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**How Foreign Aid Affect Developing Countries:**

 **The Case of Ethiopia**

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***Abstract***

Foreign aid has been an essential tool for the socio-economic development of developing countries since 1960s. It is described by OECD as the financial, technical assistance and commodity flow to the countries that are in the list of DAC (Development Assistance Committee). US’s Marshall Plan is a well-known development assistance program, which was established between 1948 and 1951 under the European Recovery Program to support Europe in economic crisis after a war became successful in reducing poverty while increasing economic growth. By taking the Marshall plan as a model, developed countries have been supporting the developing countries since then. Recently, the Millennium Development Goals was also launched in New York in 2000 to finance economic growth of poor countries. New actors from other parts of the world took their places in providing development assistance. Despite receiving more than 600 billion USD in the context of foreign aid, large part of Africa has still remained underdeveloped and in an extreme poverty. In this paper, we study the impacts of foreign aid to socio-economic development to Ethiopia. After reviewing the development and foreign aid literature from primary and secondary sources, this study benefited from data gathered from World Bank Database, Transparency International and Freedom House, and then time series data were evaluated by regression analysis. Our findings indicate that foreign aids do not have a major influence on GDP growth; but it has a considerable influence on FDI (foreign direct investment) and unemployment rate in Ethiopia. However, it is observed that foreign aid has negatively correlated with democracy and corruption levels in the country. Although, the amount of foreign aid has been continuously increasing, Ethiopia has remained one of the most corrupt and authoritarian African countries according to related indices. Consequently, our study concludes that foreign aid should be redesigned to encourage and reward receiving countries to advance their democracy and eliminate corruption within the context of recent philosophy and principle of collaborative governance for long term development.

**Keywords:** *foreign aid, development, GDP, unemployment, corruption, democracy, governance.*

**Dış Yardımların Gelişmekte Olan Ülkelere Etkisi:**

**Etiyopya Örneği**

***Öz***

Dış yardım, 1960'lardan bu yana gelişmekte olan ülkelerin sosyo-ekonomik olarak kalkınmaları için vazgeçilmez bir araç olmuştur. OECD, bu yardımları DAC (The Development Assistance Committee/Kalkınma Yardımı Komitesi) listesinde yer alan ülkelere finansal, teknik yardım ve emtia akışı olarak tanımlanmaktadır. 1948-1951 yılları arasında Avrupa İyileştirme Programı kapsamında uygulamaya koyulan ABD'nin Marshall Planı, Avrupa'daki ekonomik büyümeyi arttırırken, yoksulluğun azaltılmasını sağlamıştır. Marshall planını örnek alan gelişmiş ülkeler, 1960'lardan bu yana gelişmekte olan ülkeleri desteklemektedirler. Buna ek olarak, yoksul ülkelerin ekonomik büyümesini finanse etmek amacıyla 2000 yılında New York'ta Milenyum Kalkınma Hedefleri ortaya çıkmıştır. Afrika’ya yapılan dış yardım miktarının 600 milyar doları aşmasına rağmen, bu kıtadaki ülkelerin büyük kısmı az gelişmiş ve aşırı derecede fakir kalmıştır. Bu çalışmada, dış yardımın Etiyopya'ya olan sosyo-ekonomik etkileri incelenmiştir. Kalkınma yardımları ve dış yardım türlerine dair literatür incelendikten sonra, Dünya Bankası Veri tabanı, Şeffaflık Örgütü ve Özgürlük Evi gibi resmî kurumlardan edinilen veriler incelenmiş ve daha sonra bu zaman serisi verileri regresyon analizi yöntemi ile değerlendirilmiştir. Araştırma bulgularımız, dış yardımın GSYİH üzerinde önemli bir etkisi olmadığını göstermektedir; ancak dış yardım Etiyopya'da doğrudan yabancı yatırımlar (FDI) ve işsizlik oranı üzerinde önemli bir etkiye sahiptir. Ancak, ülkedeki demokrasi ve yolsuzluk seviyeleri ile dış yardımlar arasında anlamlı bir negatif ilişki olduğu görülmektedir. Her ne kadar dış yardımların miktarı sürekli artsa da ilgili endekslerde Etiyopya en yozlaşmış ve en otoriter Afrika ülkelerinden birisi olarak kalmaya devam etmiştir. Bu nedenle, dış yardımın alıcı ülkelerin demokrasilerini geliştirmelerini ve yolsuzluğu ortadan kaldırmalarını teşvik eden bir ödül olarak görülmesi gerekmektedir.

**Anahtar kelimeler:** *dış yardım, gelişme, GSYİH, işsizlik, yolsuzluk, demokrasi, yönetişim.*

**1. Introduction**

After the end of WWII, development assistance also called as ‘foreign aid’ began to be considered as an essential tool for growth and reduction of poverty. Since then development assistance has been used as a political tool between liberal and socialist blocs during Cold War in order to get control of the rest of the world.[[4]](#footnote-4) For instance, USA has put an aid program, the European Recovery Program for the reconstruction of Western Europe. This aid program, widely known as “The Marshall Plan” in which the US transferred 2-3% of its GDP to Europe, was successful and played a significant role in the reconstruction of the region.[[5]](#footnote-5) The struggle between the two blocs ended with the collapse of the Soviet Union in 1991. Parallel to this development, socialist ideas also collapsed, and the ideas of liberalism and globalization have become dominant throughout the world.[[6]](#footnote-6)

