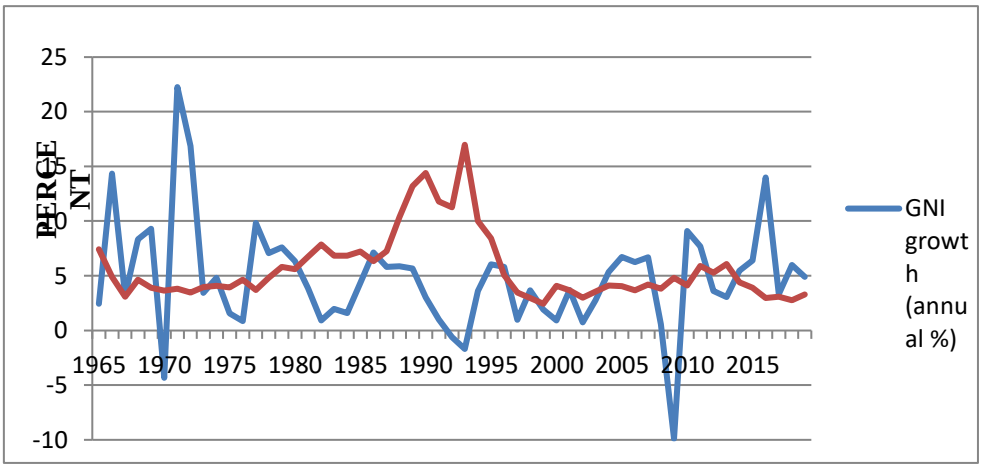
William Easterly (2006) contends that economic growth can be experienced in nations that do not receive aid. Bauer (2000) stated that poor countries are overly dependent on foreign aid which is used to finance the government and non-productive sectors, reducing their efforts to generate growth within their economies. Elakkad and Hussein (2021) from their research on the effect of ODA on domestic savings and economic growth in Egypt concluded that ODA has a beneficial effect on gross domestic savings and a detrimental effect on economic growth.

According to a study done by Kibiru (2008) on the impact of foreign aid on domestic savings in Kenya, the relationship between the two variables is negative and significant. Foreign aid inflows, according to Griffin and Enos (1970), would supplant domestic savings, acting as substitutes instead of compliments. According to the researchers, the expected assistance inflow is seen as a rise in income and will hence be utilized to boost consumption. Wako's (2011), findings indicated that ODA has a negligible effect on economic expansion. As a result, it's unclear if ODA contributes much to economic growth.

Kenya, like other developing countries, aims to maintain a sustainable economic growth rate. However, over the years, the country has gone through several turbulent periods. Between 1963 and 1980, the country saw strong economic growth and notable social achievements. During this period, the country benefitted a lot from foreign Aid.

However, the period between 1980 and 2002 was marked by a freeze on aid and donor sanctions. Following the 2002 General Elections, Kenya's economy entered a new era, with a rebound in performance. In addition, ODA inflows increased throughout this same period (Figure 1).

Figure 1. *GNI growth (annual %) and Net ODA received (% of GNI) by Kenya (1965-2019)*



Source: *World Bank, World Development Indicators 2022.*

Since 1960, Kenya has been relying on Official Development Assistance to support the country's economic growth and augment domestic savings. However, the donors halted developmental assistance when Kenya failed to comply with the International Monetary Fund's mandated governance reforms in 1991 and again in 1997. The Official Development Assistance and official assistance flows grew from US$394.79 million in 1980 to US$1181.29 million in 1990, before plummeting to US$311.25

million in 1999, and then recovering after. The drop was caused by multilateral and bilateral donors suspending ODA to Kenya in 1991 and 1997 (Mwega, 2009).

Additionally, in 1993, Net ODA to Kenya significantly decreased because of the government breaking its promises to donors, with two significant episodes of donor withdrawal and "aid freezes." (Mule *et al.,* 2002). The 2002 General Elections and commitments to changes hastened the recovery (Veledinah, 2014).

