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AID DEPENDENCY AND ECONOMIC GOVERNANCE IN THE EAC COUNTRIES

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Abstract

This study examines the interrelationship between Aid, Aid dependency, good Governance and economic growth in the East African Community (EAC) Countries using a Panel data model with fixed effects for the period of 1996-2006.
Through a Growth Model, we have found that foreign Aid negatively affects economic growth whereas good governance (which we have measured by the Corruption Perception Index as its proxy) positively affects economic performance in EAC countries.
Moreover, the Governance Model has revealed that Foreign Aid and economic performance positively affect good governance in EAC Countries. Good governance seems to have positive impact on aid dependency of the EAC partner states even though the coefficient is not statistically significant. This result suggests that the EAC partner states should focus on good governance improvement if they intend to reduce their dependency to external aid and therefore their growth volatility as well.

Key words: Aid Dependency, Volatility, Good Governance, Economic growth, Panel Data

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1. Introduction

1. 1. Study background

"Sustainable economic growth and poverty reduction will be tackled successfully only if preceded by institutional development capacity building and good governance", said ***Angel Gurria***, Secretary General of OECD, at the 2007 Heiligendamm G8 Summit.

In the past 50 years, over 1 trillion dollars have been given in foreign aid. However, millions in third world countries still live in abject poverty. Today, more than one billion people live on less than $1 per day (World Bank, 1998). The ineffectiveness of foreign aid in reducing poverty sparked a new debate on aid and its effect on growth. Because of this aid fatigue and the lack of results in terms of poverty alleviation, total aid disbursements of foreign aid have gone down from 0.33% of donor countries' gross national product (GNP) in 1990 to 0.24% of their GNP in 1999 [World Bank, 2001]. (1) The fall of foreign aid in the 1990s is noticeably significant in the case of Sub-Sahara Africa (SSA) and Middle East and North African (MENA) countries. In 1990, 37% of foreign aid went to SSA and 20% was given to MENA countries. By 2000, their share was reduced to 27% and 10%, respectively.

Proponents of foreign aid confessed to the failure of aid giving and its dismal rate of return. Project aid is suggested as a new approach that donors can ensure the effectiveness of their aid by carefully selecting

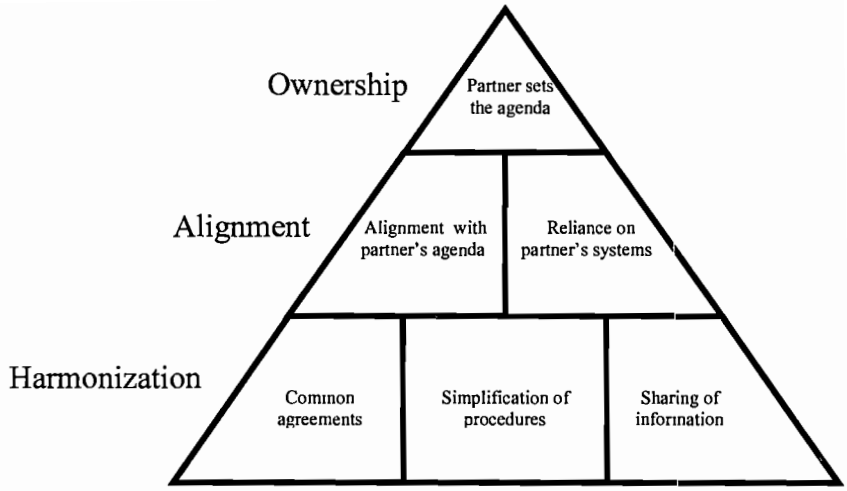
projects and monitoring their implementation. However, the fungibility of foreign aid undercuts this strategy. Fungibility, in essence, means that "a dollar is a dollar" and allows governments to adjust their own expenditures taking into account the inflow of foreign aid. Aid can also be used to reduce taxes or the budget deficit and so it follows that the impact of aid cannot be measured by project outcomes alone. Using a sectoral decomposition of concessionary loans to 14 countries from 1971 to 1990, Feyzioglu et al. (1998) showed that a dollar increase in foreign aid leads to an increase of 0.95 cents in total government spending. More importantly, they showed that higher concessionary loans to a particular sector do not necessarily increase spending in that sector.

The fact that so many countries register low per capita income after receiving enormous amounts of foreign aid questions its effectiveness as a toll for economic growth and consequently, as an instrument of poverty alleviation.

Africa's economy still largely relies on external aid for its development; and this is specifically the case of the East African Community Countries (Burundi, Kenya, Rwanda, Tanzania and Uganda). Yet, as the East African countries are getting further in regional integration, economic and monetary union and, ultimately, political federation, there is strong conviction that EAC countries should concentrate on reducing their dependency to external aid as President Paul Kagame of Rwanda stated it: "we must put an end to aid dependency" .

Poor or less developed countries are believed to be trapped in a vicious circle of poverty where low incomes lead to low savings and insufficient resources for investments. Foreign aid is supposed to boost investment and link poor countries to a virtuous circle of growth. But real per capita growth has not been strong in the context of EAC countries modern although it has been slightly improving. Some of the EAC countries have got their inflows of foreign aid increased many times over. But what we can question is to check how improved and strengthened regional integration, and therefore, the governance enhancement within the EAC members, would pave the way for new principles of efficient aid, or how may these countries (EAC members) make a difference in terms of aid-induced behavioural change.

After several years of discussions, policymakers of developed and developing countries concluded a major agreement to take far-reaching actions to reform the ways in which aid is delivered and managed (the "Paris Declaration") through specialized organizations. One of these organizations is The Development Gateway Foundation (DGF) dealing with making transparency and aid effectiveness a practical reality. Of course, governance is central to its strategy of better aid management and effectiveness. The principles of this important agreement are:



As a tool of aid effectiveness, the Aid Management Platform (AMP) allows developing countries to better monitor, manage and coordinate aid flows. Modules include aid information and project management, reporting, monitoring and evaluation, national planning, document management, and a planning calendar. AMP has been developed in concert with the ongoing discussions on aid effectiveness and harmonization, working with Ethiopia as a test case. A Steering Committee comprising the OECD Development Assistance Committee, UNDP, and the World Bank has been pivotal in developing this initiative. The potential benefits of a common aid management platform are substantial: a 1% increase in aid effectiveness – a feasible target for better aid management systems – would equal $1 billion of additional global aid per year, if all donors and developing countries participated.

