The Role of Foreign Aid on Economic Growth in Ethiopia

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Abstract
The provision of foreign aid began after the Second World War, when the US marshalling plan was announced in 1947 and involved the provision of funds for the reconstruction of war-torn Europe. The economic objectives of foreign aid are to induce high growth rates in Less Developing Countries which in turn will generate additional domestic savings and investment. However, there is much dispute as to whether development assistance to poor countries has been successful in achieving these objectives. In Ethiopia, an inflow of external resources such as loans and grants has started in the mid of 1950, the year in which the relationship between the United States and Ethiopia reached a higher level. As Ethiopia’s economy is characterized by a massive inflow of foreign capital, it is imperative to review studies conducted on this area. This paper tries to assess the role of foreign aid on economic growth in Ethiopia.

Introduction
The provision of foreign aid began after the Second World War, when the US marshalling plan was announced in 1947 and involved the provision of funds for the reconstruction of war-torn Europe. The Marshal plan was widely considered as a great success with many European countries undergoing a period of rapid industrialization during the late 1940s and early 1950s. In 1949, by following the Marshal plan, US president Truman announced a major programme of increased foreign assistance to the developing world (Easterly W, 2003). Meanwhile other rich countries and aid agencies started to give aid for developing nations. An important objective of much official development assistance (‘foreign aid’) to developing countries is the promotion of economic development and welfare, usually measured by its impact on economic growth (Easterly W, 2003).

Starting from 1950s there is a significant increase of foreign aid inflows towards Africa, but the economic progress achieved by many Sub Saharan African countries has not been satisfactory. Thus, the actual role of foreign aid inflow towards Africa in general and sub Saharan Africa in particular has been an area of controversy (Sintayehu Fissha, 2007). From the sub Saharan region Ethiopia has been one of the major recipients of international aid. In Ethiopia, an inflow of external resources such as loans and grants has started in the mid of 1950, the year in which the relationship between the United States and Ethiopia reached a higher level (Tasew Tadesse, 2015). The magnitude of aid inflow towards Ethiopia in the past varies depending on the nature and characteristics of the political system, the economic system that the regime follows, and the relationship with donor countries and institutions (Hale Girma, 2015).

In pre 1975, about 75 % of the required total investment during the series of Ethiopia five year development plan periods (1957-1973) was covered by external capital and most of the aid came from the United States of America. Ethiopia also has been one of the major recipients of international aid in recent times. According to OECD-DAC statistics, net ODA to Ethiopia amounted to US$1.94 billion in 2006, making it the seventh largest recipient among 169 aid receiving developing countries (Hale Girma, 2015).

Despite notable donor intervention in the country’s economy, less economic growth and poverty remains a reality for many years. In spite of this absurd scenario, there are few researches capturing the attention of assessing the effectiveness of aid in such a country in order to find out whether aid has been effective, or whether, in fact, the persistent poverty in such an aid-dependent country is not the result of the ineffectiveness of aid. As Ethiopia’s economy is characterized by a
massive inflow of foreign capital (most specifically foreign aid), it is crucial to review studies conducted on this area. In this paper I examined the role of foreign aid and its overall impact on the economic growth in Ethiopia by reviewing empirical researches.

**Definition of foreign aid and basic concepts**

There are various conceptions of foreign aid. The development assistance committee of the organization for economic cooperation and development (OECD) views it as official development assistance; consisting of grants or loans that one government or multilateral organization gives to developing countries to promote economic development and social welfare. Ekiring (2000) as cited by Inanga Eno L. and Mandah E. (2008) conceptualizes foreign aid as an international transfer of capital, goods, or services for the benefit of other nations. Such aid, in her view is offered in several forms: Capital transfers in cash or kind, either as grants or loans, technical assistance and training, usually as grants in the form of human resources and technical equipment and military assistance in the form of either equipment or training advisors (Haile Girma, 2015).

