

FOREIGN AID AND ECONOMIC GROWTH IN SOUTH AFRICA

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Master of Commerce in Development Finance Degree

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ABSTRACT

Foreign aid inflows have grown significantly in the post-war period. Many studies have tried to assess the effectiveness of aid. The role of foreign aid in promoting economic growth has been the subject of much debate among development specialists, researchers, aid donors as well as recipients in general and South Africa in particular. In spite of this, there are only few empirical studies that investigate the relationship between foreign aid and economic growth in South Africa. This study assesses whether there is any existent relationship between foreign aid and economic growth in South Africa using descriptive statistics for data that spans from 1994 to 2010.

The result supports the view that there is strong, positive and significant relationship between foreign aid and economic growth in South Africa. This implies that foreign aid contributes to economic growth in South Africa.

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CHAPTER ONE

INTRODUCTION

1.0 Introduction

An important objective of most official development assistance to developing countries is the promotion of economic growth. Over the last half century, foreign aid has emerged as a dominant strategy for alleviating poverty in the third world. Not coincidentally, during this time period major international institutions, such as the United Nations, World Bank, and International Monetary Fund gained prominence in global economic affairs (Ekanayake, 2009). Yet it seems that sixty years later, the lesser-developed countries (LDCs) of the world continue to suffer from economic deprivation raising questions of whether foreign aid is a worthwhile and effective approach to boosting growth and development in recipient economies. Research on the subject has attempted to draw an empirical connection between foreign aid and economic growth.

Despite these efforts, however, there is no solid consensus among scholars on the actual effectiveness of foreign aid inflows.

The term “foreign aid” can imply a number of different activities, ranging from humanitarian support in the wake of natural disasters to military assistance and arms donations (Ouattara, 2003). For the purposes of this analysis, however, I refer to the standard definition of “Official Development Assistance,” or aid that is aimed at increasing economic growth. Critics of development assistance cite a variety of reasons why it is a poor strategy for combating global poverty. Collier and Dollar (2002) argue that it can breed corruption, weaken accountability, and cause government to become excessively large. Nonetheless, as researchers Hansen and Tarp (2001) state that it is neither analytically defensible nor empirically credible to argue from the outset that aid never works. Indeed, a number of studies have shown a positive relationship between foreign aid and economic growth, especially in countries that have responsible economic policies regarding trade, inflation, and other macroeconomic concerns (Cameroon, Nigeria, Senegal...).

Since the 1990s, the amount of Foreign Aid to South Africa has been increasing, but there are controversial arguments on whether this official development assistance translates to economic growth. This research discusses in a straightforward manner the impact of aid on economic growth in South Africa.

The rest of the work is organized as follows: Chapter two is the literature review, chapter three constitute the research methodology, chapter four is the data presentation and analyses, chapter five summary of findings and recommendations and lastly chapter six conclusions.

1.1 The statement of the problem

Official Development Assistance (ODA) is given to South Africa (SA) by governments of developed nations, international aid agencies and through multilateral institutions such as the World Bank. Individuals through development charities such as Action Aid, Caritas, Care International or Oxfam also give ODA to SA in order to create long-term sustainable economic growth. The pursuit of long-term sustainable economic growth is associated with concomitant improvements in foreign aid inflows. However, the link between growth and foreign aid is not always obvious.

Since its transition to democracy in 1994, South Africa has generally experienced economic growth; the domestic outlook remains positive, strengths in the domestic economy help to sustain growth. Household spending remains robust, private-sector investment is gradually rising and interest rates are low. There are encouraging signs of employment growth in the formal sector. South Africa's banks are well capitalized. High levels of corporate saving are expected to enable increased investment spending as global uncertainty eases and business confidence strengthens. Fiscal and monetary policies remain supportive of growth. From 1994–2010, South Africa experienced an average, annualized growth rate of approximately 3.4 percent. This growth also coincided with the increase of official development assistance to South Africa; conversely, it's argued by Mr. Trevor Manuel, Minister in the Presidency: Planning of SA that as a middle-income country, South Africa is less dependent on foreign aid. This research therefore aims at answering the following research question:

Is there any significant relationship between Foreign Aid and Economic Growth in South Africa?

1.2 The purpose of the study

The principal purpose of the study is to determine whether there is any existing relationship between foreign aid inflows on economic growth in South Africa. Descriptive and inferential analyses is used to analyze the data obtained from a secondary source, namely, the World Bank's world development indicators database for 2011.

1.3 The significance of the study

Economic research on foreign aid effectiveness and economic growth frequently becomes a political football. However, when a result is passed from one source to the next, context is often stripped away so that what the result means in public discussion is different than what the original research actually demonstrated. The role of foreign aid in promoting economic growth has been the subject of much debate among development specialists, researchers, aid donors as well as recipients in general. There are tons of literature exploring the relationship between aid and growth; however, there are only few empirical studies that investigate the contributions of foreign aid to economic growth in South Africa, therefore this is a gap in research. This study intends to fill the gap in research and to contribute to development finance.

It is hopeful that the findings of this study will raise international awareness and will make the donor community know the real situation in South Africa.

1.4 Hypothesis of the study

The hypotheses that guide this study are:

- Ho: There is no relationship between foreign aid and economic growth in South Africa.
- H1: There is a relationship between foreign aid and economic growth in South Africa

1.5 Definition of terms

Relationship: The way in which two or more concepts, objects, or people are connected, or the state of being connected.

Foreign Aid: Also referred to as international aid or overseas aid, (especially in the United States) is the help, mostly economic, which may be provided to communities or countries in the

event of a humanitarian crisis or to achieve a socioeconomic objective. Humanitarian aid is therefore primarily used for emergency relief, while development aid also known as Official Development Assistance (ODA) aims to create long-term sustainable economic growth.

This research considers aid as Official development assistance (ODA), defined as government aid to developing countries designed to promote the economic growth of recipient countries. Loans and credits for military purposes are excluded. The aid may be provided bilaterally, from donor to recipient, or it may be channeled through a multilateral development agency such as the United Nations or the World Bank.

Aid includes grants, "soft" loans, and the provision of technical assistance. Soft loans are those where the grant element is at least 25%. ODA is usually measured on a net basis, that is, after subtracting loan repayments from the gross aid flows.

Economic Growth: This is the increase in value of the goods and services produced by an economy. It is conventionally measured as the percent rate of increase in real gross domestic product (GDP).

Gross domestic product is the value of all market and some non-market goods and services produced within a country. As such, it is the most comprehensive measure of a country's economic output that is generally estimated by statistical agencies.

The GDP per capita (GDP pc) is defined as the GDP of a country divided by its total population that is the average standard of living especially when expressed in purchasing power parity (PPP). It is therefore viewed as a rough indicator of a nation's prosperity.

The GDP per employed person is the average labor productivity. It provides a general picture of a country's productivity and international competitiveness.

The growth rate of real GDP is the percentage change in real GDP from one year to the next.

CHAPTER TWO

LITERATURE REVIEW

2.0 Introduction

This chapter reviews the literature related to the study in two main parts;

- The theoretical nexus between aid and economic growth
- The empirical evidence on the nexus between foreign aid and economic growth

2.1 The theoretical nexus between aid and economic growth

The empirical literature on the links between aid and economic growth has been curbed by lack of clear theoretical model on how aid would influence growth and which could pin down the empirical specification of the aid growth relationship (Easterly, 2003). The variations noticed in various aid studies are often occasioned by the peculiarities of their methodologies and choice of variables. For example Vu Minh Duc (2006) in his investigation of the empirical linkage between foreign aid and economic growth employed the endogenous growth model while Burnside and Dollar (2000) and Murphy and Tresp (2006) involving a similar work, employed the neoclassical growth model despite the peculiarities in various aid related studies, however, the use of neoclassical growth model has dominated development economics.

Until recently, the two-gap model the origin of which is associated with Mckinnon (1964) and Chenery and Strout (1966), had been the ‘saving grace’ for theoretical models on aid and growth for many years.

Although, the model has received a lot of criticisms, it has remained a prototype model for assessing the effectiveness of aid. In fact, till date, some institutions still apply the two-gap model in their aid policies and programs. In the words of Easterly (2003), “the financing gap model in which aid increases investment, which in turn increases economic growth has dubious theoretical foundations and numerous empirical failings”. Yet no other model of aid and growth has risen to take its place. The financing gap model continues to be used today in the World Bank and other institutions making aid policy. In addition, Devarajan, Miller and Swanson (2002) have acknowledged the criticisms the two-gap model has received, but nevertheless base

their projections, formulated for the World Bank, of the future aid requirements to reach the Millennium goals. They go on by stressing that it is a transparent and flexible framework for examining, for a large number of countries, the aid requirements of achieving the poverty goal.

Numerous examples of use of the two-gap model by donor agencies can be found in the work of Easterly (1999, 2001, 2003). Jhigan (2001) summarizes the criticisms against the two-gap model thus: “the two-gap analysis is based on certain restrictive assumptions which limit its usefulness in achieving the target growth rate in LDCs. It presupposes that an increase in domestic savings cannot be utilized as a substitute for the required foreign exchange to maintain investment for the target growth rate. It further assumes that the country cannot follow export promotion and import substitution policies. It also assumes structural rigidities and non-substitutability between different types of goods. Given such rigidities, if the foreign exchange gap is larger than the saving gap, the domestic saving potential can be used neither to produce capital goods nor exports. These assumptions are highly unrealistic and have not been supported by empirical evidence.”

Theoretically, the two-gap model is often considered to be significant in making aid policies because of the idea that foreign aid fills the gap between the ‘savings gap’ and the “foreign exchange gap” in order to attain a target rate growth in less developed countries. A savings gap arises when the domestic savings rate cannot guarantee the investment required to achieve the target. Similarly, a foreign gap arises if the net export falls short of foreign exchange requirements.

The foreign aid required to fill the gap is determined by the dominant gap at a given point in time. If the savings gap is larger than the foreign exchange gap, the economy is said to be in savings constraint. On the other hand, if the foreign exchange gap is larger than the savings gap, the economy is in foreign exchange constraint. Foreign aid can help in removing the savings constraint by the inflow of capital that will equate the difference between the increase in investment and the increase in savings generated by rising income. If the foreign exchange is dominant for a country at any given point in time, foreign aid can help in overcoming it. Over the long period, the required foreign aid will equal the difference between the increase in imports and exports. The foreign exchange gap will disappear when exports rise to a level that covers the required imports for the target growth of the economy.