As a result of paradigm shift in development policy approach after 1980s[[7]](#footnote-7), developed countries has taken a global responsibility since 1960s and they have been advocating foreign aid to reduce poverty and achieve development and economic growth. This global task has been reinforced with the Millennium Submit of 2000 in New York where a project called the Millennium Development Goals was launched and the international community committed itself for more contribution to the development of the developing countries. With the implementation of this program, extreme poverty was to be reduced by half until 2015. The other goals of the program were to achieve universal primary education, eliminate gender disparity in education, reduce infant and maternal mortality by two-thirds, ensure environmental sustainability, and develop a global partnership for development.[[8]](#footnote-8)

The African continent has been largely receiving foreign aid since 1960s, and more than $600 billion is transferred to the continent as foreign aid. Despite the continuing and increasing amount of aid for more than half a century, little has been achieved in terms of development in the continent. Besides, the continent’s aid dependency continues, and it is not expected to be reduced in the near future. Because of this, the effectiveness of foreign aid has been highly debated for the past two decades.

For Africa, The Millennium Development Goals (MDG) are far from being attained. According to the United Nations Development Program (UNDP) Human Development Report of 2014, 34 countries out of the 48 Least Developed Countries (LDC) in the world are in Africa.[[9]](#footnote-9) In addition, 48% of people living in Sub-Sahara Africa are in extreme poverty (live in less than 1.25$ a day).[[10]](#footnote-10) Therefore, some scholars describe foreign aid as a “failure” and contend that donor countries should rethink of this “failed aid”. Dambisa Moyo argues that the aid extended to Africa is doing more harm than good.[[11]](#footnote-11) In contrast, Sachs contends that “cutting the aid to Africa would cause the death of more than 6 million Africans a year for preventable and treatable causes, including undernourishment, lack of safe drinking water, malaria, tuberculosis and AIDS”.[[12]](#footnote-12) As Addison et al. claims that the aid has contributed to growth in Sub-Sahara Africa and, thereby, it reduces poverty.[[13]](#footnote-13)

One of the reasons that some scholars are critical of the efficiency of foreign aid is that most of the 34 African countries in the LDC have authoritarian governments and high corruption rate. This raises a concern whether foreign aid encourages corrupt and authoritarian rulers, enriches elites in poor countries, and extends the life of bad governments in power. This is consistent with the findings of Peter Boone stating that “despite the tremendous amount ($600 billion) of aid supplied to Africa, the continent has still remained one of the poorest relative to other continents”.[[14]](#footnote-14) Therefore, donor countries tend to promote responsible policies because aid works only in countries with good policy.[[15]](#footnote-15) Moreover, foreign aid promotes growth in countries with stable political environment.[[16]](#footnote-16) Because of this mixed outcome, the impact and outcome of foreign aid has been the central discussion of scholars and needs more elaboration.

For instance, Ethiopia has been one of the largest recipients of foreign aid in Sub-Sahara Africa. It has received more than $42 billion for the past two decades. Yet again, the country is found in the list of the Least Developed Countries ranking, 173rd out of 187 countries in the Human Development Index. In addition to this, it ranks 110th out of 175 countries on the Corruption Perception Index of Transparency International. Likewise, its democracy index is not appreciated, because it is 6/7 according to Freedom House Report.[[17]](#footnote-17) Yet again, it has been one of the top aid receiving countries in Africa. Therefore, the contribution of foreign aid to this country’s development is worth to be evaluated in detail.

In this study, a secondary data is used from World Bank Database, Transparency International and Freedom House. Consistent with the findings of the literature, it is expected that foreign aid or Official Development Assistance increase Foreign Direct Investment and democracy level. On the other hand, foreign aid is expected to have a negative effect on corruption. Additionally, in the study, terms like “Foreign Aid” and “Official Direct Assistance” are interchangeably used. Time series data were used to test our hypotheses with regression analysis. In order to evaluate how foreign aid influences the socio-economic development of Ethiopia, we evaluated the influence of foreign aid on foreign direct investment (FDI), GDP growth, unemployment rate, corruption, and democracy. Moreover, correlation of foreign aid with the population growth is also evaluated in the study.

As a result, we argue that foreign aid can boost economy, enhance growth by creating a space for a foreign direct investment, reduce corruption, and promote democracy. Moreover, because of the increasing investment, the unemployment rates are expected to decrease. On the other hand, foreign aid has no strong relation with the GDP growth in Ethiopia. There is a negative correlation between foreign aid and corruption as well as foreign aid and democracy in Ethiopia. Foreign aid is not associated with good democracy and governance. Despite the increasing foreign aid, Ethiopia has remained one of the most corrupt and authoritarian countries in Africa. Foreign aid should reward countries with good democracy and consider corruption performance.

After reviewing the previous research, this study assesses the influence of foreign aid on the socio-economic development of Ethiopia in five main titles; (1) the impact of foreign aid on development, (2) the negative impact of foreign aid, (3) the impact of foreign aid on corruption and (4) the contribution of foreign aid to democracy, and (5) the statistical analysis of foreign aid influence on Ethiopia.

