Impact of Foreign Aid on Economic Development: A Review

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Abstract: In Ethiopia, agriculture is a major economic source, accounting for more than 80% of export earnings and generating around 35.5% of the Growth Domestic Product of the country. Foreign aid is the transfer of the real resource from developed countries to less developed countries. The role of foreign aid in the economic development of a poor country is unquestionable. Foreign aid can be utilized in the economy where there exists a resource scarcity. Limitation of resources forces Ethiopia to look outward for foreign capital in order to fill either of the gaps which are perceived to be the binding constraint for economic growth in the long run. Analysts believe that aid increases growth by supplementing savings, financing investments, and adding to the capital stock. Studies also identify aid effectiveness, which is affected by conditions such as external and climatic, political, and institutional quality. The overall result of different literature shows the importance of increasing foreign aid flows despite contributing less due to unfavorable policies. Aid donors should be more careful in the allocation of aid so that they should give priority to providing aid to those recipient countries which have appropriate policy and institutional environments to make aid more effective. Assessing the influence of foreign aid on growth and aid has a significant and positive influence on the investment. Aid is found to be ineffective in enhancing growth. However, when aid is interacted with policy, the growth impact of aid is found to be significant. This means, aid is conditional to favorable policy environment. The United States, the World Bank, and the United Kingdom make up the top three individual donors of developing countries respectively.

Keywords: Economic Growth, Ethiopia, Foreign Aid, Investment and Receipt.

1. INTRODUCTION

Ethiopian economy is a subsistence economy which is highly dependent on agriculture, that in turn categorized by resource starved economies. Agriculture major economic sector accounts around 35.5% of the GDP and more than 80% of the export earnings of the country (CIA, 2018). The dependence on agricultural commodities resulted the country to be a victim of foreign exchange gap.
For instance, in 2001/02 the exports of goods was estimated to 15.5% of GDP while the imports of goods and services were estimated to 35.2% of GDP and resulted in 19.7% foreign exchange gap (Tadesse, 2011). The main role of foreign aid in stimulating economic growth is to supplement domestic sources of finance such as savings, increasing amount of investment and capital stock.

As Morrissey (2001) revealed, there were a number of tools through which aid can contribute to economic growth, including aid can increases investment, in physical and human capital; aid increases the capacity to import capital goods or technology; aid doesn’t have indirect influence that reduce investment or savings rates and aid is associated with technology transfer that increases productivity of capital and encourages endogenous technical change. In Ethiopia during the post revolution period, 37% of total annual campaign of 1979-83 was financed by foreign aid (Girma, 2015). According to McGillivray et al. (2006) four main alternative views on the effectiveness of aid have been suggested, These were (a) aid has decreasing returns, (b) aid effectiveness is influenced by external and climatic conditions, (c) aid is influenced by political conditions, and (d) aid depends on institutional quality.

Recipient countries recognize aid as additional income that will eventually lead to increase in demand and imports (Temple and Sijpe, 2017). For instance, development aid can be used to overcome financing limits (Chenery and Carter, 1973). Aid transfers might also disturb the recipient country’s income in the medium to long term (Martínez-Zarzoso, 2019). Development aid can also be used by political leaders to substitute public revenue with external savings, in order to gain support among others (Morrissey, 2015; Crivelli & Gupta, 2017).

The amount of foreign financial assistance that is given to the developing countries in general and for African countries in particular has been increasing from time to time. In Africa, the share of overseas Development Assistance (ODA) to GDP has significantly increased over the years (WB 1992). In Ethiopia, the high import intensity of the economy, limited capacity to produce capital goods, low levels of domestic savings and limited capacity to acquire foreign exchange make the development effort beyond domestic capacity. All these factors provide an apparently objectives justification for the huge inflow of foreign aid (Setargie, 2015).

The United States, World Bank, and United Kingdom make up the top three individual donors respectively. Ethiopia is the largest recipient of British aid and is among the largest non-war state recipient of US aid. Ethiopia adopted a development model characterized by large-scale infrastructure development and the raise of large-scale agricultural projects. Enabled by land resettlements, irrigation infrastructure, and unmatched concerns to foreign investors. While Ethiopia’s number-one export has been coffee beans, the government is promoting an expansion in the production of high value crops like cotton, rubber, sugar, palm oil, and cut flowers. Yet, the path chosen by Ethiopia for agricultural development undermines the food security of millions of Ethiopians and increases the dependency of the country on global markets in terms of monetary fluctuations, foreign currency, chemical inputs, and land misuses to sustain large-scale and foreign investment (Flores, 2013). Besides, foreign aid covered 23.2% of total revenue in 2010/11 fiscal year (NBE, 2018). This shows that foreign aid has been playing the great role in Ethiopia’s economy and explained that foreign aid has played a major role in Ethiopia’s development effort since the end of World War II. Therefore, the main objective of this paper is to review research work studied on the impact of foreign aid on Ethiopian economy.