The broad conception of aid as development finance combines official assistance with other official flows (Ramiar Refaei, 2015). According to World Bank, official development assistance and official development finance are two different concepts. That is official development which consists of grants plus concessional loan that has at least a 25% grant component is the subset of official development finance (World Bank, 1998). A loan is considered sufficiently concessional to be included in official development assistance if it has a grant element of at least 25%, calculated at a 10% discount rate. In general official development assistance includes the costs to the donor of project and program aid, technical co-operation, forgiveness of debts not already reported as official development assistance, food and emergency aid, and associated administrative expenses (Ramiar Refaei, 2015).

The official flow of aid can take the form of grants, loans or grant-like contributions. Grants should be considered as the most desirable type of foreign aid since this represents a net addition to the resources available for development purposes. Some loans are given by the international lending agencies (e.g. World Bank) at interest rate which is lower than those in the capital markets. Where the loans are granted to the less developing countries at a concessionary rate for very long periods of time, for example, for 40-50 years, the inflow of foreign resources take the character of foreign aid as foreign private investment in the less developing countries are not exactly foreign aid because of they are made on commercial terms (Abbott, G. C., 1973).

**Development assistance committee (DAC) defines foreign aid as official development assistance (ODA) and technical aid, but according to ODA foreign aid excludes military assistance. According to the development assistance committee, official development assistance flows must satisfy all three of the following criteria (Dennis Mulenga, 2008);**

- Their primary objective must be developmental, thus it excludes military aid and private investment.  
- They must be concessional, that is the terms and conditions of the financial package must be softer than those available on a commercial basis. Basically DAC defines official development assistance as official flows with a grant element of greater than 25% at a 10% discount rate.

- The flows should come from governmental agencies and go to developing country governments.  
Official development finance comprises ODA plus international flows satisfying only the first and third criteria. Flows from voluntary agencies may also counted as aid, but do not satisfy the third criterion.

**Foreign Aid and Economic Growth**

The economic objectives of foreign aid are to induce high growth rates in Less Developing Countries which in turn will generate additional domestic savings and investment (Haile Girma, 2015).
However, there is much dispute as to whether development assistance to poor countries has been successful in achieving these objectives. There have been numerous attempts to investigate the effects of foreign capital in terms of direct foreign investment, and foreign aid and other foreign inflows on developing countries, their results have been conflicting.

Aid antagonists like Bauer claim there is a negative causal relationship between aid and growth in less developing countries. This is because aid retards growth by substituting for savings and investments rather than supplementing them. Bauer (1976) argued that although private foreign investment is beneficial to growth in developing countries, the same things cannot be said about foreign aid, even if the presences of this aid inflow remedies market distortions in some cases, it creates them in others by reducing the supply of government effort and obstructing investment from the private sector” (Bauer, 1976). Foreign aid advocates, however, argue that aid helps promote growth and investment in less developed countries. As it is stated by Mosley (1987), the main theoretical case for aid rests on the presumption that foreign aid could fill the gap of saving and investment. Therefore there is a positive causal relationship between aid and growth (Dennis Mulenga, 2008).

The empirical tests of both aid advocates and aid antagonist have been subject to much criticism over their statically errors and their simplistic assumptions of the aid-growth relationship. As Mosley indicates the literature on aid and growth in less developed countries has passed through three phases: The first phase: Rosenstein-Rodan (1961), and Chenery and Strout (1966) argued that all capital inflows represented net additions to an LDC's productive capabilities. The channel of this effect was expressed sometimes through the Harrod-Domar growth model and at other times in terms of the "two-gap" models, where economic growth is obtained by the removal of foreign exchange and the savings gaps (Haile Girma, 2015).