This research will address the question to assess the nature and magnitude of the relationship between aid (dependency) and growth on the one hand, and between aid (dependency) and governance on the other hand, within the five EAC members. Governance is likely to be improved in a regional context like the one of the EAC and therefore, aid management platform may work better in these countries. The paper also asks whether there is significant correlation between aid effectiveness (on growth) and aid dependency and/or governance indicators (namely the corruption perception index). We also seek to shed light on the best policies to manage aid or how to bring revolution in the way capital is transferred to EAC countries in order to make its impacts effective.

All these considerations pushed us to investigate what are relationships existing between foreign aid, governance (approximated by its proxy, the corruption perception index) and economic growth. Finding the sign or direction and magnitude of these relationships will obviously shed light on the potential of gains and/or losses that East African countries can encounter in their integration process as they open up to each other and as they tend to attract more foreign direct investment. Moreover, such empirical results are necessary and useful in support of some economic policies (integration strategies, means of facilitating a beneficial governance framework, to enhance the impact of the globalization on domestic growth, and so on...). The questions arising from regional integration blocks especially when it comes to East African context vary from attracting foreign direct investment, internal policy reforms, institutional reforms, investment environment

reforms, regional versus international trade mechanisms and other trade matters, the best policies to be implemented in order to make the regional integration be successful and benefit to population welfare, the impact of bad governance on aid effectiveness, the regional governance framework, policy reforms, ...

This analysis intends to investigate empirically what are the direction and magnitude of the relationships between governance and foreign aid related to economic growth within the EAC economies.

1. 2. Objectives, Hypotheses and Methodology

The paper is aimed at analyzing what are the relationship between aid and aid dependency, governance and economic growth in terms of aid effectiveness in Sub Saharan Africa, namely, in the EAC countries in terms of specific case study.

The specific questions to be addressed in this paper are, inter alia:

- What is the degree of aid dependency within the EAC Partner States?
- What is the relationship between aid dependency and its effectiveness related to economic governance environment?
- Does aid cause governance or is the reverse true?

Answering to these questions will allow addressing the crucial question of knowing whether it is important to continue to rely on

external aid or if it's better to transform the former into foreign direct investment.

The governance component of aid effectiveness will be stressed on just to check how good governance and better economic environment would improve economic impact of aid in the EAC countries, at least at a theoretical level.

On one hand, the article is written to bring into discussion the fact that sometimes aid is seen as reducing vulnerability and fragility of underdeveloped countries whereas some others think that aid is very crucial for the development and growth of these less developed countries.

On the other side, there is also a statement that governance doesn't matter in terms of aid effectiveness whereas some other authors state that aid effectiveness will depend on economic governance as well as on aid dependency per se.

In the first instance, the literature review has been assessed to come aware of various philosophies on aid effectiveness versus foreign direct investment efficiency on economic growth amongst the five countries of the East African Community.

After literature review, we analyse the aid and governance environment within EAC with some key illustrations of economic performance.

In the end, we apply a simple panel data model in order to test empirically if the governance has a significant impact on aid or if the reverse is true, and to test how important are the impact of aid (dependency) and governance on the growth of the EAC economies.

Data collection has been carried from the UNCTAD CD-ROM, the World Bank Development Indicators CD-ROM, the UNDP Human Development Reports, the Transparency International, and elsewhere (national and international sources).

The paper is shedding theoretical and empirical light on these matters of fact using simple panel data analysis. The software we have used is Eviews 6.

2. Aid and Governance theories and prospective Inquiry within the EAC

2.1. Theories on Aid and Governance and their relationships to growth

A. The micro-macro Paradox in aid

The major findings by Paul Mosley and others conclude that it is impossible to establish any significant correlation between aid and growth in developing countries. One reason for this is the fungibility and the leakage of the aid into unproductive expenditure in the public sector. However, at a micro level, all donor agencies regularly report

the success of most of their projects and programs. This contrast is known as the *micro-macro paradox*. These Mosley's results have been further corroborated by Peter Boone who argued that aid is ineffective because it tends to finance consumption rather than investments: this has been seen as a confirmation of the *micro-macro paradox*. This micro-macro paradox has been attributed to inadequate assessment practices.

Burnside and Dollar recently found that the impact of aid on growth is positive in countries with a good political environment for making policy. This is indicated by a significant and positive coefficient on the 'aid' policy interaction in the growth regression.

Burnside & Dollar advocated selectivity in aid allocation. This means that aid should be allocated in countries where it works best, then that would exclude or discriminate countries that are less fortunate in terms of policies and require help most.

Burnside & Dollar's findings have been placed under heavy scrutiny since their publication. Easterly and his colleagues re-estimated the Burnside & Dollar model with an updated and extended dataset but they could not find any significant aid-policy interaction term. New evidence seems to suggest that Burnside & Dollar's results are not statistically robust.

B. Studies and Literature on Aid Effectiveness

One problem of the studies on aid is that there is a lack of differentiation between the different types of aid. Some type of aids such as short term aid do not have an impact on economic growth

while other aids used for infrastructure and investments will result in a positive economic growth.

The emerging stories from aid-growth literature are that aid is effective under a wide variety of circumstances and that nonlinearities in the impact of aid reduce the significance of the aid-growth relationship. However, returns to aid show diminishing returns due to absorption capacity and other constraints. Also, geographically challenged countries would display lower effectiveness with respect to aid and that should be taken into account in allocation.

Therefore, the challenge to aid allocation is to identify and eliminate the overriding institutional and policy constraints that will reduce the impact of aid on growth. The real challenge is thus to develop a framework of 'growth and development' diagnostics to help identify the constraints. Stefan Schmitz believes that reporting duties, results-orientated action and ongoing performance assessments are essential for the sake of aid effectiveness, but political will must be already there for this to happen.

Aid has quadrupled in the last 25 years, with the majority of aid still coming from official donors, and emerging giants such as China and India. In addition, money is being spent in different ways, for example on global programs to combat specific issues, such as the control of malaria or measles. ODI work on arguments for a redress of the way in which aid is provided through:

- Redesigning aid architecture and improving aid effectiveness.
- Reforming public finance management.