A re-commitment of numerous donors enhanced aid to the nation in the financial year 2004/2005. ODA dedications in the budget increased to roughly 5 per cent of the Gross Domestic Product (Gichanga, 2018). During the fiscal year, budget deficits would have resulted in increased domestic borrowing, taxes, and a cut in government spending if donors had not intervened (Uneze, 2011).

Even though Kenya's GDP grew by 6.9 per cent in 2007, up from 0.5 per cent in 2002, the post-election violence crisis had a detrimental effect on the nation, lowering it to 0.2 per cent in 2008. In its 1st medium-term plan covering from 2008 to 2012, Kenya Vision 2030 aimed for a 10% growth rate; however, the yearly growth rate in 2012 was only 4.6 per cent. The GDP remained unstable, where little to no changes were seen; in 2019 the GDP growth rate was 4.981 per cent.

Although Kenya has been getting substantial ODA to help it deal with its economic problems. Despite donor funding and government initiatives, the country's domestic savings and economic growth have remained poor, and poverty reduction has trailed behind growth. The fall in performance could be explained by a variety of qualitative and quantitative factors, but the downward trend implies that Kenya's economic problems go beyond its low-income base, and it also raises doubts about the impact of ODA on domestic savings and growth. This research investigated whether ODA had any significant impact on domestic savings and economic growth in Kenya.

2. Literature Review

Several studies have found a positive relationship between foreign aid and economic growth. Earlier studies such as Papanek (1973) showed that international aid had a beneficial effect on economic expansion because, unlike domestic savings, it could close both the foreign exchange and savings gaps. Burnside and Dollar (2000) showed that an increase in aid flows strengthens economic growth in poor countries when the policy environment is conducive.

In the presence of poor policies, aid was not found to have any positive effect on growth. Collier and Dollar (2002), support the significance of the policy environment for aid effectiveness while Collier and Dehn (2001) note that well-timed aid alleviates the effects of negative export shocks, while Collier and Hoeffler (2004) find that aid works particularly well in good policy environments.

Tofik (2012) in Ethiopia found that ODA had a beneficial contribution to the development. Other studies (Mckee and Bells, 2013) in 30 Sub-Saharan African countries; Bruckner, (2013) in Cambodia; Ojiambo (2013) in Kenya; Suphian and Kim (2017) in East African countries, all found that foreign aid stimulates a country's economic growth.

Moreira (2005) explored the effect of foreign aid on economic expansion and concluded that the former had a beneficial effect on the latter. Sakyi (2011) found foreign aid and trade openness significantly and positively influenced economic growth. Fasanya and Onakoya (2012) study on the effect of ODA on economic expansion in Africa concluded that the inflow of aid into the nation promoted economic growth by boosting domestic savings and investments, freeing up resources that improve domestic investment.

Fayissa and El-Kaissy (1999) concluded that because international aid supplements domestic savings rather than substituting for them, it has a positive impact on the growth of the economies of developing states. In Nepal Bhattarai (2009) found that aid went hand in hand with economic growth, savings, and investment. A more recent study by Tang and Bundhoo (2017) examined the relationship between foreign aid, and the economic growth rate of Sub-Saharan Africa's 10 largest recipients of foreign aid, for a 23-year period from 1990 to 2012. They found that aid by itself does not have a significant impact on economic growth.

However, it becomes positive and statistically significant when interacted with the policy index. This indicates that aid tends to increase the growth rate in a good policy environment. Another recent study by Abate (2022) using panel data from 2006-2019 obtained from 48 developing countries found that the relationship between aid and economic growth was nonlinear.

Other studies have found a negative relationship between economic growth and foreign aid. Djankov *et al.* (2006), and Mallik (2008) in 6 of the most impoverished African nations found that there was an unfavourable relationship between the two variables in the long term. The unpredictability of aid and the utilization of assistance for humanitarian purposes rather than for investment were all factors associated with the negative impact of aid on economic growth. Kibiru (2008) in Kenya noted the presence of an adverse link between foreign aid and national savings.

