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ADDIS ABABA UNIVERSITY SCHOOL OF GRADUATE STUDIES

FISCAL EFFECTS OF AID IN ETHIOPIA

BY

BERHANU ALEMU ZEWDIE

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“Fiscal Effects of Aid in Ethiopia.”

By

Berhanu Alemu Zewdie

Approved by the Board of Examiners:

Teshome Mulat

Advisor

Nowf

Signature

Alemayehu Ges

Examiner

[Signature]

Signature

S. L. NARAYANA

Examiner

[Signature]

Signature

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Acronyms

ADB	African Development Bank
ADF	African Development Fund
ACP	African Caribbean Pacific
AMC	Agricultural Marketing Corporation
ARDU	Arsi Rural Development Unit
BADEA	Arab Bank for Economic Development in Africa
BoFED	Bureau of Finance and Economic Development
CADU	Chilalo Agricultural Development Unit
CCF2	The second Country Cooperation Framework
CRS	Creditor Reporting System
CIDA	Canadian International Development Agency
DAC	Development Assistance Committee (of the OECD)
DAG	Development Assistance Group
DRS	Debtor Reporting System (of the World Bank)
ESAF	Enhanced Structural Adjustment Facility (of the IMF)
EDF	European Development Fund
EEC	European Economic Community
EMCP	Expenditure Management and Control Programme
EU	European Union
EIB	European Investment Bank
ECOSOC	Economic and Social Council
ECA	Economic Commission for Africa
FAA	Foreign Assistance Act
FAO	Food and Agriculture Organization
FRM	Fiscal Response Model
GEF	Global Environment Fund
GTZ	German Agency for Technical Cooperation
GoE	Government of Ethiopia
HIPC	Heavily Indebted Poor Countries

IDA	International Development Association (of the World Bank)
ILO	International Labour Organization
IMF	International Monetary Fund
IFAD	International Fund for Agricultural Development
IBRD	International Bank for Reconstruction and Development (of the World Bank)
IFC	International Finance Corporation
ICSID	International Center for Settlement of Investment Disputes (ICSID)
JICA	Japan International Cooperation Agency
JBIC	Japan Bank for International Cooperation
LIEO	Liberal International Economic Order
LDCs	Least Developed Countries
LDLLICs	Least Developed Land Locked and Island Countries
MEEC	Ministry of External Economic Cooperation
MEDaC	Ministry of Economic Development and Cooperation
MOFED	Ministry of Finance and Economic Development
MDGs	Millennium Development Goals
MIGA	Multilateral Investment Guarantee Agency
NGOs	Non Governmental Organizations
NTF	Nigerian Trust Fund
NDF	Nordic Development Fund
OECD	Organization for Economic Cooperation and Development
ODA	Official Development Assistance
OLS	Ordinary List Squares
OPEC	Organization of Petroleum Producing Countries
PSIP	Public Sector Investment Programme
PADEP	Peasant Agriculture Development Extension Programme
PIP	Public Investment Programme
PPF	Project Preparation Facility
PRSC	Poverty Reduction Support Credit
SIDA	Swedish International Development Agency
SIP	Sector Investment Programme

SAP	Structural Adjustment Programme
SPA	Special Program for Africa
SDP	Sector Development Programme
SAC	Structural Adjustment Credit
SAF	Structural Adjustment Facility (of the IMF)
SDPRP	Sustainable Development and Poverty Reduction Programme
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme
UNFPA	United Nations Fund for Population Agency
UNHCR	United Nations High Commission for Refugees
UNESCO	United Nations Education Science and Cultural Organization
USAID	United States Agency for International Development
UNICEF	United Nations Children's Fund
UNIDO	United Nations Industrial Development Organization
UNSO	United Nations Sudano-Sahelian Office
U.S.	United States
VEC	Vector Error Correction Model
VAR	Vector Autoregression Model
WFP	World Food Program
WHO	World Health Organization

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Abstract

A core deficiency of the aid – growth literature is that, it fails to recognize explicitly that most aid conventionally defined is given primarily to the government. And any effect of aid on growth and poverty reduction will depend on government behavior.

To identify the effects of aid on public sector aggregates, both qualitative and empirical methodologies are used.

Vector autoregressive methods are applied to 39 years of annual data in Ethiopia to model the effect of aid on fiscal behavior. Results suggest that;

First, an increase in grants and an increase in foreign loans results in an increase in recurrent budget expenditure and a decrease in capital budget expenditure. This might show the existence of fungibility.

Second, an increase in grants, foreign loans and ODA results in an increase in domestic borrowing. Which might require policy measure towards the decrease in the domestic borrowing.

Third, an increase in grants results in an increase in tax revenue and on the contrary an increase in foreign loans results in a decrease in tax revenue. This unclear effect might have been caused by the different nature of grants and foreign loans. As the total effect is represented by the ODA, an increase in ODA results in an increase in the tax revenue which implies that ODA does not discourage taxation efforts.

Forth, a rise in ODA results in an increase in the tax revenue, domestic borrowing, recurrent expenditure and capital expenditure, i.e. a rise in all fiscal aggregates. This could probably be the effect part of the ODA which is not included in the budget. And this may require the need for developing systematic guidelines as to how all ODA's should be indicated in the budget,

CHAPTER ONE

INTRODUCTION

1.1 Definitions and basic concepts

Aid: aid is just one of several sources of capital flows in to developing countries. International movements of capital may come from either official or private sources.

Official sources are;

- (a) Governments and governmental agencies also called (bilateral lenders) and
- (b) International organizations (called multilateral lenders).

Private sources comprise

- (a) Commercial suppliers and manufacturers, which provide export credits for the purchase of their goods,
- (b) Commercial banks, which provide export credits or cash loans,
- (c) Other private investors, who invest in foreign enterprises in which they seek a lasting interest (direct investment) or purchase of stocks or bonds issued by foreign companies or governments (portfolio investment), and
- (d) Charitable organizations, which provide financial aid, goods and services as grants. (World Bank, 1985).

Foreign aid is conventionally measured on the basis of the Organization for Economic Cooperation and Development (OECD's) Official Development Assistance (ODA), a concept introduced in the early 1970s. The guardian of official information about aid is the Development Assistance Committee (DAC) of the OECD: its annual volume development cooperation contains the most commonly used aid statistics. For the DAC aid qualifies as ODA on three criteria;

1. It has to be undertaken by official agencies
2. It has to have the promotion of economic development and welfare as its main objectives.

3. It has to be provided on concessional terms with a grant element¹ of 25 percent or more.

The fundamental idea of aid is a transfer of resources on concessional terms -on terms, that is, more generous or "softer" than loans obtainable in the world capital market. Therefore Official Development Assistance (ODA) is defined as loans and grants made on concessional terms from official sources with the objective of promoting economic development and welfare (for a loan at least 25 percent grant element. (Robert, 1987).

This definition of aid excludes some concessional flows, namely those of the private voluntary agencies and net grant by NGOs. It also excludes official flows of little or no concessionality (non-concessional flows from official creditors). Grants, soft loans, or credits for military purposes are also specifically excluded. But food aid and technical cooperation are included. The latter covers assistance (nearly all grants) for developing country individuals receiving education or training at home or abroad, and for teachers, administrators, technical experts and the like working in developing countries. (Robert, 1987)

Therefore in the present study the word "aid" is used in the strict sense of Official Development Assistance (ODA). And the leading measure of foreign aid flows is the so called Net ODA, which is the net disbursement amount i.e. disbursements minus amortization, (disbursements of grants and loans minus repayments of principal on earlier loans). Thus ODA comprises grants and loans (net of repayments of principal) that meet the DAC definition of ODA.