1.1. Impact of Foreign Aid on Ethiopian Economy

The foreign aid is the transfer of the real resource from developed county to less Developed countries on favourable term development assistance committee define it’s as official development assistance and technical aid (Zimmerman, 2007). According to Clemens and Postel (2017) aid categorized into three: The first category includes aid to health and education as well as to support democracy and the Environment, while the second category includes budget support and infrastructure investments and third category is aid for productive sectors. The study revealed that the third aid category had a significant effect on growth over a four-year period, while the other categories had no significant effect.

A study conducted by McGillivray et al. (2005) analyzes how aid to African countries not only increases growth as well as reduces poverty. The study also points out the important fact that constantly growing poverty, mainly in sub-Saharan African countries, compromises the Millennium Development Goals (MDGs) main target of dropping the percentage of people living in extreme poverty.
poverty to half the 1990 level by 2015. The study concluded that the policy regimes of countries, such as inflation and trade openness influence the amounts of aid received.

Studies examine trends in official aid to Africa over the period 1960 to 2002 show that incredible decrease in aid over the last decade which will have an impact on Africans living in poverty and to the economy as a whole. Because of the shortfall in aid, the MDGs will be much harder if not difficult to be achieved. The study also concludes that aid in fact does stimulate growth and reduces poverty. Furthermore, it also positively affects public sector aggregates, contributing to higher public spending and to lower domestic borrowing. Yet, it seems that the MDGs cannot be achieved with development aid alone, but other innovative sources of development needed to be explored as well (McGillivray et al., 2005).

### 1.2. Debates on Foreign Aid Impact on Economic Growth

Critics of foreign aid maintain that foreign aid discourages domestic saving and domestic tax revenue in developing countries and is simply diverted into consumption instead of investment. The same in Ethiopia as other developing countries (NBE, 2018). The act of Ethiopia in improving an investment and upgrade of economic growth through domestic capital sources and private capital inflow only is far from adequate. This makes the importance of foreign aid positive to the performance of the economy (Tadesse, 2011). Generally, economists who contribute to the anti-aid view agree that aid has no effect on growth and it may actually undermine it (Girma, 2015). Economists called for an end in aid, arguing that it is not an essential requirement for the economic growth of a country. Both Friedman and Bauer declare that foreign assistance to governments is dangerous because it increases the power of the elite in the recipient governments, leads to risky and hinders economic growth (Hansen and Tarp, 2001).

Though the importance of a sound policy environment for growth is unquestionable, but the argument of Burnside and Dollar (2004) that aid is effective only in a good policy environment which contradict with Setargie (2015) argued that aid is effective in promoting growth in Ethiopia but its effectiveness would have been higher if it was supported by a sound macroeconomic policy environment. In other words, the argument that foreign aid tends to have diminishing returns beyond some threshold level is operate in the Ethiopian situation since countries with low level of human capital and poor institutions are expected to have a capacity constraint in absorbing excessive capital from abroad and the current condition in Ethiopia an example of the scenario for Developing countries (Lensink and White, 2001; Wondwossen, 2003; Burnside and Dollar, 2004). Analysts believed that aid increases growth by supplementing savings, financing investments, and adding to the capital stock. They argue that aid also helps to increase productivity, especially aid in health or education programs (Girma, 2015). Also Malik (2008) analysed that foreign aid has a long run positive impact on growth. Similarly, Setargie (2015) found that the impact of aid on growth is significant at 5% significance level. The study also revealed that, foreign aid interacted with policy has a significant positive influence on growth. The positive result was associated with the policy environment in the country which makes aid more effective.

### 1.3. Aid and Economic Growth in Ethiopia

The general problem of concern for many studies conducted has been to find a correlation between aid and growth and whether this growth depends on the policy environment. As Ethiopia’s economy is characterized by a substantial inflow of foreign aid M’Amanja et al. (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. The result found shows that the inflow of foreign aid has a strong positive relationship with growth in the long run. The result promote that the positive association between foreign aid and economic growth is attributed to the incremental effect that aid has on government expenditure. Generally, M’Amanja et al. (2007) show that increases in foreign aid result in higher government expenditure, and has significant positive long term impact on economic growth. The expenditure has role in development of public service such as education, health, transport service and others.
According to Setargie (2015), foreign aid has a positive impact on growth; however, its impact is insignificant in the short run. This study also revealed that foreign aid was used to finance investment which has a longer gestation period and its impact may not be reflected in the short run. This leads aid-policy interaction term to have a negative and significant influence on growth which indicates the unfavourable role of poor policies for growth in the short run.

Study by Gomane et al. (2005) addresses directly the mechanisms through which aid growth using a sample of 25 Sub-Saharan African countries over the period 1970 to 1997, and determined that foreign aid has a significant positive effect on economic growth. Furthermore, the study also identifies investment as the most significant mechanism. The study concludes increase in the GNP ratio contributes a certain percentage to the growth rate.