Owing to the limitations of the two-gap model, its use in academic literature has become unpopular. The Neoclassical growth model and the endogenous growth theory have gained prominence, although the latter seems to be dominant in development economics and in empirically based research.

2.2 Empirical evidence on the nexus between foreign aid and economic growth

There are three contrasting sides to this debate. One side argues that there is a strong relationship between aid and economic growth, with even more impact in countries with sound economic and trade policies. Another side contends that there is no existing relationship between foreign aid and economic growth and that aid causes corruption, encourages rent-seeking behavior, and erodes bureaucratic institutions. A third side argues that the relationship between aid and economic growth could be positive or negative depending on several factors.

To date, there is no consensus among scholars as to the existence of a relationship between foreign aid and economic growth.

There have been several prominent studies that find a causal link between foreign aid and economic growth. Papanek (1973), in a cross-country regression analysis of 34 countries, treating foreign aid, foreign investment, other flows and domestic savings as explanatory variables, finds that foreign aid has a greater effect on economic growth than the other variables. He explains that “aid is supposed to be specifically designed to foster growth and, more importantly, is biased toward countries with a balance-of-payment constraint”. He also finds a strong negative correlation between foreign aid and domestic savings, which he believes contributed to the growth performance.

Chenery and Carter (1973), following the previous two-gap derived model of Chenery and Strout (1966) and using data from 50 countries over the period 1960-1970, show that the effects of Official Development Assistance (ODA) on the development performance of countries under study are different among certain groups of countries. In five countries, namely Taiwan, Korea, Iran, Thailand and Kenya, foreign assistance accelerated economic growth whereas in six cases it retarded growth, that is, India, Colombia, Ghana, Tunisia, Ceylon and Chile.

In a related study, Singh (1985) also finds that foreign aid has a strong positive impact on economic growth in less developed countries for the periods 1960-1970 and 1970-1980. He concludes that this is very possible when state intervention is not taken into account. When the

state intervention variable is included in the regression, the effect of foreign aid gets statistically weak. Snyder (1993), taking country size into account, finds a positive and significant relationship between aid and economic growth. He emphasizes that, “Previous econometric analysis has not made allowance for the fact that larger countries grow faster, but receive less aid”. He also claims that donors favor small countries for a number of reasons. Based on the model developed by Papanek (1972, 1973) and then extended by Mosley and Hudson (2001), Snyder analyzes the relation between foreign aid inflow and the growth rate of gross domestic product in 69 developing countries over three periods (the 1960s, 1970s and 1980-1987), incorporating country size (measured by gross domestic product) in the model. He argues that when country size is not included, the effects of aid are small and insignificant but when this factor is taken into account, the coefficient of aid becomes positive and significant.

Fayissa and El-Kaissy (1999) came out with the same conclusion as (Chenery and Strout, 1966), that overseas development assistance accelerates economic growth by supplementing domestic capital formation (economic theory of foreign aid). They conducted a study of 77 countries over sub-periods 1971-1980, 1981-1990 and 1971-1990. The results showed that that foreign aid positively affects economic growth in developing countries. Using modern economic growth theories, they pointed out that foreign aid; domestic savings, human capital and export are positively correlated with economic growth in the studied countries.

Lensink (2001) and Morrissey (2001) posited that uncertainty in aid receipts would influence the relationship between aid and investment, how recipient governments respond to aid, and will capture the fact that some countries are especially vulnerable to shocks. When they accounted for uncertainty (which is negative and significant), they found that aid has a significant positive effect on growth, largely due to its effect on the volume of investment. The finding that uncertainty of aid receipts reduces the effectiveness of aid is robust. When the regression was estimated for the sub-sample of African countries, these findings were weaker than for the full sample, although the effectiveness of aid appeared.

For instance, the most well-known prominent studies that find a causal link between foreign aid and economic growth was performed by two researchers for the World Bank, Craig Burnside and David Dollar (1998). They found that foreign aid enhances economic growth, so long as “good” fiscal policies are in place. These policies can include maintaining small budget deficits, controlling inflation, and being open to global trade. Since the Burnside and Dollar (2000) paper,

many papers have reacted to their results including Hansen and Tarp (2001), Dalgaard and Hansen (2001), Guillaumont and Chauvet (2001), Collier and Dehn (2001), Lensink and White (2001), Collier and Dollar (2002), Easterly, Levine and Rodman (2004), Harms and Lutz (2004), and Murphy and Tresp (2006). Some of these papers confirm the message of Burnside and Dollar that aid only works in a good policy environment, while others find that when particular variables are added, the coefficient on the interaction between aid and policy becomes near zero and/or statistically insignificant.

For example, Collier and Dehn (2001), as part of their contributions to entrench the brilliant research work of Burnside and Dollar (2000) incorporated export price shocks into Burnside and Dollar, showing a significant and negative relation between negative shocks and economic growth. They argued “the adverse effects of negative shocks on growth can be mitigated by offsetting increases in aid”. Therefore, they suggested that targeting aid towards negative shock expressing countries could be more effective than towards good policy countries. Using a 2.5% cut off in their sample size of 113 countries, they found 14 positive shocks and 99 negative shocks episodes. They indicated that the change in aid interacted with positive shocks is insignificant at the 1% level. Additionally; incorporating shocks into Alesina and Dollar’s (1998) regression, they showed that so far donors have not taken shocks into account in aid allocation. Finally, they claimed that aid effectiveness might be increased significantly if both policy and adverse export price shocks are considered in determining aid allocation.

Hansen and Tarp (2001) find that aid increases the growth rate, and this conclusion is not conditional on the policy index established by Burnside and Dollar (2000) they used a fairly standard growth model capturing non-linear effects between aid and growth, the empirical specification, with most support by data, does not include an aid–policy interaction term. They therefore believe to have substantiated that it is premature to rely on policy indexes, such as the one proposed by Burnside–Dollar, in the allocation of aid. They also note that empirical conclusions about aid effectiveness, based on cross-country growth regressions, depend on poorly understood non-linearity and critical methodological choices.

Ali and Isse (2005) further confirmed the findings of Burnside and Dollar.

Irandoosta and Ericsson (2005) applied the new developments in the field of likelihood-based panel co-integration analysis to examine the long-run relationship between foreign aid, and economic growth. The countries in the panel are: Niger, Nigeria, Rwanda, Senegal, and Togo,

and the sample period is 1965–2000 they show that foreign aid enhance economic growth for all countries in the sample. The same year, Moreira (2005) using a cross country study, also found that; aid has positive effect on growth, and concluded that in terms of magnitude, aid has less effect on growth in the short-run than in the long-run and that the time lags in the aid-growth relationship should not be ignored. Durbarray, Gemmell, and Greenaway (2006) also found a positive association between foreign aid and economic growth, and confirmed Burnside and Dollar's (2000) finding of conditionality on good economic policy. The study also concluded, however, that the degree to which aid impacts GDP depends largely on other factors as well, such as geography. In another study, Ekanayake (2009), using the annual data on a group of 85 developing countries covering Asia, Africa, and Latin America and the Caribbean for the period 1980-2007 and the panel data series for foreign aid, while accounting for regional differences in Asian, African, Latin American, and the Caribbean countries as well as the differences in income levels demonstrated that foreign aid has a positive effect on economic growth in African countries. He also highlighted the fact that Africa is the largest recipient of foreign aid than any other region. Vu Minh Duc (2006) found that foreign aid to Inland countries as well as South Asian countries during the period 1992-2000 significantly and positively correlates with growth. To answer to his research question; does foreign aid work, Collodel (2011) said: "Yes, aid does have a positive impact on growth". He stated that there is an urgent need to reform the aid system and develop a new methodology for measuring the effectiveness of foreign aid. Dacy (2006) analyzed the growth impact of official development assistance to developing countries. Their approach followed two major ways. First, they disentangle the effects of two components of aid: a developmental, growth-enhancing component and geopolitical, possibly growth-depressing component. Second, they designed specifications that allow for the effect of aid and economic growth to occur over long time lags involving periods of up to several decades. Their results indicate that aid of the right kind promote long run growth. The effect of developmental aid is significant, large, and withstands a battery of robustness checks including alternative proxies for developmental aid, specifications and treatment of outliers. The basic implication of their findings is that increasing the level of developmental aid (whether by changing the composition or level of total aid) can have a sizeable impact on long run growth. Recently, Kargbo (2012) using a triangulation of approaches involving the autoregressive distributed lag bounds test approach and the Johansen maximum likelihood approach to co-

integration for the period 1970-2007, found that foreign aid has a significant contribution in promoting economic growth in Sierra Leone.

In general, aid is found to have a significant relationship with economic growth because it increases investment, increases the capacity to import capital goods or technology, aid does not have an adverse impact on investment and savings and lastly because aid increases the capital productivity and promotes endogenous technical change (Morrissey, 2001).

Although foreign aid is found to have a significant relationship with economic growth, Pedersen (1996) in a related study asserted that it is still not possible to conclude that aid affects growth positively. He used the game theory, to demonstrate that the problems lie in the built-in incentive of the aid system itself. The aid conditionality is not sufficient and the penalties are not hard enough when recipient countries deviate from their commitments. In fact, there are incentives for aid donating agencies to disburse as much aid as possible. This hinders the motivation of recipient countries and raises the aid dependency, which in turn distorts their development. Easterly, Levine and Roodman (2004) suggest that economists and policy makers should be less sanguine about concluding that foreign aid will boost growth in countries with good policies.

The study of Ali and Isse (2005) also demonstrated, that aid is subject to decreasing marginal returns, indicating a threshold beyond which development assistance can become detrimental to economic growth. Knack (2000), in a cross-country analysis, presented results, indicating that higher aid levels erode the quality of governance indexes, that is, bureaucracy, corruption and the rule of law. He argues “aid dependence can potentially undermine institutional quality, encouraging rent seeking and corruption, fomenting conflict over control of aid funds, siphoning off scarce talent from bureaucracy, and alleviating pressures to reform inefficient policies and institutions”.