The Harrod-Domar model expressed by a formula 
\[ g = s/v \]
where \( g \) is growth rate of output, \( s \) is the savings rate and \( v \) is the incremental capital-output ratio states that the growth rate of output is equal to the savings rate divided by the incremental capital-output ratio. In the 1950's and 1960's this analysis is used much, for example, Chenery and Strout (1966) argued that foreign aid is a supplement to domestic savings and hence raised the growth rate of output to 
\[ (s+a)/v \]
where \( a \) is foreign aid as a percentage of recipient GNP (Haile Girma, 2015).

This increase in the growth rate would raise income, and then the saving rate would increase because the marginal saving propensity is greater than average saving propensity in developing countries and hence the higher growth rate would become self sustaining without the need of further inflows of foreign aid. Thus, according to this view, inflows of foreign aid would have the effect of raising the savings rate in subsequent periods.

The second phase: Griffin (1970), Weisskopf (1972), Areskoug (1976), challenged the assumption that foreign capital inflows add to capital formation without disturbing domestic savings and consumption. They criticized the simplistic-findings of the former group and emphasized that not all aid was an increment to the capital stock of LDC’s since some aid was diverted for consumption purposes. Aid may also raise the capital output ratio. Consequently, if giving aid to a poor country depresses that country’s savings rate- or raises its capital output ratio- to a sufficient extent then there is a possibility that aid may positively help the recipient (Dennis Mulenga, 2008). 

Griffin and Enos (1970) found that foreign aid has neither accelerated growth nor helped towards faster democratic political regimes. Foreign aid, at least in some countries, might impair rather than promote growth. If anything aid may have retarded development by leading to lower domestic saving by distorting the composition of investment and thereby raising the capital-output ratio, by frustrating the emergence of an indigenous entrepreneurial class and by inhibiting
institutional reforms. It was further suggested that foreign aid increases consumption, and thus reduces the savings rate (Ibid).

The Third Phases: Papenek (1972) severely criticized the methodology of his predecessors. Firstly, authors were found quality of combining aid with other foreign resource inflows. Secondly, they ignored the data problems that arise from using savings as an independent variable when in most LDC’s is calculated as a residual. “Most important of all, they inferred one way causal relationship from aid to saving levels in LDC’s from an undoubted negative correlation between these two variables when what was more probably happening in many countries was that both lower savings ratios and high aid levels stemmed from an extraneous third factor i.e. political and economic arises in the recipient country (Ibid).

The finding of Sogge and David (2002) states there has been various outcomes of foreign aid on economic growth. They argue that most studies show that where aid has dominated, pride and ambition have given way to dependence and deference, and where it has been targeted, public management and services have either decayed or collapsed, poverty and inequality have worsened, and insecurity has prevailed. He cites Rwanda as an example where many developed countries helped to position the country at the edge of the abyss of genocide – only to disclaim any responsibility in the aftermath. With a few exceptions, (Korea, Botswana and Honduras) where aid has had a significant impact on poverty reduction, improved social services and competent public institutions, in a much larger number of countries (Cuba, Zambia, Democratic Republic of Congo, Haiti, Sierra Leone, Somalia) western aid has played a minor role in building efficient public sector and in lifting millions out of poverty. In some cases, major recipients of aid are today collapsed states (e.g. Congo Democratic Republic, Sierra Leone, Somalia). One of the best-known attempts to assess the impact of aid on growth is by Burnside and Dollar (2000). The study shows that aid has positive effects on growth in the good policy environment, while it does not work in a distorted environment. Good policy environments, according to Burnside and Dollar, are those that are open to trade, have low inflation rates, good share of the budget surplus in relation to GDP (lower budget deficit) and balanced government consumption in GDP. They further argue that there appears to be no systematic impact from aid on policy. For example, in Ghana, good policies were rewarded, while in the case of Zambia, aid increased between 1970 and 1993, while policies deteriorated throughout the period. Burnside and Dollar thus found that aid significantly increased growth in good policy environments as measured by a composite measure of macroeconomic policies, had no effect in average environments, and was actually damaging in bad policy environments.