Grants: are defined as, "a current transfer of capital, goods, or services to a foreign country that results in no current or future obligation to make a like transfer from the recipient country to the donor." Grants could be in the form of capital or technical assistance, or both. (World Bank, 1985)

Loans: are an in flow of resources to be used for a specified period of time and they should be repaid some time in the future. (World Bank, 1985)

¹ Grant element- determines the extent to which a loan can be considered a grant. It is the difference between the original face value of the loan and the discounted present value of debt service, as a percentage of the original face value. Thus, a true grant has a grant element of 100 percent; Discount rate of 10 percent is conventionally used in all present value calculation. Loan interest rates (used to compute interest charges) are assumed to remain constant through out the life of the loan. The grant element measures the degree of concessionality of an aid transfer compared with market terms, which are normally taken to include a rate of interest of 10 percent. Thus an outright grant of aid, has a 100 percent grant element; a loan at 10 percent interest rate has a zero grant element; a soft loan will lie somewhere in between. The maturity of a loan (that is, the number of years over which it is repaid) and its grace period; the interval between repayment starts also affect the measured grant element. (Robert, 1987)

Loans are classified as soft loans or hard loans on the basis of the terms of repayment .This are: the rate of interest charged, grace period, and repayment period.

Loans at below market rate of interest and with grace period and maturity period longer than that commercially available are "soft loans". Thus, "soft loans" are concessional while "hard loans" are non concessional. That is, concessional flows are international lending on terms more favorable to the borrower than those obtainable through normal market transactions. Non concessional flows are lending on or near terms prevailing in private financial markets. (World Bank, 1985)

Technical assistance: is a component part of development aid which involves the transfer of technical and institutional know how. It could be in any form, but the main forms of technical assistance are

1. Experts and advisors serving in a purely advisory capacity.
2. Experts and advisors with semi operational functions, eg, in establishing a new institution.
3. Equipment for use in teaching, training or research;
4. Operational personnel placed at the disposal of the recipient government for such tasks as may be assigned to them ;
5. Students and trainees, from developing countries in receipts of scholarships from donor agencies. (White, 1974)

The composition of aid: ODA comprises balance of payment support, budget support, investment projects , food aid, debt and emergency relief, technical assistance, concessional funding , other small categories of aid. (OECD/DAC, International Development Statistics CD-ROM, 2003 Edition).

Concessional debt: is used and denotes debt on concessional loans.

Concessional debt service: is the sum of interest payments and repayments of principal on concessional debt. (World Bank, 1988)

Recurrent Budget

Financial proclamation 57/1996 and financial regulation 17/1997 defined only the capital budget, implicitly defining the recurrent one as a residual. The recurrent expenditure is generally defined as

outlays of recurring nature. The common practice, however, is to include in the recurrent budget expenditures of recurrent nature (like wages, salaries of civil servants and operational expenses).

Capital Budget

Capital budget is budget for capital expenditures. Financial proclamation 57/1996 defined capital expenditure as “outlay for the acquisition of improvements to fixed assets, and includes expenditures made for consultancy services”. Financial regulation 17/1997 further provided a detailed definition of capital expenditures to mean:

- a. The acquisition, reclamation, enhancement as laying out of land exclusive of roads, buildings or other structures;
- b. The acquisition, construction, preparation enhancement or replacement of roads, buildings and other structures;
- c. The acquisition, installation or replacement of movable plant, machinery and apparatus, vehicles and vessels;
- d. The making of advances, grants or other financial assistance to any person towards him /her on the matters mentioned in [a] to[c] above or in the acquisition of investments;
- e. The acquisition of share of capital or loan capital in any body corporate; and
- f. Any associated consultancy cost of the above.

Capital budget could thus broadly be described as an outlay on projects that result in the acquisition of fixed assets and the provision of development services.(Ministry of Planning and Economic Development 1993)

1.2 Background and statement of the problem

The history of economic thought on foreign aid is some what peculiar. The phenomenal success of the Marshall Plan in the late 1940s and 1950s led many to believe that similar transfers of aid to developing countries would permit their comparably spectacular transformation. Foreign aid as an institution began in 1947 with the Marshall Plan. Debrah.etal (2004) and almost immediately concerns arose over the impact of large amounts of aid on the behavior of recipient governments.

Aid, or foreign development assistance, has been a dominant feature of the relationship between industrial and developing countries. Since the 1960s, aid receipts have been a major source of external finance for the majority of countries in Africa and Asia since they gained independence.

The predominant nature of aid has changed considerably, from project finance in the 1960s to adjustment support in the 1980s. The flow of aid to developing countries have been increasing from time to time. For instance aid flow to Africa increased from about \$ 1 billion in 1960s to \$32billion in 1991. (UN, 2002).

Africa's share of ODA to GDP has also been increasing. It was about 2.4% during 1972/73 and rose to 5% in 1983/84 and 9.8% in 1998 (World Bank, 1998). Moreover, UNCTAD (2000) report indicated that aid accounts for over 25% of GNP in 20 countries out of which 17 are in Africa.

In many countries of Sub Saharan Africa, aid flows are such that aid dynamics simply dominate local development efforts. Moss and Subramanian [2005] identify 22 low income countries, 16 of which are in Sub Saharan Africa where ODA inflows are equivalent to at least half of total government expenditure. In twelve poor countries of which 10 are African, the ratio of ODA to government expenditure was 75 percent or more.

In mid 2005, substantial increases in the volume of foreign aid to low income countries are once again at the center of public policy debates. The so-called Blair Commission (Commission for Africa, 2005) has called for an immediate increase of aid to Sub Sahara Africa of some 25 billion dollars per annum with an additional increase of 25 billion to come by 2015.

The millennium development Goals (MDGS) now provided clear set of objectives for mobilizing the international development community, notably with area of global ODA. The recent millennium project report recommends that high income countries should increase official development assistance from 0.25 percent of donor GNP in 2003 to 0.44 percent in 2006 and 0.54 percent in 2015 (UN 2005). This would amount to doubling official world aid from its current level, of approximately US \$120 billion per year.

As aid had been such an important source of finance, a large literature has emerged on evaluating its effects, especially the macro economic impact of aid on savings, investment, and growth.

The theoretical literature on aid effectiveness stems from the two gap model of Chenery and Strout (1966). The basic premise of the two gap model is that low domestic savings and inadequate foreign exchange earnings constrain the growth performance of developing countries. Given these countries limited access to capital, aid has a role of filling the financial gaps between domestic savings and investment needed to attain a targeted rate of economic growth. This theoretical literature has a dubious theoretical foundations and numerous empirical failings, White (1992).

Generally, the role of foreign aid in the process of economic development is debatable. Some studies (see for example Papanek (1973), Singh (1985), Levey (1988) and Hadjimichael et al (1995) indicate that foreign aid leads to an increase in investment resources in developing countries, which eases their foreign exchange constraints and creates multiplier effects on their over all economic development. On the other hand other studies suggest (see for example Griffin (1970), Griffin and Enos (1970) and Vivodas (1973), Boone (1996) and Mosley (1980) indicate no positive and significant relationship between foreign aid and economic growth, and conclude that foreign aid is ineffective in promoting growth. It thus appears that the impact of foreign aid on economic growth of the recipient countries remains ambiguous and controversial.

Yet after decades of transfers of foreign aid to developing countries and numerous studies of empirical relationships between aid and growth the effectiveness of foreign aid in achieving economic growth remains questionable.

1.2.1 Statement of the problem

A core deficiency of the “aid-growth” literature is that it fails to recognize explicitly that aid is given primarily to the government and that hence any effect of aid on macro economic performance of the economy will depend on government behavior, in particular how fiscal decisions on taxation and expenditure are affected by aid revenues.