**2. Foreign Aid, Development and Foreign Investment**

The Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD), preferring to use Official Development Assistance (ODA) instead of foreign aid, has defined the ODA as the financial, technical assistance and commodity flow to the countries that are in the list of DAC. This assistance is the sum of grants and loans to aid recipient countries found in the list of the DAC.[[18]](#footnote-18) Steven Radelet states that the aim of foreign aid is to stimulate economic growth, support consumption of food and other commodities, strengthen education, health, environment or political system and help stabilize an economy following economic shocks.[[19]](#footnote-19) Moreover, foreign aid has positive impact on the growth[[20]](#footnote-20) and development of developing countries, and attracts foreign investment.[[21]](#footnote-21)

Thus, foreign aid can boost economy and bring growth by preparing space for foreign direct investment. It is believed by the International Monetary Fund and World Bank that Foreign Direct Investment (FDI) can play a vital role in the fight against poverty in developing countries. For instance, the World Bank has established the Multilateral Investment Guaranty Agency (MIGA) in 1988 “*to enhance the flow to developing countries of capital and technology for productive purposes under conditions consistent with their developmental needs, policies and objectives, on the basis of fair and stable standards to the treatment of foreign investment*”.[[22]](#footnote-22) Hence, MIGA encourages and facilitates FDI so that it could ease the unemployment of developing countries. For Elizabeth Asseidu and Yi Jin, foreign aid is a source of capital because it creates jobs, boosts wages and promotes economic growth.[[23]](#footnote-23) Accordingly, aid recipient countries that tend to reduce poverty and unemployment, are supposed to make the necessary arrangements for FDI.

For the proponents of foreign aid, it can relieve credit shortages faced by the governments. This will allow them to invest in the development of public infrastructure and human capital, which will increase growth.[[24]](#footnote-24) Recipient countries use resources obtained from foreign aid to cover the “saving gap” and “the foreign exchange gap”.[[25]](#footnote-25) In addition, if the effect of aid on domestic savings is positive, then it can be argued that aid will spur growth. Otherwise, aid will probably be detrimental to the economic growth of developing countries.[[26]](#footnote-26) As a result, for aid recipient countries, in this model, aid takes the place of savings and these savings lead to investment, which eventually results in growth.

Furthermore, in order to have an effective foreign aid, recipient country’s implementation of good policy is necessary.[[27]](#footnote-27) Many scholars argue that foreign aid works better in countries with good policies. This means that for countries with good fiscal, monetary, institutional quality and trade policies, foreign aid promotes growth and development. Similarly, the Canadian International Development Agency suggests that good policies make foreign aid effective.[[28]](#footnote-28)

One of the components of good policies is to have an open trade policy. Trade plays a vital role in bilateral aid since donor countries are more interested in this type of aid. Thus, open economy also plays a major role on attracting foreign investment flow.[[29]](#footnote-29) William Morrissey[[30]](#footnote-30) identifies mechanisms through which aid can contribute to economic growth. These mechanisms include a) aid increases investment, in physical and human capital; b) aid increases the capacity to import capital goods or technology; c) aid does not have indirect effects that reduce investment or savings rates; and aid is associated with technology transfer that increases the productivity of capital and promotes endogenous technical change. Peter Bauer[[31]](#footnote-31) supports foreign financial assistance by arguing that “(a) it is instrument for economic development; (b) reduces the poverty; (c) it is a powerful tool for international income redistribution; (d) acknowledging past mistakes and making up for them with compensating measures; (e) serving the interests of developed countries; (f) helps controlling the unprecedented growth in population”.[[32]](#footnote-32)

Similarly, Howard White suggests that the impact of foreign aid on income would result in feed back into higher savings and it is also possible that aid can also result in an increase of taxes and an increase of government expenditure in excess of the value of the aid inflows. To him, “*the impact of aid on these variables depends crucially upon the relationship between aid and private investment. If aid crowds out private investment then there is a greater possibility that aid will reduce taxes, and it may even reduce national income*”.[[33]](#footnote-33)

Furthermore, Karuna Gomanee et al. found in their empirical work that aid has positive impact through investment.[[34]](#footnote-34) As a result, it increases growth.[[35]](#footnote-35) Likewise, Gitaru Karras conducted a study on the relationship between foreign aid and growth in per capita GDP using annual data from the 1960 to 1997 period for a sample of 71 aid-receiving developing economies.[[36]](#footnote-36) His findings suggest that the effect of foreign aid on economic growth is positive, permanent, statistically significant, and not negligible. Moreover, the finding shows that foreign aid rise by $20 per person of the receiving country results in a permanent increase in the growth rate of real GDP per capita by approximately 0.16 %. His research shows the positive relation between foreign aid and growth. Therefore, the literature indicates that aid has a positive impact on growth and development of developing countries. In addition to this, we suppose that the foreign aid extended to Ethiopia is associated with economic growth and development. Relying on a previous research, following hypotheses can be formed:

*Hypothesis 1: Foreign aid is more likely to increase economic growth and development in recipient countries.*

*Hypothesis 2: Foreign aid is more likely to attract foreign direct investment to the recipient countries.*

*Hypothesis 3: Foreign aid is more likely to reduce unemployment in the recipient countries.*

