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Unraveling the Impact of Foreign Aid on Economic Dynamics: Evidence from Palestine

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Abstract
This study delves into the complex dynamics of foreign aid in Palestine, seeking to unravel its impact on key macroeconomic variables. Drawing upon theoretical literature that presents divergent views on the effects of aid, ranging from positive to negative outcomes, our analysis focuses on two primary aspects: the influence of aid on domestic savings and its implications for economic growth. Additionally, we explore whether the phenomenon of Dutch disease, characterized by adverse effects on domestic industries due to foreign aid inflows, is evident in the Palestinian context. To investigate these relationships, we employ two distinct modeling approaches. First, we utilize a single-equation model to assess the direct impact of aid on economic growth, employing ordinary least squares (OLS) regression techniques. Subsequently, we adopt a two-equation simultaneous equations model to examine the joint effects of aid on both domestic savings and economic growth, employing the two-stage least squares (2SLS) technique to address potential endogeneity concerns. Our empirical findings reveal several noteworthy insights. Firstly, we observe that foreign aid tends to crowd out domestic savings, indicating a substitution effect whereby external inflows replace rather than supplement domestic sources of capital accumulation. Furthermore, our analysis indicates a negative impact of aid on economic growth, suggesting that the presence of aid may impede overall economic performance in Palestine. Importantly, our results also provide evidence of the Dutch disease phenomenon, wherein the influx of aid disrupts the balance of the domestic economy and hampers the growth of indigenous industries. In light of these findings, we offer several policy recommendations aimed at mitigating the adverse effects of foreign aid while maximizing its developmental impact. These include measures to bolster domestic savings, such as incentivizing savings behavior and fostering a conducive environment for investment. Additionally, we advocate for a strategic allocation of aid towards productive sectors and infrastructure projects that stimulate long-term economic growth. Furthermore, enhancing the policy environment to attract foreign direct investment (FDI) and promote private sector development emerges as a critical priority. By shedding light on the nuanced relationship between foreign aid, domestic savings, and economic growth in Palestine, this study provides valuable insights for policymakers, development practitioners, and stakeholders seeking to navigate the complexities of aid effectiveness and promote sustainable development in the region.
Keywords: Foreign Aid, Domestic Savings, Economic Growth, Dutch Disease, Palestine, Macroeconomic Dynamics
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1. INTRODUCTION

Research on the effectiveness of aid often presents divergent perspectives on its impact on growth and development. While some studies argue for the positive effects of aid, others highlight potential drawbacks or negative consequences. Foreign aid plays a significant role as a source of support for developing countries, addressing various economic challenges such as limited savings, constrained export earnings, and inadequate tax revenues (Baldé, 2011). By providing additional resources, aid can facilitate investment, either directly or through government spending, thereby contributing to economic development. Proponents of aid effectiveness argue that it can stimulate economic growth by providing essential funding for infrastructure development, healthcare, education, and other key sectors. By filling gaps in domestic resources, aid can support investment in critical areas, leading to improved productivity, human capital development, and overall economic expansion (Fleisher et al., 2010). Additionally, aid can help countries address urgent humanitarian needs, mitigate the impact of crises, and promote stability and resilience in vulnerable regions. However, critics of aid effectiveness raise concerns about potential negative consequences, including dependency, corruption, and distortion of local markets. They argue that excessive reliance on aid may discourage domestic resource mobilization, weaken accountability mechanisms, and perpetuate inefficient or unsustainable development practices (Bräutigam and knack, 2004). Moreover, poorly designed aid programs or conditionalities attached to aid disbursements can undermine national sovereignty, limit policy flexibility, and exacerbate social inequalities.

Besides foreign direct investment (FDI) and private inflows, various forms of aid play a crucial role in addressing economic challenges, including the import-export and saving-investment gaps, which are common in many developing countries, including the Palestinian economy. Aid can take different forms, including official development assistance (ODA), humanitarian aid, grants, concessional loans, technical assistance, and capacity-building support (Erdem Türkelli, 2021). Official development assistance, provided by governments and multilateral organizations, is often a primary source of aid for many developing countries, including Palestine. ODA can be instrumental in financing infrastructure projects, social programs, and institutional reforms aimed at promoting economic growth and development. Additionally,

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humanitarian aid plays a critical role in addressing immediate needs during crises or emergencies, such as natural disasters or conflicts, and can help stabilize affected communities and lay the groundwork for long-term recovery. Grants, which do not require repayment, are particularly valuable for countries with limited fiscal capacity and high debt burdens, such as Palestine. Grants can support various development initiatives, including education, healthcare, agriculture, and small-scale enterprises, contributing to poverty reduction and sustainable livelihoods (Vandenberg and Creation, 2006). Concessional loans, offered at below-market interest rates and with flexible repayment terms, can provide additional financing options for development projects and infrastructure investments. While loans entail repayment obligations, concessional terms make them more affordable and less burdensome for recipient countries, enabling them to invest in priority areas without risking debt distress. Technical assistance and capacity-building support are essential components of aid that help strengthen institutional capacity, improve governance frameworks, and enhance policy formulation and implementation. By providing expertise, training, and knowledge transfer, technical assistance programs empower local institutions and officials to address development challenges effectively and sustainably (Helling et al., 2005). In the case of Palestine, aid in various forms plays a critical role in supporting economic development efforts, addressing humanitarian needs, and promoting stability and resilience in a challenging political and economic context. By leveraging different forms of aid strategically and in alignment with national development priorities, Palestine can mitigate economic vulnerabilities, strengthen its productive capacities, and advance towards sustainable growth and prosperity.