Even before Burnside and Dollar’s monumental findings, a study by Bourguignon and Morrisson (1998) found that aid-intensive African countries experienced zero per capita economic growth in the 1970s and 80s, despite foreign aid actually increasing (as measured by share of GDP). Svensson (1998) argues that large aid inflows do not necessarily result in general welfare gains and high expectation of aid may increase rent seeking and reduce the expected public goods quality. Moreover, there is no evidence that donors take corruption into account seriously while providing aid. In another study by, Gomanee and Morrissey (2002), they find that a permanent rise in foreign aid reduces long-run labor supply and capital accumulation, increases long-run

consumption and has no impact on long-run foreign borrowing. They used the optimal growth model with foreign aid, foreign borrowing and endogenous leisure-and-consumption choices to show that foreign aid depresses domestic saving, mostly channels into consumption and has no relationship with investment and growth in developing countries. According to Burnside and Dollar, (2000), the impact of foreign aid on growth is subject to certain factors. In their work “Aid, Policies, and Growth”, they find that has little impact on countries where fiscal, monetary and trade policies are poor. They use data from 56 countries for six four-year periods from 1970-1973 until 1990-1993 and construct a growth convergence model to illustrate. They explain, “Aid can affect output only through its effect on the stock of capital, that is, to the extent that it is used for investment rather than consumption”. They argue that aid itself has small and insignificant impact but aid interacting with good policy has a significant positive impact on growth. In fact, policy seems more important for aid effectiveness in lower income countries. Another finding is that there is no tendency for total aid or bilateral aid to favor good policy, while multilateral aid is allocated in favor of good policy. They indicate that aid works well in a good policy environment and a poor country with good policy should get more aid, which is not always the case in reality. Burnside and Dollar, (2000) also state that a well-designed aid plan can support effective institutions and governance by providing more knowledge and transferring technology and skills. It is recommended to decentralize the aid flows in recipient countries. Money aid is important but idea aid is even more important. Aid can be the midwife of good policy in recipient countries. In poor-policy countries, idea aid is especially more essential than money aid. This implies that in a good-policy environment, aid increases growth via the investment channel whereas in a poor-policy environment, it nurtures the reforms through policymakers training or knowledge and technology transfer. These non-money effects are believed even more important and viable than the money value of aid. Aid works much better where the reform is initiated or internalized by local government rather than when outsiders impose it. Therefore, aid is normally more effective when it facilitates efficiently and timely reforms triggered by the local authority (World Bank, 2000). Ouattara (2003) concludes that different types of aid have different impacts on growth. In a country analysis of Cote d’Ivoire from 1975 to 1999, he categorizes foreign aid into project aid, program aid, technical assistance and food aid. Using a disaggregation approach with auto regressive techniques, he finds that project aid displaces public savings. The impact of program aid is almost neutral while technical

assistance and food aid increase public savings. Project aid and to a lesser extent, program aid, worsen the foreign dependence of Cote d'Ivoire while technical assistance and food aid reduce the gap. Mbaku (1993), in his work "The impact of Foreign aid on economic growth in Cameroon", uses an econometric model, based on the neoclassical production function, to test the relationship between foreign aid and economic growth. The model is tested using time series data on the country from 1971 to 1990. The results show that domestic resources have a stronger impact on economic growth in Cameroon than foreign resources. Cleveland (2006), applying a Granger causality test between foreign aid and economic growth and other diagnostic tests, finds a causal relationship between foreign aid loans, but not foreign aid grants, with economic growth in Cameroon, which contradicts the previous work of John Mbaku (1993).

Rajan and Subramanian (2005) attempted to analyze why it is so hard to find a robust effect of aid on the long-term growth of poor countries, even those with good policies. They look for a possible offset to the beneficial effect of aid, using a methodology that exploits both cross-country and within country variation. They found that aid inflows have systematic adverse effect on countries competitiveness. They also found evidence suggesting that these effects stem from the real exchange rate evaluation caused by aid inflows.

Vu Minh Duc (2006) attempted to quantify the relationship between foreign aid and economic growth in developing countries over the period 1975-2000. Using cross-country data comprising thirty-nine countries, he found evidence that foreign aid negatively correlates with growth in developing countries. The results suggest that:

- There may be problems in the present aid providing system, where aid hinders growth of developing countries.
- The successful experience of some Inland countries and South Asian countries nations during the period of 1992-2000 could be a good lesson for other developing countries.
- Finally, a strong evidence of divergence implies that if the condition were not improved upon in the least developing countries, there would be large income dispersion among developing countries in the future.

In another studies, (Bell and Rich, (1994), Ravallion and Datt, (1994), Ravallion and Chen, (1997), Dollar and Kraay, 2000), find that there is a widely recognized positive correlation between sustained economic growth and poverty reduction, but not between foreign aid and economic growth. They argue that increases in economic growth are expected to benefit the poor

due to their participation in economic activities, and this leads to larger tax revenues and higher government expenditures, which might include transfers to the least well off as well as increasing access to services such as health and education.

Murphy and Tresp (2006) reconsidered the role of economic policy in determining the effectiveness of foreign aid for generating economic growth in developing countries. They updated and modified the dataset originally used by Burnside and Dollar (2000) in order to more fully consider the critique presented by Easterly (2006). Their findings suggest that the relationship among foreign aid, government policy, and economic growth is tenuous and depends importantly on the subset of countries included in the analysis. Good policy enhances the effectiveness of foreign aid in spurring growth when we use the original set of countries included in Burnside and Dollar, but this relationship disappears for an expanded set of countries. Because the relationship among aid, policy, and growth is likely to be nonlinear, they presented an alternative model emphasizing growth thresholds. Their results from this alternative analysis confirmed the conclusions of Easterly, finding little support for the view that good policy increases the probability that foreign aid contributes to growth.

As a contribution to a well-known recent paper by Burnside and Dollar (2000) that aid promotes growth only in a good policy environment, Gunning (2006), addressed nonlinearity in the aid, policy and growth relationship without improving any particular structure in the relationship and examined the varying effects of aid and policy in different segments of the data. By using commonly used aid and policy variables, they revisited the issue from a new perspective. Their semi-parametric estimation shows that aid diminishes returns. These findings suggest that nonlinearities if not appropriately addressed may hide some key details, providing only indistinct information about the aid-policy-growth nexus. Studies carried out by (Kosack, 2003); reveal that aid can directly decrease welfare; he indicates that there is no relationship between aid and economic growth in poor democracies.

Despite the fact that foreign aid is found to have no significant existing relationship with economic growth and that aid causes corruption, encourages rent-seeking behavior, and erodes bureaucratic institutions. Collodel (2011) states that the relationship between aid and economic growth could be positive or negative depending on several factors. He argues that there is also evidence that the effects of foreign aid can be mitigated by other non-economic factors. Situations of state failure, such as ethnic conflict, genocide or politicization, and revolution can

all potentially influence the extent to which aid impacts growth. George Mason University's Political Instability Task Force (PITF) created a binary dataset indicating in which countries and during what years these events take place. According to the PITF, an ethnic conflict requires the clash of two separate ethnic, religious, or nationalistic factions, and also must meet two threshold criteria: 1,000 people must be mobilized for armed conflict, and at least 1,000 people per year must have died as a direct result of this conflict. Similarly, revolutions are defined as episodes of violent conflict between political groups in hopes of overthrowing the current regime, and must meet the same threshold criteria as ethnic wars. Not a lot of attention is paid to genocide, politicization, and revolution and their effects on growth in the literature. Moreover, there has been virtually no research performed on this question as it concerns the effectiveness of aid. It is reasonable to believe, though, that resources (including foreign aid) are siphoned off by the dominant party and used for individual benefit rather than for economically efficient activities, as intended. Finally, genocide and politicization are defined in a slightly different manner. These events occur when the group in power carries out sustained policies that target ethnic, religious, or political rivals, ultimately resulting in the deaths of a "substantial" portion of one of those groups. Hjertholm and White (2000) studied the effects of high ethnic fractionalization on economic growth. By fractionalization, they mean the probability that two randomly chosen people from a population will be of different ethno-linguistic backgrounds. Easterly, Levine, and Roodman, (2004) concludes that movement from heterogeneity to homogeneity (decreasing fractionalization) results in better schooling, more efficient infrastructures, and more developed financial systems and foreign exchange markets. According to their findings, then, it is entirely possible that ethnic conflict, in its attempt to move away from ethnic diversity and towards ethnic homogeneity, will actually improve economic growth. Despite their findings, however, the instability of the regime could still negatively impact the degree of aid's effectiveness. Furthermore, out of respect for state sovereignty, these events are not likely to prompt a major international response, which would perhaps eliminate local control over resources and allow them to be used productively. Ethnic conflict typically ignores state boundaries. One study by Charles (2002) estimated that over two-thirds of identified ethnic communal groups in the world have kindred in another country. The spread across state borders allows other states to intervene without violating state sovereignty, which could positively impact how resources are used, and ultimately, economic growth.

Additionally, a country's geographic location can influence economic performance; nations that are landlocked, for instance, are at a natural disadvantage in global trade. Sachs and Warner (1996) indicate that landlocked countries, in particular, face very high costs of shipping, since they must pay road transport costs across at least one international boundary in addition to sea freight costs. Although air shipments can help overcome many of these problems, only certain goods can be economically shipped by air, and most countries still import and export the majority of goods by the sea. A report by the UN Economic and Social Commission for Asia and the Pacific specifically mentions the positive relationship between aid and growth in landlocked countries, noting that they are at a disadvantage for these reasons, as well (Tarp, 2000). Due to their geographical position, then, landlocked countries could potentially benefit from foreign assistance, as it may fill the gap in trade that they experience relative to countries with easy access to international trade.

2.3 General summary of literature review

The following table presents the general summary of literature review.

Table 1: Showing names of author and findings

Name	Findings
Papanek (1973)	Foreign Aid had a greater impact on economic growth.
Chenery and Carter (1973)	ODA accelerated economic growth in some countries but retarded it in some.
Singh (1985)	Foreign aid had a strong positive impact on economic growth in less development countries when state intervention is not taken into account.
John Mbaku (1993)	Domestic resources had a greater impact than foreign resources.