A study by Karras (2006) investigates the correlation between foreign aid and growth in per capita GDP using annual data from the 1960 to 1997 for a sample of 71 aid-receiving developing countries. This paper concludes that the effect of foreign aid on economic growth is positive, permanent, and statistically significant. More specifically, a permanent increase in foreign aid by $20 per person results in a permanent increase in the growth rate of real GDP per capita by 0.16 percent, these results are obtained without considering the effects of policies.

A study conducted by McGillivray (2006) demonstrates how aid to African countries not only increases growth but also reduces poverty. Furthermore, the author points out the important fact that continuously growing poverty, mainly in sub-Saharan African countries, compromises the MDGs (Millennium Development Goals) main target of dropping the percentage of people living in extreme poverty to half the 1990 level by 2015. His research econometrically analyzes empirical, time series data for 1968-1999. The paper concludes that the policy regimes of each country, such as inflation and trade openness, influence the amounts of aid received. Ouattara (2006) analyzes the effects of aid flows on key fiscal aggregates in Senegal. This paper utilizes data over the period of 1970 – 2000 and primarily focuses on the interaction between aid and debt. The author determined three main outcomes of his study. First, that a large portion of aid flows, approximately 41%, are used to finance Senegal’s
debt and 20% of the government’s resources are devoted to debt servicing. Second, that the impact of aid flows on domestic expenditures is statistically insignificant, and third that debt servicing has a significant negative effect on domestic expenditure. As a result, his paper suggests that debt reduction could become a more successful policy tool than obtaining additional loans.

In his research, Ram (2004) looks at the issue of poverty and economic growth from the view of recipient country’s policies as being the key role in the effectiveness of foreign aid. Nevertheless, in his paper the author disagrees with the widely-acknowledged view that redirecting aid toward countries with better policies leads to higher economic growth and poverty reduction rates. As a result, based on his research the author concludes that evidence is lacking to support the leading belief that directing foreign assistance to countries with good ‘policy’ will increase the impact on growth or poverty reduction in developing countries.

A modified neoclassical growth model provides the analytical framework for how to achieve economic growth in developing countries. The neoclassical model suggests that poor countries should have a high return to capital and a fast growth rate in transition to the steady state; there are several factors that could interfere with this result, however. With a subsistence consumption constraint and imperfect international capital markets, poor countries will tend to grow slowly despite a high marginal return to investment (Dennis Mulenga, 2008).

In this context foreign aid can accelerate growth rates in the transition to a steady state. Furthermore, various institutional and policy distortions can lower the return to capital and reduce transitional growth rates. In general, developing country growth rates will depend on initial income, institutional and policy distortions, aid, and aid interacted with distortions.

History of foreign aid in Ethiopia

The origin of the current aid package began in the 1940s with the aim to serve the economies of Western Europe. This aid package was the largest in the history and known as the ‘Marshall Plan’ which helped these countries to rebuild their economies after the severe devastation of World War II (Easterly W, 2003). However, through time, the direction of the flow of foreign aid changed from these countries to less developed ones. The success story of development aid given to Western Europe in the 1940s and 1950s led many institutions to believe that similar transfer to developing countries would permit them a comparably similar transformation (Krueger,1986). Consequently, developing countries continues to receive increasing amount of development aid from various bilateral and multilateral sources from time to time.

In Ethiopia, an inflow of external resources such as loans and grants has started in the mid of 1950, the year in which the relationship between the United States and Ethiopia reached a higher level. For instance in pre 1975, about 75 % of the required total investment during the series of Ethiopia five year development plan periods (1957-1973) was covered by external capital (Haile Girma, 2015).