While aid can provide critical support for economic development, it also poses challenges and risks that need to be carefully managed (Holzmann and Jørgensen, 2001). One such challenge is the potential for aid inflows to crowd out domestic savings and investment, leading to a range of economic distortions and vulnerabilities. When aid inflows exceed a country's absorptive capacity or are not effectively channeled into productive investments, they can lead to a phenomenon known as the "Dutch disease." This occurs when large inflows of foreign currency, such as aid or revenues from natural resource exports, cause the domestic currency to appreciate. A stronger currency makes imports cheaper, which can lead to increased consumption of imported goods and reduce demand for domestically produced goods and exports (Krueger, 1985). This, in turn, can weaken the competitiveness of domestic industries, hinder export-led growth, and exacerbate trade imbalances. In the context of Palestine, which faces unique challenges due to the ongoing occupation and political instability, aid inflows must be managed judiciously to avoid exacerbating existing economic vulnerabilities. While aid can provide vital resources to address immediate humanitarian needs and support essential public services, such as healthcare and education, policymakers must ensure that aid is effectively targeted towards productive investments that promote long-term sustainable development. Efforts to enhance aid effectiveness in Palestine should prioritize measures to strengthen domestic institutions, improve governance frameworks, and enhance transparency and accountability in aid delivery and utilization (Springer, 2015). By promoting greater coordination and alignment among donors, as well as engaging with local communities and stakeholders in aid planning and implementation, aid can be more effectively leveraged to support Palestine's development priorities and contribute to poverty reduction, economic resilience, and sustainable growth. The investigation of aid impact on economic growth, domestic savings, and the potential occurrence of Dutch disease represents a significant contribution to developmental studies, particularly in the context of the Palestinian economy. By examining these interrelated factors, the study aims to provide insights into the multifaceted effects of aid on economic development and sustainability. Understanding the dynamics between aid inflows, economic growth, and savings behavior is crucial for policymakers and development practitioners seeking to design effective strategies for poverty reduction and sustainable development (Chakravarti, 2005). By elucidating the potential trade-offs and synergies between these variables, the study can inform more targeted and evidence-based approaches to aid allocation and utilization in Palestine.

The identification of Dutch disease effects, wherein aid inflows may inadvertently lead to currency appreciation and other macroeconomic imbalances, underscores the importance of adopting holistic approaches to aid management and coordination. By taking into account the broader macroeconomic implications of aid, policymakers can mitigate the risks of adverse effects on domestic industries and employment while maximizing the positive impacts on growth and development (Stiglitz et al., 2006). While the study acknowledges limitations related to the availability and granularity of aid data, its findings can still provide valuable insights into the overall trends and patterns of aid utilization in the Palestinian economy. By highlighting areas for further research and data collection, the study contributes to ongoing efforts to strengthen the evidence base for aid effectiveness and developmental impact assessment.

2. LITERATURE REVIEW

The impact of foreign aid on macroeconomic variables, particularly its effect on economic growth, remains a subject of intense debate in economic research. While some empirical studies have suggested positive impacts, attributing aid to supplementing domestic savings, filling foreign exchange gaps, and facilitating access to technology and managerial expertise, others have highlighted the importance of effective fiscal, monetary, and trade policies for aid effectiveness. Early studies such as Chenery and Strout (1966) laid the groundwork for understanding the potential positive impact of aid on economic growth by emphasizing its role in bridging investment and resource gaps. Subsequent research by scholars like Papanek (1972), Dowling and Hiemenz (1982), Gupta and Islam (1983), and more recent studies by Hansen and Tarp (2001), Burnside and Dollar (2000), Gomanee et al. (2005), Dalgaard et al. (2004), and Karras (2006) have provided empirical support for this notion, highlighting the beneficial effects of aid on growth in economies with sound policy frameworks. However, the effectiveness of aid in promoting growth is contingent upon the quality of economic policies implemented by recipient countries. Studies by Burnside and Dollar (2000) underscored the importance of good governance and policy environment, suggesting that aid has positive impacts only when complemented by favorable

fiscal, monetary, and trade policies. Murshed and Khanaum (2014) further emphasized the pre-requisite of sound economic policies for aid effectiveness, indicating that aid alone may not guarantee sustainable growth outcomes. While there is evidence to support the positive impact of foreign aid on economic growth, particularly in countries with conducive policy environments, the nuanced relationship between aid and growth underscores the importance of comprehensive policy frameworks and effective aid management strategies for maximizing developmental outcomes. Further research and empirical analysis are needed to explore the specific channels through which aid influences growth dynamics and to inform more targeted interventions for promoting sustainable development in recipient countries.

McGillivray et al. (2006) argue that the effectiveness of aid hinges on institutional quality and is influenced by various factors including political, external, and climatic conditions. They suggest that aid can contribute to increased investment in both physical and human capital, thereby enhancing the capacity to attract additional capital goods and technology. This, in turn, promotes productivity growth and facilitates endogenous technological advancements, as highlighted by Morrissey (2001). Furthermore, McGillivray et al. (2006) suggest that aid exhibits diminishing returns, implying that each additional dollar of aid has a diminishing positive impact on growth compared to the preceding dollar. Therefore, aid is more likely to have a positive impact on growth when it does not adversely affect investment and savings.

Ultimately, the impact of aid on growth is seen as a key driver of developmental outcomes such as poverty alleviation. However, achieving such goals depends on the equitable allocation of aid across economic sectors, geographical regions, types of government expenditure, and approaches to poverty reduction. This underscores the importance of strategic aid allocation and effective aid management to maximize developmental impacts and ensure sustainable poverty reduction efforts.