Snyder (1993)	Foreign aid had a strong and positive relationship with economic growth when country size is taken into account.
Bell and Rich, (1994), Ravellion and Datt, (1994), Dollar and Kraay, (2000).	Positive correlation between sustained economic growth and poverty reduction
Pedersen (1996)	Used game theory to show that foreign aid distorts development.
Burnside and Dollar (1998)	Aid had a positive impact on growth in countries with good governance.
Svensson (1998)	Aid inflows do not result in welfare gains.
Fayissa and El-Kaissy (1999)	ODA accelerated economic growth. Foreign aid, domestic savings, human capital and export are positively correlated with economic growth.
Knack (2000)	Too much dependence on aid undermines institutional quality and encourages corruption.
Morrissey (2001)	Foreign aid had positive impact on economic growth because it increases investment.
Mosley and Hudson, (2001)	Foreign aid has an indirect impact on poverty and the well being of recipient countries.
Gomanee and Morrissey (2002)	A permanent rise in foreign aid reduces long run labor supply and capital accumulation.
Quattera (2003)	Different types of aid had different impact on growth.
Kosack, (2003)	Aid directly increases welfare but only in democracies.

Collodel (2011)	The relationship between aid and economic growth could be positive or negative depending on several factors.
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Source: Table done by myself.

The above literature on the impact of aid on growth reveals the fact that the relationship between the variables varies, depending upon the models, data, non-economic factors and countries of analysis. Therefore, the question of aid effectiveness is still inconclusive as stated by Easterly, Levine and Roodman (2004) after conducting a new test on the previous work of Burnside and Dollar (2000). The above literature review also reveals the fact that most of the researchers have used cross-country analyses. Some of the studies have concentrated on regions to assess the impact of aid on growth. Few have considered particular country cases studies and even the few that have done so, have not gone into looking at the relationship between aid and economic growth in South Africa. The novelty of this study therefore is to assess the existence of the relationship between foreign aid on economic growth in particular country case study; South Africa.

CHAPTER THREE

RESEARCH METHODOLOGY

3.0 Introduction

This chapter highlights the methodology employed in the study. The chapter consists of a background of study area, research design followed by research instrumentation and lastly variables for data collection and procedure for data analysis.

3.1 Background of study area

According to the CIA world fact book, South Africa became a republic in 1961 after a whites-only referendum, it has a population of 50,586,757 (July 2012 est.), and its population growth rate is 1.1 % (2012 est.), the 2010 midyear estimated figures for the categories were Black African at 79.4%, White at 9.2%, Coloured at 8.8%, and Indian or Asian at 2.6%. According to the 2001 national census, Christians accounted for 79.7% of the population. This includes Zion Christian (11.1%), Pentecostal (Charismatic) (8.2%), Roman Catholic (7.1%), Methodist (6.8%), Dutch Reformed (6.7%), Anglican (3.8%); members of other Christian churches account for 36% of the population. Muslims accounted for 1.5% of the population, Hindus about 1.3%, and Judaism 0.2%. 15.1% had no religious affiliation, 2.3% were other and 1.4% was unspecified. South Africa has eleven official languages: Afrikaans, English, Ndebele, Northern Sotho, Sotho, Swazi, Tswana, Tsonga, Venda, Xhosa, and Zulu. It has a three-tier system of education starting with primary school, followed by high school and tertiary education in the form of (academic) universities and universities of technology. Its healthcare varies from the most basic primary healthcare, offered free by the state, to highly specialized hi-tech health services available in the both the public and private sector.

According to the Bloomberg, South Africa has a modern and well-developed transport infrastructure. The roads are world-class. The air and rail networks are the largest on the continent. And the country's ports provide a natural stopover for shipping to and from Europe, the Americas, Asia, Australasia and both coasts of Africa. The transport sector has been

highlighted by the government as a key contributor to South Africa's competitiveness in global markets. It is increasingly being seen a crucial engine for economic growth and social development, and the government has unveiled plans to spend billions of rand to improve the country's roads, railways and ports. Major shipping lanes pass along the South African coastline in the south Atlantic and Indian oceans. Approximately 96% of the country's exports are conveyed by sea, and the eight commercial ports are the conduits for trade between South Africa and its southern African partners as well as hubs for traffic to and from Europe, Asia, the Americas and the east and west coasts of Africa.

According to the 2010 CIA world fact book report, South Africa's total road network is about 754 000 kilometers, of which over 70 000km are paved or surfaced roads. The drive from Musina on South Africa's northern border to Cape Town in the south is a 2 000km journey on well-maintained roads. South Africa has an extensive rail network – the 14th longest in the world – connecting with networks in the sub-Saharan region. The country's rail infrastructure, which connects the ports with the rest of South Africa, represents about 80% of Africa's total. The Gautrain is an 80km rapid rail network, connecting Johannesburg, Pretoria and OR Tambo International Airport, easing congestion on the Johannesburg-Pretoria highway by offering commuters a safe and viable alternative to road travel. Sixty-two airlines, making 274,000 aircraft landings and carrying 16.5-million passengers (counting departures only), moved through South Africa's ten principal airports in 2009.

South Africa's telecom sector boasts the continent's most advanced networks in terms of technology deployed and services provided. In a virtually saturated voice market, four mobile networks – Vodacom, MTN, Cell C and Telkom SA – are competing for market share in the next growth wave, mobile broadband. 3G/HSPA mobile broadband services now rival available DSL fixed-line offerings in terms of both speed and price, and have consequently taken the upper hand in terms of subscriber numbers. All four operators are preparing the introduction of the next generation of mobile technology, LTE (also referred to as 4G), but are being held back by delays with suitable frequency spectrum allocations.

3.1.1 Economy

South Africa is a middle-income, emerging market with an abundant supply of natural resources; well-developed financial, legal, communications, energy, and transport sectors; a stock exchange that is the 18th largest in the world; and modern infrastructure supporting a relatively efficient distribution of goods to major urban centers throughout the region (KPMG report, 2010).

According to the 2010 Millennium development goal growth was robust from 2004 to 2007 as South Africa reaped the benefits of macroeconomic stability and a global commodities boom but began to slow in the second half of 2007 due to an electricity crisis and the subsequent global financial crisis' impact on commodity prices and demand. GDP fell nearly 2% in 2009 but recovered in 2010-11. Unemployment remains high and outdated infrastructure has constrained growth. State power supplier Eskom encountered problems with aging plants and meeting electricity demand necessitating “load- shedding” cuts in 2007 and 2008 to residents and businesses in the major cities. Daunting economic problems remain from the apartheid era – especially poverty, lack of economic empowerment among the disadvantaged groups, and a shortage of public transportation.

According to the KPMG's 2010 Report, South Africa's economic policy is fiscally conservative focusing on controlling inflation and attaining a budget surplus. The current government largely follows these prudent policies but must contend with the impact of the global crisis and is facing growing pressure from special interest groups to use state-owned enterprises to deliver basic services to low-income areas and to increase job growth. South Africa is well known throughout the world for its Gold, Diamonds, Coal and Platinum industries, but besides for these minerals, the country mines a number of other minerals. What is not as commonly known, is that the country also has a wide range of additional natural resources that are not as well-known such as timber, sugar and other agricultural items. The 2010 KPMG report states that driving through the area of Mpumalanga (formerly the Eastern Transvaal) and also Kwazulu-Natal's midlands area, one will see huge areas of timber plantations. These plantations are the foundations of a very large and lucrative industry. The timber industry of South Africa is very productive and supplies almost all the countries timber requirements as well as exporting a sizeable percentage of wood grown in these plantations. Also not generally known is South Africa's sugar Industry situated mainly in Kwazulu Natal and to a lesser degree in the Eastern Cape and the Mpumalanga area.

The Sugar Industry of South Africa generates an income of about six billion rand annually and provides work opportunities for a very large amount of people living in these areas. Not to be forgotten of course is the Wine Industry of South Africa. Since the end of Apartheid the export of wines from South Africa has continued to grow with each passing year and today South Africa is one of the top ten wine producers in the world. South African agriculture encompasses a wide range of products such as fresh fruit (grapes, citrus, nectarines and others), as well as maize, tobacco wool and cotton. Most of these items are also exported.

3.1.2 South Africa latest economic indicators

South Africa latest economic indicators are shown on the table below.

Table 2: South Africa latest economic indicators.

	2010			2011				2012
	2 Qtr.	3 Qtr.	4 Qtr.	1 Qtr.	2 Qtr.	3 Qtr.	4 Qtr.	1 Qtr.
General government finance (R m)								
Revenue	153 848	160 363	171 239	202 009	166 886	170 048	208 060	219 683
Expenditure	184 452	206 506	201 883	202 919	201 601	234 042	220 512	239 540
Balance	(30 604)	(46 143)	(30 644)	-910	(34 715)	(63 994)	(12 452)	(19 857)
Output								
GDP at constant 2000 prices (R bn)	1 829,3	1 843,3	1 863,7	1 884,6	1 889,1	1 897,1	1 911,9	n/a
Manufacturing index (2000=100)	102,1	100,2	101,6	104,3	102,9	102,5	103,7	105,5
Durable goods	94,7	89,8	95,7	98,1	98,3	95,8	97,1	98,3
Non-durable goods	108	109,7	106,9	108,8	107,5	108,9	110,6	111
Employment & prices								
Employment, private (2000=100)								
Mining	119,4	120,5	121,1	123,6	124,3	123,7	124,5	n/a
Manufacturing	90,3	89,5	89,7	89,5	88,7	88,8	89,1	n/a
Construction	184,8	183,6	180,1	183,8	188,4	196,4	191,8	n/a
Consumer prices (2008=100)	111,2	111,8	113	114,5	116,3	118	120,1	121,7
Consumer prices (% change, year on year)	4,2	3,4	3,4	3,7	4,6	5,5	6,3	6,3
Production prices (2000=100)	191,3	192,6	194,7	200,3	204,6	211,2	214,7	216,5
Production prices (% change, year on year)	7,2	7,3	6,3	6,4	7	9,7	10,3	8,1
Financial indicators								
Exchange rate R: US\$ (av)	7,5	7,3	6,9	7	6,8	7,2	8,1	7,8
Exchange rate R: US\$ (end-period)	7,6	7	6,6	6,8	6,8	8	8,1	7,7
Deposit rate (av; %)	6,8	6,5	5,4	5,9	5,7	5,6	5,5	n/a
Lending rate (av; %)	10	9,8	9,2	9	9	9	9	n/a

