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Untying the motives of giving grants vs. loans

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ABSTRACT

The aid allocation literature has assumed that two forms of aid flows – grants and concessional loans – are determined identically. Its findings reflect average behavioral patterns based on an aggregate of these two distinct transfer types. This analysis shows that the past findings generally apply to grants but not to concessional loans. In particular, the amount of grants decreases with income, whereas the amount of concessional loans increases with income. However, donors increase both grants and loans to politically aligned administrations during election years irrespective of recipients' income level. Other econometric issues such as endogeneity of income and cross-sectional dependence are taken into account.

1. Introduction

In general, past studies reveal that the association between an aid-recipient country's income and its aid inflows is negative, implying that, all else equal, poorer nations receive more aid.[1] However, these studies mainly examine aggregate aid allocation, implicitly assuming that both grants and concessional loans are determined identically. Arguably, donors' motive for apportioning aid into two distinct transfers can be different. Thus, findings based on aggregate aid may mask important insights that could be obtained by investigating its two components separately. Furthermore, the existing literature has paid little attention to the endogeneity problem associated with inclusion of income per capita as the main explanatory variable in aid regressions.[2] We fill this gap in the literature.

A disaggregated analysis of aid should also shed some light on the aid-effectiveness debate, which remains contested in the literature.[3] The literature has identified several factors that may have contributed to the lackluster performance of aid in recipient countries. These factors include misappropriation of funds, widespread corruption, overvaluation of the domestic currency resulting in Dutch disease, and aid fungibility, among others. The effectiveness of aid, however, may also depend on the mix of concessional loans and grants in total aid. Grants are free transfers, while loans are usually a project-specific type of aid and are actively

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[1] Early aid allocation models have tended to focus on limited factors reflecting recipient needs and donors' interests (e.g., Maizels and Nissanke, 1984; McKinlay and Little, 1979). Subsequent research has employed more enriched models covering a number of other determinants of the supply of aid. For example, Bandyopadhyay and Wall (2007) and Trubmull and Wall (1994) find that countries that guarantee more political rights are rewarded more with aid. Some studies show that donor interest variables, such as favorable voting in the UN, colonial ties, and trade promotions, among others, dominate the aid allocation decision (e.g., Dreher et al., 2008; Gaibulloev and Sandler, 2012; Kuziemko and Werker, 2006; Younas, 2008). However, the unequivocal finding in almost all studies is that poorer nations, as commonly measured by their per capita income, receive more aid.

[2] See, for example, Bruckner (2013) on the simultaneity between aid and growth.

[3] For example, some studies find that aid promotes growth (Bandyopadhyay et al., 2015; Dalgaard et al., 2004), whereas others are skeptical about any positive association between aid and growth (Easterly, 2007; Rajan and Subramanian, 2008; Young and Sheehan, 2014). A third strand of literature argues that the effect of aid on growth depends on the institutional environment (Burnside and Dollar, 2000; Collier and Dollar, 2002). Easterly and Pfutze (2008, p. 23), have attributed aid failure to donors' decisions by arguing that "A lot of aid still goes to corrupt and autocratic countries and to countries other than those with the lowest incomes."

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monitored by donors who expect to be repaid in the future. These distinct aid-types may prompt different economic and political incentives for donors and differences in the behavior of recipients. First, the amount of aid supplied by a donor may be smaller if the proportion of grants in total aid is larger. Second, donors may be less diligent in monitoring the performance of grants, where they derive no direct financial benefits from grant-funded projects or assistance, but more diligent in monitoring loan-funded projects, where they expect repayment. Third, politicians in the recipient country may feel less accountable to citizens in their disposition of grants, since grants do not directly impose financial burden on society. Grant usage can provoke other undesirable consequences including a decline in government savings and a slowdown of policy reforms, further neutralizing the effect of aid on the economy.[4]

Using a panel of 113 aid-recipient countries over the period of 1975–2010, we examine three alternative measures of aid – total aid, grants, and concessional loans.[5] To estimate the causal impact of income per capita on aid, we employ the variation in remittances as an instrument capturing the exogenous variation in income per capita. The results show that the determinants of grants and loans differ and that the findings in the aid allocation literature are generally driven by the grants component of aid. In particular, while the effect of income per capita on grants – as well as total aid – is negative, the impact of income per capita on concessional loans is positive. Furthermore, our analysis shows that donors influence the outcome of elections in recipient countries by increasing *both* grants and loans during election years holding the recipients' GDP per capita constant. The effect of income per capita on loans is not statistically significant for sub-Saharan Africa. For this region, internal conflict is the determining factor of both concessional loans and grants. A variety of robustness checks are performed to support the main results.