Mosley (1980), Mosley et al. (1987), Rajan and Subramanian (2005), and Jensen and Paldam (2003) provide evidence suggesting that aid has no significant impact on economic growth. Additionally, Cordella and Dell'Ariccia (2003) argue that the relationship between aid, policies, and growth is contingent upon whether the aid is delivered in the form of budget support or project financing, suggesting the need to differentiate between these two types of financing. Furthermore, Djankov et al. (2006) contend that the direction of the impact of aid—whether positive or negative—depends on whether government spending is allocated towards public consumption or investment. If aid encourages public or private investment, it can have positive consequences for the investment ratio and lead to increased economic growth. Moreover, the type of aid, particularly Official Development Assistance (ODA), plays a crucial role in determining its impact. ODA disbursed in the form of grants or loans can create different incentives, influencing whether the funds are directed towards investment or consumption. Grants may incentivize investment, while loans could potentially lead to increased consumption, thereby affecting growth outcomes positively or negatively.

Sachs et al. (2004) assert that the impact of aid on economic growth hinges on its influence on investment and public consumption. Additionally, they suggest that this impact may be influenced by the proportion of loans versus grants in which aid is disbursed. In other words, the mix of loans and grants in aid disbursement can shape the direction and magnitude of its effects on investment, public consumption, and ultimately, economic growth. Understanding the dynamics of aid disbursement, particularly the balance between loans and grants, is crucial for comprehending its broader economic effects. Loans may incentivize investment but also lead to debt burdens, while grants can stimulate public consumption but might not necessarily contribute directly to productive investment. Thus, the allocation of aid between loans and grants can significantly influence the effectiveness of aid in fostering economic growth. Moreover, the impact of aid on investment and public consumption may vary depending on the specific conditions and policies of the recipient country. For instance, aid that is channeled towards productive sectors or infrastructure projects may have a more substantial positive effect on investment and growth compared to aid directed towards general budget support or consumption-oriented initiatives. Additionally, the effectiveness of aid in promoting growth may be contingent on the quality of governance, institutional capacity, and policy environment in the recipient country. Aid is more likely to contribute to sustainable growth when accompanied by sound economic policies, effective governance structures, and transparent institutions that facilitate the efficient utilization of resources.

Diverse literature has shed light on the complexities surrounding the relationship between aid and economic growth. Notably, Burnside and Dollar (2000) and Brautigam and Knack (2004) have contributed to this discourse by highlighting the negative repercussions of aid on growth trajectories. Their findings underscore the importance of examining aid effectiveness through a critical lens. In a similar vein, Boone (1996) delves into the nuanced dynamics of aid allocation and its impact on investment and various human development indicators. Contrary to expectations, Boone's research suggests a lack of positive and significant correlations between aid inflows and these critical metrics. Moreover, Boone's analysis reveals a concerning trend wherein aid inflows tend to inflate the size of government, potentially hindering sustainable development efforts. Furthermore, Boone's study emphasizes the differential impact of fungible and non-fungible aid. While the former often faces challenges in achieving desired outcomes due to its interchangeable nature, the latter emerges as a more promising avenue for promoting development initiatives. Boone's insights serve as a reminder of the need for strategic aid allocation and comprehensive evaluation frameworks to maximize developmental impact and foster sustainable growth trajectories. Research conducted by Barro and Lee (2005) sheds light on the effects of IMF aid, revealing a negative impact on economic growth and investment. Their findings suggest that higher rates of loan participation correlate with decreased economic growth and investment levels. However, a notable positive effect is observed in terms of increased openness within the economy. Barro and Lee's study underscores the multifaceted nature of IMF aid and its implications for economic development. While the provision of aid may enhance economic openness, it appears to come at the expense of growth and investment, highlighting the trade-offs inherent in aid allocation strategies. These findings contribute valuable insights to ongoing discussions surrounding the effectiveness of international financial

assistance and underscore the importance of carefully weighing the potential consequences of aid programs on various facets of economic development. Djankov et al. (2006) present findings indicating a direct negative impact of Official Development Assistance (ODA) on economic growth, alongside its failure to stimulate investment. Interestingly, their research highlights a contrasting positive effect on government expenditure. Their analysis delves into the perplexing dynamics underlying aid allocation, particularly its divergent impact on economic variables (Djankov et al., 2006). posit a hypothesis suggesting that the accessibility of aid may inadvertently fuel rent-seeking activities among incumbent parties. Consequently, these activities divert resources away from productive endeavors, thereby impeding investment and fostering non-productive resource utilization.

Furthermore, the study suggests that aid disbursement mechanisms may be susceptible to favoritism, wherein certain groups benefit at the expense of others due to inefficient allocation criteria driven by rent-seeking behavior. This phenomenon not only elucidates the observed increase in government expenditure but also underscores the nuanced interplay between aid allocation strategies and their repercussions on economic growth. In essence, Djankov et al.'s findings underscore the critical role of aid spending behavior and sectoral allocation in shaping its overall impact on economic growth. They advocate for a more discerning approach to aid allocation, one that prioritizes productive investments while mitigating the adverse effects of rent-seeking behavior on development outcomes. Neanidis and Varvarigos (2005) discovered that the allocation of aid to different sectors yields contrasting effects on economic growth. Specifically, directing aid towards productive sectors results in a positive impact on growth, whereas allocating it to non-productive sectors has a negative effect. Their research sheds light on the nuanced relationship between aid allocation and its consequences for economic development. By distinguishing between productive and non-productive sectors, Neanidis and Varvarigos (2005) emphasize the importance of strategic aid distribution in maximizing its potential benefits for growth. Their findings underscore the significance of channeling aid towards sectors that enhance productivity and generate sustainable economic gains. Moreover, they highlight the detrimental effects of misallocating aid to non-productive sectors, which can hinder overall growth prospects.