3-month money market rate (av; %)	6,3	6,2	5,6	5,3	5,3	5,3	5,3	n/a
Long-term Gov. bond yield (av; %)	8,9	8,3	8,2	8,7	8,6	8,3	8,5	n/a
M2 (end-period; R bn)	1 550	1 588	1 677	1 650	1 645	1 720	1 798	n/a
M2 (% change, year on year)	0,3	2,9	5,6	4,6	6,1	n/a	n/a	n/a
JSE, all items (Dec 1960=100)	26 259	29 456	32 119	32 204	31 865	29 674	31 986	33 554
JSE, all items (% change, year on year)	20,7	26	29,8	21,3	37	-12,7	-18,8	-7,9
Gold mining share prices (2000=100)	63,4	63,5	69,5	68,6	67,3	68,7	76,7	70,3
Gold mining share prices (%change, year on year)	-1,9	1,9	4,9	16,1	6,1	8,2	10,5	2,5
Sectorial trends (2000=100)								
Gold mining (volume of production)	65	64,6	64,6	63,5	62,1	58,4	60,7	56,2
Other mining (volume of production)	91	98,3	101	100,2	99,6	95	94,6	91
Retail sales, volume	101,3	102,1	102,9	104,6	105,7	108,3	110,4	109,3
Foreign trade (US\$ m)								
Exports fob	19 383	21 563	23 767	22 481	24 824	25 862	23 780	22 173
Net gold exports	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Imports cif	(19 016)	(21 445)	(21 497)	(23 088)	(24 694)	(26 647)	(25 398)	(25 564)
Trade balance	368	118	2 270	-607	130	-784	(1 618)	(3 391)
Foreign payments (US\$ m)								
Merchandise trade balance	890	705	2 521	675	1 389	669	-317	n/a
Services balance	(1 003)	(1 386)	(1 218)	(1 211)	(1 790)	(1 202)	-637	n/a
Income balance	(1 864)	(2 107)	(1 658)	(2 160)	(2 049)	(3 781)	(1 295)	n/a
Net transfer payments	-356	-815	-339	-351	-647	-574	-400	n/a
Current-account balance	(2 333)	(3 603)	-694	(3 047)	(3 097)	(4 888)	(2 649)	n/a
Reserves excl gold (end-period)	37 202	38 765	38 175	43 512	43 984	43 208	42 595	43 982

Source: 2010 KPMG report; South Africa country profile

3.1.3 South Africa economy indicators; five years forecast

The tables below show five years forecast South Africa economic indicators.

Table 3: South Africa five years economic indicators forecasts: Growth and productivity.

	2007 (a)	2008 (a)	2009 (a)	2010 (b)	2011 (b)	2012 (b)	2013 (c)	2014 (c)	2015 (c)	2016 (c)
Growth and productivity (%)										
Growth of capital stock	6,3	7,2	5,8	4,9	4,9	4,6	4,6	4,7	4,9	5,1
Growth of real GDP	5,5	3,6	-1,5	2,9	3,1	2,5	3	3,8	4	4,2
Growth of real GDP per head	4,6	2,7	-2,1	2,8	3,3	2,9	3,5	4,2	4,2	4,1

a) Actual; b) estimates c) forecasts

Source: 2010 KPMG report; South Africa country profile

The table below shows South Africa five years Gross Domestic Product at current market prices.

Table 4: South Africa five years economic indicators forecast: Gross Domestic Product at current market prices

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
	(a)	(a)	(a)	(a)	(a)	(b)	(b)	(b)	(b)	(b)
Expenditure on GDP (R bn at current market prices)										
GDP	2 016,2	2 262,5	2 398,2	2 661,4	2 964,3	2 967,4	3 067,5	3 173,5	3 303,8	3 406,4
Private consumption	1 264,7	1 393,0	1 460,9	1 575,9	1 737,3	1 872,8	2 060,1	2 261,9	2 506,2	2 776,9
Government consumption	380	426,4	502,5	573,5	636,4	704	766,7	849,1	947,7	1 062,8
Gross fixed investment	406,3	520,7	521,7	520,4	559,9	579	614,5	655,8	704,3	756,7
Exports of goods & services	634,6	809,6	657,2	727,7	854,3	996	1 062,6	1 121,3	1 248,0	1 404,3
Imports of goods & services	689,8	878,7	678,3	733	872,4	1 156,8	1 415,7	1 696,1	2 075,9	2 565,7
Domestic demand	2 073,0	2 332,6	2 434,4	2 666,4	2 958,7	3 151,8	3 444,2	3 771,9	4 155,3	4 591,4
Expenditure on GDP (US\$ bn at current market prices)										
GDP	286,1	274	284,7	363,8	408,3	364,6	368,4	384,7	386,4	380,6
Private consumption	179,5	168,7	173,4	215,4	239,3	230,1	247,4	274,2	293,1	310,3
Government consumption	53,9	51,6	59,7	78,4	87,7	86,5	92,1	102,9	110,8	118,7
Gross fixed investment	57,6	63,1	61,9	71,1	77,1	71,2	73,8	79,5	82,4	84,5
Exports of goods & services	90,1	98	78	99,5	117,7	122,4	127,6	135,9	146	156,9
Imports of goods & services	97,9	106,4	80,5	100,2	120,2	142,2	170	205,6	242,8	286,7
Domestic demand	294,2	282,4	289	364,5	407,6	387,3	413,7	457,2	486	513
Economic structure (% of GDP at current market prices)										
Private consumption	62,7	61,6	60,9	59,2	58,6	63,1	67,2	71,3	75,9	81,5
Government consumption	18,8	18,8	21	21,5	21,5	23,7	25	26,8	28,7	31,2
Gross fixed investment	20,1	23	21,8	19,6	18,9	19,5	20	20,7	21,3	22,2
Exports of goods & services	31,5	35,8	27,4	27,3	28,8	33,6	34,6	35,3	37,8	41,2
Imports of goods & services	34,2	38,8	28,3	27,5	29,4	39	46,2	53,4	62,8	75,3
Memorandum item										
National savings ratio (%)	14,2	15,3	15,7	16,6	16,4	14,2	15,8	17,3	18	18,3

a) Actual; b) estimates c) forecasts

Source: 2010 KPMG report; South Africa country profile

3.1.4 Country risk rating

Country risk rating is divided into 5 type of risk: sovereign, currency, banking sector, political and economic structure risk.

3.1.4.1 Sovereign risk

Stable, a strong macroeconomic policy framework will continue to support the sovereign's rating, but rising public debt – fuelled by sustained pressure on the government to step up public spending – will weigh on sovereign risk (Bloomberg).

3.1.4.2 Currency risk

Stable. The rand will be supported by fairly robust investment inflows, but it will remain vulnerable to shifts in global sentiment and local policy developments. Sudden withdrawals of portfolio flows in the event of a worsening of the crisis in the euro zone will sustain the risk of volatility (Bloomberg).

3.1.4.3 Banking sector risk

Stable. The banking system will remain sound, supported by strong regulation. Further underlining banking sector stability, the non- performing loan ratio has returned below the critical 5% threshold. However, rising costs and the stringent requirements of Basel III represent significant challenges for local banks (KPMG country profile report).

3.1.4.4 Political risk

According to Bloomberg, the Political uncertainty is set to increase ahead of the ANC party conference in December 2013. The president, Jacob Zuma, is likely to be re-elected as party leader, but hardliners could be voted into office, leading to an increasingly populist stance.

3.1.4.5 Economic structure risk

A highly diversified export base and a well-regulated financial system underpin the BBB rating. However, structural constraints, including skills shortages and inefficient parastatal, will continue to act as a drag on growth (2010 KPMG country profile report). The table below summarizes the South Africa risk rating.

Table 5: Country risk rating

	Sovereign risk	Currency risk	Banking sector risk	Political risk	Economic structure risk	Country risk
August 2012	BBB	BBB	BBB	BBB	BBB	BBB

Source: 2010 KPMG report; South Africa country profile

3.1.5 South Africa outlook for 2012 – 2016

This section presents the South Africa outlook for 2012 to 2016 in the following sub topic; economic growth, inflation, exchange rate, external sector and policy trends.

3.1.5.1 Economic growth;

Leading indicators for the first half of 2012 reveal a mixed picture. Sectors with greater export exposure, particularly manufacturing and mining, have performed much less impressively, held back by the euro zone debt crisis and global uncertainties. During the 2013 budget speech, Mr. Pravin Gordhan, South Africa finance minister indicates that the situation may not be sustained, despite the relatively robust performance of retailing, while other economic sectors remain in the doldrums. Coupled with the weak and highly uncertain external outlook, the Economist Intelligence Unit has revised down its forecast for growth to 2.5% in 2012 (from 2.8%) and to 3% in 2013 (from 3.5%). Consumer spending will slacken in the face of weak job creation, high debt levels and subdued economic activity, despite low interest rates, brisk real wage growth and adequate credit availability. The government will remain supportive of growth through an ongoing fiscal stimulus, although private investors will be cautious, especially given uncertainty about some government policies. The risk of recession is low, but growth will be too sluggish to

cut the high unemployment rate, which will continue to constrain aggregate demand. In addition, the external outlook for 2012 is most uncertain, leaving South Africa highly vulnerable to a downturn in global growth (Mr. Pravin Gordhan).

3.1.5.2 Policy trends

According to Mr. Trevor Manuel South Africa Minister in the Presidency, Planning, the main challenge facing policymakers in 2012 will be to expedite the country's ongoing recovery from the 2009 recession by maintaining stimulus measures (including a budget deficit and cheap money) while guarding against macroeconomic imbalances and mitigating the risks associated with global economic fragility. The main test in the medium term (2013-16) will be to overcome the structural barriers (such as skills shortages) that prevent South Africa from entering a phase of faster, more labor-intensive growth. However, the task will be complicated by the emergence of new policymaking centers such as the National Planning Commission and the Department for Economic Development, to add to the treasury, the South African Reserve Bank (SARB, the central bank) and the Department of trade and Industry.