- Strengthening resource allocation and use at sector and local levels.
- Improving national policy and planning processes.

C. The Tied Aid Mechanism

Tied aid is defined as project aid contracted by source to private firms in the donor country. It refers to aid tied to goods and services supplied exclusively by donor country businesses or agencies and this aid's tying severely reduces its impact on development as it increases the cost of assistance and has the tendency of making donors to focus more on the commercial advancement of their countries than what developing countries need by insisting on donor country products.

It is further argued that tied aid, if well designed and effectively managed, would not necessarily compromise the quality as well as the effectiveness of aid (Aryeetey, 1995; Sowa, 1997). It must be emphasized however, that commercial interest and aid effectiveness are two different things and it would be difficult to pursue commercial interest without compromising aid effectiveness. Thus, the idea of maximizing development should be separated from the notion of pursuing commercial interest. Tied aid improves donors export performance, creates business for local companies and jobs.

D. The Paris Declaration on Aid Effectiveness

In February 2005, international community came together at the Paris High Level Forum on Aid Effectiveness, hosted by the French government and organized by the OECD. The role of aid in promoting

development was attracting increasing public scrutiny in the run-up to the G8 Summit in Gleneagles, Scotland, and the global campaigns such as Make Poverty History. While some progress had been made in harmonizing the work of the different international aid donors in developing countries, it was acknowledged that much more needed to be done. The aid process was still too strongly led by donor priorities and administered through donor channels, making it hard for developing countries to take the lead. Aid was still too uncoordinated, unpredictable and un-transparent. Deeper reform was felt to be essential if aid was to demonstrate its true potential in the effort to overcome poverty.

At the Paris meeting, more than 100 signatories—from donor and developing-country governments, multilateral donor agencies, regional development banks and international agencies—endorsed the Paris Declaration on Aid Effectiveness. The Paris Declaration went much further than previous agreements; it represented a broader consensus among the international community about how to make aid more effective. At its heart was the commitment to help developing-country governments formulate and implement their own national development plans, according to their own national priorities, using, wherever possible, their own planning and implementation systems.

The Paris Declaration contains 56 partnership commitments aimed at improving the effectiveness of aid. It lays out 12 indicators to provide a measurable and evidence-based way to track progress, and sets targets for 11 of the indicators to be met by 2010.

The Declaration is focused on five mutually reinforcing principles: Ownership, Alignment, Harmonization, Managing for results, Mutual accountability…

• *Ownership*: Developing countries must lead their own development policies and strategies, and manage their own development work on the ground. The target set by the Paris Declaration is for three-quarters of developing countries to have their own national development strategies by 2010.

• *Alignment*: Donors must line up their aid firmly behind the priorities outlined in developing countries' national development strategies. In Paris, donors committed to help strengthen and/or to make more use of developing countries' procedures for public financial management, accounting, auditing, procurement and monitoring. They also promised to improve the predictability of aid and to continue to "untie" their aid from any obligation that it be spent on donor-country goods and services.

• *Harmonization*: Donors must coordinate their development work better amongst themselves to avoid duplication and high transaction costs for poor countries. They agreed on a target of providing two-thirds of all their aid via so-called "programme-based approaches" by 2010.

• *Managing for results*: All parties in the aid relationship must place more focus on the end result of aid, the tangible difference it makes in poor people's lives. They must develop better tools and systems to measure this impact. The target set by the Paris Declaration is for a one-third reduction by 2010 in the proportion of developing countries

without solid performance assessment frameworks to measure the impact of aid.

• *Mutual accountability*: Donors and developing countries must account more transparently to each other for their use of aid funds, and to their citizens and parliaments for the impact of their aid. The Paris Declaration says all countries must have procedures in place by 2010 to report back openly on their development results.

A first round of monitoring of the 12 Paris Declaration indicators was conducted in 2006 based on activities undertaken in 2005 in 34 countries. A second survey was organized in early 2008 in which 54 developing countries examined progress against the targets at country level. This 2008 Survey covers more than half all the official development assistance delivered in 2007—nearly USD 45 billion. The evidence so far suggests that progress has been made.

E. Aid dependency and aid increase: some experts' viewpoints

There is a hot debate in literature and empirical studies and also in experts' viewpoints regarding the aid dependency paradox and the amount of aid delivered to Africa in general. Some arguments are for a substantial increase of the aid and some others are definitely against this increase and they even suggest to stop any form of aid dependency for African states.

On one hand, we have those who are opposed to any form of aid increase towards Africa, stating that the development of these countries has been delayed by that aid. On the 13th of February 2009,

Kigali welcomed the arrival of Dr Dambisa Moyo, the author of *'Dead Aid - Why aid is not working and how there is another way for Africa.'* The visit occurred at the moment Rwanda has embarked on seeking a paradigm shift from the TINA (There Is No Alternative) doctrine, to aid dependency and other related policies that blight Africa's development. Moyo portrayed a cynical view to aid, which she defines as an "orchestrated worldwide pity", which has made poverty a permanent feature in Africa.

Dr Moyo made poignant observations on why aid is not working in Africa, giving reasons on how it has prevented African economies from achieving sustainable growth. This visit has been reported to urge the noble cause to unshackle Africa from aid dependency.

On the other hand, according to a report from UNCTAD, if the pernicious cycle of low growth and aid dependence experienced by sub-Saharan Africa is to be broken, donors must commit themselves now to a big push on external aid.

A doubling of aid flows for SSA to $20 billion a year would amount to no more than an increase of five US cents to every $100 of consumer spending in the OECD countries, Mr. Richard Kozul-Wright, an UNCTAD staff economist pointed out at a press briefing held in Geneva on the 27th of July 2000. "Not only have there been serious shortcomings in the design and implementation of policies, but also adjustment has generally been under-financed. A judicious combination of a big push in external official financing and a reorientation of domestic policies on the basis of the lessons drawn from the experience of the past three decades appears to be the only

viable way of securing rapid and sustained growth in the region, and eventually eliminating its dependence on aid.", added Mr. Richard Kozul-Wright.