Abuzeid (2009) concluded that foreign aid is not enough for developing nations because of poor governance and weak institutions. Similarly, Eregha *et al.* (2012) argue that the inefficiency of aid in the majority of developing African nations can be attributable to money being diverted to wasteful consumption. In the literature, there is consensus that aid promotes economic growth but only in good policy environments (Burnside and Dollar, 2000).

Boone (1996) argues that foreign aid does not increase economic growth rates in poor countries because economic growth depends on the ability of the recipient country to pursue sound economic policies.

3. Research Methods

3.1 Theoretical Framework

The empirical model is motivated by the two-gap model and is utilized to provide a bridge between theory and empirical research. The main premise of the two-gap model is the discrepancy between a nation's own resource supply and its capacity for absorption. The difference results in the Savings Gap and the Foreign Exchange Gap. The amount of investment and capital creation that can be done will be constrained by whichever of the two gaps is binding (or is the largest). The "Two-Gap model" results when external funding (loans or grants) supplements domestic resources.

The assumption is that most developing countries either do not have enough domestic savings to bolster investment prospects or are constrained by foreign exchange requirements to finance the necessary intermediate and capital goods. The Savings Gap is experienced when savings are insufficient to invest properly and productively. The Foreign Gap is experienced when foreign exchange profits are insufficient to pay for the essential foreign components and materials.

The fundamental macroeconomic identity: Aggregate Expenditure is equated to Aggregate output. Consequently, presuming there isn't a public sector, the model can be expressed as:

$$Y = C + I + (X-M) \quad (1)$$

Where Y = Gross National Product (GDP), C = Consumption, I = Investment, X = Exports and M = Imports.

The source of resources employed in the country is equal to the employment of resources in the nation (expenditure targets):

$$Y + M = C+I+X \quad (2)$$

Deducting consumption from all sides results in equation 3:

$$Y-C+M = I+X \quad (3)$$

Subsequently, $Y – C = S$ (4)

Where; S stands for domestic savings. Substituting equation 4 for equation 3 results in equation 5:

$$S + M = I + X \quad (5)$$

With (S+M) being the withdrawals and (I+X) being the injection. Equation 5 can further be expressed as:

$$M - X = I - S \quad (6)$$

Equation 6 (M – X) shows the Foreign Exchange gap and (I – S) shows the Savings gap. The gaps comprise 2 distinct constraints. Reducing one doesn't eliminate the other. Using equation 6 shows how the gap can come into existence; the country might not be able to do as much I as it would otherwise be able to because S is too little. So, there would be a Savings Gap; and the country might not be able to employ the M needed to utilize all the nation's resources because X is too little. As a result, there would be a Foreign Exchange Gap. Even though the two gaps are unique from one another, both can be filled through international transfers.

Therefore, the model suggests that foreign aid and foreign direct investment are the most effective approaches to ending the cycle of poverty and dealing with the 2 gaps simultaneously. Since the analysis assumes that domestic savings as well as foreign capital inflows can be used to fund domestic investment. Foreign aid and grants are two examples of the various ways that foreign capital might flow to a country.

These foreign flows enable imports to surpass exports, allowing investment to outpace domestic savings. An increase in ODA will increase savings which will then lead to the growth of the economy. Most developing countries have gross savings rates that are below what is required, and Kenya is no exception.

4. Empirical Model

Estimating the growth and savings equations separately may bring about simultaneity bias, as some of the independent variables might not actually be exogenous for instance foreign aid and government spending are more likely to be statistically correlated and thus might not be truly exogenous (Gupta and Islam, 1983). In estimating the two equations, the variables were transformed into natural logs. This transformation enables the interpretation of the regression coefficients as elasticities. As a result, the model's variables are all represented in natural logarithm form to get the elasticities and reduce multicollinearity. Thus, the equation is expressed as:

$$\ln GDPPC = \beta_0 + \beta_1 \ln ODAID + \beta_2 \ln GDS + \beta_3 \ln GOVEXP + \beta_4 \ln TRADEOPEN + \mathcal{E} \quad (7)$$

$$\ln GDS = \alpha_0 + \alpha_1 \ln ODAID + \alpha_2 \ln GDPPC + \alpha_3 \ln GCF + \alpha_4 \ln TRADEOPEN + v \quad (8)$$