The remainder of the paper proceeds as follows. Section 2 offers some preliminaries on the likely rationale of supplying grants versus loans. Section 3 describes the data used in the analysis and this is followed by a discussion of the empirical methodology in Section 4. Section 5 discusses the empirical results and Section 6 concludes.

2. Preliminaries

The fundamental precept of giving foreign aid is that richer nations should help to finance the development of capital-scarce poorer nations, who are unable to raise sufficient private capital in international markets. Advocating the morals of aid giving, Stern (1974) argues that if the benefits to poorer nations exceed the costs to richer nations, then the benevolence of the latter is economically justifiable. This implies that people in developed nations derive utility from the perceived welfare gains – associated with transfers of aid – to the people in developing nations.

In practice, aid is supplied in grants and concessional loans. The benevolence of rich nations in splitting aid into these two broader categories may be driven by the mix of their altruistic and self-interest motives. Therefore, it can be argued that the determinants of loans and grants may differ. Supply of grants may primarily be driven by the altruistic motive of donors as it carries no obligations for repayments, implying that they add no debt burden to the recipients. Moreover, a large portion of grants is apportioned for humanitarian assistance such as for the victims of natural calamity or widespread diseases. Yet, it is not realistic to assume that donors intend no self-interest and are totally selfless in giving grants. The benevolence of donors is likely to strengthen their politico-strategic relationship with the recipients, who may reciprocate by returning the favors in whatever ways they can. However, these acts of reciprocity can distort incentives in a way that a recipient country may misappropriate grants and a donor ignores such malpractices. A well-known study by Kuziemko and Werker (2006) finds support for this conjecture; they show that the United States uses aid to sway votes of the member countries in the Security Council of the United Nations.

On the other hand, the self-interest aspect of giving aid is more germane to loans as they need to be paid back with interest in the future. Assuming a constant rate of inflation, loans ensure higher future consumption for donor nations. Thus, citizens of donor countries may be more receptive to providing a larger fraction of aid in loans. Usually these concessional loans are extended at more generous terms and at below private market interest rates to developing countries, who often lack financial leverage for borrowing at international markets. Although loans create debt burden, the obligation of repayments can generate positive incentives for their investment into productive activities. Therefore, besides economic-interest motive, an element of altruism can also play a role in donors' decision of supplying concessional loans.

A few past studies offer a detailed comparison between these two types of aid. For instance, Collier (2006) elaborates on three rationales in favor of providing loans over grants: (i) *Economic convergence*. Loans are temporary transfers that have to be paid back. According to the theory of economic convergence, lower income countries tend to grow faster than rich income countries. Therefore, it is reasonable to expect that poor countries will pay back the loans that helped them to grow. (ii) *Transition to capital*

[4] Clements et al. (2004) show that grants suppress domestic tax revenue and this effect is particularly grave in corruption-plagued countries. The increased flow of grants appears to divert attention of the recipient governments from strengthening tax compliance, expanding tax base, and eliminating tax exemptions to the powerful interest groups. By contrast, the impact of loans on raising domestic tax revenue is positive. Studying the relative effectiveness of the two types of aid in Latin American countries, Tezanos et al. (2013) show that concessional loans have a larger stimulus effect on their economic growth than grants. They argue in favor of enhancing loans to the economies that provide guaranties of repayment and need external resources for productive investments; more grants may be granted to the countries with weaker repayment capacities. In a recent study, Bandyopadhyay et al. (2015) find that the grants-growth relationship is concave, while the concessional loans-growth relationship is strictly convex. Grants promote growth when these transfers are small and they depress growth after reaching a certain threshold. On the other hand, the effect of concessional loans on growth remains positive. One possible drawback of loans is that they increase the future debt burden of the recipient country. This, however, may not be a disadvantageous proposition if loans augment the productive capacity of the recipient country. See also Mascarenhas and Sandler (2005), who examine the composition of foreign aid (i.e., grant-loan mix) used by various donors to finance international and national public goods.

[5] We restrict our analysis to bilateral assistance insofar as the multilateral agencies such as the International Monetary Fund and the World Bank mostly provide loans under structural adjustment programs. Appendix A provides the list of aid-recipient countries in our study. We exclude Egypt, Israel, top oil producing countries and transition economies from the sample – see Section 3.