**3. Does Foreign Aid More Harm Than Good?**

contrary to the above literature, some scholars argue that foreign aid does harm than good to developing countries contending that foreign aid is not an effective tool for growth and development.[[37]](#footnote-37) Additionally, it is argued that it creates dependency, keeps authoritarian governments in power and encourages corruption. Dambisa Moyo argues that aid has been a disaster for Africa.[[38]](#footnote-38) For Moyo, the notion that aid brings growth is a “myth” as aid has been and continues to be, an unmitigated political, economic and humanitarian disaster” for most developing countries. By contrary to the notion that aid encourages investment, she argues that aid chokes off investment, encourages dependency and facilitates corruption, adding that this cycle “*perpetuates underdevelopment and guarantees economic failure*” in poor regions.[[39]](#footnote-39) She also emphasizes the huge cost of armed conflict in Africa between the period 1990-2005 is estimates to be more than $300 billion. As a result, aid should be a rewarding element to good performing countries, because, most of the reasons lying under the underdevelopment of Africa is attributed to bad governance and mismanagement of resources than lack of it (resource).[[40]](#footnote-40)

Jeffrey D. Sachs described that out of the aid extended by the USAID, only aid intended for transformational development aims to support long-term economic change by helping a country achieve structural transformations that should allow it ultimately to escape dependence on outside aid.[[41]](#footnote-41) Furthermore, Ömer Eroğlu and Ali Yavuz argue that all foreign aid are not effective and contribute to development.[[42]](#footnote-42) The effectiveness of aid, however, depends largely upon both the donor and recipient motives and how these may be aligned or may conflict with the objectives of aid. Hence, a conflict of interest might arise between the donor and recipient countries. For instance, Meernik et al. suggest that security concerns were the main motive behind the foreign aid extended to the developing countries during the cold war.[[43]](#footnote-43) To them, whether the recipient uses aid to increase savings and investment rather than switch aid resources to consumption and other non-productive purposes, also determine the effectiveness of aid. Thus, the motives and intentions of donor countries should play a significant role on the expenditure of aid. Considering the corruption rate and poor democratic performance of most developing nations, the domain to which aid is spent should be highly controlled.

Subsequently, all types of aid could not contribute to growth and development. William Easterly and Tobias Pfutze state that three types of aids are widely considered to be not very effective: tied aid, food aid, and technical assistance.[[44]](#footnote-44) Countries like the USA and Portugal extend food aid to subsidize the local farmers. Studies show that if food aid is to be extended donor countries are supposed to buy from the local markets of the recipient countries because the prices are by half or lower than the prices in the donor countries.[[45]](#footnote-45) William Easterly and Tobias Pfutze describe food aid as a way for donor countries to “dump” their excess agricultural production on markets in low-income countries.[[46]](#footnote-46)

OECD defines technical assistance as  “grants to nationals of aid recipient countries receiving education or training at home or abroad, and payments to consultants, advisers and similar personnel as well as teachers and administrators serving in recipient countries, (including the cost of associated equipment)”.[[47]](#footnote-47) Tied aid happens when recipient country is required to purchase goods from the aid-granting country. On the other hand, DAC recommends donor country to be pro-untied aid, which means aid recipient should be freely available to buy goods and services from all countries. Tying aid can give it more political support at home, but it can also make it more costly and less effective.[[48]](#footnote-48) In conclusion, tied aid and food aid should be reconsidered by the donors. Especially donors need to supply the food aid (if necessary) from the local market. This will benefit the local producers as well as the consumers that get more aid in quantity than supplying from donor country local market.

Wolfensohn quoted in World Bank that "*We have learned that corruption, bad policies, and weak governance will make aid ineffective*".[[49]](#footnote-49) He continued by arguing that corruption, bad policies, and weak governance has improved in poor countries, and donors have become more discriminating in directing aid to "good" countries. Therefore, there should be “*roughly a doubling of current aid flows*”.[[50]](#footnote-50) Thus, good policies and strong institutions are needed to have an effective and working foreign aid. Otherwise, it will be an elite enriching tool for authoritarian rulers.

**4. Foreign Aid and Corruption**

Good governance is a requisite to fight against corruption. It is also known as State-market-civil society synergism and the new public governance in the literature. The term governance was firstly used by World Bank report. There are three important factors that differentiate governance from previous approaches.[[51]](#footnote-51) Firstly, good governance approach expects cooperation between state, private sector and civil society. This approach locates civil society as an important factor in decision-making process which is also called as ‘third sector’. Secondly, good governance enforces interaction, participation and corporation of citizens in creating public policy contrary to new public management based on customer interest in the competitive market conditions. Thirdly, governance approach argues that active citizens should attend in all type of policy-making processes through civil society mechanism. Therefore, they can determine their needs and solutions for their problems by negotiating with each other and rulers. Thus, responsibility of the state can be shared with active citizens; so public policies are going to be more legitimate.

The World Bank has been arguing about the governance crisis in the Sub-Sahara Africa for a long time. In a report which was released in 1989 it was specified that the governance crisis is the main problem of Africa region because some problems such as poor quality institutions, weak rule of law, lack of accountability, tight controls over information, and high levels of corruption are still remained unsolved in many African countries today.[[52]](#footnote-52) In their empirical work Andrew Young and Kathleen M. Sheehan concluded that aid “flows are associated with deterioration in the legal system and property rights of a recipient country and its international trade freedoms. The results of growth regressions suggest that, in turn, such deterioration can be associated with large, negative effects on growth”.[[53]](#footnote-53)

Since good governance has a great influence on the destiny of a country, it should be a necessary condition of foreign aid. Unfortunately, many developing countries often have bad governance and this situation prevents governments from establishing economic reform and development process of their countries.[[54]](#footnote-54) Thus, it is inevitable to for recipient countries to improve their governance. Especially the international institutions that encourage governance, say, the World Bank and IMF, are expected to play a major role on this issue. Moreover, institutional quality is essential for growth and development; therefore, foreign aid is expected to mitigate institutions.

