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Spatial aid spillovers during transition

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ARTICLE INFO

Article history:

Received 26 February 2015

Received in revised form 13 October 2015

Accepted 16 October 2015

Available online 24 October 2015

JEL classification:

O4

O5

F35

Keywords:

Aid effectiveness

Spatial aid spillovers

Transition economies

ABSTRACT

We investigate whether development aid stimulates growth in transition economies, paying particular attention to the possibility of spatial spillovers arising from aid. We find that common borders and a shared historical and political heritage result in a complex set of associations between aid and growth. Aid has a positive impact on growth in the recipient country. However, the impact of aid also spills over to affect other nations. Aid appears to create positive spillovers through improved total factor productivity and possibly currency appreciation. At the same time, aid depletes human capital through emigration and it particularly adversely affects democracy and governance quality in other transition economies. On balance, aid generates net adverse growth spillovers in transition economies.

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1. Introduction

The aid–growth relationship has been explored extensively. However, studies have yet to reach consensus on the impact of aid on economic growth, with numerous contradicting results reported (Doucouliagos and Paldam, 2015). One limitation with extant studies is that they consider growth and aid to be independent across countries, with little attention given to spatial dimensions of aid effectiveness.¹ Aid flowing into a recipient country could plausibly impact, either positively or adversely, upon the growth of other nations, *i.e.*, aid can spillover. Omitting spatial spillovers can result in misspecification of the underlying data generating process and possibly incorrect inference regarding the *net* effect of aid. If there are positive (negative) spillovers from aid, then conventional cross-country growth regressions can potentially understate (overstate) aid effectiveness.

Our contribution in this paper is to investigate *spatial aid effectiveness*, that is, spatial spillovers arising from aid. The spatial diffusion of growth itself has been noted by numerous studies. For example, international trade, foreign direct investment (FDI), policy emulation, and knowledge and technology have all been identified as potentially important channels for growth spillovers.² We expect that growth spillovers among transition nations will also play a role in their growth experience.³ Links between transition economies remain solid, especially through trade and migration. For example, trade between Russia and many

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¹ The terms ‘effectiveness’ and ‘effect’ are very widely used in the literature. However, due to the inherent difficulties in establishing causality, we here adopt a more prudent approach and use these terms to denote the presence of a relationship rather than a causal effect.

² Easterly and Levine (1998) identify several sources of spillovers, such as trade, foreign investment, and emulation of growth promoting policies. See also Romer (1990), Coe and Helpman (1995), Ades and Chua (1997), and Van Pottelsberghe de la Potterie and Lichtenberg (2001).

³ While spillovers may exist also between transitional economies and other nations, our focus in this paper is exclusively on spillovers among transitional economies.

transition countries is particularly strong (IMF, 2014), especially among Commonwealth of Independent States (CIS) members. Belarus, Kazakhstan, and Russia have formed a Customs Union, while Belarus, Kazakhstan, the Kyrgyz Republic, Tajikistan and Russia have formed the Eurasian Economic Community (EBRD, 2012). Furthermore, many transition nations observe and often emulate developments in others, e.g., the privatization of state assets and other market reforms.⁴ However, to date, little attention has been given to the possibility of spatial spillovers arising from development aid.

We expect aid spillovers to be a feature of transition. For example, if aid affects growth then it can affect the growth of other nations through growth spillovers. Likewise, if aid affects the development of institutions this may spillover to affect institutions in other nations. The potential for aid spatial spillovers arises because of common political and economic history, shared borders and on-going political ties. It can also arise from the way aid is administered. For example, some funding agencies advocate initiatives that transcend borders. A case in point is the Development Assistance Committee (DAC) which advocates “building systems or networks – across institutions and individuals, often across borders, to achieve common objectives” (OECD, 2001: 57). Another example is the TACIS (Technical Aid to the Commonwealth of Independent States) program which funded infrastructure networks such as common border-crossing facilities (European Commission, 2001). Indeed, cross-border cooperation is an important part of EU policy for regional and intra-regional cooperation (Liikane, 2013).