There is a growing literature on how aid affects fiscal behavior of government (reviewed in McGillivray and Morrissey, 2001). The literature is important because most aid, conventionally defined, goes to the public sector and any impact on growth and poverty reduction will be mediated by how this aid influences government behavior (on policy generally, and fiscal policy in particular). It follows that any understanding of the broader impacts of aid including those on growth and poverty must start with understanding of its usage by this sector.

Is aid used for the purposes for which donors provided it? What are the effects of aid on various categories of public sector expenditure, including investment (fixed and human) and consumption? What are the effects on revenue and financing decisions, including those relating to taxation and borrowing? What are the systems and policies of donors?, What are the government budgetary systems?, because government budgetary systems are central to the fiscal effects of aid.

The recent literature on the effects of aid on growth recognizes this in part by focusing attention on the interaction between aid and policy, here the literature recognizes the importance of policy, the studies condition aid effectiveness on policy rather than examining how aid affects policy. The literature is however inconclusive. Burnside and Dollar (2000) argue that aid is only effective in increasing growth if accompanied by “good” policies; aid has a positive impact on growth in developing countries with good fiscal, monetary and trade policies. Hanssen and Trap (2001) find that aid and policy have independent and positive effect on growth. Neither study, nor the literature in general resolves the highly contentious issue of how aid affects policy, this study address one specific aspect of this, how aid affects fiscal aggregates (government fiscal behavior). To put it more simply the study looks at the (broad) public sector 'fiscal response' to foreign aid inflows, i.e, time series impact of aid on fiscal aggregates. Such aggregate fiscal effects over time are likely to be important determinants of aid effectiveness.

In Ethiopia capital in flow has been started around 1950's, during the imperial era 60-70 percent public sector investment programmes commend themselves to aid givers. (Imperial Ethiopian Government, 1968) i.e major part of the public sector investment program was covered by aid. During the period (1952-1974) Ethiopia obtained 1021.60 million Birr grant and 626 million Birr foreign loan, totally 1647.60 million aid. The ODA to GDP ratio of the period was 4.8 percent.

During post 1974, Derg formulated a Ten Year Perspective Economic Plan (1985-1994) with an unrealistic expectation of receiving foreign aid to finance more than half of planned investment (World Bank 1987). During the period (1975-1991) the country obtained Birr 5526.87 million grant and Birr 5658.30 million foreign loan, totally 11185.17 million aid. The ratio of aid to public investment expenditure during the period was 72.5 percent. The ODA to GDP ratio of the period was 11.8 percent.

In post 1991 period there exists significant increase in aid flows, mainly due to the economic policy of the EPRDF, significant amount of aid is obtained for stabilization, rehabilitation, reform and

sector development programs, and a number of donors have joined the support program. During (1991-2005) the country has received Birr 26980.90 million grant and Birr 28225.50 million foreign loan, totally 55206.40 million aid. This figure is 77 percent greater than the pre 1991 period. And is 84.2 percent from the public sector investment expenditure. The ODA to GDP ratio of the period was 20 percent.

Generally in all the three regimes the country has obtained Birr 33529.37 million grant and Birr 34509.80 million foreign loan, totally 68039.70 million aid, which is 83 percent of public investment expenditure. As aid being such an important source of public expenditure, identifying the fiscal effects of aid in Ethiopia is fundamental, which is a pre-requisite to understand the macroeconomic effectiveness of aid. Thus this study tries to explore the fiscal effects of aid in Ethiopia.

(Figures are calculated from MoFED data and ODA from OECD -DAC database).

1.3 Hypothesis

On the basis of the analysis of the literature review the following general hypothesis can be made

- 1.3.1 Aid inflows have been associated with increase in development budget and to some extent the recurrent budget.
- 1.3.2 Aid inflows have induced large increase in expenditure.
- 1.3.3 Aid inflows have not discouraged domestic revenue mobilization (tax effort).
- 1.3.4 Aid inflows may have been associated with decreases in domestic borrowing.

1.4 Objectives of the study

1.4.1 General objectives of the study

- 1.4.1.1 To identify the effects of aid on public sector aggregates
- 1.4.1.2 To examine donor's aid policies and systems.
- 1.4.1.3 To examine the government budgetary systems.
- 1.4.1.4 To identify issues and problems of aid.
- 1.4.1.5 To suggest likely solutions and policy implications.

1.4.2 Specific objectives of the study

- 1.4.2.1 To identify the effect of aid on government revenue (taxation).
- 1.4.2.2 To examine the effect of aid on recurrent expenditure.
- 1.4.2.3 To identify the effect of aid on government capital expenditure.
- 1.4.2.4 To identify the effect of aid on domestic borrowing.

1.5 Significance of the study

For many countries aid remains a principal source of revenue, for instance, aid inflows were roughly equal in magnitude to taxation, and constituted approximately half of all public expenditure, in low income countries during the mid to late 1990s (World Bank 1996-99).

In the Ethiopian case aid accounts 83 percent of public investment expenditure, and the ODA to GDP ratio is 16.8 percent. It follows that any understanding of the broader effects of aid, including those of growth and poverty, must start with understanding of the fiscal effects of aid. That means time series impacts of aid on government fiscal behaviour. Such aggregate fiscal effects overtime are likely to be important determinants of aid effectiveness. This paper, therefore, is a contribution, providing an empirical method to estimate fiscal effect and applying this to Ethiopia.

1.6 Organization of the study

This study is apportioned into seven chapters. Following the introductory chapter, chapter II presents a review of the existing literature regarding the fiscal effects of aid. A brief review of donor's aid policies, aid management and accounting, Ethiopia's economic policies & budgetary systems are presented in chapter III. Chapter IV entails the formulation of methodology and model specification. Chapter V deals with model application and analysis of results, and chapter VI deals with conclusion and policy implication. Finally Chapter VII deals with bibliography and annexes.

1.7 Scope and limitations of the study

The study attempts to explore the fiscal effects of aid in Ethiopia. A 39 year period aid is covered. The period of study covers from 1966 to 2004.

Although this study attempts to shed light on the fiscal effects of aid in Ethiopia, yet the study suffers from certain limitations.

The first limitation arises from the problem of inconsistency in data as reported by different institutions. Even data from the annual reports of MoFED shows different figures for the same year. And data available at the responsible organ (MoFED) is very much fragmented in its presentation.

The other problem is that there is a significant statistical discrepancy between domestic and international sources. For example ODA (OECD, CRS) is acknowledged to be an authoritative source on external aid figures. Hence the inconsistency of its data services with that of MoFED, a responsible body for aid in Ethiopia is of such concern. Most of the annual figures reported by OECD/DAC are greater than those reported by MoFED. Nevertheless the data used for this study are drawn from both domestic sources and OECD/DAC publications so that we can have a wider coverage.

CHAPTER TWO

LITERATURE REVIEW

There is a growing literature on the fiscal effects of aid, the fiscal effects of aid, has been addressed by two separate strands in the literature. (World Bank, 1998) First, studies of fungibility are concerned with identifying whether aid that is intended (by donors) to be spent on a particular expenditure item, such as health or education, is in fact allocated to that area. This is often referred to as categorical fungibility as the issue is the allocation of aid to expenditure categories and whether recipients allocate aid in the way donors intended when granting the aid.

Second, the fiscal response literature explicitly models how the impact of aid is mediated by public sector behavior. As such, these models are broader in coverage, considering not only categorical allocation but also the effects of aid on tax effort and public borrowing. We discuss both strands of the literature in turn.

2.1 Fungibility

Aid is said to be fungible if the recipient uses (or has the ability to use) aid for purposes other than those intended by the donors.

If fact, as discussed below, much of the literature is concerned with whether spending on sectors to which aid is directed actually increases by the amount of the aid. For example, does spending on education increase by the amount that donors allocate for education? This relates to composition of government spending. And it may be of valid concern to donors in terms of how their aid is spent.