Corrupt countries still get lion’s share of foreign aid. Scholars like Stephen Knack argue that foreign aid is identified with corruption and bad government performance. He, for instance contends that foreign aid erodes the quality of governance and rule of law and is associated with high level of corruption.[[55]](#footnote-55) This enforces the argument that foreign aid enriches elites in recipient countries. In addition to this, Martin Acht et al. concluded in their empirical finding that more corrupt countries receive higher amount of total aid.[[56]](#footnote-56) In consequence, it will be a tough task for Africa to achieve the Millennium Development Goals. Accordingly, urgent measures and reforms are needed to be taken by the MCC (Millennium Challenge Cooperation).

Furthermore, it is argued that corrupt governments that follow very poor policies receive just as much aid as less corrupt ones.[[57]](#footnote-57) World Bank report of 1998 suggests that financial assistance does not often reach the real need in developing countries, but is wasted in inefficiency.[[58]](#footnote-58) Alberto Alesina and Beatrice Weder state that the corruption record of the recipient country issue is not considered in the application of debt relief. However, there is an exception for Scandinavian countries and Australia. These countries give more aid to less corrupt governments. In general, multilateral aid, namely, aid from international organizations, does not discriminate against corruption of the receiving country; thus, aid does not serve as a rewarding tool for the better performing countries.[[59]](#footnote-59)

In fact, recipient countries may sometimes apply some “bad” policies and use aid funds instead of adopting and implementing good policies. donor countries also play a major role on the allocation of aid. For instance, when Ethiopia invaded Somalia in 2007, it had the support of its major donors. In the same year, the country was suffering from huge humanitarian crisis. Therefore, foreign aid may sometimes be spent on war as well. On the other side, good policies and strengthened governance can improve the governance level of the recipient as it has been the case for Taiwan, South Korea and Botswana.[[60]](#footnote-60)

If one of the objectives of foreign aid is to contribute to the growth of the economy, logically fighting against corruption must be an important policy, because, corruption is known to have a negative effect on the growth and development of a country.[[61]](#footnote-61) Accordingly, an extreme corruption is associated with poor infrastructure which discourages foreign investment. This will eventually lead to poor growth and development. A study conducted by Azmat Gazni in the Pacific Island Countries shows that “*the lack of voice and accountability, deterioration in rule of law and high levels of corruption are negatively correlated with per capita foreign aid while regulatory quality and government effectiveness are positively associated with per capita foreign aid*”.[[62]](#footnote-62) Moreover, if the corruption remains in the receiving country, it is problem for donor countries where corruption is minimized, because the interest of citizens to help economic development of poor countries is respected in these countries.[[63]](#footnote-63) Hence, donors are expected to consider the governance and corruption records of the recipients.

Aid policy can also affect the corruption of the recipient country. Most of the time in bilateral aid, donor countries extend aid for their interests. During 1980’s the US foreign aid was mostly based on the ideological stance of the recipient, whereas Japan’s foreign aid was driven by trade.[[64]](#footnote-64) Thus, they may not consider the corruption state of the recipient. This has been the case during the cold war time in general. Especially France does not consider the democracy and corruption level of the recipient countries; French language and ex-colonial relation play a vital role on its aid allocation.[[65]](#footnote-65) Carl Jan Willem Schudel found that corruption reduces bilateral aid. However, not all donor countries are equally responsive to recipient corruption. Donor countries that are relatively corrupt do not seem to respond negatively to recipient corruption levels.[[66]](#footnote-66)

In contrast to the above literature, (who?) concluded in their empirical work that foreign aid generally decreases corruption. However, this is true for multilateral aid.[[67]](#footnote-67) On the other hand, in the case of major donor countries such as France, UK and USA, bilateral aid has no significant effect on corruption. To test this, we propose the following hypothesis:

*Hypothesis 4: Foreign aid is more likely to reduce corruption in recipient countries.*

**5. Foreign Aid and Democracy**

The impact of foreign aid on democracy is one of the debated issues among scholars working in this field. There is no universal criterion in defining and measuring democracy in a country but Dahl’s eight criteria[[68]](#footnote-68) in his book “Polyarchy” can be used as an essential framework.[[69]](#footnote-69) His first five criteria are about comprehensive, competitive and fair elections, and the last three criteria are about social and political rights.[[70]](#footnote-70) Considering these criteria, it is important to find out if foreign aid has any influence on democracy in a country.

Murat Önder and Fatih Ulaşan argue that both culture and public administration in a country are influential on growth and development.[[71]](#footnote-71) They claim that culture influences growth and development of a country in two ways. Firstly, each individual subject to the culture in a society which encourages or discourages directly or indirectly economic growth. For instance, competition is part of a culture in capitalist societies where individual interest is very essential, so competitiveness enforces growth and development in these societies. Secondly, private and public organizations or NGOs are influenced by the national culture which is dominant in that society, because their capabilities, organizational cultures and environment are shaped by that culture. Murat Önder, for instance, suggests that national culture is very influential in explaining presence of NGOs.[[72]](#footnote-72) He uses the model of culture built by Geert Hofstede which is based on four dimensions: power distance, uncertainty avoidance, individualism, and masculinity.[[73]](#footnote-73) In this direction, he argues that “in high power-distance countries, power is centralized, organizations are highly hierarchical, bosses are autocratic, and subordinates expect to be told that what to do. In low power-distance countries, there are changeable roles within decentralized and flat hierarchies, and differences between subordinates and bosses are downplayed”.[[74]](#footnote-74) On the other hand, public administration can foster growth and development through principles of governance, because deficient public administration can restrict economic growth.