The only feasible way to end aid dependence of Africa is to launch a massive aid Programme and to sustain rapid growth for a sufficiently long period so as to allow domestic savings and external private flows to gradually replace official flows, the report says.

An aid package on a sufficient scale could lead to rapidly rising incomes, pulling up savings and attracting private flows, Kozul-Wright said. Reliance on ODA would fall and rising consumption could reduce poverty.

F. Foreign Investment, official development aid and institutional governance in Africa

The impacts of ODA and FDI on governance in Africa have been empirically tested in several studies. It's frequently argued that both ODA and FDI can influence governance reform in African states given the dependence of these countries on foreign capital (ODA and FDI) to cover significant share of their annual government budget. The economic size of host countries is also another factor that makes capital flows to have influence in economically weak states of Africa.

Goldsmith (2001) found that ODA promotes good governance (i.e. improves democratic institutions and political right) in a host country. Although weak, the lag effects from ODA have some positive effects on governance. Adugna Lemi (2005) concluded that if there is consistent aid flows expected, the process of good governance may

deepen well into later years by improving the performance of governance institutions in African states.

Investors of FDI may be concerned about the functioning of business and security related institutions but not as such on the political governance of a host country. The empirical results confirm that there is not any significant impact from FDI flow on any of the three governance indicators. However, investors may demand some kind of smooth functioning of the institutions to run their day-to-day activities in the country. Hence, it is only after about a year or two that FDI investors demand and, in fact push for, improved performance of the institutions.

From the approaches of the two major multilateral institutions the World Bank and IMF – it sounds that pursuing good economic governance can eventually lead to good political governance. The other donors also play significant role, especially those donors who provide aid directly for governance reform. Coupling the direct involvement of these donors in the governance and democratic process of African states and the role of IMF and the World Bank in promoting good economic governance, it is not surprising to that ODA has had positive and significant impacts on governance in Africa (Adugna Lemi, 2005).

2.2. Aid Dependency and Governance within EAC partner States

A. Governance framework agenda in the EAC

It's obvious that the authorities of the EAC stress on the role of good governance as a prerequisite for East Africa economic integration. The EAC Common Market is the backbone of any integration as it will facilitate free movement of persons, goods, services, capital, right of residence and establishment. It requires establishment of regional supra national institutions that will address the challenges of these freedoms. Thus, the need to establish institutions and structures that will promote good governance, uphold rule of law, combat corruption and enhance ethics and integrity. With these freedoms, also comes challenges of issues related to peace and stability in the region; to which end, a lot is being done to ensure the appropriate mechanisms are in place to address those challenges.

B. Aid Dependency and Governance within EAC countries

B.1. Aid dependency in EAC countries, 2007

Table 1: Aid dependency in EAC countries, 2007

Country	*Aid dependency*
Burundi	47.88
Kenya	4.71
Rwanda	20.99
Tanzania	17.43
Uganda	14.81

Source: Data extracted from OECD.Stat

B. 2. Governance in EAC Partner States

(a) Investment Environment in EAC: the Doing Business ranking performance

According to the World Bank/IFC doing business ranking of 178 countries, a ranking based on the ease of doing business in the area, the EAC countries rank as follows:

- Burundi (174),
- Kenya (82),
- Rwanda (150),
- Tanzania (130),
- Uganda (118).

The EAC countries have been improving in one or another of the 10 surveyed areas/indicators (Starting a Business, Dealing with Licenses, Employing Workers, Registering Property, Getting Credit, Protecting Investors, Paying Taxes, Trading across Border, Enforcing Contracts, Closing a Business). The Improvements from 2007 (to 2008) have been achieved in the five member countries of the EAC respectively against the following indicators:

- Burundi - in employing workers and in registering property.
- Kenya – in starting a business, dealing with licenses (ranked at 9), getting credit (13) and slight improvement in paying taxes.
- Rwanda – in dealing with licenses, paying taxes and trading across borders. Good ranking in starting a business at 63.
- Tanzania - in starting a business. Good ranking at enforcing contracts at 35.
- Uganda - trading across borders. Plus good ranking at 11 in employing workers and 48 at closing a business.

In Doing Business 2010 ranking, for the first time a Sub-Saharan African country—Rwanda—was the world's top reformer, based on the number and impact of reforms implemented between June 2008 and May 2009. Rwanda, another repeat reformer, reformed in seven of the 10 business regulation areas measured by Doing Business. It now takes a Rwandan entrepreneur just two procedures and three days to start a business. Imports and exports are more efficient, and transferring property takes less time thanks to a reorganized registry and statutory time limits. Investors have more protection, insolvency

reorganization has been streamlined, and a wider range of assets can be used as collateral to access credit.

(b) External perception of the EAC economies

EAC Countries fare very badly in the Corruption Perception Index by Transparency International.

As outlined in the table below, in 2007, Kenya worst amongst the EAC countries at position 150 out of the 180 nations surveyed. The Kenyan situation has been as bad as countries facing stability problems in Africa including DRC Congo, Liberia, Cote d'Ivoire and Sierra Leone). Tanzania leads in the region as the least corrupt in the Transparency International study taking position 94 out of 180, followed by Uganda (110), Rwanda (111) and Burundi (134). Yet, even for Tanzania, the score is poor, considering that it is placed 57 places below Botswana with the cleanest graft record in Africa.

In terms of foreign investment attractiveness, the perception of potential or would be investors matters. Therefore, the EAC as a region needs to respond to the challenges related to corruption, as it does affect the business climate in the region. The newly formed anti-corruption association in East Africa needs to proceed and address the substantive corruption problems the region faces.