There are two reasons why we devote some attention to empirical studies of fungibility. First, they have been unduly influential in policy debates regarding aid. Second, general fungibility can be quite important in terms of aid effectiveness. That is, if aid intended for investment is actually diverted into government consumption spending, then the potential growth impact of aid may be reduced.

Empirical Approaches

The fundamental objective of the categorical fungibility studies is to detect the extent to which aid in practice is used in a fungible manner. That is, they attempt to model the actual extent to which

aid, or some portion thereof, is used for purposes other than for which it was intended. Categorical fungibility studies can be divided into two groups. The first group includes Feyzioglu et al. (1998), Swaroop et al. (2000) and K. hilji and Zampelli (1991,1994).

Each of these studies derives, from a utility maximizing problem, and estimates a simultaneous linear expenditure system. The second group adopts a more adhoc approach, in that it is not based on explicit theoretical framework, but it estimates a set of simultaneous equations. Probably the best known study belonging to the first group is Feyzioglu et al (1998). Feyzioglu et al. (1998) estimated 35 equations using cross- country data, for 14 aid recipients for the period 1971 – 80. Twenty –six of these equations were estimated individually using ordinary least squares (OLS) and 10 jointly using the generalized methods of moments (GMM) technique, Swaroop et al (2000) followed similar approach, estimating 20 equations, individually using OLS and four equations simultaneously using two-stage least squares (2SLS), but using 1970 – 95 time series data for India, Khilji and Zampelli (1991) also used time series data, but for 1960 -86 US aid to Pakistan. Rather than estimating a relatively large number of equations, this study estimated a single system, containing three equations, using the full information maximum likelihood (FIML) approach. Khilji and Zampelli (1994) followed the same approach but used cross country data for eight aid recipients. Results are discussed below. Studies belonging to the second group looking at categorical fungibility include those by pack and pack (1990,1993), Cashell – Cordo and Craig (1990) and Gupta (1993). Pack and pack (1990,1993) arguably the best known of these studies, assume that the government under consideration (or a collective decision making group) possesses a community indifference curve and is faced by a budget line. Various equations are then posited which represent the demand curves derived from the corresponding optimizing decisions.

Results

Those reported by pack and pack (1990) for Indonesia are quite encouraging. Taken on face value, aid to this country has entirely been used for the purposes intended by donors. Aid seems to have caused increases in domestic revenue, has not caused increases in non developmental or (recurrent) consumption expenditure, has caused a greater than proportional increase in both total and developmental expenditure and has led to higher expenditure on health and education. Gupta's results for India are also reasonably encouraging. Although a one unit increase in aid seems to lead to an uncomfortably large 0.73 unit increases in non-developmental expenditure, the increase in

development expenditure of 0.96 units is greater, over all total spending increase by significantly more than the amount of aid. The remaining results are less than encouraging, again taken on face value. Casher- Cordo and Craig (1990) report surprisingly large – aid induced incremental increases in domestic revenue and in the case of African countries a large incremental increase in total expenditure.

In contrast to Gupta (1993), Swaroop et al. (2000) find that aid has no impact on revenue or on expenditure categories except non-developmental expenditure, defined in this case to include spending on defence, interest and general administrative services. Khilji and Zampelli (1991) and Pack and Pack (1993), for Pakistan and the Dominican Republic respectively, find that aid is highly fungible and has led to lower revenue in both countries.

Given the variation in results, there are few obvious conclusions from the fungibility literature. Clearly, aid is used in a fungible manner, although one can not make any general comment regarding the extent of fungibility. Not only do the results vary (from Zero in Indonesia to complete fungibility in Pakistan) the studies also imply mixed conclusions regarding the incremental impact of aid on spending in some cases total spending increases by more (or falls by less) than non-development spending ‘some unwarranted conclusions have been drawn, notably that fungibility’ help explain why large amounts of aid have had no lasting effect in highly distorted environments’ (World Bank, 1988). Aid ineffectiveness is as likely to be due to low productivity of aid – financed investments as to aid being diverted to unintended uses. What the literature does suggest is that donors would be rather naïve if they tried to target aid accurately to specific expenditures, a point recognized in World Bank (1998). Generally one may respond that fungibility studies are, however, informative regarding the impact of aid on the composition of government spending.

Limitations of Categorical Fungibility Studies

The fundamental deficiency of the fungibility approach is that it pays insufficient attention to the broader fiscal impacts of aid over time, especially on tax effort and borrowing. In fact, as we have argued by citing the limitations, fungibility studies tell us very little of relevance to fiscal impact.

According to World Bank (2000) Public Expenditure Review (PER), fungibility has become a prominent topic in the aid debate, but it is a much misunderstood topic. The crucial point is that fungibility is not about what is done with the funds directly, but about what they may finance

indirectly. What difference does aid make?, fungibility arises because resources can be substituted for each other. When aid is provided it increases the total resources available to the recipient. If aid finances any activity that the recipient would otherwise have financed itself, the resource that the recipient would have spent on that activity becomes available to finance something else. There are two important points to note.

- ➡ Fungibility does not depend on the recipient misusing any aid funds or breaking any aid agreements.
- ➡ Earmarking of aid funds to a specific project does not prevent fungibility.

Some donors may be content to follow the trail of their funds, check that the funds were indeed spent as specified in the project agreement, and ask no further questions. Others may wonder, What difference did our aid make? Which is not an easy question to answer because:

- a) all the recipient's expenditures have to be considered, and
- b) even if adequate data are available, the actual 'with aid' situation needs to be compared with a hypothetical 'without aid' situation.

At the same time, fungibility is at the root of many donors' reluctance to provide aid to countries in conflict. It is feared that aid will indirectly finance the increase in defense expenditures. The fungibility concern reinforces the case for making strategic expenditure plans, the national budget and its implementation the subject of regular and institutionalized dialogue with donors.

2.2 Fiscal response

Mosley et al (1987) and Gang and Khan (1991), picking-up on an earlier paper by Heller (1975), model the public sector fiscal responses to foreign aid inflows. The Heller (1975) approach is predicated on the observation that a basic task facing public sector decision makers in all countries is to allocate revenue among various expenditure categories subject to budget constraints. To keep the exposition simple they can distinguish two categories of public expenditure; recurrent expenditure or government consumption (G) and capital expenditure or public sector investment (Ig).

Government revenue is obtained from domestic sources in the form of taxation and other recurrent revenue (T) and borrowing (B). In these models, aid (A) is treated as exogenous: aid is an external source of revenue that enters the budget constraint.

Public sector policy makers are assumed to act in a rational, utility maximizing manner. In the standard approach, contributors have assumed that governments set targets for various expenditure headings and set revenue targets for tax and borrowing. Governments maximize their utility by attaining these revenue and expenditure targets.

What the government now wants to do is maximize utility subject to budget constraint that expenditure can't exceed (all) revenue, Binh and McGillivray, 1993; Gang and Khan, 1993, 1994: Khan 1994: White, 1994 attempted to model public sector behavior in presence of aid inflows, recent papers endogenize aid (Franco-Rodriguez et al, 1998; McGillivray and Ahmed, 1999). Governments have a target for aid revenue, and this expected revenue is incorporated into their fiscal planning that is when determining revenue and expenditure allocations, anticipated aid revenue is taken into account. The model with endogenous aid overcome many of the problems inherent in the standard fiscal response models (those earlier papers with exogenous aid). In sum, the fiscal response model allows governments to set revenue and expenditure targets, and to attempt to raise and allocate the revenue required to meet these targets so as to maximize utility. Aid like tax and borrowing, is treated as one of the forms of revenue.