Neanidis and Varvarigos (2005) study provides valuable insights into the role of aid allocation in shaping economic growth trajectories, advocating for a targeted approach that prioritizes investments in productive sectors to foster sustainable development. Bulíř and Hamann (2008) uncovered the detrimental effects of high volatility in aid on macroeconomic management, particularly in severely impoverished and aid-dependent nations. Their research highlighted the pro-cyclical nature of aid, which fails to serve either as a stabilizing force or as an effective insurance mechanism. Their findings underscore the pressing need for donors to adopt swift and efficient responses to significant adverse shocks. Moreover, they advocate for greater flexibility in the conditionality attached to aid disbursements. Bulíř and Hamann's recommendations emphasize the importance of adaptive and responsive aid policies in mitigating the destabilizing effects of aid volatility on macroeconomic management. By advocating for more agile donor responses and flexible conditionality criteria, their insights aim to foster greater resilience and sustainability in aid-dependent economies. Neanidis and Varvarigos (2005) uncovered a noteworthy aspect regarding aid volatility's impact on different sectors. Contrary to their previous findings, they observed that while aid volatility to productive sectors undermines its positive effects, it surprisingly enhances growth in non-productive sectors. This revelation adds a layer of complexity to our understanding of aid allocation dynamics. The varying effects of aid volatility across sectors highlight the need for nuanced strategies in aid distribution and management. Neanidis and Varvarigos (2005) updated findings underscore the importance of carefully considering the sector-specific implications of aid volatility. Their insights prompt further exploration into the underlying mechanisms driving these contrasting effects, offering valuable guidance for policymakers and practitioners striving to optimize aid effectiveness in diverse economic contexts. The impacts of aid or foreign transfers inflows are rooted in the fundamental debate between Keynes and Ohlin. This debate, initially explored in the context of natural resources, gained significant attention through seminal works such as those by Van Wijnbergen (1985, 1986) and Rajan and Subramanian (2011).

These early analyses laid the groundwork for understanding the complexities surrounding the effects of aid and foreign transfers on economic dynamics. Building upon the Keynes-Ohlin debate, subsequent research by Van Wijnbergen, Rajan, Subramanian, and others has delved into the intricate mechanisms through which aid inflows influence economic outcomes. Their contributions have enriched our understanding of the multifaceted nature of aid impacts, providing valuable insights into the interplay between foreign assistance, resource allocation, and economic development. By contextualizing aid within the broader framework of economic theory, these studies have contributed significantly to ongoing discussions surrounding aid effectiveness and optimal policy responses. The impact of foreign aid inflows on the real exchange rate and subsequently on the exporting sector is a subject of considerable scholarly debate and concern. Bevan (2005) and Adam (2005) have both explored the repercussions of this phenomenon, emphasizing its significance in the context of developing countries where the exporting sector, often centered around agriculture, plays a pivotal role in economic development. The appreciation of the real exchange rate can be particularly detrimental to the exporting sector, exacerbating existing challenges and impeding the sector's ability to contribute meaningfully to economic growth and poverty alleviation. Poor families, who often rely heavily on employment and income derived from agriculture, are disproportionately affected by the adverse effects of exchange rate appreciation (Benjamin et al., 1989; Stevens, 2003). Efforts to address these challenges must prioritize the resilience and sustainability of the exporting sector, recognizing its critical importance for overall economic development. Rajan and Subramanian (2005) and Adam and Bevan (2005) have contributed valuable insights into potential strategies for mitigating the negative impact of exchange rate appreciation and ensuring that its effects are temporary rather than prolonged. Furthermore, Ahmad et al. (2014) have delved into the specific impact of sector-specific foreign aid, focusing on the health and education sectors in Pakistan. Their findings

underscore the complex interplay between foreign aid, demographic trends, and socioeconomic outcomes, highlighting the potential for targeted interventions to drive positive change. Expanding aid aimed at non-tradable goods sectors, such as construction, and government-supported services like healthcare and education, can have significant economic implications, as noted by Rajan and Subramanian (2011). This strategy often leads to an appreciation of the exchange rate, primarily driven by increased demand for non-tradable goods and services. The upsurge in aid-driven investment in non-tradable sectors tends to elevate wages within these industries. However, with a fixed supply of skilled labor, this results in a reallocation of skilled workers from tradable to non-tradable sectors, where profitability is perceived to be higher. Consequently, overall wages in the economy experience an increase.

While wages soar in non-tradable sectors, the prices of these goods and services also tend to rise due to heightened demand fueled by aid injections. Conversely, in the traded sectors, prices remain relatively fixed due to the assumption of a small open economy. This creates a scenario where higher wages reduce profitability and competitiveness in the traded sector, leading to a decline in exports—a phenomenon termed the 'resource movement effect' by Corden and Neary (1982). The implications of this dynamic are multifaceted, with potential impacts on economic growth, employment patterns, and trade balances. As aid inflows continue to shape economic landscapes, policymakers must carefully consider the trade-offs and unintended consequences associated with targeting specific sectors for aid-driven growth. The influx of higher wages into non-tradable sectors has a notable impact on consumption patterns within the economy. As wages rise and prices increase in the non-tradable goods sector, relative prices of these goods become higher compared to tradable goods. Consequently, consumers tend to shift their consumption towards relatively cheaper tradable goods. This shift in consumption behavior, driven by the relative affordability of tradable goods, exacerbates the challenges faced by the traded sector. The increased spending on tradable goods further depresses the competitiveness of the traded sector, as highlighted by Corden and Neary (1982) in their analysis of what they termed the 'spending effect.' This effect, as elucidated by Rajan and Subramanian (2011), compounds the difficulties faced by the traded sector in maintaining its competitiveness in the face of rising wages and prices in the non-tradable sector.