Although new initiatives are needed, especially to deal with deep-rooted problems such as high unemployment, stark inequality, skills shortages, crime and HIV/AIDS, there is a risk of conflict and inertia (or both) in the absence of decisive leadership. Mr. Trevor Manuel states that he expected completion of major infrastructure projects will facilitate business activity, but there will be new challenges in the form of stricter anti-competition laws and steep rises in electricity tariffs (2013 budget speech)

3.1.5.3 Inflation

According to KPMG country profile report, sound policies, sluggish consumer demand and spare industrial capacity will help to keep inflation in check, but upward pressure will come from steep rises in electricity prices and wage increases. Inflation edged down to a ten-month low of 5.6% in June, helped by cheaper food, to lie comfortably below the SARB's 6% target ceiling. Commodity prices are expected to continue to moderate in 2012-16 and domestic demand to remain subdued in 2012-14, which will help to curb inflationary pressure. Average inflation will rise slightly, from 5% in 2011 to 5.3% in 2012, underpinned by wage growth, higher

administered prices and a weaker rand. Inflation is expected to return to the 4-5% range 2013-16, helped by more stable commodity prices, subdued economic growth, stricter competition policy and efficiency gains arising from infrastructure investment. Except for temporary breaches, inflation will remain below the 6% target ceiling.

3.1.5.4 Exchange rates

After strengthening in early 2012, helped by a large interest-rate differential with rich-country markets, the rand encountered volatility in response to renewed global uncertainty and a shift away from riskier emerging-market assets. After sliding to R8.40: US\$1 in June, a three-year low, the rand strengthened slightly to R8.25: US\$1 in July, still 21.4% weaker, year on year. According to the South Africa Minister of Economic Development: Mr. Ebrahim Patel, the rand is expected to move within the R8-8.3: US\$1 range during the remainder of 2012, despite inevitable daily volatility, provided that the euro zone debt crisis does not spiral out of control. Gradual rand depreciation is forecast in 2012-16 because of South Africa's persistent current-account deficit, relatively high inflation and political uncertainty surrounding the 2014 election. The rand is now expected to decline from an average of R7.26: US\$1 in 2011 to R8.14: US\$1 in 2012 and R8.33: US\$1 in 2013. Thereafter, it will drift to R8.95: US\$1 in 2016, although exogenous shocks or unwelcome policy shifts could lead to a faster decline.

3.1.5.5 External sector

According to Bloomberg, South Africa's current-account deficit is expected to widen from a provisional 3.4% of GDP in 2011 to 5.2% of GDP in 2012. Export growth will be comparatively muted in 2012, owing to fragility in key OECD markets and weaker commodity prices, thereby producing a merchandise trade deficit. However, merchandise exports will grow slightly more quickly than imports in 2013-16 (on an average annual basis), reflecting a pick-up in global demand. The far larger invisibles deficit (comprising services, income and current transfers) will remain large throughout the forecast period, underpinned by income outflows to foreign investors and transfers to fellow members of the Southern African Customs Union. A gradual decline in the invisibles deficit in 2013-16 (helped by tourism and income earned by outward investors), combined with stronger exports, will narrow the current-account deficit from 4.3% of

GDP in 2013 to 3.2% in 2015. The gap will widen slightly in 2016, to 3.7% of GDP, as faster GDP growth and massive latent demand increases imports to US\$111.3bn.

3.2 Research design and methodology

The research design that we adopted for the study is descriptive statistics. We use the correlation analysis to investigate whether there is any existing relationship between foreign aid and economic growth in South Africa. The strength of the relationship between those two variables is determined by the correlation coefficient. This is because the data for analysis is not too large and therefore does not require statistical econometric methods. Yearly GDP values over the period 1994-2010 are used as a sufficient measure of economic growth. We choose 1994 because this year is an historic year for South Africa, it's South Africa transition year to democracy, and South Africa has generally witnessed economic growth since its transition to democracy in 1994, the domestic outlook remains positive. 2010 is the year where South Africa hosted its first big even; 2010 world cup, in 2010, South reveals itself to the world. We are not interested on assessing whether there is any existing relationship between foreign aid on economic growth in South Africa after the 2010. From 1994–2010, South Africa experienced an average, annualized growth rate of approximately 3.4 percent. This growth also coincided with the increase of official development assistance to South Africa. To answer the question whether there is any existing significant relationship between Foreign Aid and Economic Growth; descriptive and inferential analyses are used to analyze the data, all in an effort to investigate the relationship between foreign aid and economic growth in South Africa. We use the Statistical Package for the Social Sciences (SPSS) to estimate the result of the correlation between the variables and the T-test to test the hypothesis of the study.

3.3 Research instrumentation

All analysis in the study is made by the use of secondary data obtained from a secondary source, namely, the World Bank's world development indicators database for 2011.

3.4 Variables for data collection and procedure for data analysis

The variables for data collection are Official Development Assistance (ODA) net flows to South Africa, yearly, from 1994 to 2010, GDP per capita values US purchasing power parity (\$PPP) over the same period.

The GDP (Gross Domestic Product) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory. GDP formula is shown below;

$$\mathbf{GDP = C + G + I + NX}$$

Where:

"C" is equal to all private consumption, or consumer spending, in a nation's economy

"G" is the sum of government spending

"I" is the sum of all the country's businesses spending on capital

"NX" is the nation's total net exports, calculated as total exports minus total imports. (NX = Exports - Imports)

GDP is commonly used as an indicator of the economic health of a country, as well as to gauge a country's standard of living. Critics of using GDP, as an economic measure say the statistic does not take into account the underground economy - transactions that, for whatever reason, are not reported to the government. Others say that GDP is not intended to gauge material well-being, but serves as a measure of a nation's productivity, which is unrelated.

A correlation is done to assess whether there is any existing relationship between foreign aid and economic growth. If ODA and the GDP covary, there exists a relationship between foreign aid and economic growth.

A correlation coefficient is known as a measure of the strength and direction of the linear relationship between foreign aid and economic growth.

3.4.1 Characteristics of correlation coefficient

The correlation coefficient ranges from -1 to $+1$. The closer to the absolute value is to 1 , the stronger the relationship. When the correlation coefficient is zero, it indicates that there is no linear relationship between variables. The coefficient can either be positive or negative.

3.4.2 Scatter Plot and Correlation

If r is the correlation coefficient; for any two variables, X and Y , the correlation coefficient between them is given by the formula:

$$r = \frac{\sum(X - \bar{X}) \cdot (Y - \bar{Y})}{\sqrt{\sum(X - \bar{X})^2 \cdot \sum(Y - \bar{Y})^2}}$$

The characteristic of the relationship is shown on the table below:

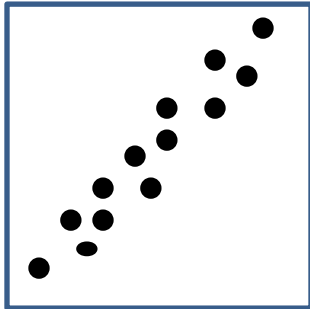
Table 6: Characteristic of the relationship

Relationship	Correction Index (r)
Strong Correlation	$0.85 < r \leq 1.00$ or $-0.85 > r \geq -1.00$
Moderate Correlation	$0.75 < r \leq 0.85$ or $-0.75 > r \geq -0.85$
Weak Correlation	$0.6 < r \leq 0.75$ or $-0.6 > r \geq -0.75$
No Correlation	$0 < r \leq 0.6$ or $0 > r \geq -0.6$

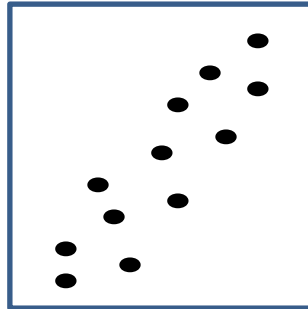
Source: Table done by myself.

Scatter plot is presented below:

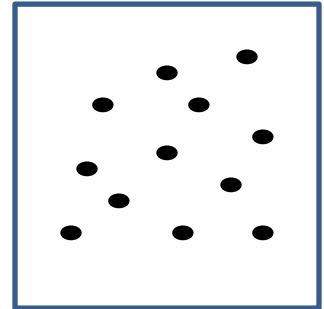
Figure 1: Scatter plot



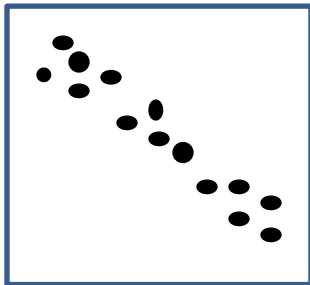
Strong positive correlation
 $R= +1$



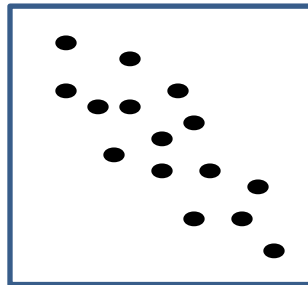
Moderate positive correlation
 $R= +0.75$



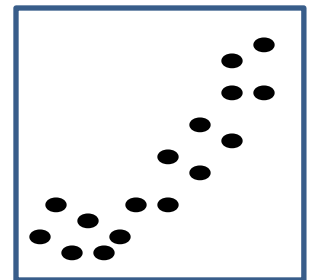
No correlation



Strong negative correlation
 $R= -1$



Moderate negative correlation
 $R= -0.6$



Curvilinear relationship

Source: Figure done by myself

To test the hypothesis, a two-tail test is conducted at 0.02 test level, (+_2.6) with N-2 degrees of freedom (10-2=8).

CHAPTER FOUR

DATA PRESENTATION AND ANALYSIS

4.0 Introduction

This chapter presents the data that were collected from all secondary sources namely from the 2011 world development indicators.

Descriptive and inferential analyses are used to analyze the data, all in an effort to investigate whether there is any existing relationship between foreign aid and economic growth in South Africa.

4.1 Descriptive analyses

The variables used are the official development assistance (ODA) and the gross domestic product (GDP) of South Africa from 1994 to 2010.

4.1.1 Official Development Assistance (ODA) to South Africa from 1994 to 2010

The ODA refers to aid flows from official donors to countries and territories in part II of the Development Assistance Committee (DAC) list of recipients: more advanced countries of Central and Eastern Europe, the countries of the former Soviet Union, and certain advanced developing countries and territories. Total official flows are the sum of Official Development Assistance (ODA) or official aid and Other Official Flows (OOF) and represent the total disbursements by the official sector at large to the recipient country. OOF are transactions by the official sector whose main objective is other than development-motivated, or, if development-motivated, whose grant element is below the 25 per cent threshold which would make them eligible to be recorded as ODA.