Where: GDPPC is GDP per capita in constant US$ 2015 prices; ODAID is net official development assistance and official aid received in constant US$ 2020 prices; GDS is the gross domestic saving in current US$ prices; GOVEXP is government final consumption expenditures in constant US$ 2015 prices; GCF is the gross capital formation in constant US$ 2015 prices; TRADEOPEN is the trade openness measured as the sum of exports plus imports as a share of GDP; Ɛ and v are error terms. The parameters β_1, β_2, β_3 and β_4 represent the elasticities of GDPPC with respect to ODAID, GDS, GOVEXP and TRADEOPEN. The parameters α_1, α_2, α_3 and α_4 represent the elasticities of GDS with respect to ODAID, GDPPC, GCF and TRADEOPEN.

The study's interest was to investigate the relationship between ODA, domestic savings, and economic growth in Kenya. It is assumed that ODA increases domestic savings, which in turn raises gross investments, and subsequently leads to economic growth. By utilizing resources and scale economies, openness is seen to significantly influence growth. In addition, GCF was used as a proxy for domestic investment.

To address the endogeneity issue, the study employed the 2SLS, which generates consistent estimates by using the endogenous explanatory variable's estimated values. Running a regression to determine the predicted values of the explained variables yields the predicted values. Next, the predicted values are used as independent variables in respective equations. Once the independent variables have been replaced by the predicted values, the regression is once again run. This method solely uses knowledge of the specific equation's coefficient restrictions to estimate every single equation independently. Table 1 provides the variables, their measurement and the expected effect on the dependent variable.

Table 1. *Definition of the Variables and the Expected Signs*

Abbreviation	Name	Unit	Description	Expected Sign
GDPPC	GDP per capita	Constant 2015 US$	It is calculated by dividing GDP by the midyear population. GDP is calculated as the total gross value added by all producers who are residents of the country, plus any applicable product taxes, less any unaccounted-for subsidies that are not included in the value of the products.	Dependent Variable Positive

ODAID	Net ODA received.	Constant 2020 US$	It comprises disbursements of "soft" loans and grants from DAC member's official agencies, non-DAC nations and multilateral institutions to boost economic growth and the well-being of the recipient nations.	Positive Positive
GDS	Gross domestic saving	Current US$	It is determined by the GDP minus final consumption expenditure (total consumption). GDS comprises savings of the public sector, household sector and private corporate sector in a given country.	Positive Dependent Variable
GOVEXP	General government final consumption expenditure	Constant 2015 US$.	It comprises all current government expenditures for the procurement of goods and services. Additionally, it comprises the majority of government spending on security and defense; however, the State military's expenses that are covered by GCF are excluded.	Negative
GCF	Gross capital formation	Constant 2015 US$	It comprises expenditures on additions to the fixed assets of the nation and net changes in the inventory levels.	Positive
TRADEOPEN	Trade openness	sum of exports plus imports as a share of the GDP	Trade openness describes how a nation's economy is structured in relation to international trade. The actual volume of an economy's reported imports and exports serves as a gauge of how open it is. Trade openness is calculated as the sum of a nation's exports and imports as a percentage of its GDP.	Positive Positive

Source: *Own study.*

5. Results and Discussion

5.1 Descriptive Statistics

Table 2 presents descriptive statistics used in the econometric model. The country's log value of GDPPC ranged from 6.51 as the lowest value to 7.38 as the highest value, while the mean and standard deviation stood at 7.04 and 0.2 respectively. This output shows that most data sets are located quite near to the mean. The more consistent the Mean, the nearer the Standard Deviation is to zero, which also

demonstrates that the sample's volatility is relatively low. From this basis, therefore, the GDPPC with a standard deviation of 0.2 is a consistent variable. The country's log value of ODAID varied in value from 19.22 to 21.91, with 19.22 being the lowest value, while the mean and standard deviation stood at 20.62 and 0.65 respectively.