The magnitude of aid flow to Ethiopia in different time varies depending on the nature and characteristics of the political system, the economic system that the regime follows, and the relationship with donor countries and institutions (Ibid). During the socialist Derg (1974-1991) period, Ethiopia had been receiving development assistance from Eastern Block donors particularly from the Soviet Union and East Germany, as well as from Western bilateral and multilateral donors to some extent. In the Derg period the country received Birr (Ethiopian currency) 1.1 billion on average terms per year. The average share of aid (ODA) was 4.8 percent in the same period (Tasew Tadesse, 2011). Thus, increasing efforts were made to mobilize foreign aid in the last two regimes (in the Imperial and Derg regimes).
Currently most of foreign aid to Ethiopia comes from the western developed countries and other multilateral organizations. Comparatively the total flow of foreign aid has increased under the current economic system due to changes in policies which meet the interests of donors, and adoption of a market-oriented economic system. Since the policy change by the present regime the magnitude of development aid (both loan and grant) has increased continuously. Following the change in political regime in 1991 and the adoption of the structural adjustment program in 1992 in particular, the country has enjoyed a significant amount of aid. A large and growing inflow of concessionary loans and grants has occurred since 2001, following the issuance of the first poverty reduction strategy paper (known as the Sustainable Development Poverty Reduction Program) from 14 multilateral sources—mainly IDA, EC, the Global Fund, and the African Development Fund and more than 30 bilateral sources—mainly the USA, UK, Italy, Canada, Germany, Ireland, Japan, Netherlands, Norway, and Sweden (Dennis Mulenga, 2008).

Ethiopia has been one of the major recipients of international aid in recent times. According to OECD-DAC statistics, net ODA to Ethiopia amounted to US$1.94 billion in 2006, making it the 7th largest recipient among 169 aid receiving developing countries. In absolute terms, the amount of ODA has risen sharply from an average of $881 million per annum in the second half of the 1990s to over $1574 million per annum for the first half of the 2000s (Hile Girma, 2015). Over the last seven years (2000-2006), ODA has averaged at $1683 million per year (Ibid). The average contribution of bilateral donors to ODA over the eight year period was $322.4 million per year accounting for 31 percent of ODA. In the 1990s, some 49 percent of the total net ODA was in the form of multilateral aid. This was slightly reduced to 46 percent for 2000-2006, reflecting the increased importance of non-multilateral sources (Ibid).

As shown, the flow of net ODA actually declined from 1992 to 2000 and sharply increased in 2001 with a modest increase onwards. The main driving force for donors to resume their assistance was the issuance of the Sustainable Development Poverty Reduction Program in 2001 (Haile Girma, 2015). Of these significant net ODA flows, the contribution of the World Bank’s support through the soft windows of IDA was tremendous. In 2001 alone it was 38.7 percent of the total net ODA. Since 1993, the Bank has committed a total of $3.1 billion to Ethiopia. Ethiopia receives about $8.0 per capita from IDA. This makes Ethiopia the largest IDA borrower in Africa and the fifth largest in the world. In addition, the Bank has coordinated a consortium of donors to support the economic reform program (Fentaye Ejig, 2015).

In 2006, ODA flow accounts for about 48 percent of the gross national savings, 40 percent of gross domestic investments, 58.5 percent of overall government expenditure, and 10 percent of the GNI of the country. Although there was an increasing ODA inflow, the savings-investment gap was as high as 20 percent of GDP, leaving a huge gap to be bridged by non-ODA inflows (world fact book, 2013).

The role of foreign aid on economic growth in Ethiopia

The presence of a resource gap (saving-investment, fiscal and foreign exchange gap) in poor countries forces the country to look outward for foreign aid in order to fill either of the gaps which are perceived to be the binding constraint for economic growth (Getnet Alemu, 2009).

Alemayehu (2001) argued that the most important permanent feature of the Ethiopian economy is the presence of resource (financial) gap. The resource gap can be explained as the presence of savings investment gap, foreign exchange gap and fiscal gap. In recent years the savings-investment gap has been widening from an average of 1.1% of GDP during the Imperial period (1960-74) to 6% of the GDP during the Derg period (1974-91) to 11.7% of the GDP in the EPRDF (1991-2008) (Getnet Alemu, 2009). The presence of resource gap (gross domestic investment-gross domestic savings) forces the country to rely on an inflow of foreign finance (specifically foreign aid) to bridge
the gap. Thus, the presence of these resource gaps in one way or another shows that the domestic economy is not capable of generating enough finance to close these gaps and make the country’s reliance on foreign capital inflow compulsory.