The combined impact of the resource movement effect and the spending effect underscores the complex dynamics at play in economies undergoing significant shifts in aid-driven investment and consumption patterns. Policymakers must navigate these complexities carefully to ensure that aid interventions effectively balance sectoral growth while promoting overall economic stability and competitiveness. The reallocation of skilled resources from the tradable to the non-tradable sector can have profound implications for production dynamics and trade balances within the economy. As skilled labor migrates to non-tradable sectors due to higher wages and perceived profitability, the production capacity of the tradable sector diminishes, resulting in reduced competitiveness and profitability, as you rightly pointed out. This reduction in production and supply of tradable goods has a twofold effect: firstly, it increases the demand for tradable goods domestically due to their relative affordability compared to non-tradable goods. This heightened demand, fueled by aid-driven consumption and increased purchasing power, further exacerbates the strain on the tradable sector. Secondly, the decrease in production capacity limits the supply of tradable goods available for export, leading to a decline in exports. Consequently, the economy becomes increasingly reliant on imports to satisfy domestic demand, financed by aid inflows. This creates a situation where aid-financed consumption outpaces the economy's ability to generate export revenue, leading to a reliance on external financing without the necessity to export goods to balance trade. This phenomenon can inhibit economic growth by perpetuating a cycle of aid-dependent consumption without corresponding increases in productive capacity or export earnings. This complex interplay of factors underscores the importance of carefully managing aid inflows to ensure that they contribute to sustainable economic development rather than inadvertently hindering growth. Policymakers must consider the trade-offs involved in promoting consumption-driven growth and strive to strike a balance between supporting non-tradable sectors and maintaining the competitiveness of the tradable sector to foster balanced and resilient economic expansion.

Van Wijnbergen (1984) insights from underscore the critical role of traded sectors in driving technological progress and fostering economic development. Traded sectors, by virtue of their engagement with international markets, face pressures to meet stringent international standards and to enhance competitiveness. This necessity for adherence to global standards and competition compels firms within these sectors to innovate and adopt advanced technologies at a faster pace than their counterparts in non-traded goods sectors. The rapid technological progress observed in traded sectors can have significant spillover effects on the broader economy. As firms within these sectors innovate and upgrade their production processes, they generate knowledge and expertise that can diffuse to domestic producers across various industries. This spillover of technological advancements can lead to productivity gains, efficiency improvements, and enhanced competitiveness among domestic firms, ultimately driving broader economic growth and development. Van Wijnbergen (1986) emphasis on the importance of traded sectors highlights the pivotal role they play in catalyzing technological innovation and facilitating economic transformation. By recognizing the unique dynamics at play within these sectors and prioritizing policies that promote their competitiveness and integration into global markets, policymakers can foster an environment conducive to sustained economic progress and prosperity. The debate surrounding the aid-saving nexus has been a focal point in economic literature, prompting discussions on the potential effects of international aid on domestic savings. Griffin (1970) seminal work in proposed a distinctive perspective, suggesting that aid inflows could indeed diminish domestic savings, primarily through their impact on government expenditure patterns Griffin (1970) proposition hinges on the notion that increased aid inflows often lead to changes in government expenditure allocations. As governments receive aid, they may redirect funds towards immediate consumption or non-investment expenditures, rather than allocating them towards long-term savings or investment. This shift in expenditure patterns can crowd out domestic savings by reducing the resources available for private investment and savings accumulation. The implications of this

dynamic are significant, as they highlight the intricate interplay between aid inflows, government spending decisions, and domestic savings levels. By influencing government expenditure patterns, aid can shape the broader economic landscape, impacting savings rates, investment opportunities, and ultimately, economic growth trajectories. Griffin (1970) pioneering work laid the groundwork for subsequent research and debate on the aid-saving nexus, prompting scholars to explore the nuanced mechanisms through which aid inflows affect savings behavior and economic outcomes. As the discourse continues to evolve, understanding the complex interactions between aid, government policies, and savings behavior remains crucial for informing effective development strategies and policies.

Heller (1975) work in provides further insight into the relationship between aid, government expenditure, and fiscal policy. Contrary to Griffin (1970) proposition, Heller (1975) analysis suggests that loans, a common form of international aid, do not necessarily lead to a significant overall increase in total government expenditure. Heller (1975) findings indicate that while loans may indeed contribute to government expenditure, this increase is often offset by other fiscal adjustments. Specifically, loans can reduce the need for borrowing and taxation, as governments utilize these funds to finance various projects and programs. However, rather than channeling the entirety of loan proceeds towards productive investment, governments may prioritize current consumption expenditure over long-term investment. This shift in expenditure patterns, characterized by a reduction in government investment and an increase in consumption, reflects the complex trade-offs inherent in aid utilization. While loans can provide governments with much-needed resources for development initiatives, their impact on overall fiscal dynamics may vary depending on how these funds are allocated and utilized. Heller (1975) conclusions highlight the importance of considering the broader fiscal implications of aid inflows, beyond just their immediate contribution to government expenditure. By understanding the intricate interactions between aid, fiscal policy, and government spending decisions, policymakers can better assess the effectiveness and sustainability of aid interventions in driving long-term development outcomes.

Njeru (2003) research in sheds further light on the dynamics between government expenditure, official development assistance (ODA), and taxation policies. His findings reveal a positive and statistically significant relationship between the share of government expenditure in gross domestic product (GDP) and the share of net disbursement of ODA. This suggests that as ODA inflows increase, governments tend to allocate a larger proportion of their GDP towards expenditure. However, Njeru (2003) study also highlights a nuanced aspect of aid utilization: the limited evidence of aid leading to tax relief. Despite the increase in government expenditure fueled by ODA, there is little indication that governments use these funds to reduce taxation burdens on their citizens. This finding underscores the complexity of aid utilization and the diverse ways in which governments may allocate and manage aid inflows. The positive relationship between government expenditure and ODA suggests that aid plays a significant role in financing public expenditure, particularly in sectors such as infrastructure, education, and healthcare. However, the lack of evidence regarding tax relief raises questions about the extent to which aid inflows contribute to broader fiscal sustainability and economic development.