To analyze the impact of aid, in a model where government expect to receive aid, one can derive the structural equations from maximizing and then derive the reduced form equations these can then be estimated and results are reported below.

Fiscal response models focus on the time series impact of aid on fiscal aggregates, such aggregate fiscal effects over time are likely to be important determinants of aid- effectiveness.

Table 2.2A Selected results of fiscal response studies

Study	Sample	Incremental impact of aid on			
		T	Ig	G	B
Heller (19975)	Cross-section (Africa)	-0.4	1.1	-0.1	
Gang & Khan (1991)	India	0.0	0.0	0.0	
Khan & Hoshino (1992)	Cross-section (Asia)	1.2	1.2	0.3	
Iqbal (1997)	Pakistan	0.0	0.0	1.6	
Franco-Rodriguez et al (1998)	Pakistan				
	Direct effects	-2.9	0.1	-2.0	-1.1
	Total effects	-3.6	0.1	-2.4	0.9
McGillvray & Ahmed (1999)	The Philippines	-0.1	-0.02	0.02	-1.81
Franco-Rodriguez (2000)	Costa Rica				
	Direct Effects	1.1	-0.36	2.47	-1.27
	Total effects	0.05	-0.02	0.07	-0.08

Notes: Figures are the total effect (incremental impact) of a unit of aid on public investment, public consumption spending, tax revenue and, where reported borrowing (measured in the same units).

Source: Iqbal (1997)

Table 2.2.A reports selected results from a number of fiscal response studies. The earlier studies provide mixed results for example there is no significant impact in India. We are inclined to attach greater weigh to the findings of the last three studies cited as they use longer time series data and report full results for the incremental impact of aid. Aid does appear to discourage tax effort, although this is not the case for Costa Rica. There is little encouraging evidence that aid induces significant increases in investment spending, in Pakistan the incremental impact on investment is positive and the significant reduction in tax effort seems to bear on consumption spending (and borrowing needs). In Costa Rica and to a lesser extent the Philippines investment spending falls and the increased tax effort seems to be used to fund consumption spending and a reduction in borrowing.

We can't draw general conclusion from so few studies of fiscal response, however we can make some observations, emphasizing that these studies focus on the incremental impact of aid (incorporating the time dimension), first the evidence from fiscal response models doesn't lend clear support to the more limited fungibility studies. It is not evident that aid increases consumption spending by more than it increases investment spending although of the more robust studies, this is true for Costa Rica and the Philippines but not for Pakistan. Second fiscal response models high light that aid can have important effects on tax revenue, and the tendency is that tax effort is reduced. It may be that the expectation of aid reduces the incentive for government to raise tax

revenue. It may also be that aid is associated with policy reforms (such as trade liberalization that reduces tax revenue (tariff reductions). Third there is evidence that aid has effects on borrowing; aid is associated with reduction in borrowing in Costa Rica and the Philippines but with increased borrowing in Pakistan. Finally, it is evidence that the impact of aid varies by country; it suggests the need for more time series country studies.

Limitations of the fiscal response

Limitations of the fiscal response studies are the following: they are notoriously difficult to estimate, and highly sensitive to (and demanding of) the quality of the data, one inherent empirical problem is that it is necessary to estimate the targets, but there is no accepted theory regarding how governments form revenue and expenditure targets. In an ideal World it may be possible to trawl government plans and budgets to obtain stated targets, but in practice this is not possible and target values are estimated econometrically (normally using actual values in someway). Another problem is that the structural equations are typically estimated using non-linear least squares which is not very robust. The next problem lies in the theoretical framework: a loss function may not be good representation of government behavior, the most important problem and also the most insoluble is that the behavioral relationship being estimated is assumed fixed over the period, in practice, we would expect the impact of aid on fiscal behavior to change over time, a final general problem is that fiscal response models do not related aid and fiscal behavior to growth.

Although fiscal response model offers an important improvement over the fungibility approach in analyzing the impact of aid on government behavior, they have their shortcomings, the estimates for the structural equations are very sensitive to the way in which the targets are approximated and the three stage non-linear technique used tend not to be robust to change in data or model specification.

Studies conducted in Ethiopia

The study by Alemayehu and Haile (2000), which tested the saving behavior in the country, examined the impact of foreign aid on saving and growth. They found that aid is negatively linked with private savings and its growth contribution is significant.

The study by Abeba (2002), which tested the macroeconomic impacts of external assistance in Ethiopia, she has found the insignificant effect of foreign assistance on saving rate, and positive

effect on government consumption and the Dutch Diseases impacts are the responsible factors for the negative impacts of external assistance on the economic growth of the Ethiopian Economy.

Daniel (1998) and Aberra (2004) were the first attempts on fiscal response context, where they have tried to assess the impact of foreign aid on government revenues and expenditures.

Daniel's study was based on the model developed by Alemayehu (1996) as an alternative approach to analyze the fiscal response to foreign financial inflows. Since the variables are non-stationary at levels, Daniel estimated the first difference of the variables, which shows only short-run relation among variables. Daniel's (1998) results are similar to the result of Alemayehu (1996) found for some African – Countries. The results showed that foreign financial flows have a negative impact on both direct and indirect taxes and a positive and strong impact on government recurrent expenditure.

Aberra tries to examine the impact of foreign aid on government revenues, expenditures and borrowing in Ethiopia using the two alternative approaches (the neoclassical approach of Heller, 1975) a model based on optimization of policy makers loss function; and the non neo-classical model of Alemayehu (1996, 2002) with some modifications.

The results indicate that in the non-neoclassical model only the short run model were estimated as the variables have no long run relationship as justified by Johansen co-integration test. The results confirm that in the short run foreign aid tends to induce direct tax revenue collection but doesn't have an impact on indirect tax revenues.

The estimation result of government spending shows that foreign aid in the short run is used to finance investment rather than consumption. Despite the theoretical expectation, the variables in the non-neoclassical model failed to co-integrate in the long run, which makes comparison between the two models difficult.

The results indicated that aid in Ethiopia is mainly used to finance investment with only some portion of grants and bilateral aid leaking to consumption. Results from the neo-classical model shows that grants and bilateral aid tends to increase government expenditure (consumption and investment) while loans and aid from multilateral sources tends to reduce it.

CHAPTER THREE

AID AND POLICY

3.1 Pros and Cons of aid arguments

The theoretical literature on aid effectiveness stems from the two gap model of Chenery and Strout (1966). The basic premise of the two gap model is that low domestic savings and inadequate foreign exchange earnings constrain the growth performance of developing countries. Given these countries limited access to capital, aid has a role of filling the financial gaps between domestic savings and investment needed to attain a targeted rate of economic growth. This theoretical literature has a dubious theoretical foundations and numerous empirical failings, White (1992).

Theories of aid for development were criticized by some researchers. The first critique of the conventional theories of aid of the 1960s was by Griffin and Enos (1970). They argued that powerful countries give economic aid to powerless ones, not because aid is associated with progress but only because aid is one of the instruments of foreign policy such as diplomacy, cultural exchange and military intervention. The only justification for economic aid, according to their argument, is that “aid is less destructive” than other instruments. Aid, they argue, is inversely related to domestic savings. That is, “foreign savings often tend to supplant rather than supplement (let alone increase) domestic savings.” The large share of aid is channeled to activities which are not directly productive and, thus, aid may retard rather than accelerate long-run economic growth. They say that aid hinders the emergence of a native entrepreneurial class and inhibits institutional reform (Griffin and Enos, 1970).

Despite its contribution to development aid also has a number of problems associated with it. In the first place, the motives for giving aid by donors are not purely developmental. A naive logic, of course, would lead one to believe that aid is directed where there is greatest poverty or, alternatively, where it can be best employed to put an end to an intolerable situation. Even a cursory examination of available data, however, shows that this is not the case.