Despite massive inflow of aid to developing countries and extensive empirical work for decades on the aid-growth link, the aid effectiveness literature remains controversial. An important objective of much Official Development Assistance (‘foreign aid’) to developing countries is the promotion of economic development and welfare, usually measured by its impact on economic growth (Fentaye setargie Ejigu2015). Yet, after decades of capital transfers to these countries, and numerous studies of the empirical relationship between aid and growth, the effectiveness of foreign aid in achieving these objectives remains questionable.

As Ethiopia’s economy is characterized by a massive inflow of foreign capital (most specifically foreign aid), it is imperative to review studies conducted on this area. Mesfin(2007) examined the fiscal impact of foreign aid(disaggregated in to loan and grant) and its overall relationships with economic growth in Ethiopia covering over the period 1960/61 to 2004/05. He analyzed the data applying a vector autoregressive modeling mechanism. The result obtained shows that the inflow of foreign aid has a strong positive relationship with growth in the long run. The result further indicated that the positive association between foreign aid and economic growth is attributed to the incremental effect that aid has on government expenditure i.e. the transmission mechanism of foreign aid to growth is through the channel of government expenditure. The study also showed that foreign aid has a negative impact on tax revenue but it improves the fiscal position (closing the fiscal gap) unlike government expenditure. Generally, Mesfin’s (2007) study shows that increases in foreign aid result in higher government expenditure, and has significant positive long term impact on economic growth.

However, the study failed to identify foreign aid financed government expenditure from not. As a result, all the effect may be attributed to aid while the case may be not. He also included both government expenditure and foreign aid in the determination of the growth model. This may resulted in problem of double counting as part of aid finances government expenditure especially through public investment. Despite the mentioned problems, the study indicated that there exists a role for aid effectiveness in Ethiopia in the long run.

Tolessa(2001) examined the relationship between foreign aid(in disaggregated form: loan and grant), domestic savings, investment and economic growth for the period 1964 to 1999 using Johansen’s maximum likelihood estimation procedure. He specified and estimated three equations: saving, investment and growth equations. The result obtained from the investment equation showed that both foreign loan and domestic saving promote domestic capital formation. However, the study found that the grant element of foreign aid has negligible effect on domestic capital formation. The result obtained from the growth equation also showed that saving and loan have a positive impact on growth while grant has an adverse effect on growth of per capita income. Tolessa also included an index of policy variables to see whether aid effectiveness is conditional on good policy environment. The finding showed that policy affects growth significantly and negatively. However, the model used in the study is poorly specified. The main weakness of the specification is that the problem associated with double counting: for instance, he used loan and grant as explanatory variables both in the saving, and investment equation, and more over he used saving as an explanatory variable in the investment equation. Therefore, the result obtained may not reflect the true relationship between the variables and it may produce a biased result.

Another study by Wondwesen (2003) analyzing the impact of foreign aid on growth on annual data covering the period 1962 to 2000 applying Johansen’s maximum likelihood technique found that aid has significant contribution to investment both in the short run and long run. Aid is found to be
ineffective in enhancing growth. However, he found that when aid is interacted with policy, the growth impact of aid found to be significant i.e. aid is conditional on quality policy environment. His result further implied that attention should be focused on improving the existing macroeconomic policy environment for an inflow of aid to be used effectively. This study is different from the previous studies in the following aspects i.e., it incorporates the recent advances in the literature, construction of a broader policy index, and considering other variables (notably rainfall variability) to the growth equation.