Njeru (2003) research contributes valuable insights into the multifaceted relationship between aid, government expenditure, and taxation policies. By understanding the dynamics at play, policymakers can make more informed decisions regarding aid allocation and utilization, striving to maximize the positive impact of aid on sustainable development outcomes. Sabra (2015) study in presents compelling insights into the relationship between government size and economic growth in selected countries in the Middle East and North Africa (MENA) region, including Palestine. His findings indicate a negative association between government size and economic growth, highlighting the potential adverse effects of larger governments on overall economic performance. One key aspect highlighted by Sabra (2015) research is the composition of government expenditure. He suggests that governments in the MENA region, including Palestine, tend to prioritize current and consumption expenditure over investment expenditure. This emphasis on short-term consumption-oriented spending, rather than long-term investment in infrastructure, human capital, and productive sectors, may hinder economic growth prospects. The focus on current expenditure, which includes items such as salaries, subsidies, and administrative costs, can lead to inefficient allocation of resources and limited returns on investment. In contrast, investment expenditure, which includes spending on infrastructure projects, education, and healthcare, has the potential to stimulate productivity, enhance competitiveness, and spur long-term economic growth. Sabra (2015) findings underscore the importance of prudent fiscal management and strategic allocation of government expenditure to foster sustainable economic development. By prioritizing investment in critical sectors and promoting policies that support private sector-led growth, governments in the MENA region, including Palestine, can enhance their economic resilience and improve prospects for long-term prosperity. Moreover, the influx of aid can have broader implications for economic growth. Mosley (1980) suggests that aid dependency, coupled with an expansion of public spending at the expense of domestic savings, can lead to a low-growth economy. This dynamic highlights the importance of balancing short-term aid inflows with long-term considerations for sustainable economic growth and development. Additionally, the increase in prices of non-tradable sectors relative to tradable sectors can trigger the Dutch disease effect. This phenomenon occurs when resources flow into non-tradable sectors, drawing away efficient resources from the tradable sector. As a result, the competitiveness and efficiency of the export sector are compromised, particularly over the long run.

These intertwined effects underscore the complex nature of aid inflows and the need for nuanced policy responses. While aid can address immediate needs and facilitate development in certain sectors, policymakers must carefully consider its long-term implications. Striking a balance between short-term objectives and long-term sustainability is essential to ensure that aid contributes to lasting economic growth and resilience in developing countries. Aid flows not only impact recipient nations but also influence donor countries through tied aid and conditionality, facilitating the flow of goods and services to the recipients. Tied aid, where aid is provided with the condition that it be used to purchase goods or services

from the donor country, serves to promote exports from the donor nation. Conditionality attached to aid agreements may also include requirements for trade liberalization, reducing barriers to trade between developed and developing countries. Moreover, aid allocation often reflects the commercial interests of donor countries, aimed at promoting their exports into recipient countries. Donors may prioritize aid to countries with which they have significant trade ties, seeking to support their exports and expand their market presence. This approach aligns with the strategic goals of donor countries to enhance their economic interests while providing development assistance. Empirical evidence supports the notion that aid can effectively promote exports from recipient countries. Wagner (2003) found that for every unit of aid provided by the OECD, goods exports increased by 133%, highlighting the positive impact of aid on export growth. Similarly, Sabra (2013) conducted research in the MENA region, revealing that for every $10 of aid from the Development Assistance Committee (DAC), exports increased from 9.7 to 17 units. These findings underscore the role of aid as a tool for promoting economic development and trade integration, benefiting both donor and recipient countries. By leveraging aid to support exports and reduce trade barriers, donor countries can contribute to the economic advancement of developing nations while advancing their own commercial interests.

On the one hand, increased government expenditure fueled by aid can stimulate GDP growth in the short term. However, this boost in spending may be accompanied by rent-seeking behavior, leading to the Dutch disease effect. This phenomenon reduces the productive base of the economy by diverting resources from productive to non-productive sectors, ultimately hindering long-term investment and growth prospects. Moreover, aid-driven growth models may prioritize consumption over investment, as observed in Palestine from 2007 to 2012, according to the World Bank (2015). While this may temporarily bolster GDP, it often lacks sustainability and can lead to a decline in domestic savings. This consumption-driven growth pattern contrasts with the traditional role of aid in supplementing the investment-saving gap and promoting capital accumulation. These dynamics highlight the dual nature of aid's impact on developing economies. While aid can provide crucial resources for short-term development objectives, policymakers must carefully consider its long-term implications. Balancing investment in productive sectors with prudent fiscal management is essential to ensure sustainable economic growth and resilience in the face of external shocks.

3. ECONOMIC MODELLING

Model one use time series data for the Palestinian economy from 1995 to 2021 using OLS technique. The model shown in equation one uses GDP per capita as dependent variable and a group of independent variables, which are net official development assistance (ODA) as a percent of GDP, and both gross domestic saving (SAV) and foreign direct investment stock (FDI stock) as a proxy for physical capital, from one side and population growth (POP) as a proxy of human capital and finally openness (OPEN) in term of exports plus imports divided on GDP.