Although it seems that aid is synonymous with charity given to alleviate poverty, the main motive of the rich countries to give aid to poorer ones is to promote their own interest. Self, interests such as

winning useful friends, supporting strategic aims, or promoting donors exports, it is argued, are the main motives to give aid (Todaro, 1995);

For example, almost half of America's aid budget over the past two decades has been earmarked for Egypt and Israel. Peace in the Middle East may be worth a lot to America, and the world, but neither Israel nor even Egypt is among the world's neediest countries. (The Economist, 1993)

Although conventional aid theory persisted in conjunction with the justification of providing aid for structural adjustment, it was continuously criticized. Those who support the laissez faire approach to economic development argued that aid "retards economic growth by frustrating the free operation of the market, distorting the price system and impeding private sector development" (Riddle, 1987). They, however, advocate the provision of aid for the development of the private sector if it is supported by a policy of minimal government intervention. This laissez faire approach to aid theory has been developed by economists such as Fridman, Bauer, Yamey and Krauss. Their argument is that borrowing is better than aid to developing countries.

Among those who replied to the criticism by Griffin and Enos, Papanek (1973) defended the hypothesis that foreign aid contributes to growth and investment. He argued that the critique by Griffin and Enos has a number of defects. First, they aggregate all foreign flows, and deal with the net total flows only. However, the negative effect on economic growth are caused by the flows other than aid. Second, they underestimate non-monetary investment, which is important in the least developed countries.

Third, they ignore net factor payments. Papanek argued that low savings and growth are caused by other unfavorable economic and/or political situations. These are exogenous factors such as war, civil conflict, political disturbances, and changes in the terms of trade (especially for countries heavily dependent on exports) which result in a simultaneous reduction of economic performance and savings, and lead to increased flows.

Therefore, according to this argument, the negative correlation between savings and inflows found in many studies does not mean there is a causal relationship between them as long as both are affected by third factors.

There are also a number of other arguments which support the view that aid contributes effectively to development for example Singh (1985), Cassen (1988), Levey (1988).

Generally given this controversial issues, most professional economists tend to think that weather aid is effective or not is an empirical question that can be addressed only with empirical evidence.

3.2 Donor’s aid policies and systems

Ethiopia at present has received aid from 19 multilateral organizations and 22 bilateral donors. Among the multilateral organizations IDA has the lion’s share and among the bilateral donors USAID is the largest one. In order to know the fiscal effects of aid, the central issue is to study donors (multilateral and bilateral) policies and systems.

Table 3.2A Major Multilateral Organizations and Bilateral Donors for Ethiopia

Major Multilateral Organizations

Major multilaterals	Percentage share from total multilateral aid
IDA	47
EU	24
ADB	11.5
Major UN agencies (UNDP, UNICEF, UNFPA, WFP)	11
Others	6.5

(Figures are calculated from MoFED’s various annual reports (revised))

Bilateral Donors

Major bilateral	Percentage share from total bilateral aid
USAID	18
Italy	13
Japan	13
Swden	9
German	7
Netherlands	6
Others	34

(Figures are calculated from MoFED’s various annual reports (revised))

3.2.1 Major multilateral organizations

The United Nations

The United Nations was founded in 1945 to maintain international peace and security and to develop international co-operation in addressing economic, social, cultural and humanitarian problems. The United Nations officially came into existence on October 1945. The UN's chief administrative officer is the Secretary General elected for a five year term by the General Assembly on the recommendation of the Security Council.

Membership: membership of the United Nations requires percentage contributions to the UN budget, total membership 191 (April 2005).

Coordinating Bodies:- The 28 member United Nations system Chief Executives Board for coordination – CEB, founded in 1946 as the administrative committee on coordination, convenes at least twice a year under the chairmanship of the Secretary General to coordinate UN system wide policies, activities and management issues.

Finance: The majority of the UN's peace keeping operations are financed separately from the UN's regular budget by assessed contributions from member states. A development Account was established, in December 1997 under the Secretary General's reform programme: administrative savings were to be channeled through this to finance development projects. (EUROPA, 2006)

The UN System

Four major development partners within the UN System are the UNDP, UNICEF, WFP and UNFPA. All these agencies are subsidiary organs of the General Assembly and administered under the authority of the Economic and Social Council (ECOSOC) and the General Assembly.

Developing countries receive grant assistance from these agencies by virtue of being members of the United Nations. Such factors as size of population, life expectancy, GNP per capita, child/infant mortality rates are taken into account when grant allocations are made from these agencies. And in determining allocations to countries in various situations include: Size of country, past and expected performance, availability of other sources of aid and intensity of need are among the main factors in determining allocations.

United Nations Development Programme UNDP

Policy

The programme was established in 1965 by the UN General Assembly. Its policy is to help countries to eradicate poverty and achieve sustainable level of human development, on approach to economic growth that encompasses individual well being and choice, equitable distribution of the benefits of development, and conservation of the environment. UNDP advocates for more inclusive global economy. UNDP has defined the following areas of intervention for poverty reduction, these are, millennium development goals, democratic governance, poverty reductions, crisis prevention and recovery, energy, environment and HIV/AIDS.

Organization

UNDP is responsible to the UN General Assembly, to which it reports through ECOSOC which promotes world cooperation on economic, social, cultural and humanitarian problems.

Executive Boards:- The Executive Board is responsible for providing intergovernmental support to, and supervision of the activities of UNDP. Major policy issues resource allocation criteria for countries and programme packages of individual countries are approved by the Executive Board. It comprises 36 members: eight from Africa, seven from Asia and the Pacific, four from eastern Europe, five from Latin America and the Caribbean and 12 from western Europe and other countries. Membership serve a three year term. Five regional bureaux, all headed by an assistant administrator, cover: Africa, Asia and pacific; the Arab States: Latina America and the Caribbean and Europe and the Common Wealth of Independent States. In almost every country receiving UNDP assistance there is an office, headed by the UNDP Resident Representative, who usually also serve as UN- Resident coordinator, responsible for coordination of all UN technical assistance and operational development activities.

Finance

UNDP and its various funds and programmes are financed by the voluntary contributions of members of the United Nations and the programme's participating agencies, as well as through cost sharing by recipient governments and third party donors. (EUROPA, 2006)

Procedures

Countries that receive support from the UNDP are expected to formulate the country programme document and submit it to the Executive Board for approval. The funding cycle ranges from 3-5 years.

Management

UNDP supported programmes are implemented on the basis of National Execution Policy Framework. National Execution entails that government takes the responsibility of overall management of programmes /projects along with responsibility and accountability of production of outputs and achievement of objectives. All the management, financial accounting and procurement procedures are reflected in the National Execution manual jointly prepared by UNDP and the recipient Country.

Monitoring and Evaluation

Monitoring of performance is a joint exercise. Every programme is subject to review twice a year by a programme review committee established and chaired by recipient country. The committee is composed of all stakeholders including UNDP. It is a prerequisite to report to the donor on the status of physical and financial implementation. Funds are advanced to the management subject to accounting for previous advances received. In addition the country programme is also subject to a mid-term review. Independent in-depth evaluation of each programme is also mandatory once during the life of the implementation of the programme.

United Nations Children's Fund – UNICEF

Policy

UNICEF was established in 1946 by the UN General Assembly as the UN International Children's Emergency Fund, to meet the emergency needs of children in Post – War Europe. In 1950s its mandate was expanded to respond to the needs of children in developing countries. In 1953 the General Assembly decides that UNICEF should continue its work, as permanent arm of the UN system, with emphasis on programmes giving long term benefits to children everywhere, particularly those in developing countries. UNICEF is dedicated to the well being of children adolescents and women and works for the realization and protection of their rights within the frame

works of the convention on the rights of the child which was adopted by the UN General Assembly in 1989 and by 2005 was almost universally ratified and of the convention on the elimination of all forms of discrimination against women, adopted by UN General assembly in 1979.