Proponents of foreign aid contend that it promotes democracy and solidifies institutions of the recipient countries. Yener Altunbaş and John Thornton conducted a research on the impact of foreign aid on democracy in a panel of 93 developing economies during 1971–2010 and found that a percentage point increase in foreign aid leads to an increase in the Polity Democratic Development Index.[[75]](#footnote-75) Foreign aid can foster democracy, because it can help to increase education level, encourage free press and fair elections as well as promote legislative and judicial checks on executive power in the receiving countries.[[76]](#footnote-76) Sarah Blodgett Bermeo has examined the aid data of 15 years and found out that receiving more aid from democratic sources is often associated with an increased likelihood of a democratic transition.[[77]](#footnote-77) Additionally, she finds out that the opposite is true for aid from authoritarian sources, which consistently has a negative relationship with the likelihood of democratization. Alberto Alesina and David Dollar have found out that countries that democratize get 50% increase in aid.[[78]](#footnote-78) Thus, for scholars who are pro-aid, foreign aid is essential and important catalyzer for democracy and democratization process. Agnes Cornell[[79]](#footnote-79) suggests that “*the impact of democracy aid differs between different types of authoritarian regimes. Democracy aid has a positive impact on democracy levels in the most stable types of authoritarian regimes where political institutions are also in place, that is, one-party regimes*”.[[80]](#footnote-80)

During the Cold War, many donor countries were more interested in security thus allocating their aid to their allies. The USSR supported strategic allies, especially Marxist-Leninist regimes, the US and other Western donors provided economic assistance to developing countries that helped contain communism and Soviet ‘expansionism’.[[81]](#footnote-81) This hindered the development of democracy in recipient countries; even sometimes being a discouraging factor of democracy. However, this situation has changed after the Cold War, because donor countries have publicly committed to reward political reforms with high aid flows.[[82]](#footnote-82) On one hand, the Soviet threat has disappeared so the political environment has favored liberal economy and democratization process of the developing world. Since then, donors like the EU and DAC have been sensitive to political changes and they have consistently encouraged liberalization in the recipient countries.[[83]](#footnote-83) Burcu Savun and Daniel C. Tirone find out that “*democratizing countries that receive high levels of democracy aid are less likely to experience civil conflict than those that receive little or no democracy aid*”.[[84]](#footnote-84) The USAID has also spent millions on democracy and democratization process since the end of the Cold War.[[85]](#footnote-85) Thus, this shows the commitment of Bilateral and Multilateral Aid Organizations to democracy.

The negative impact of foreign aid on democracy is also examined by other scholars. For instance, Jakob Svenson and Simeon Djankov et al. argue that aid hinders the development of democracy in recipient country by fostering weak institutions.[[86]](#footnote-86) Moreover, Simeon Djankov et al. adds that foreign aid has a negative impact on the democratic stance of developing countries and economic growth by reducing investment and increasing government consumption. Likewise, Sarantis Kalvitis and Irene Vlachaki studied the correlation between aid and democracy of 64 recipient countries for the period 1967-2002 and concluded that aid flows affect negatively the probability of observing democracy in recipients. They also found that aid from the USA has a non-significant effect on the political regime of the recipients, whereas aid from multilateral agencies has a negative and statistically significant effect.[[87]](#footnote-87) It even reduces economic freedom in poor countries.[[88]](#footnote-88) Furthermore, Stephen Knack argues that aid might reduce the need for taxation, thereby reducing the demand for democratic accountability.[[89]](#footnote-89) This argument, in fact, supports those economists who contend that “*aid promotes slow tax collection*” and “*ill public administration*”. There are also scholars like Burcı Savun and Daniel C. Tirone who find that aid has no effect on political regime type. We propose following hypothesis regarding foreign aid and democracy relations:[[90]](#footnote-90)

*Hypothesis 5: Foreign aid is more likely to develop democracy in recipient countries.*

**6. The Case of Ethiopia**

**6.1. Research Design**

To explain the impacts of foreign aids on socio-economic variables in developing countries, we offer different simple regression models since influencing factor of foreign aid is a single independent variable to test our hypotheses derives from the literature. These hypotheses include several causative relationships between our independent variable and various dependent variables. In this study for the case of Ethiopia, a secondary data is collected from World Bank Database, Transparency International and Freedom House. In order to explain the impacts of foreign aids on the socio-economic development of Ethiopia, we evaluate the impacts of foreign aids on Foreign Direct Investment, GDP growth, unemployment rates, corruption, and democracy. The data covers the years beginning from 1991 till 2016.

Simple regression is a statistical technique used to assess the magnitude and direction of the relationship between a criterion variable and a predictor variable. Ordinary Least Squares (OLS) regression analysis will be used to estimate the models. OLS regression was selected for two reasons. First, it is a widely accepted statistical procedure for exploring and predicting the relationships among different variables. Second, the results of regression are easy to interpret.[[91]](#footnote-91) Regression runs with variables against each criterion variable and the results are reported in the findings in a subsequent title.