Mohammed (2014) conducted his study on the effects of conditional aid varied substantially and aid is not a growth promoter. Recipient countries lack the exact mechanisms to use aid effectively and efficiently to improve their economic conditions. Key result in Hansen and Tarp (2001) is that foreign aid does increase growth but is subject to “diminishing returns”. That is, the marginal impact of aid on growth declines as the total inflow increases. There were also possibilities to investigate whether aid has an impact on efficiency and/or productivity at industry level. Rajan (2005) studied the aid effect on country competitiveness and claimed that aid inflow indicates to exchange rate revaluation which, resulted in lower growth in labour intensive industries.

1.4. Factors Affecting the Effectiveness of Aid

A number of researchers explored other aid-related factors that can influence its contribution to national economic growth and development. According to Tadesse (2011), aid efficiency is affected by external and climatic conditions, political conditions and institutional quality. Therefore, it is important to note that not only factors such as the amount and type of financial aid influence the effectiveness of offered funds but also the proper use of these funds by the recipient country plays a crucial role. Studies relate the effectiveness of aid to the prevailing aid policy of the recipient country and concluded that aid policies do matter for aid effectiveness (Burnside and Dollar, 2004). Aid donors should be more careful in the allocation of aid; they may give priority to provide aid to those recipient countries which have appropriate policy and institutional environments to make aid more effective. Recipients must have ownership of the aid-funded activity, to implement it effectively and sustainably (Gurmessa, 2012).

Other studies sought to investigate the determinants of the allocation of aid among recipient countries. Most aid allocation studies suggest that donors pursue humanitarian, economic and political objectives in allocating aid grants to recipient countries (McGillivray et al., 2006). In Ethiopia, the high import intensity of the economy, limited capacity to produce capital goods, low levels of domestic savings and limited capacity to generate foreign exchange make the development effort in Ethiopian beyond domestic capacity. All these factors have provided an apparently objective justification for the enormous inflow of foreign aid (Setargie, 2015). Assessing the influence of foreign aid on growth and aid has a significant and positive influence on the investment (Wondwesen, 2003).

1.5. Major donors to Ethiopia economy

Developed countries have usually used foreign aid as a means of advancing their foreign policy aims in developing countries (Martínez-Zarzoso, 2019). The United States, the World Bank, and the United Kingdom make up the top three individual donors respectively. Ethiopia is currently the largest recipient of British aid and is among the largest non-war state recipient of US aid of the $2.8 billion in total foreign aid committed to Ethiopia in 2011, commitments by the US, the World Bank Group, and the UK comprised $1.5 billion. The combined aid from these three donors consistently provides close to half of total international assistance to Ethiopia. On average, Ethiopia has received $3.5 billion from international donors, which represents between 50 to 60% of its national budget (OECD, 2013).

1.6. U.S. Foreign assistance to Ethiopia

U.S.A’s portfolio in Ethiopia is one of the leading and most complex in Africa. Over the last decade, Ethiopia has made tremendous development gains in education, food security and health. GDP growth was 10.3% (WB, 2017). The addition of 38,000 health extension workers has helped reduce the
under-five child mortality rate by more than six present a year since 2000. However, Ethiopia still remains one of the poorest countries in the world, with an estimated annual per capita income of $768 (WB, 2017). According to World Bank’s evidence Ethiopians is still vulnerable to food insecurity, and nearly 70% depend on agriculture for employment. U.S’s assistance is an investment to build Ethiopia’s self-reliance by increasing economic growth, delivering quality basic public health and education services, and promoting a governance environment that is conducive to sustainable economic development.

2. CONCLUSION

Foreign aid remained as an important source of finance for capital scarce of developing countries and continued to play various roles in financing their development desires. Thus one can find both success and failure stories. Most of literatures reviewed examine the macroeconomic impact of aid in Ethiopia with special emphasis given to the impact of foreign aid on domestic capital formation and economic growth. Ethiopia is known by receiving aid from foreign country like any other developing countries. The major point emerging from this work is that foreign aid has a mixed impact on economic growth of developing countries. According to different finding aid may have a diminishing return; that is, the impact of aid on growth becomes negative after a certain period of time. Foreign aid is an important source of finance for less developed countries and continued to play a multifaceted role in financing their development needs. Some scholar found that aid has positive effects on economic growth, whereas others find that it has no effect. Even though it is the 21st century, many developing countries still face the issue of serious resource problems. A large portion of these countries are in the on-going battle with severe debts and strictly dependent on financial aid inflows. Aid contributed positively to economic growth in the long run, but its short run effect appeared insignificant. In the contrary, when aid is interacted with policy, the growth impact of aid is negative implying the harmful effect of unfavourable policies on growth in the long run. Though the view that aid is ineffective but only in a good policy environment supported by some study, the finding points the importance of a good policy environment to make aid more effective. Thus setting a sound policy environment is crucial to use aid more effectively and make domestic investment efficient. Therefore foreign aid can be used to improve economic growth.

3. REFERENCES

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