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Foreign Aid: Good for Investment, Bad for Productivity

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Pages 139-161 | Published online: 03 Apr 2012

Cite this article <https://doi.org/10.1080/13600818.2012.675053>

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Abstract

This paper examines the effects of aid on sources of growth: capital accumulation and

total factor productivity. We find that aid has a positive effect on capital accumulation, but a negative effect on total factor productivity. This is true for both developed and developing countries. The effect of aid on total factor productivity is also found to be negative in the long run. This finding is robust to a variety of sensitivity tests. Our results suggest that aid is not a panacea for growth, and that aid may be more effective in promoting capital accumulation than in promoting productivity growth. We also found that aid has a positive effect on growth, but a negative effect on productivity growth, and that aid has a positive effect on receiving aid.

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Notes

1. The significance of TFP growth in explaining cross-country variations in the level and growth of income has been questioned by some studies, which found no significant role for TFP growth. For instance, Young ([1995](#)) shows that factor accumulation was key to the growth miracle of some East Asian countries. Abu-Qarn & Abu-Bader ([2007](#)) also examined the sources of growth in 10 Middle East and North African countries and found that the explanatory power of variation in TFP growth is negligible.
2. Average annual growth rate of TFP is computed as $TFP\ growth = [\ln A_t - \ln A_{t-1}] * 100 / 5$.
3. $\theta(s)$ is a piecewise linear function with different slopes. For instance, the return to education for ≤ 4 years of education is assumed to be 13%.
4. Hausman test for random-effects versus fixed-effects model (with null hypothesis of random-effects model); we reject the null with $\chi^2(11) = 44.42 (0.0000)$.
5. In all cases, we do not reject the null that the instruments are valid and there is no second-order autocorrelation.
6. The results are available on request.
7. The excluded countries are China, Democratic Republic of Congo, Iraq, Malawi, Mozambique and Papua New Guinea.



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