The OLS regression models used variables as given in the following;

Y1..n = a + bX + e

            Where;

X = Official Development Assistance,

Y1..n = Foreign Direct Investment, GDP growth, Unemployment Rate, Corruption, and Democracy.

e = Error term.

**6.2. Official Development Assistance and GDP Growth**

In the literature, little evidence is found about the direct influence of foreign aid on GDP; only an exception is Gitaru Karras who found that foreign aid has a positive impact on GDP. For the Ethiopian case, it could be concluded that there is official development assistance only explains 24% variance in GDP growth in the country.[[92]](#footnote-92) Our hypothesis 1 regarding the influence of foreign aid on economic growth and development in recipient countries is supported by the data about Ethiopia. However, there is no strong relationship and our model only accounts for partial relationship between two variables. For instance, in the years 1991, 1992, 1997, 1998, 2002, 2003 and 2009, despite the increase in foreign aid, there was a substantial decrease in GDP, sometimes even dropping to negative. For instance, in 1998 the Ethio-Eritrean war that ended in 2003 started. In both years, the GDP went down to -3,5 and -2,2 consecutively. On the other hand, in the years 1995, 1996 and 1999, while foreign aid decreased, GDP growth was positive.

**Figure 1: Official Development Assistance and GDP growth rate**

Source: World Bank Database

Pearson R2: .24, Adjusted R2 =.21, F =7.418, Significance of F = .012,  :2.645,  P < .05, N: 25

**6.3. Official Development Assistance and Foreign Direct Investment**

The literature above has shown that foreign aid boosts foreign direct investment. It can also relieve credit shortages faced by the governments. This will allow them to invest in the development of public infrastructure and human capital, which will increase growth.[[93]](#footnote-93) Moreover, aid recipient countries make structural changes and good policies to attract foreign investment. One of the components of good policies is to have an open trade policy. Trade plays a vital role in bilateral aid since donor countries are more interested in this type of aid. Thus, open economy also plays a major role in attracting foreign investment flow.[[94]](#footnote-94) Thus, directly or indirectly foreign aid boosts foreign direct investment, and this would lead to more growth. For instance, Karuna Gomanee et al. found in their empirical work that aid has positive impact on investment.[[95]](#footnote-95) Consistent with the literature, we find out that foreign aid increases as development assistance or foreign aid increases and the vice versa. Moreover, there has been structural changes as well as many institutional reforms in Ethiopia that would ease the red tape of bureaucracy in the government since 2004. As a result, the country has been one of the preferred foreign investment destinations. Thus, foreign aid seems to boost foreign direct investment in the Ethiopian context. Our hypothesis 2 regarding the positive influence of foreign aid on foreign investment in recipient countries was supported by the data about Ethiopia.

**Figure 2: Official Development Assistance and Foreign Direct Investment**

Source: World Bank Database

Pearson R2: .25, Adjusted R2 =.22, F =7.426, Significance of F = .012,  :.283, 

P < .05, N: 24 P < .05, N: 24

**6.4. Official Development Assistance and Democracy Rate**

Foreign aid is used as one of the democratizing tools for authoritarian countries. Thus, aid can promote democracy through raising the educational level of the population, through the support of free press and fair elections as well as the promotion of legislature and judicial checks on executive power.[[96]](#footnote-96) For Sarah Blodgett Bermeo receiving more aid from democratic sources is often associated with an increased likelihood of a democratic transition.[[97]](#footnote-97) Additionally, she finds out that the opposite is true for aid from authoritarian sources, which consistently has a negative relationship with the likelihood of democratization. In contrast, Jakob Svenson and Simeon Djankov et al. argue that foreign aid hinders the development of democracy in recipient country by fostering weak, obedient, and collaborative governments and institutions; he thus contends that foreign aid has a negative impact on the democratic stance of developing countries.[[98]](#footnote-98)

For the Ethiopian case, holding the other factors in constant, foreign aid is negatively associated with democracy. As aid increases, the democracy level of the country decreases. Considering the Freedom House rating from 1 (Best Democracy) to 7 (Worst Democracy), the Ethiopian democracy has fallen from 4 to 6 despite the increasing of foreign aid each year. For the period between 2000 and 2009, there was no change on the democracy rate of the countries which were rated as 5. Hence, it could be concluded that foreign aid in Ethiopia does not promote democracy. Our hypothesis 5 regarding the positive influence of foreign aid on democracy in recipient countries was not supported by the data about Ethiopia. Conversely, there is a negative statistically significant relationship between foreign aid and democracy levels in the country.

**Figure 3: Official Development Assistance and Democracy Rate**

Source: World Bank Database

Pearson *R2: .55,* Adjusted R2 =.52, F =19.807, Significance of F = .001,  :.362, 

*P < .05, N: 18*

**6.5. Official Development Assistance and Unemployment Rate**

Foreign aid does not have a direct impact on unemployment. However, increasing foreign aid can enforce the improvement on foreign direct investment that would create jobs, so unemployment is likely to decrease. For the Ethiopian case, there is a direct negative relationship between foreign aid and unemployment rate, because when foreign aid increases, unemployment rate decreases. Thus, it could be concluded that foreign aid has a positive impact on reducing unemployment. Our hypothesis 3 regarding on positive influence of foreign aid on reducing unemployment in recipient countries was supported by the data about Ethiopia.