The standard deviation being a value close to shows that the variable is consistent, with a reliable mean. The log value of the GDS registered 18.71 as the smallest value and 23.07 as the greatest value, and the mean and standard deviation were 20.84 and 1.2 respectively. The average log values of GOVEXP, GCF and TRADEOPEN are 21.64, 22.02 and 4.02 respectively. The σ (SD) depicts that the data deviates from the mean by 0.96, 0.81 and 0.18 respectively. They are all close to 0, implying that the variables are consistent.

Table 2. *Descriptive Statistics*

	Ln GDPPC	**Ln ODAID**	**Ln GDS**	**Ln GOVEXP**	**Ln GCF**	**Ln TRADEOPEN**
Mean	7.04	20.62	20.84	21.64	22.02	4.02
Standard Error	0.03	0.08	0 .16	0.12	0.10	0.02
Median	7.07	20.58	20.86	21.64	21.85	4.05
Standard Deviation	0.20	0.65	1.20	0.96	0.81	0.18
Minimum	6.51	19.22	18.71	19.68	20.53	3.46
Maximum	7.38	21.91	23.07	23.15	23.56	4.31
Observation	60.00	60.00	60.00	60.00	60.00	60.00

Source: *Own calculations.*

5.2 The Relationship between Aid and Economic Growth

Table 3 presents the results of the effect of ODA on economic growth. The coefficient on ODA is positive but not statistically significant. These results support the finding by Ang and Bundhoo (2017) who found that aid by itself does not have a significant impact on economic growth. However, by interacting the variable aid with the policy index, it was found to be statistically significant and positive, which means that aid tends to increase the growth rate in a good policy environment.

Further, by including an institutional quality index and an interaction term in the model, they found the institutional quality to be positive and statistically significant. A similar study by Burnside and Dollar (2000) which showed that the relationship between ODA and economic development was unclear. Similar findings by Burke and Ahmadi-Esfahani (2006) found that the effect of ODA on economic development was insignificant. Other similar findings were reported by Erkinharju

(2021) who found ODA had no effect on the growth of the economies of the countries in the study.
Finally, a recent study by Abate (2022) concluded that the effect of aid on economic growth depends on the amount of aid received, the quality of the institution, and economic freedom.

The coefficient on government expenditure (GOVEXP) was positive and statistically significant at the 5% significant level. This implies that a percentage increase in government expenditure (GOVEXP) increases economic growth by 0.127 per cent. On the contrary, both Gross Domestic Savings (GDS) and Trade openness (TRADEOPEN) had a positive but insignificant relationship with economic growth.

Table 3. *Impact of ODAID on economic growth*

Ln GDPPC	**Coef.**	**Std. Err.**	**z**	**P>|z|**	**[95% Conf. Interval]**	
Ln GDS	0.0439908	0.0533744	0.82	0.410	-0.0606211	0.1486026
Ln ODAID	0.0320649	0.0558442	0.57	0.566	-0.0773877	0.1415176
Ln GOVEXP	0.1267789	0.0354484	3.58	0.000	0.0573012	0.1962565
Ln TRADEOPEN	0.033791	0.0709345	0.48	0.634	-0.105238	0.17282
_cons	2.578735	0.8208544	3.14	0.002	0.9698896	4.18758

Source: *Own calculations.*

5.3 The Effect of Aid on Domestic Savings

Table 4 presents the results on the effect of ODA on domestic savings. The coefficient on ln GDPPC is positive and statistically significant at the 5% level. This implies that a 1% increase in economic growth increases domestic savings by 1.952%. The coefficient on ODAID is positive and statistically significant at 5% level of significance, implying that a 1% increase in ODA increases domestic savings by 0.732%.