Table 2: Transparency International, the corruption perception index, 2007

Country	Corruption Perception rank (out of 180 states)	Corruption Perception Index
Burundi	134	2.4
Kenya	150	2.2
Rwanda	111	2.5
Tanzania	94	2.9
Uganda	110	2.7

Source : Author's calculations and arrangements from Transparency International Annual Reports (2007, 2008) and Chikwanha (2007)

Table 3: Global integrity scores

Country	Civil society, public info and media	Elections	Government accountability	Admin and civil service	Oversight	Anti-corruption and rule of law	Overall rating
Burundi	-						
Rwanda	-						
Uganda	Strong	Moderate	Moderate	Moderate	Strong	Moderate	Moderate
Kenya	Moderate	Weak	Very weak	Moderate	Strong	Moderate	Moderate
Tanzania	weak	Very weak	Very weak	Very weak	Weak	weak	Very weak

Source : Author's calculations and arrangements from Chikwanha (2007)

Table 4: State currency to US dollar exchange rate

Indicator	States	2004	2005	2006	2007	2008
End of year (31st December)	Burundi	1	997.8	1	1	1 235
	Tanzania	109.5	1	002.5	119.5	1
	Uganda	1	165.5	1	1	280.3
	Kenya	043.0	1	261.6	132.1	1
	Rwanda	1	816.9	1	1	949.2
	East	738.6	72.4	741.4	697.3	77.7
	Africa	77.3	553.9	69.4	62.7	558.9
		567.6	-	549.6	544.2	-
		-		-	-	
Annual average	Burundi	1	1	1	1	1
	Tanzania	100.9	081.6	029.0	081.9	185.7
	Uganda	1	1	1	1	1
	Kenya	089.1	129.2	253.9	244.1	206.3
	Rwanda	1	1	1	1	1
	East	810.8	780.7	831.5	723.5	720.4
	Africa	79.2	75.5	72.1	67.3	69.2
		575.0	557.0	548.0	547.0	547.6
		-	-	-	-	-

Source : EAC (2010), East African Community Facts and Figures – 2009

Table 5: Real GDP, Million US dollars

State	2004	2005	2006	2007	2008
Burundi	628	703	884	858	837
Tanzania	9 625	9 968	9 581	10 154	12 395
Uganda	7 437	8 320	8 659	9 944	10 875
Kenya	13 948	15 514	17 260	19 842	19 668
Rwanda	1 504	1 669	1 790	1 973	3 682
East Africa	-	-	-	-	-

Source : EAC (2010), East African Community Facts and Figures – 2009

Table 6: Macroeconomic stability (GDP figures for 2007, estimates by IMF staff)

	BU		KE		RW		TA		UG	
	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007
GDP (US Billion)	0.9	1.0	22.8	29.3	2.9	3.3	14.2	16.2	9.5	11.2
Population (Million)	7.6	7.7	34	35	9.2	9.4	38.2	39	29.8	30.9
GDP Growth (%)	5.1	3.6	6.1	6.9	5.4	6.2	6.7	7.2	5.7	6.5
Inflation (%)	2.8	8.3	14.4	9.8	8.8	9.4	7.2	7.0	6.6	6.8
GDP per Capita (US $)	120	128	670	854	311	353	371	415	318	363

Source : EAC (2010), East African Community Facts and Figures – 2009

Economically, the EAC Partner States have all embarked on comprehensive reforms that seek to reduce government intervention in the economy. As highlighted in the tables above, EAC countries have had a somehow stable macroeconomic environment, marked by steady economic growth.

Tableau 7: EAC Development indicators, 2008

Country	Population (million)	Human development index	Ranking (out of 117 countries)	Adult literacy (% ages 15 and >)	Life expectancy at birth (yrs)
Burundi	8,09	0,384	169	59,3	42
Rwanda	7,5	0,450	158	64,9	44,2
Uganda	27,8	0,502	145	66,8	48,4
Kenya	33,5	0,491	152	73,6	47,5
Tanzania	37,6	0,430	162	69,4	45

Source : EAC (2010), East African Community Facts and Figures – 2009

3. Literature Review, Data and Methodology

3. 1. Literature Review: Effects of Foreign Aid on Economic Performance

(a) Foreign Aid as an Engine of Economic Growth

The notion that foreign aid increases economic performance and generates economic growth is based on Chenery and Strout's Dual Gap Model. Chenery and Strout [1966] claimed that foreign aid promotes development by adding to domestic savings as well as to foreign exchange availability, thus helping to close either the savings-investment gap or the export-import gap. Chenery and Strout [1966] pioneered the so-called Financial Two Gap Approach, which is an extension of the Harrod-Domar thesis.

The Financial Two Gap Approach assumed that a gap exists either between saving and investment or between exports and imports. It posited that developing countries could not overcome the shortage of savings and foreign exchange on their own due to their limited resources. Thus, the rationale of the Financial Two Gap Approach is that foreign aid should make up the differences between either the saving-investment gap or the export-import gap.

Levy [1987] reports that foreign aid in low-income countries raised investment in a one-to-one ratio and Chaudhuri [1978] finds similar results in his study of India. Roemer [1989] suggests that foreign aid

relaxes the foreign exchange bottleneck and therefore, increases output. Newlyn [1990] also claimed that foreign aid is effective while noting that foreign aid's positive effects are offset by negative oil shocks, debt crisis, and other exogenous variables.

Davenport (1970) found a positive and significant relationship between aid and GNP per capita, contrary to the popular notion that aid is allocated preferentially to poor countries. This supports the perception that aid is a political tool of donor governments and donors prefer providing aid to stable governments that are inclined towards the West, irrespective of the recipient's need. Easterly (1998) renounced the validity of these studies and asserted that foreign aid failed to increase investment. He noted that the Financial Two Gap Approach calculation produced distorted incentive for aid – the lower a country's domestic saving, the larger the gap, and the more the aid a country is expected to receive.

(b) Foreign Aid as an Obstacle to Economic Growth

The proposition that foreign aid is inimical to economic growth is based on the presumption that it will strengthen the power of predatory governments and thus, undermine the emergence of the private sector [Friedman, 1958; Bauer, 1972]. Krauss [1997] claimed that Taiwan's high growth rate was mainly encouraged by the loss of American aid in early 1960. Since the foreign aid was withheld, Taiwan had no option but to abandon its protectionist trade policy that was previously sustained by foreign aid. Griffin [1970] argued that

foreign aid displaces savings, which in turn retards investment and consequently economic growth.

Furthermore, Levy (1984) found that the negative impact of foreign aid on public savings as government reduces tax levels or tax efforts is not completely offset by its positive impact on income. Likewise, Pillai (1982) found that 60% of foreign aid in Jordan was used to finance investment while the remaining 40% was used either to reduce taxes or slacken revenue collection. Boone (1996) overturned the positive results of Dowling and Hiemenz (1982) and Levy (1988) by using instrument techniques and panel data. He finds that foreign aid has no impact on investment and economic growth. Rather, he found that foreign aid increased the scope of government activities. He also noted that only wealthy and powerful groups gain from foreign aid.