Net official development assistance in the following table consists of disbursements of loans made on concessional terms (net of repayments of principal) and grants by official agencies of the members of the Development Assistance Committee (DAC), by multilateral institutions, and

by non-DAC countries to promote economic development and welfare in countries and territories in the DAC list of ODA recipients. It includes loans with a grant element of at least 25 percent (calculated at a rate of discount of 10 percent). Data are in current U.S. dollars.

The aggregation method used is the sum, and the periodicity is annual.

The following data presents the net official development assistance (ODA) received (current US\$) to South Africa from all donors from 1994 to 2010.

Table 7: Net ODA received (current US\$) to South Africa from 1994 to 2010.

YEAR	AMOUNT IN CURRENT PRICES (MILLIONS OF US DOLLARS)
1994	293
1995	386
1996	362
1997	496
1998	513
1999	540
2000	486
2001	425
2002	511
2003	656
2004	629
2005	690
2006	715
2007	807
2008	1 125
2009	1 075
2010	1 032

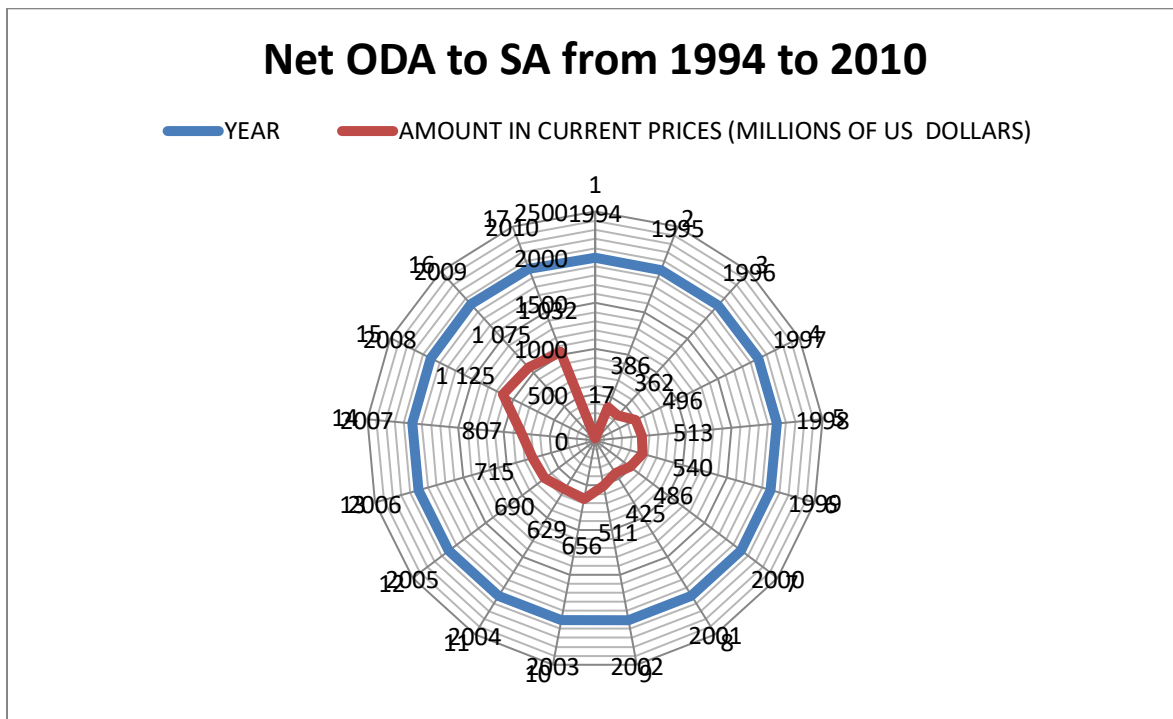
Source: 2011 World development indicators

The table 6 indicates that the amount of ODA received to South Africa was \$293 million in 1994, it increased from \$293 in 1994 to \$540 million in 1999, which was the post apartheid period, just after the first democratic election in South Africa. This amount reduced slightly from \$486 in 2000 to \$425 million in 2001 when South Africa first democratic elected president Mr. Nelson

Mandela decided to step down. The amount of ODA to South Africa (SA) started picking up from \$511 in 2008 to \$1,125 million in 2008, showing South Africa good economics' era.

According to the World Health Organization, this period is also marked by the increase of number of human death in South Africa due to HIV-AIDS, tuberculosis, diarrhea, and childhood diseases. During this period, many developed and developing countries and international organization are willing to help SA to develop his economy and to fight those diseases. Some of these international organizations will double the amount of ODA to SA. The *big push* campaign initiated by the former British Prime Minister Mr. Tony Blair will also contribute to increase the amount of ODA to SA. From 2008 to 2010 ODA to SA reduced from \$1,125 to \$1,032 million due to the global financial crisis. The figure below shows the graphic of the radar of the net ODA to SA from 1994 to 2010.

Figure 2: net ODA to SA from 1994 to 2010



Source: Figure done by myself.

4.1.2 South Africa Gross Domestic Product (GDP) from 1994 to 2010

The following table shows South Africa GDP from 1994 to 2010.

Table 8: South Africa GDP from 1994 to 2010

YEAR	GDP AMOUNT IN CURRENT PRICE (BILLIONS OF US DOLLARS)
1994	136
1995	151
1996	144
1997	149
1998	134
1999	133
2000	133
2001	118
2002	111
2003	168
2004	219
2005	247
2006	261
2007	286
2008	275
2009	283
2010	364

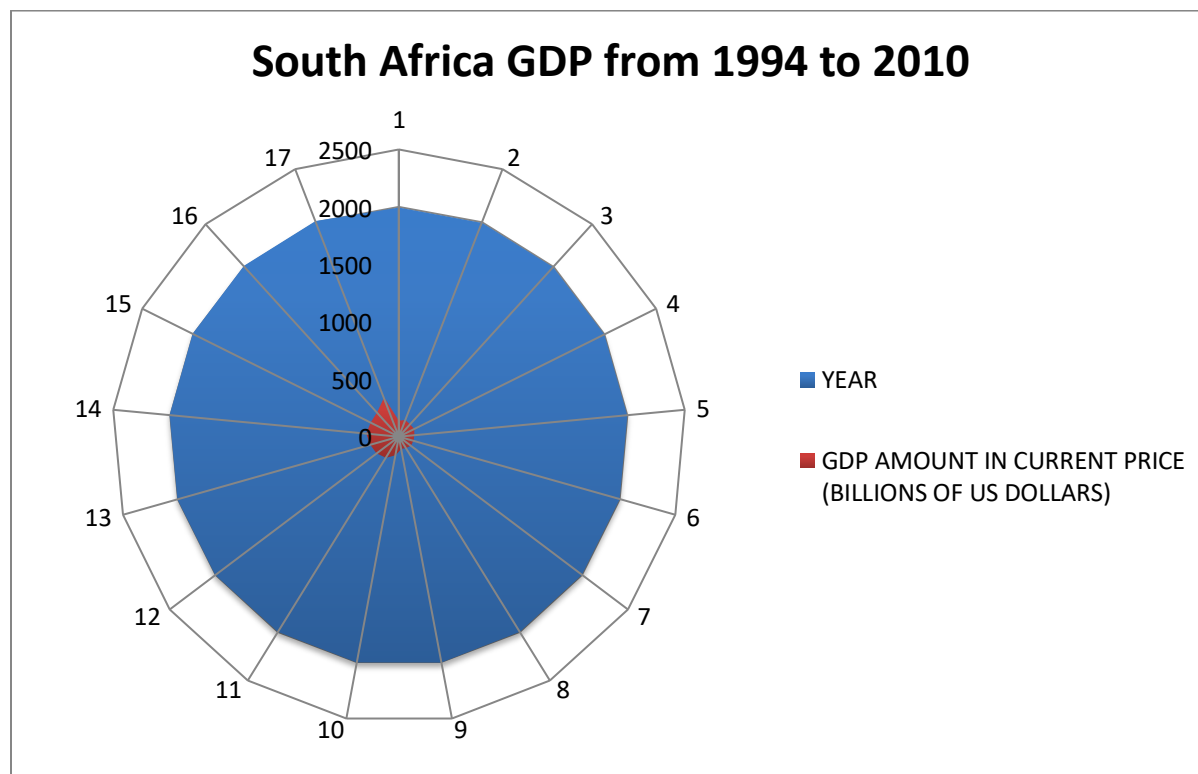
Source: 2011 World development indicators

The above data shows that the GDP figures of South Africa from 1994 to 2010 were fluctuating. The GDP value stood at \$136 billion in 1994 and experienced an increase of about 11.1% in 1995, an average drop of 4.86% from 1995 to 1999, and was stable from 1999 to 2000. It witnessed another drop of about 16, 54% in 2002. From 2003 to 2007, the GDP experienced a

gradual increase at an average of \$29.5 billion annually, indicating South Africa growing economy. During this period Mr. Thabo Mbeki former South Africa president just took over from Nelson Mandela and his economic policy was fiscally conservative, but pragmatic, focusing on targeting inflation and liberalizing trade as means to increase job growth and household income. According to the 2010 CIA World fact book report, Mbeki was a major force behind the continued neoliberal structure of the South African economy. He drew criticism from the left for his perceived abandonment of state-interventionist social democratic economic policies, such as nationalization, land reform, and democratic capital controls, prescribed by the Freedom Charter, the ANC's seminal document. In 2008 SA's GDP experienced a drop of about 3.84% due to the global financial crisis and a slight increase of 2.9 % in 2009. In 2010, South Africa's GDP witnessed an increase of about \$81 billion due to the 2010 FIFA world cup.

The following figure shows the graph radar of the South Africa GDP from 1994 to 2010.

Figure 3: South Africa GDP from 1994 to 2010



Source: Figure done by myself.

The table below shows the combined figures of South Africa ODA and GDP at current prices, both figures are in millions of US dollars.

Table 9: South Africa ODA and GDP from 1994 to 2010 in millions of US dollars.

YEAR	ODA	GDP
1994	293	135 778
1995	386	151 113
1996	362	143 732
1997	496	148 814
1998	513	134 296
1999	540	133 184
2000	486	132 878
2001	425	118 479
2002	511	111 101
2003	656	168 219
2004	629	219 093
2005	690	247 052
2006	715	261 007
2007	807	286 169
2008	1 125	275 279
2009	1 075	282 754
2010	1 032	363 910

Source: Computation done by myself.