Researchers under pro aid category maintain that the claims of the anti-aid school of thought are only partially correct, that aid can spur growth but its effectiveness decreases as the level of aid infused into the economy increases. In other words, aid has diminishing returns. Some early studies like Papenek GF (1972) found that aid had a positive impact on growth, hence sparking the debate between among economists and researchers. These analysts believed that aid increases growth by augmenting savings, financing investments, and adding to the capital stock. They argue that aid also helps increase productivity, especially aid in health or education programs. They also consider the transfer of knowledge and technology from rich countries to poor countries as a positive effect (Getnet Alemu, 2009). Like the early anti-aid literature, these claims were barely substantiated with empirical research. That there is an absolute positive correlation between aid and growth was more a belief than an actual fact since research at this time was focused on testing a linear relationship between aid and growth.

Jifar T. (2002) has tried to address the effect of foreign aid on public spending with particular reference to the case of aid fungibility in Ethiopia. The analysis was done using OLS estimation. In estimating the short run impact, he employed Error Correction Model. The estimated result in education and agriculture sectors were marked by nonfungibility in which case the sectoral aid impact on sectoral spending have crowding in effect. However, for transport and communication and construction sector, aid fungibility seems to exist which means that there is crowding out effect. In this case, the sectoral aid impact on the sectors spending is negative. For non-developmental expenditure, aid is found to be significantly affecting debt servicing expenditure but insignificant for general service and defense expenditures. Tasew T (2010) examined the impact of foreign aid on investment and economic growth in Ethiopia over the period 1970 to 2009 using multivariate co-integration analysis. The empirical result from the investment equation shows that aid has a significant positive impact on investment in the long run. On the other hand, volatility of aid by creating uncertainty in the flow of aid has a negative influence on domestic capital formation activity. Foreign aid is effective in enhancing growth. However, the aid-policy interaction term has produced a significant negative effect on growth implying that bad policies can constrain aid effectiveness. The growth equation further revealed that rainfall variability has a significant negative impact on economic growth as the economy. His study indicated also that the country has no problem of capacity constraint as to the flow of foreign aid.

Yohannes B (2011) has examined the impact of foreign aid on economic growth and the Transmission mechanisms (i.e. investment, import and government consumption expenditure) of Ethiopia using Johansson maximum likelihood approach over the period of 1970/1 to 2008/9. The co-integration test result indicates the existence of long run relationship among the variables entered in all models. According to him in the long run foreign aid has a positive and significant impact on growth through its significant contribution to investment and import. However, the dynamic short runs model points out that aid to have a significant impact on growth it has to be assisted by good monetary, fiscal and trade policy. In addition, in the short run aid has significant impact on government consumption expenditure, which confirms the existence of aid fungibility. His study also confirms the existence of debt overhang problem in the Ethiopian economy. He concluded that Aid can enhance growth by financing the three gaps. However to mitigate the problems with aid fungibility and debt overhang, foreign aid has to be linked to a good policy framework.
Conclusion

The results of some studies reviewed by this paper revealed that aid contributed positively to economic growth of less developed countries in the long run, but its short run effect appeared insignificant indicating that most of the aid has been used to finance investment which has a long gestation period. Therefore, aid is effective in promoting growth in Ethiopia in the period considered. But most of reviewed literature consistently indicates that, despite the huge flow of aid to Ethiopia, it is ineffective in bringing about the desired changes like poverty reduction and economic growth. But this does not imply that aid is totally wasted (or, aid is ineffective at all) because there are some improvements in the social indicators like enhancing access to education and health services.

In general the results of this investigation suggests that poor countries like Ethiopia, should have a high return to capital and a fast growth rate in transition to the steady state; there are several factors that could interfere with this result, however. With a subsistence consumption constraint and imperfect international capital markets, poor countries will tend to grow slowly despite a high marginal return to investment. In this context foreign aid can accelerate growth rates in the transition to a steady state. Furthermore, various institutional and policy distortions can lower the return to capital and reduce transitional growth rates.

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