Mosley et al. (1987) corroborated the results that foreign aid does not relieve severe bottlenecks, furnish absent skills, or enhance technological transfer. Their empirical results fail to show a positive correlation between economic performance and foreign aid. Voivodas (1973) found a negative but insignificant relationship between growth and aid for 22 developing countries from 1956 to 1968. Casella and Eichengreen (1994) claimed that the expectation of foreign aid could essentially intensify the delay in stabilization processes and allow interest groups to resist growth-enhancing reforms. Pack (1994) asserted that proponents and opponents of foreign aid alike acknowledge the fact that foreign aid is fungible. They claim that because of the fungibility of foreign aid, an increase in government

income in the form of foreign aid will be crowded out by rent dissipation and misguided policy mistakes. Similarly, Svensson (1996) argued that the simple expectation of more foreign aid increases rent dissipation and delays efficient economic policies. Moreover, Ranis and Mahmood (1992) claimed that foreign aid resources retard a country's ability to adhere to responsible economic policies.

Dowling and Hiemenz (1982) suggested that good economic policies enhance the ability of aid to increase growth. Yet, the paradox remains that most foreign aid recipients adopt policies that are diametrically opposed to sustainable economic development. Burnside and Dollar (2000) found that foreign aid per se does not impact the economic growth of aid recipient nations. However, the authors found that when aid interacts with policy variables, it has a positive effect on growth in an environment of good economic policies. Their result is robust to different specifications of the model. They found that foreign aid is more effective in those countries with high budget surpluses, low inflation, and free trade. This implies that good governance that brings a more stabilized macroeconomic environment leads to more effectiveness of foreign aid.

3. 2. Empirical Literature Review

In spite of criticisms by prominent economists such as Friedman (1958), easterly (2006), Collier (2007) regarding the effectiveness of foreign aid in stimulating growth, the developed world continues to

commit substantial aid to SSA countries in an effort to stimulate growth as stated by Ali and Isse (2004); Gourmanee, Mourissey and Girma (2005).

The MDGs inherently assume that aid is growth promoting and they require countries to institute certain good macroeconomic policies recommended in the work of Burnside and Dollar (2000). Is foreign aid to SSA countries more likely to act as a catalyst to domestic production, boosting exports and growth (Burton, 1969) or are they doomed to aid dependence (Arellano, Bulir, Lane and Lipschitz; 2005)?

Even though aid may boost growth, it might be the very presence of low growth that attracts more aid, and it thus becomes a manifestation of endogeneity problem (Radelet, Clemens and Bhavnani; 2005). And this might be a strong part of explaining the persistent negative correlation found between aid and growth.

After fifty years and more than 2.3 trillion dollars in aid from the West to alleviate poverty in the underdeveloped countries, there is shockingly little to show for it (Easterly; 2006).

It is rather ironic that the economic literature is yet to reach a consensus about the effect of aid on growth given the substantial work that has already been completed in the field (Roodman, 2004).

According to the gap-theory as developed by Chenery and Strout (1966), aid can promote growth because it often increases the foreign exchange needed in production for aid-dependent ventures (Chenery, 1966; Islam, 2005; and Easterly, 2003)

Countries that receive aid just use it in consumption and they effectively become aid-dependent (Radelet et al., 2005; Ali and Isse, 2005). The aid funds are neither directed to productive use, nor invested and this is mainly due to aid fungibility (Gomannee, 2005) and the ease with which aid funds can be affected to direct consumption (Burnside and Dollar, 2000; Hansen and al., 2004). Arellano et al. (2005) stated that a permanent flow of aid most likely ends up in consumption.

Another group of economists argue that aid funds actually retard growth and at the best, they have non significant effect on growth (Boon, 1996; Mckinley, 1994, Cassen, 1994).

Hansen and Dalgaard (2001) find that aid promotes growth irrespective of policy environment whereas Lensik and White (2000) find positive but decreasing marginal returns to aid by introducing the square of the aid variable. Moreover, Lensik and White (2000) found that good policies are more growth promoting when supported by aid flows. Burnside and Dollar (2000) have found a positive aid-growth correlation only for good policy countries and a negative correlation for bad policies countries. Islam (2005) found that a stable political environment is a necessary condition for aid to promote growth.

Just as the 'old left' believed that *trade* between poor and rich economies caused immiserizing dependency, so the 'new right' currently believes that *aid* has had this effect. While the propositions are distinct, they have in common a negative view of aid, and I will term
this negative opinion the 'aid dependency school'.

It has been a rich debate to discuss on the proposition that Africa has grown more slowly than other continents in part because it has received much more aid relative to GDP than other developing areas. Bauer (1982) argued that aid reduced the incentive to adopt good policies. The same proposition has more recently been advanced by Ravi Kanbur et al. (1999) arguing that large gross flows of project aid overwhelm the management capacity of governments.

The critique of Collier (1999) can be summarized in five main propositions:

1. Aid is historically detrimental;
2. The disincentive effect provides a theoretical underpinning for this experience;
3. Private, not public capital is important;
4. Aid has been fickle so that it cannot be relied upon as a component of a budget;
5. And in any case, aid budgets are rapidly falling so that governments must learn to live without it.

Controversies about aid effectiveness go back decades as this has been argued by Radelet Steven (2006). The author has noticed that some experts charge that aid has enlarged government bureaucracies, perpetuated bad governments, enriched the elite in poor countries, or just been wasted. Others argue that although aid has failed, it has supported poverty reduction and growth in some countries and prevented worse performance in others.

According to Deborah and Knack (2004), it is possible that continued over long periods of time, large amounts of aid and the way it is delivered make it more difficult for good governance to develop; and this is exactly the case in some parts of sub-Saharan Africa because of the way aid affects institutions in weak states.

In their article, Deborah and Knack (2004) addressed the connection between aid impact and governance in SSA in asking how dependence on large amounts of aid might affect governance in SSA.

Their three main findings are summarized as follows:

- A robust statistical relationship between high aid levels in Africa and deteriorations in governance,
- A strong relationship between higher aid levels and a lower tax share of GDP,
- Increases in GDP per capita tend to be associated with improvements in governance, while violence is associated with declines in governance and in the tax share of GDP.