$$\ln \mathrm{GDPC} = \beta_0 + \beta_1 \ln \mathrm{AID} + \beta_2 \ln \mathrm{SAV} + \beta_3 \ln \mathrm{OPEN} + \beta_4 \ln \mathrm{POP} + \beta_5 \ln \mathrm{FDI} + \epsilon \quad 1$$

$$\ln \mathrm{GDPC} = \beta_0 + \beta_1 \ln \mathrm{ODA} + \beta_2 \ln \mathrm{SAV} + \beta_3 \ln \mathrm{OPEN} + \beta_4 \ln \mathrm{FD} + \epsilon \quad 2$$

$$\ln \mathrm{SAV} = \alpha_0 + \alpha_1 \ln \mathrm{ODA} + \alpha_2 \ln \mathrm{GDPC} + \alpha_3 \ln \mathrm{OPEN} + \alpha_4 \ln \mathrm{GFCF} + \upsilon \quad 3$$

4. RESULTS AND DISCUSSION

Table 1 displays the outcomes of an Ordinary Least Squares (OLS) regression analysis, where various independent variables are regressed against the dependent variable GDPC (Gross Domestic Product Growth). The coefficients represent the impact of each independent variable on GDPC, while the t-statistics in parentheses indicate the statistical significance of each coefficient. The results indicate that AID (foreign aid), POP. Growth (population growth), OPEN (openness of the economy), SAV (savings), and FDI (foreign direct investment) all have significant impacts on GDPC growth. Specifically, the coefficients for AID, POP. Growth, OPEN, SAV, and FDI are statistically significant at the 1% level (*) or 5% level (), indicating their importance in explaining variations in GDPC growth. For instance, a positive coefficient for OPEN suggests that greater economic openness tends to correlate with higher GDPC growth. Conversely, negative coefficients for variables like SAV indicate an inverse relationship, suggesting that higher levels of savings are associated with lower GDPC growth. The F-statistic of 76.97*** suggests that the regression model as a whole is statistically significant, indicating that the independent variables collectively have a strong explanatory power for GDPC growth.

Table 1: Outcomes of Ordinary Least Squares

	Constant	AID	POP. Growth	OPEN	SAV	FDI Stock	F-stat
GDPC	-2.1**	-.21***	.33***	-.84***	-.33***	.22**	76.97***
	(-2.6)	(-.34)	(.51)	(-4.7)	(-5.9)	(2.6)	

Table 2 presents the results of various diagnostic tests conducted to assess the regression model's validity and potential issues. Firstly, the Breusch-Pagan/Cook-Weisberg test for heteroskedasticity examines whether the error terms have constant variance. The test statistic chi2(1) is 0.71 with a corresponding p-value of 0.4. Since the p-value is greater than the significance level of 0.05, we fail to reject the null hypothesis (Ho), suggesting that there is no evidence of heteroskedasticity. Secondly, multicollinearity is assessed using the variance inflation factor (VIF) for each independent variable. The VIF measures the degree of multicollinearity, with values above 10 typically indicating a cause for concern. In this case, all VIF values are below 10, with an average VIF of 3.7, indicating that multicollinearity is not a significant issue. Next, the Breusch-Godfrey LM test examines whether there is serial correlation in the residuals. The test statistic

chi2 is 0.009 with a corresponding p-value of 0.93. Since the p-value is greater than 0.05, we fail to reject the null hypothesis, suggesting no evidence of serial correlation in the residuals. Finally, the Shapiro-Wilk W test assesses the normality of the residuals. The test statistic W is 0.93 with a corresponding p-value of 0.192. Since the p-value is greater than 0.05, we fail to reject the null hypothesis, indicating that the residuals are normally distributed. The diagnostic tests suggest that the regression model meets the necessary assumptions for validity, including constant variance, no multicollinearity, no serial correlation in residuals, and normally distributed residuals.

Table 2: Diagnostics Tests

Test of heteroskedasticity: Ho: Constant variance		
Breusch-Pagan/Cook-Weisberg test for heteroskedasticity	chi2(1)	Prob > chi2
	0.71	0.4
	Multicollinearity	
Variable	VIF	1/VIF
AID	6.5	0.15
POP. Growth	5.6	0.18
OPEN	3.1	0.31
SAV	1.8	0.54
FDI Stock	1.4	0.72
Mean VIF	3.7	
test for autocorrelation: H0: no serial correlation		
Breusch-Godfrey LM test for autocorrelation	chi2	Prob > chi2
	0.009	0.93
d-statistic(6, 18) =	1.83834	
Normality Test H0: Residuals are normally distributed		
Shapiro-Wilk W test for normal data	W: 0.93	P-value: 0.192

Table 3 presents the outcomes of the two-stage least squares (2SLS) regression analysis, focusing on the variables Gross Domestic Product per Capita (GDPC) and Savings (SAV). For GDPC, the constant term is estimated at 3.95, albeit not statistically significant. ODA (Official Development Assistance) exhibits a coefficient of -0.34, indicating a negative but insignificant relationship. SAV (Savings) is negatively and significantly associated with GDPC, with a coefficient of -0.5. OPEN (Openness) demonstrates a negative and significant impact on GDPC, with a coefficient of -1.13. Conversely, FD (Foreign Direct Investment) shows a positive and significant relationship with GDPC, boasting a coefficient of 0.21. The overall regression is highly significant, as indicated by the chi-squared statistic of 141.8. Shifting the focus to Savings, the regression yields a significant constant term of 4.7. ODA is negatively and significantly associated with SAV, with a coefficient of -0.74. GDPC demonstrates a negative and significant relationship with SAV, displaying a coefficient of -1.18. FD exhibits a negative and significant relationship with SAV, with a coefficient of -1.42. The overall regression for Savings is also highly significant, evidenced by the chi-squared statistic of 238.2.