We explore these issues by first estimating a growth model that specifically allows aid to impact on the growth of the recipient country, as well as other transition economies. We then explore several possible channels through which aid spillovers might arise. Instead of examining a varied cross-section of heterogeneous countries, we focus on a specific group of countries that share the common experience of having undergone (or undergoing) transition towards a market economy.⁵ Transition economies present an interesting case study. Transition involves the development of a market based economy, legal, political and institutional reforms, trade, financial liberalization, and integration (Svejnar, 2002). In particular, the collapse of the Soviet Union led to deep economic and political shocks in many transition countries, especially those from Europe and Central Asia.⁶ Aid became an important feature of the transition process for many countries, with aid as a share to GDP been a major source of funds for several countries, e.g., Albania (28%), Armenia (24%), Bosnia and Herzegovina (73%), Kyrgyzstan (33%), and Tajikistan (30%). Indeed, between 1990 and 2012, donors provided more than 348 billion dollars (United Nations, 2002) in aid to transition economies. Relatively little is known about the effects of these large aid flows on growth. The two extant studies by Fischer et al. (1996) and Askarov and Doucouliagos (2015a) both find that aid had a small positive effect on growth.⁷ However, both studies ignore spatial spillovers.

We confirm in this paper the findings from prior studies that aid given to transition economies is associated with growth in aid recipients. Nevertheless, we also report evidence that aid is also associated with adverse spatial spillovers; the relationship between aid and growth is not confined within the recipient country. Rather, aid is associated with economic and political spillovers that are correlated with growth in other countries. It appears that political economy factors dominate economic factors. Specifically, we find that while aid is associated with positive spillovers through currency appreciation and total factor productivity, it is also associated with offsetting negative spillovers through democracy and governance quality.

The structure of the paper is as follows. Section 2 discusses the possibilities for spatial aid spillovers. Section 3 describes the econometric methodology and data. Section 4 presents estimates of the relationship between spatial aid and growth. In Section 5 we explore several channels that can give rise to spatial aid spillovers. Section 6 concludes the paper.

2. Spatial aid effectiveness

While the extant literature provides little guidance into this issue, we identify several channels through which aid can potentially generate spatial spillovers on growth. Aid spillovers can be the consequence of either intentional or unintentional actions. Specifically, we consider economic factors relating to the impact of aid on migration, currency movements, and technology, and political economy factors relating to the impact of aid on military conflict, and institutions, as reflected in democracy, governance quality, economic freedom and market liberalization. We expect that aid can potentially impact through all these channels, and perhaps in contradictory and offsetting ways. The net effect is thus an entirely empirical matter.

2.1. Migration and ‘brain drain’

A feature of transition has been large scale migration of millions of workers between transition and established market economies and also among transition economies (United Nations, 2002; EBRD, 2013). Many transition countries have faced large scale emigration of skilled workers. Indeed, emigration rates for some transition economies, such as Bosnia and Herzegovina, Kazakhstan and Kyrgyzstan have been among the highest in the world (United Nations, 2002).⁸

⁴ Technology spillovers arising from inter- and intra-industry FDI are another channel for growth spillovers between transition countries (Djankov and Hoekman, 2000; Damijan et al., 2013).

⁵ Cross-country samples may contain excess heterogeneity that blurs underlying relationships. A narrower sample is potentially less noisy and more informative. The cost of this is that our findings may apply only to a unique group of countries whose experience may not generalize.

⁶ The dissolution of the Soviet Union is only part of the transition story; transition in several countries commenced prior to this event. See Askarov and Doucouliagos (2015b).

⁷ Fischer et al. (1996) analyze 20 transition economies for the years 1992–1994. Askarov and Doucouliagos (2015a) examine a larger sample of 32 transition countries for the years 1990–2012.

⁸ Emigration of skilled labor can have severe effects. For example, of the 388,500 Russians living in Tajikistan in 1989, 220,000 left by 1998, resulting in skill shortages that adversely affected the Tajik economy (International Organization for Migration, 1999).

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