(a) Causes of aid dependence

Five main forces create aid dependence:

1. Past structures of historically embedded relations between the former imperial and colonial powers and the so-called developing countries;
2. Lack of availability of alternatives to aid dependence, reinforced by pressing needs to solicit aid;
3. Aid as a soft option;
4. A psychology of aid dependence among the peoples of the South, reinforced by a lack of self-confidence in their own ability;
5. Third world governments who do not accept aid are often made to feel that they are being irresponsible about the plight of the poor.

(b) Foreign aid and aid dependence

Foreign aid as an institution began in 1947 with the Marshall Plan, and almost immediately concerns arose over the impact of large amounts of aid on the behavior and attitudes of recipient governments.

As stated by Deborah A. B. and Stephen Knack (2004), high levels of aid have the potential to improve governance, but they can also work against governance improvements.

Yet high levels of aid might also block governance improvements in at least two ways:

a) The way large amounts of aid are delivered can weaken institutions rather than build them;
b) High levels of aid can create incentives that make it more difficult to overcome the collective action problems involved in building a more capable and responsive state and a more effective foreign aid system.

The analysis of Deborah and Knack (2004) ends up with seven steps to end aid dependence:

a) Adjusting the mindset;
b) Budgeting for the poor not for the donors;
c) Putting employment and decent work (wages) upfront;
d) Creating the domestic market and owning domestic resources;
e) Plugging the resource gap;
f) Creating institutions for investing national savings;
g) Limiting aid to national democratic priorities.

3. 3. Model specification and variables selection

(a) Model specification

In our paper, we use a model adapted from the one of Collier and Dollar's simple growth model with some changes on the explained variables and on the explanatory variables. We alternatively test the relationship between foreign aid, governance and growth:

- *Growth model: (GDPi)* = $C + A*Xi + \boldsymbol{u}$ij **(model 1)**;
- *Governance model: (CPIi)* = $C + A*Xi + \boldsymbol{u}$ij **(model 2)**;

- *Aid model: (AIDi)* = $C + A * Xi + \boldsymbol{u}ij$ **(model 3)**;
- *Aid dependency model: (AIDDEPi)* = $C + A * Xi + \boldsymbol{u}ij$ **(model 4)**.

GDP = Gross Domestic Production.

CPI = Corruption Perception Index.

AID = Foreign Aid.

AIDDEP = Degree of Dependency to Foreign Aid.

In each model specification amongst the four here above represented, *Xi* represents a vector (set) of explanatory variables varying from each equation to another; C represents the intercept or constant term and A represents the vector of estimated coefficients associated to each explanatory variable; $\boldsymbol{u}ij$ represents the error term.

(b) Data sample

The data used in this paper are gathered directly from the statistics of the East African Community database – Facts and Figures 2009, from the various reports of UNCTAD on the EAC, from the World Bank database CD-ROM, from the Transparency International database and reports on governance and corruption, and so on...

These data cover the period from 1990 until 2008. However, estimations are done after dropping out the missing data and unavailable series so that the dataset is frequently automatically adjusted to 1996 – 2006 and only 50 observations (with cross sections) are taken into account in the simple panel models we

estimate; due to various missing values, the data sample has adjusted up to 32 observations.

4. Estimation Results and Comments

4. 1. The growth model

Initially, we estimate a model of growth by estimating variable on aid, on the square of aid variable (to capture the economies of scale in aid) and the governance variable represented by the corruption perception index. We use a panel data model with fixed effects.

A look at the results obtained (see table 8 her below) let us state that the estimated coefficients reveal that:

- Foreign aid negatively affect the economic performance (coefficient of AID is negative and statistically significant) with increasing returns to scale (coefficient of SAID is positive and statistically significant);
- Governance is positively correlated with the economic growth given that the coefficient of CPI is positive and statistically significant. We see that the higher the CPI (which means improvements in good governance, i.e. less corruption), the higher the economic performance in terms of GDP increase.

The overall significance is also validated by the r-squared adjusted or not adjusted (more than 99% in both cases) and by the Fisher-test statistic which is significantly in favour of overall significance (with a 0.0000% probability of committing the type I error).

Tableau 8: The growth model estimation results

Dependent Variable: GDP?

Method: Pooled Least Squares

Total pool (unbalanced) observations: 32

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	5.32E+11	6.70E+10	7.932722	0.0000
AID?	-2.55E+10	2.88E+09	-8.869362	0.0000
SAID?	2.14E+08	26982033	7.918269	0.0000
CPI?	1.32E+11	2.86E+10	4.610684	0.0001
Fixed Effects (Cross)				
_BU--C	-2.37E+11			
_KEN--C	-8.47E+10			
_RW--C	-7.33E+11			
_TA--C	-7.31E+11			
_UG--C	1.04E+12			

Source: Author's own calculations and estimations from Eviews 6

4. 2. The governance model

In the second instance, we estimate a model of governance by regressing the governance variable on aid, on the square of aid variable (to capture the returns to scale in aid) and the economic performance (GDP) variable. We also use a panel data model with fixed effects.

A look at the results obtained (see table 9 her below) let us state that the estimated coefficients reveal that:

- Foreign aid positively affect the governance (the coefficient of AID is positive and statistically significant) with decreasing returns to scale (the coefficient of SAID is negative and statistically significant);
- Growth (economic performance) is positively correlated with the governance given that the coefficient of GDP is positive and statistically significant. We see that the higher the GDP, the higher the corruption perception index (which means improvements in good governance, i.e. less corruption).

The overall significance is also validated by the r-squared adjusted or not adjusted (more than 60% in both cases) and by the Fisher-test statistic which is significantly in favour of overall significance (with a 0.0000% probability of committing the type I error).

Tableau 9: The governance model estimation results

Dependent Variable: CPI?