**Figure 4: Official Development Assistance and Unemployment rate**

Source: World Bank Database

Pearson R2: .79, Adjusted R2 =.78, F =85.704, Significance of F = .001,  :-.869, 

 P < .05, N: 25

**6.6. Official Development Assistance and Population Size**

Figure 5 shows that foreign aid increases together with the population size even considering population increase. The population of Ethiopia was 49 million in 1991, whereas the foreign aid extended to the country was $1.09 billion. In 2013, the foreign aid almost became four-fold to that of 1991 increasing to $3.82 billion. There is also very high bivariate correlation between foreign aid per capita and official development assistance (*Pearson Correlation: .98,* *P < .05, N:23). ODA is increasing parallel to population size.*

**Figure 5: Official Development Assistance and Population size**

Source: World Bank Database

Pearson Correlation: .90, P < .05, N: 25

**6.7. Official Development Assistance and Corruption**

The impact of foreign aid on governance and corruption has been central to the debate of comparative development scholars. Most of the aid recipient countries are characterized with poor quality institutions, weak rule of law, absence of accountability, tight controls over information, and high levels of corruption.[[99]](#footnote-99) Accordingly, since good governance is essential and it plays a vital role in determining the destiny of a country, it should be a prerequisite of foreign aid. Most of the developing countries have usually poor governance and this is a major obstacle that hinders the economic reform and development process of these countries.[[100]](#footnote-100)

Yet, corrupt countries still get lion’s share of foreign aid; scholars have hotly debated this issue and some have concluded that foreign aid is identified with corruption and bad government performance. This is true for the Ethiopian case as well. The country’s corruption index is getting worse each year. Despite this unappreciated corruption record, the country has been receiving tremendous amount of foreign aid compared to other African countries.

For instance, the country is ranked 110 out of 177 countries on the corruption perception index of 2014. It has scored 33%; which means that it is one of the most corrupt countries in the world. There is no statistically significant relationship between ODA and corruption in Ethiopia. Thus, foreign aid has no significant impact on corruption in Ethiopia. Our hypothesis 4 regarding the positive influence of foreign aid on reducing corruption in recipient countries was not supported by the data about Ethiopia.

**Figure 6: Official Development Assistance and Corruption**

Source: World Bank Database

*Corruption perception index.*

Pearson R2: .03, Adjusted R2 =.06, F =.323, Significance of F = .581,  :-.007,  P= .58, N: 13

**7. Conclusion**

After the World War II, development aid became an important policy instrument for industrialized and rich Western states in terms of international economy and politics. Especially, this instrument is used for control of the rest of the world both by liberal and socialist blocs during the Cold War. However, development aid has been criticized for problems such as dependence, one-sidedness, conditionality, participation, cohesion and failure to contribute adequately to the development processes in the receiving countries.

The Marshall Plan of the United States is the most well-known foreign aid program in Europe under European Recovery Program between 1948 and 1951. The plan worked efficiently in reducing poverty and increasing economic growth in the European region. Afterwards, developed countries took responsibility under Millennium Development Goals, which was launched in 2000, New York, and started to finance economic growth of countries which need development aid. The main purpose of this aid has been to contribute to the development of poor countries and reducing poverty.

On the other hand, despite the billions of dollars transferred, development assistance has not been successful because the development gap between poor and rich countries has not been closed. There are many reasons behind this failure. Firstly, the neoliberal policies such as structural regulatory dynamics and dependent or conditional development aid have resulted in unequal and repressive relations between poor and rich countries. Secondly, the lack of coordination, overly ambitious goals, unrealistic time targets, budgetary problems and political interventions that global development has faced since the 1960s have prevented the aid from being effective at the desired level.[[101]](#footnote-101) Against the traditional paradigm of aid created by industrialized / developed northern states led by the United States, developing countries have begun to develop their own paradigms towards these problems with South-South Cooperation, Arab Donors and other new actors.

The findings of this research clearly show that foreign aid increases foreign direct investments. It is also observed that the unemployment rate declines by foreign aid. At this point, there is a high correlation between foreign direct investment and unemployment rates. On the other hand, it can be said that foreign aid has a weak correlation with GDP in the case of Ethiopia. In Ethiopia, there is a negative relationship between foreign aid and democracy as well as corruption. It cannot be said that external assistance is directly related to higher level democracy and governance. Perhaps the priority of poverty in some of these aids may lead to ignorance of the existing system of authoritarianism, corruption and weak democracy. It will be useful in future research to concentrate on where these aids are used. Despite increased foreign aid, Ethiopia remains as one of the most corrupt and authoritarian countries in Africa. Accordingly, the method of awarding foreign aid to countries with better democracy and corruption performance can be considered.

In the context of the influence of governance philosophy; expanding role of the business community, charities, non-governmental organizations and local governments have resulted in a new understanding of foreign aid in which donor and receiving countries should corporate with many actors. Therefore, it is important to consider the good governance principles and planning process in the framework of the collaborative governance paradigm. The traditional understanding of aid has also moved to new dimensions as a result of the increasing knowledge transfer between developing countries and other actors. For this reason, aid should be re-analyzed and constructed within the framework of governance approach and new transformations.

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