Table 3: Outcomes of 2SLS

	Constant	ODA	GDPC	SAV	OPEN	FD	GFCF	Chi2
GDPC	3.95***	-.34***	----	-.5***	-1.13***	.21**	-----	141.8***
	(1.18)	(.11)		(.10)	(.30)	(.092)		
SAV	4.7*	-.74***	-1.18***	----	-1.42**	----	-.077	238.2***
	(2.85)	(.096)	(.21)		(.612)		(.13)	

5. CONCLUSIONS

The study investigates the influence of aid on economic growth and domestic savings, considering them as key developmental indicators. Both Ordinary Least Squares (OLS) and Two-Stage Least Squares (2SLS) techniques are employed to analyze the data. The main findings reveal a negative impact of aid on both economic growth and domestic savings. This implies that increases in aid are associated with decreases in both GDP growth rates and the level of domestic savings. The negative impact on economic growth suggests that aid inflows may not necessarily stimulate productive activities or foster sustainable development in the recipient country. Instead, aid may be channeled into non-productive sectors or result in inefficient resource allocation, hindering overall economic growth. Similarly, the negative relationship between aid and domestic savings implies that aid inflows may crowd out domestic savings, reducing the level of funds available for investment in the economy. This can have detrimental effects on long-term development prospects, as domestic savings are crucial for financing investment in productive assets and infrastructure. In our analysis, we further explored the interplay between economic growth, trade openness, domestic investment, and government spending. A key finding of our study is the negative relationship observed between domestic savings and economic growth, particularly in the context of foreign aid inflows. This suggests that increases in foreign aid are associated with reductions in domestic savings, which in turn exert a negative influence on economic growth. Moreover, our results indicate that foreign aid itself has a negative impact on economic growth, independent of its effect on domestic savings. This suggests that while aid may provide crucial resources for development, its overall contribution to economic growth may be limited, possibly

due to factors such as aid dependency, inefficient allocation of resources, or adverse effects on incentives for domestic investment and productivity growth.

These findings highlight the complex dynamics at play in the relationship between foreign aid, domestic savings, and economic growth. While aid can provide vital support for development efforts, its effectiveness may be contingent on various factors, including the recipient country's institutional capacity, policy environment, and ability to mobilize and allocate resources effectively. The observed negative relationship between foreign aid and domestic savings suggests that aid inflows may indeed crowd out domestic savings, rather than complementing them. This phenomenon can have several underlying causes and implications. Firstly, the negative impact of domestic savings on growth may stem from their allocation towards low-productivity investments or consumption of non-traded and imported goods. Inefficient allocation of savings may fail to stimulate productive activities or contribute to sustainable economic growth. Additionally, the possibility of savings being smuggled abroad highlights governance and regulatory challenges that may undermine the effectiveness of domestic savings as a driver of economic growth. Weak enforcement of capital controls and anti-money laundering measures may facilitate capital flight and hinder the retention of savings within the domestic economy. Furthermore, the negative relationship between foreign aid and economic growth may be exacerbated by a poor policy environment. Ineffective governance, corruption, and lack of transparency can impede the efficient utilization of aid resources, limiting their potential to catalyze economic development. Moreover, for countries with very low levels of income, foreign aid may primarily serve humanitarian relief purposes rather than fostering long-term development. This suggests a prevalence of the Dutch disease phenomenon, where aid inflows fail to promote productive capacities and physical capital accumulation, contributing to stagnant growth and economic vulnerability.

The identified negative relationships between economic growth and trade openness reveal significant insights into the dynamics of aid dependency and the challenges posed by external factors such as Israeli restrictions on the Palestinian economy. Firstly, the negative association between economic growth and trade openness suggests a form of aid dependency, where foreign aid is utilized to bridge the gap between demand and production of traded goods. This reliance on aid to sustain trade activities highlights the vulnerabilities inherent in the Palestinian economy, particularly in terms of its limited capacity for export-led growth and productive diversification. Moreover, the presence of a negative relationship between economic growth and trade openness underscores the adverse effects of external constraints, including Israeli restrictions and the Paris Protocol's unilateral customs union. Israeli restrictions such as closures, high transport costs, and interruptions to inputs inflow and exports outflow severely hamper the Palestinian economy's ability to engage in international trade and capitalize on its comparative advantages. Additionally, the crowding of the local labor market due to aid dependency and limited opportunities for productive employment exacerbates the challenges faced by the Palestinian economy. The reliance on aid to finance trade activities may contribute to a stagnant labor market and hinder the development of sustainable employment opportunities, further constraining economic growth prospects. The findings of the study provide valuable guidance for policymakers aiming to foster sustainable economic development and reduce reliance on foreign aid in the Palestinian economy. Based on these findings, policymakers could focus on several key policy interventions. Firstly, efforts should be directed towards promoting domestic savings as a means to decrease dependence on foreign aid. Policymakers could implement measures to incentivize saving, such as tax incentives or financial literacy programs, and encourage a culture of saving through public awareness campaigns. Once domestic savings are mobilized, they can be allocated towards critical areas of development, such as human capital investment, infrastructure projects, and enhancing production capacity. Investing in education, healthcare, and technology can contribute to long-term economic growth and sustainability. In parallel, policymakers should work to attract foreign direct investment (FDI) by creating an attractive investment climate and reducing regulatory barriers. Streamlining investment procedures, improving infrastructure, and providing incentives for foreign investors can help stimulate economic growth and create employment opportunities. Improving the policy environment is also crucial for fostering economic development. Addressing governance challenges, reducing corruption, and enhancing the rule of law are essential for creating an enabling environment for investment and growth. Moreover, policymakers should ensure the efficient use of aid by redirecting it towards productive investment purposes. Emphasizing aid effectiveness, monitoring and evaluation mechanisms, and alignment with national development priorities are essential for maximizing the impact of aid resources on economic development. Overall, by implementing these policy recommendations, policymakers can work towards reducing aid dependency, promoting sustainable economic growth, and improving the well-being of the Palestinian population. Collaboration with international partners, civil society organizations, and the private sector will be crucial for the successful implementation of these policies.

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