Method: Pooled Least Squares

Total pool (unbalanced) observations: 32

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.948219	0.635298	-1.492557	0.1486
AID?	0.110850	0.021136	5.244493	0.0000
SAID?	-0.000947	0.000184	-5.149178	0.0000
GDP?	3.57E-12	7.74E-13	4.610684	0.0001
Fixed Effects (Cross)				
_BU--C	0.782691			
_KEN--C	-0.038273			
_RW--C	3.131462			
_TA--C	2.876744			
_UG--C	-3.704031			

Source: Author's own calculations and estimations from Eviews 6

4. 3. The governance model with aid dependency variable

In the third equation, we estimate a model of governance regressing the governance variable on aid, on the square of aid variable (to capture the returns to scale in aid), on the economic performance (GDP) variable and on the aid dependency variable (the ratio of aid to GDP). We use a panel data model with fixed effects.

- Foreign aid positively affect the governance (the coefficient of AID is positive and statistically significant) with decreasing returns to scale (the coefficient of SAID is negative and statistically significant);
- Growth (economic performance) is positively correlated with the governance (CPI) given that the coefficient of GDP is positive and statistically significant.
- Aid dependency (AIDDEP) is positively correlated with the governance given that the coefficient of AIDDEP is positive, but statistically insignificant.

The overall significance is also validated by the r-squared adjusted or not adjusted (more than 60% in both cases) and by the Fisher-test statistic which is significantly in favour of overall significance (with a 0.0000% probability of committing the type I error).

Tableau 10: The governance model taking the aid dependency into account

Dependent Variable: CPI?
Method: Pooled Least Squares
Total pool (unbalanced) observations: 32

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.798438	0.650780	-1.226894	0.2323
AID?	0.103100	0.022401	4.602410	0.0001
SAID?	-0.000965	0.000185	-5.231029	0.0000
GDP?	3.23E-12	8.40E-13	3.838522	0.0008
AIDDEP?	119017.9	115232.1	1.032854	0.3124

Source : Author's own calculations and estimations from Eviews 6

4. 4. The aid dependency model

We estimated the fourth equation of aid dependency model by introducing in a regression the explained variable (aid dependency, defined as the ratio of aid to Gross Domestic Production) and the explanatory variables, namely, governance variable represented by the corruption perception index and the economic performance (GDP) variable. Once again, we use a panel data model with fixed effects.

- Governance seems to have positive impact on aid dependency of the EAC partner states even though the coefficient is not statistically significant.
- Growth or economic governance (represented by GDP) reveals a negative impact on the aid dependency within the EAC countries, but the coefficient of GDP is not statistically significant.

The model reveals non significant coefficients being on CPI or on the GDP. Nevertheless, the overall significance is validated by the r-squared adjusted or not adjusted (more than 90% in both cases) and by the Fisher-test statistic which is significantly in favour of overall significance (with a 0.0000% probability of committing the type I error).

Tableau 11: Estimation output of the aid dependency model

Dependent Variable: AIDDEP?

Method: Pooled Least Squares

Total pool (unbalanced) observations: 32

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	9.50E-07	1.28E-06	0.742882	0.4645
CPI?	3.99E-07	4.83E-07	0.825740	0.4168
GDP?	-2.19E-19	1.77E-18	-0.124263	0.9021
Fixed Effects (Cross)				
_BU--C	-1.84E-06			
_KEN--C	3.43E-06			
_RW--C	-2.03E-06			
_TA--C	-1.37E-06			
_UG--C	-1.58E-06			

Source : Author's own calculations and estimations from Eviews 6

5. Concluding Remarks and the way forwardg

5. 1. Main conclusions

Efforts are being made to make the EAC members countries open up their respective economies towards more openness and deepen their integration. Amongst other issues to be addressed in this integration process, the matter of investment environment safety and assurance, the regional governance framework, the attractiveness to foreign direct investment, are set as priorities. The analysis and tests conducted revealed that within the EAC, the macroeconomic

environment is somehow stable and converging to improved levels. Moreover, the governance environment revealed to be still very low and the economies of the EAC have been found still highly dependent to external foreign aid.

Our estimation results reveal that aid didn't boost growth within the EAC partner states. Our results are corroborating those of Burnside and Dollar (2000) and they do suggest that good governance has had a positive impact on growth in EAC countries.

Following Radelet, Clemens and Bhavnani (2005), we conclude that there is a persistent negative correlation between aid and growth. These results also converge with those of another group of economists arguing that aid funds actually retard growth and at the best, they have non significant effect on growth (Boon, 1996; Mckinley, 1994, Cassen, 1994).

Our findings contradict the conclusions of Hansen and Dalgaard (2001) that aid promotes growth irrespective of policy environment, and also those of Lensik and White (2000) who found a positive impact with decreasing marginal returns to aid by introducing the square of the aid variable.

Contrary to Bauer (1982), Ravi Kanbur et al. (1999), Deborah and Knack (2004), we found a positive correlation between aid and governance, and it has revealed to be a positive correlation between the two variables in a feedback relationship. Even aid dependency didn't reveal any significant negative effect on governance indicator.

We also found that the higher the GDP, the higher the governance performance.

Conversely, the economic performance measured by the GDP has revealed to have a negative impact (although not statistically significant) on aid dependency within the EAC.

5. 2. Policy Recommendations and Suggestions

Some policy implications and recommendations have been drawn from these analyses:

- The EAC secretariat and head of states should concentrate more at implementing common and shared infrastructures projects first in order to make the regional market as integrated as possible and let the economic growth be boosted by modern and renewed socio-economic infrastructures ;
- Economic growth and wealth creation should be set as priorities of the integration process in order to reduce or even put an end to foreign aid dependency within the EAC partner states;
- Advancements towards a common market will surely improve the integration process and generate the expected regional institutions which need to be more transparent and allow good governance development within the region.
- The emergency is not to stop receiving foreign aid as some may misinterpret the argument, we just suggest a strategy aimed at improving the governance climate, able to attract the foreign investment as a complement and in the end as a substitute to

foreign aid. Therefore, EAC partner states will come to an end of aid dependency.

5. 3. Further Research Study Proposals

Amongst other unanswered questions, we can mention:

- How can post conflict countries, like Rwanda, record suggest considerable transformation of their economic investment environment and become the top reformer in the world (Doing Business 2010)? This suggests a possible regional strategy to improve the EAC investment climate as a whole.
- Is the foreign aid dependency correlated with the degree of external trade dependency?
- What are the effects of FDI on growth and governance compared to those of foreign aid, within the EAC countries?

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