Table 4. *Impact of ODAID on domestic savings*

Ln GDS	Coef.	Std. Err.	z	P>|z|	[95% Conf. Interval]	
Ln GDPPC	1.95195	0.55312	3.53	0.000	0.8678551	3.036046
Ln ODAID	0.7320329	0.0955886	7.66	0.000	0.5446827	0.9193831
Ln GCF	0.5144407	0.1094966	4.70	0.000	0.2998313	0.7290501
Ln TRADEOPEN	0.1443353	0.2490857	0.58	0.562	-0.3438637	0.6325343
_cons	-19.89099	2.199422	-9.04	0.562	-24.20178	-15.5802

Source: *Own calculations.*

These results support the finding made by Elakkad and Hussein (2021), who explored the effect of ODA on domestic savings and economic growth in Egypt, from 1965- 2020. The results showed that ODA had a beneficial effect on national

savings. Additionally, Fayissa and El-Kaissy (1999) concluded that international aid supplements domestic savings rather than substituting it.

The coefficient on GCF is positive and statistically significant at a 5% level of significance, showing that a 1% increase in gross capital formation increases domestic savings by around 0.514%. On the contrary, Trade openness had a positive but insignificant relationship with gross domestic savings.

6. Discussions

The main goal of ODA is to help developing nations develop socially and economically. ODA is expected to increase GDS which increases investments, as a result, it enhances economic expansion. This is supported theoretically by the two-gap model which states that the economy can grow at the desired rate by bridging this savings gap with foreign aid.

The same sentiments are supported by several studies including Durbary *et al.* (1998) and Juselius *et al.* (2014). These studies indicate that ODA affects economic development positively. Additionally, Veledinah (2014) states that due to the inadequate financial resources in Africa, ODA is assumed to provide additional foreign exchange, supplement domestic savings, and aid in the development of domestic capability, to hasten growth and lower poverty.

The study's findings partially match the theoretical prediction. According to the two-gap model's underlying assumptions, this study found a positive and significant relation between GDS and ODA. This implies that the more Kenya receives ODA the higher its domestic savings will be which should raise the level of investment in the country. This is a good sign that ODA is partly achieving its goal and this finding supports similar findings by Elakkad and Hussein (2021).

On the contrary, the results show a positive but insignificant relation between ODA and economic growth. The results contradict the aim of contributing to ODA, hence raising questions as to why ODA is not meeting its main target, yet funds are still being contributed to the recipient countries. The findings support the work of some scholars like Wako (2011), who found that ODA has a negligible effect on economic expansion. The failure to meet its goal might be due to various reasons including the ease with which aid funds can be used for non-productive, non-investment-inducing activities.

According to Djankov *et al.* (2006), the way foreign aid is distributed among different economic sectors determines how effective they are in achieving economic expansion. Abate (2022) notes that the impact of foreign aid received by developing countries on their economic growth is contingent on the amount received. The study noted that the impact of aid on economic growth is negative (or positive) when the amount of aid received is below (or above) the threshold level respectively.

7. Conclusion

ODA can significantly contribute to Kenya's economic growth and can potentially increase the country's domestic savings. However, the findings show that although aid has a positive effect, it was not statistically significant. Although this study did not assess the effect of an interactive term-aid and policy term, it is highly likely that the ineffectiveness is explained by bad governance inherent in most Sub-Saharan African countries including Kenya. Like in many other countries, ODA in Kenya is susceptible to political manipulation and maybe diverted to sectors or other uses with no potential for economic growth.

Additionally, the veracity of the individuals managing it, the capacity of the necessary organizations, like the law enforcement agencies, judicial, and executives, as well as the current domestic political, economic, and climatic conditions, all have an impact on the effectiveness of ODA.

Thus, while ODA significantly impacts domestic savings and has the potential to effectively promote economic growth, its efficacy depends on a variety of aspects, including the degree of corruption, the stability of the worldwide economy, the distribution for the intended course, and the recipient government's financial discipline.

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