4.2 Inference analysis

4.2.1 Introduction

This section will test the hypothesis

4.2.2 Hypothesis

The hypotheses that guide this study are:

- Ho: There is no relationship between foreign aid and economic growth in South Africa.
- H1: There is a relationship between foreign aid and economic growth in South Africa

Values for ODA and GDP were entered into a Statistical Package for the Social Science (SPSS) spreadsheet and the Pearson Moment Correlation was computed. The result is shown in tables below:

Table 10: Descriptive statistics ODA and GDP

<i>Alpha value (for confidence interval)</i>		0,02
(ODA)		
<i>Count</i>		17
<i>Mean</i>		631,91588
<i>Variance</i>		63 015,51563
<i>Standard Deviation</i>		251,02891
<i>Mean Standard Error</i>		60,88345
(GDP)		
<i>Count</i>		17
<i>Mean</i>		194 873,96069
<i>Variance</i>		5 862 914 714,46894
<i>Standard Deviation</i>		76 569,67229
<i>Mean Standard Error</i>		18 570,87333

Source: Computation done by myself.

The table shows that the study is for a period of 17 years with an alpha value of 0,02. The table also shows the mean the variance, the standard deviation and the mean standard error for both variables. The table indicates that the mean of ODA to SA is \$631,91588 million with a standard

deviation of \$251,02891 million and the mean of the GDP is \$194 873,96069 million with a standard deviation of \$76 569,67229 million. The mean standard error is \$60,88345 for ODA and \$18 570,87333 million for GDP.

Table 11: Correlation coefficient

Correlation Coefficients			
<i>Sample size</i>	17	<i>Critical value (2%)</i>	2,60248
		<i>ODA</i>	<i>GDP</i>
ODA	Pearson Correlation Coefficient	1,	
GDP	Pearson Correlation Coefficient	0,87348	1,
GDP vs. ODA			
		0,87348	

Source: Computation done by myself.

The table shows a correlation coefficient of **0.87348**, which is an indication of a positive strong relationship between foreign aid and economic growth in South Africa. To test the hypothesis, a two-tail test was conducted at 0.02 test level, (+_2.6) with N-2 degrees of freedom (10-2=8). The results are presented on the table below.

Table 12: correlation coefficient and critical value

<i>Sample size</i>	17	<i>Critical value (2%)</i>	2,60248
		<i>ODA</i>	<i>GDP</i>
ODA	Pearson Correlation Coefficient <i>R Standard Error</i> <i>T</i> <i>P-value</i>	1,	
GDP	Pearson Correlation Coefficient <i>R Standard Error</i> <i>T</i> <i>P-value</i>	0,87348 0,0158 6,9484 0,	1,

Source: Computation done by myself.

The table shows a critical value of 2.60248 and a standard error of 0.0158 with a t value of 6.9484.

The table below shows the summary of the hypothesis testing.

Table 13: summary of the hypothesis testing.

ODA/GDP						
Hypothesis	Sample size	Critical value (2%)	Pearson correlation Coefficient	R Standard Error	T	Decision (Ho)
	17	2,60248	0,87348	0,0158	6,9484	Rejected

Source: Computation done by myself.

From the above table, the t-value (6.9484) calculated, is greater than the critical value (2.6), therefore we reject the null hypothesis and accept the alternative hypothesis that there is a significant relationship between foreign aids (ODA) and economic growth (GDP). The Pearson correlation coefficient (r) is 0,87348, which greater than 0.85, indicating that there is a strong and positive relationship between foreign aid and economic growth in South Africa.

CHAPTER FIVE

SUMMARY OF FINDING AND RECOMMENDATION

5.0 Introduction

This chapter summarized the work, made recommendations based on the findings.

5.1 Summary of findings

Our research question was; is there any significant relationship between Foreign Aid and Economic Growth in South Africa?

Statistics from table 7 and 8 on ODA and GDP values for South Africa respectively, from 1994 to 2010, and the results of the Pearson Correlation Coefficient computed in table 11 and 12, show that there is a strong and significant relationship between foreign aid and economic growth in South Africa. Table 11 shows that the hypothesis H_0 is rejected. This implies that there is a positive relationship between ODA and GDP. The findings show that foreign aid contributes to economic growth in South Africa.

5.2 Recommendations

The Pearson correlation coefficient between ODA and GDP from 1994 and 2010 is 0,87348. Despite the fact that there is a positive and strong relationship between foreign aid and economic growth in South Africa, a lot still need to be done in order for foreign aid to effectively impact economic growth in South Africa. To achieve this objective, foreign aid need to be effectively managed and the government of South Africa should fight against corruption in order to avoid the fungibility of aid.

The following measures can be taken in order to effectively manage foreign aid and fight against corruption;

- ◇ The government of South Africa should divert a larger portion of aid to investment in agriculture because according to the CIA 2010 world fact book, its agriculture products are very rich and only about 9% of its labor force has agriculture as an occupation.

Agriculture contribute only 2,5% of South Africa's GDP. Agricultural trade liberalization is particularly important and growth in agriculture has a disproportionate effect on poverty reduction.

- ◇ The efforts of various aid donors to South Africa must be well coordinated because concerted action avoids duplication and wastage of scarce resources.
- ◇ South Africa real GDP real growth rate was estimated to 2,9% in 2010, country comparison to the world 105. South Africa should divert another larger portion of aid to investment in education in order to ease employment and foster economic growth, South Africa unemployment rate was estimated to 24,9% in 2010.

Funding and enough resources should also be diverted to civic education to help South Africans be informed about the roles and responsibilities of their elected representatives.

- ◇ Aid donors should provide a framework for the implementation aid funds. Aid can and does have an impact when provided within a framework that acknowledges the drivers for broad based growth. Well-targeted aid increases the ability of South Africa to maximize the benefits of trade liberalization, improve the environment for investment and ensure that the poor have the ability to contribute in achieving growth.
- ◇ South Africa witnessed a GDP growth of about \$81 billion in 2010. Basic social indicators still remain some of the worst in the world. There are many reasons for this but the most important are; corruption, and relatively poor governance, which have allowed revenue windfalls to be squandered and have impeded growth. Corruption has a substantial negative impact on economic growth and development and weakens institutions and government. The costs of corruption fall disproportionately on poor people. In order to solve this problem, the following measures have been recommended:
 - Systematic anti-corruption reform should be implemented and should be driven from within. Efforts to combat corruption are most successful when change is driven internally, and when political leadership is strong. The private sector and citizens have a major role and responsibility in fighting corruption and therefore should well encourage. Industry representatives, including trade unions, have proven to be strong champions and thus should be encouraged.
 - To be effective, anti-corruption strategies must adapt to meet emerging challenges.
 - An Anti-corruption strategies for South Africa must be long term and multifaceted. An effective anti-corruption strategy requires a multi-pronged approach. It needs to draw on successful

strategies that support local reform constituencies, reduce opportunities for corruption, and provide positive and negative incentives.

- Donor priorities and responses must be informed by local needs, identified through South Africa's anti-corruption planning. This will determine the scope, sequence and speed of assistance, as well as where emphasis is warranted. For example, where political will is weak, engagement with civil society will be the key to success.
- The South Africa women should be given a greater chance in administration, economy and politics because women are less prone to corruption than men. The linkages between gender equality and anti-corruption can be promoted, for example, by introducing anti-corruption measures alongside support for anti-discrimination measures
- The civil society groups, churches, the media, and nonprofit organizations that have the capacity to gather information on the incidence of corruption in South Africa should be supported, to promote awareness among constituencies most affected by corrupt activities, improve understanding of public processes, monitor government activities, and report cases of corruption.

CHAPTER SIX

CONCLUSION

6.1 Conclusion

The purpose of this analysis was to determine whether there is any existing relationship between official development assistance and economic growth. The model developed in this paper provides evidence supporting the contention that there is a strong and positive relationship between foreign aid and economic growth. Foreign aid positively impacts economic growth in South Africa. Therefore, it is not in the interest of developed countries and international bodies to discontinue aid programs. Moreover, it would be extremely difficult for a donor country to stop aid since it would be seen by both the domestic and foreign populations as punishing an already poor country.

The issue of whether foreign aid leads to economic growth is still debatable one. What is clear is that the impact may be significant or insignificant depending on the country understudy, type of aid, the adjective of the donor country, the implementation policy of the recipient country, the methodology used, and the period of study.

However, the effects of aid on economic growth are modest, and fostering economic growth through foreign aid would be incredibly inefficient and expensive. For instance, using foreign aid alone to increase GDP by 1% in a country would require an expensive foreign aid package. Spurring economic growth in South Africa to desirable levels would be an enormous expenditure.

Efficient infrastructures and institutions might make foreign aid donations more effective in South Africa. As an upper middle-income country, South Africa has good fiscal policies in place. These policies can include maintaining small budget deficits, controlling inflation, and being open to global trade. South Africa build its record of prudent macroeconomic and fiscal management; use public resources more effectively to alleviate poverty and improve service delivery; expand capital infrastructure projects that boost capacity and productivity over the longer term; lower the costs of doing business; take steps to promote a well-regulated environment for the private sector to expand and thrive; and focus on regional and international

partnerships to expand and diversify trade and investment. Donor governments and multilateral institutions should continue to push economic reforms and trade liberalization on recipient governments. Not only will this improve the effectiveness of foreign aid, but it will also result in less aid being required.

Success in these areas lays the foundation for strong, sustainable growth and job creation.

6.2 Suggestions for further Research

Many studies have tried to assess the effectiveness of aid at different level. While micro-evaluations have found that in most cases aid positively impact economic growth, those at the macro-level are ambiguous.

Future research should further explore the role of sound economic policies and good governance in aid effectiveness. Scholars should also explore other ways of quantifying tropical geography, and governance to provide for additional testing of potential impacts on the effectiveness of foreign aid. Research can be carried out on the effectiveness of foreign aid, or corruption and its impact on growth and development in South Africa

Finally, future study of foreign aid should also investigate its effects on economic development, instead of growth. Doing so will shed light on the question of whether the growth caused by foreign aid translate to economic development or whether it improves the quality of life in developing countries.

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