Organization

Executive Board, as the governing body of UNICEF comprises 36 member governments from all regions, elected in rotation for a three year term by ECOSOC. The Board establishes policy, reviews programmes and approves expenditure. It reports to the General Assembly through ECOSOC.

Secretariat:- The Executive Director of UNICEF is appointed by the UN Secretary General in consultation with the Executive Board. UNICEF has a net work of eight regional and 126 field offices serving 157 countries and territories. (EUROPA, 2006)

Finance

UNICEF is funded by voluntary contributions from governments and non-governmental and private sector sources. And also UNICEF is supported by 37 National Committees, mostly industrialized countries whose volunteer members, numbering more than 100,000 raise money through various activities including the sale of greeting cards. The committees also undertake advocacy and awareness campaigns on a number of issues and provide an important link with the general public. (EUROPA, 2006).

Procedures

Management of the programme and Monitoring and Evaluation systems of UNICEF are similar to that of sister programme UNDP.

United Nations Population Fund –UNFPA

Policy

Created in 1967 as the Trust Fund for Population Activities, the UN Fund for population activities (UNFPA) was established as a Fund of the UN General Assembly in 1972, and was made a subsidiary organ of the UN General Assembly in 1979 with the UNDP governing council (now the Executive Board) designated as its governing body. In 1987 UNFPA's name was changed to United Nations Population Fund (retaining the same acronym).

UNFPA's mandates are to advance the knowledge and capacity to respond to needs in population and family planning; to promote awareness of population problems in developed and developing countries and possible strategies to deal with them; to assist countries, at their request, in dealing with their population problems in the form and means best suited to the individual countries requirements and to play a leading role in the UN system in promoting population programmes and support and coordinate projects. The current UNFPA's Policies are all couples and individuals enjoy good reproductive health, including family planning and sexual health, through out life. There is a balance between population dynamics and social and economic development, gender equality and empowerment of women.

Organization

In 1979 the Executive Board of UNDP is designated as the governing body of UNFPA. The Executive Director has the rank of under Secretary General of UN, is responsible for the overall direction of the fund, working closely with governments, other United Nations Bodies and agencies and non-governmental and international organizations to ensure the most effective programming and use of resources in population activities. UNFPA operates field offices, each headed by an UNFPA Representative, in more than 100 countries. In other countries UNFPA uses UNDP's field structure of Resident Representatives as the main mechanism for performing its work. The field offices assist governments in formulation requests for aid and coordinate the work of the executing agencies in any given country or area. (EUROPA, 2006)

Finance

UNFPA is supported entirely by voluntary contributions from donor countries.

Procedures

UNFPA provides financial and technical assistance to developing countries and countries with economies in transition, at their request. In many projects assistance is extended through member organizations of the UN System (in particular, FAO, ILO, UNESCO, WHO) although projects are executed increasingly by national governments themselves. The Fund may call on services of international, regional and national non-governmental and training organizations, as well as research institutions. In addition, eight UNFPA regional technical support teams, composed of experts from

the UN, its specialized agencies and non-governmental organizations, assist countries at all stages of project/programme development and implementation.

All the Procedure, Management, Monitoring and Evaluation systems of UNFPA are similar to that of UNDP.

World Food Programme –WFP

Policy

The principal food aid organization of the United Nations, became operational in 1963. It aims to alleviate acute hunger by providing emergency relief following natural or man made humanitarian disasters and supplies food aid to people in developing countries to eradicate chronic undernourishment to support social development and to promote self-reliant communities. WFP is the only multilateral organization with a mandate to use food aid as a resource. It is the second largest sources of assistance in the UN, after the World Bank group, in terms of actual transfers of resources, and the largest source of grant aid in the UN system. WFP handles more than one-third of the world's food aid. The policies governing the use of WFP is food aid must be oriented towards the objective of eradicating hunger and poverty. The ultimate objective of food aid should be the elimination of the need for food aid.

Organization

The governing body of WFP is the Executive Board, comprising 36 members 18 of whom are elected by the UN Economic and Social Council (ECOSOC) and 18 by the Council of Food and Agriculture Organization (FAO). The Board meets four times each year at WFP head quarters, WFP's Executive Director is appointed jointly by the UN Secretary General and the Director General of FAO and is responsible for the management and administration of the programme. WFP administers some 87 country offices, in order to provide operational financial and management support at a more local level, and has established seven regional bureaux, located in, Bangkok, Thailand (for Asia), Cairo, Egypt (for the Middle East, Central Asia and the Mediterranean), Rome, Italy (for Eastern Europe), Managua, Nicaragua (for Latin America and the Caribbean). Yaunde, Cameroon (for Central Africa), Kampala, Uganda (for Eastern and Southern Africa), and Dakar, Senegal (for West Africa). (EUROPA, 2006)

Finance

The programme is funded by voluntary contributions from donor countries (UN and FAO member), intergovernmental bodies such as the European Commission and the private sector. Contributions are made in the form of commodities, finance and services. WFP will exploit its capability to operate virtually every where in the developing world, without regard to the political orientations of governments, and to provide a neutral conduit for assistance in situations where many donor countries could not directly provide assistance.

WFP will provide services; advice, good offices, logistic support and information and support to countries in establishing and managing their own food assistance programmes. To be truly effective, food aid should be fully integrated into the development plans and priorities of recipient countries and coordinated with other forms of assistance. WFP's starting point is the national policies, plans and programs of developing countries, including their food security plans. The country strategy note, where this exists should provide the frame work for an integrated system by the United Nations system. In some especial cases WFP will adopt a multi – country or regional approach, particularly for the provision of humanitarian assistance, WFP attaches in collaboration with other agencies particularly with United Nations and FAO, UNHCR other NGO's, IFAD, World Bank, IMF regional bodies and institutions and bilateral donors in support of economic and social development. WFP works in dialogue with recipient governments and the aid community, advocate policies, strategies and operations that directly benefit the poor and hungry. Request shall normally be presented through the UNDP Resident Representatives in their capacity as the programme representatives and as appropriate, the representatives of other United Nations Agencies fully informed. The Executive Director, upon receipt of request from governments proceed to appraise the projects, either at Head quarter or through field investigation. (EUROPA, 2006)

All the Management and Monitoring and Evaluation systems of WFP are similar to UNDP.

Other UN Agencies Operating in Ethiopia

The agencies that are categorized as other UN agencies by MoFED comprises FAO, GEF, ILO, UNCDF, UNIDO and UNSO. These agencies have common procedures i.e., provide grant and allocate resources on project by project basis. The implementation procedure, is similar to UNDP. And has minimum contribution as compared to the major UN agencies.

World Bank Group

The World Bank, as it is commonly known, comprises the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). The affiliated group of institutions, comprising the IBRD, the IDA, the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA) and the International Center for Settlement of Investment Disputes (ICSID) is now referred to as the World Bank Group.

Organization

Officers and staffs of the IBRD serve concurrently as officers and staff in the IDA. The World Bank has offices in New York, Brussels, Paris, Frankfurt, London, Geneva and Tokyo as well as in more than 100 countries of operation. Country Directors are located in some 30 country offices.

Board of Governors:- The Board of Governors consists of one governor appointed by each member nation. Typically, a governor is the country's finance minister, Central Bank governor, or a minister or an official of comparable rank. The Board normally meets once a year.

Executive Directors:- with the exception of certain powers specifically reserved to them by the Articles of Agreement, the governors of the Bank have delegated their powers for the conduct of the general operations of the World Bank to a Board of Executive Directors which performs its duties on a full time basis at the Bank's head quarters. There are 24 Executive Directors, each Director selects an Alternate. Five Directors are appointed by the five members having the largest numbers of shares of capital stock and the rest are elected by the governors representing the other members. The president of the bank is chairman of the board.

Members:- Only members of the International Monetary Fund (IMF) may be considered for membership on the World Bank.

Finance:- Subscriptions to the capital stock of the Bank are based on each members quota in the IMF, which is designed to reflect the country's relative economic strength. Voting rights are related to share holdings.

Among the World Bank Group institutions it is only IDA which is relevant for the concern of the study.

International Development Association - IDA

Policy

The International Development Association began operations in November 1960. Affiliated to the IBRD, IDA advances capital to the poorer developing member countries on more flexible terms than those offered by the IBRD. IDA assistance is aimed at the poorer developing countries (i.e. those with an annual GNP per capita of less than US \$ 865 in 2002 dollars were to qualify for assistance in 2003/04 and support their poverty reduction strategies. Under IDA lending conditions, credits can be extended to countries whose balance of payments could not sustain the burden of repayment required for IBRD loans. Terms are more favorable than those provided by the IBRD, credits are for a period of 35 to 40 years with a grace period of 10 years, and carry no interest charges. At mid 2004, 81 countries were eligible for IDA assistance, including several small – islands economies with a GNP per head greater than \$ 865, but which would otherwise have little or no access to Bank funds, and 15 so called “blend borrowers” which are entitled to borrow from both the IDA and IBRD. IDA administers a Trust Fund, which was established in November 1996 as part of World Bank /IMF initiative to assist heavily indebted poor countries (HIPC).

The IDA -13 lending framework emphasized the following objectives, promoting sound policies for growth and poverty reduction, ensuring effective assistance and measurable results, improving coordination, transparency and consultation and providing for substantial replenishment of resources.

The replenishment programme also provided for greater use of grants to address the problems of the poorest recipient countries example those most vulnerable to debt than those in post conflict situations as well as reconstruction projects after a natural disaster and HIV/AIDs programmes (EUROPA , 2006).

Organization

Officers and staff of the IBRD serve concurrently as officers and staff of IDA.

Members: IDA has 165 members

Finance: IDA's total development resources, consisting of members subscriptions and supplementary resources (additional subscriptions and contributions) are replenished periodically by contributions from the more affluent member countries. In addition, other co-financiers such as the

European Development Fund, the several Arab Funds, the regional development Banks, bilateral aid agencies and a growing number of Commercial Banks joining to an increasing extent in co-financing projects that, in many instances are appraised and supervised by the Bank. (EUROPA, 2006).

Procedures

Types of Loans

Investment Projects:- Most Bank lending goes for investment projects which require specific goods and services to meet their objectives.

Adjustment Operations:- Adjustment loans are linked to programs of reform and are usually disbursed in a series of tranches as structural reforms are implemented, adjustment lending usually finances a large volume of imports over a short period.

In 1980 the World Bank introduced structural adjustment lending which (instead of financing specific projects) supports programmes and changes necessary to modify the structure of an economy. So that it can restart or maintain its growth viability in its balance of payments over the medium term.

Project Preparation Facility Advances (PPF):- PPF advances are made by the Bank to provide financial and technical assistance to borrowers for the preparation of new projects. PPF fund is provided only when the borrower cannot pre-finance these costs or find other sources of funds.

Terms of Loans

IBRD - Interest rate - in accordance with a guideline related to its costs of borrowing
repayment period – 20 years including 5 years grace period.

IDA - Interest rate - no interest paid
Commitment charge - 0.5%
Repayment period - 40 years including 10 years grace period.

Identification and Preparation of projects

The first phase of the project cycle is concerned with identifying projects that have a high priority; that appear suitable for Bank support, and the Bank the government and the borrower are interested in considering.

Economic and sector analyses carried out by the Bank provide a frame work for evaluating national and sectoral policies and problems and an understanding of the development potential of the country. They also assess a country's credit worthiness for Bank of IDA lending.

Appraisal

Appraisal is solely the Bank's responsibility, and it is conducted by the Bank staff, sometimes supplemented by individual consultants. Appraisal covers four major aspects of the project:- technical, institutional, economic and financial.

Negotiation and approval

At the stage of negotiation the Bank and the borrower endeavor to agree on the measures necessary to assure the success of the project. The result is a legal agreement between the borrower and the bank that precisely defines the project and specifies the programme to be followed to achieve its objectives. After negotiation is completed the Bank management submits a report on the proposed loan together with all the necessary documents to the Bank's Executive Directors for their approval. When approval by the Bank and the Borrower government is secured the loan agreement is signed. Before withdraws can begin, the borrower must fulfill conditions necessary effectiveness, and the Bank must declare the loan effective.

Implementation and Supervision

After the loan has become effective, it is the responsibility of borrower to implement the project. The Borrower sends to Bank periodic reports on the progress of the project. The Bank in turn regularly sends supervision mission to review progress to ensure that funds are spent as per the agreement.

Evaluation

After the loan has been fully disbursed and the project is completed, the Operation and Evaluation Department (a separate and independent organizational unit reporting to the Bank's Executive Directors) evaluates the results of the project by comparing with what had been expected before the project started.

Legal Agreements

The main legal document for a project is an agreement signed by the borrower and the Bank, which sets out the terms and conditions of the loan; Different names are assigned for these agreements.

- Loan agreements for IBRD loans
- Development credit agreement for IDA credits
- Letter agreement for project preparation facility advance.
- Grant agreement for most trust funds administered by the Bank.

African Development Bank –ADB

Established in 1964, the bank began operations in July 1966, with the aim of financing economic and social development in African countries. The Bank's headquarter is based on Abidjan, Coted Ivoire. From February 2003, however, in view of ongoing security in Coted Ivoire, the Bank's operations were relocated on a temporary basis to Tunis.

Membership – All African countries and there are also 24 non-African members

Organization:- Board of Governors

The highest policy making body of the Bank, each member country nominates one Governor, usually its Minister of Finance and Economic Affairs, and an alternate Governor or the Governor of its Central Bank. The Board meets once a year. It elects the Board of Directors and the President.

On the delegation of power by the Board of Governors, the Board of Directors, in accordance with Article 32 of the Agreement establishing the Bank, Board of Directors is responsible for the general operations of the Bank. The Board consists of 18 members (of whom six are non-African) elected by the Board of Governors for a term of three years, renewable once. The Board meets on a weekly basis. The president is responsible for the organization and the day to day operations of the Bank

under guidance of the Board of Directors. The president is elected for a five year term and serves as the chairman of the board of Directors. (EUROPA, 2006)

Financial Structure

The ADB group of development financing institutions comprises the African Development Fund (ADF) and the Nigeria Trust Fund (NTF), which provide concessionary loans, and the African Development Bank itself (ADB).

ADB: The Bank makes loans at a variable rate of interest, which is adjusted twice a year plus a commitment fee of 0.75%

ADF: The Fund commenced operation in 1974. It grants interest free loans to low income African countries for projects with repayment over 50 years including a 10 year grace periods) and with a service charge of 0.75% per annum. Grants for project feasibility studies are made to the poorest countries.

NTF: The agreement establishing the Nigeria Trust Fund was signed in February 1976 by the Bank and the Government of Nigeria. The Fund is administered by the Bank and its loans are granted for up to 25 years, including grace period of up to five years and carry 0.75% commission charges and 4% interest charges. The loans are intended to provide financing for project in cooperation with other lending institutions. The Fund also aims to promote the private sector and trade between African countries by providing information on African and international financial institutions-able to finance African trade.

The capital stock of the Bank was at first exclusively open for subscription by African countries, with each members subscription consisting an equal number of the paid up and callable shares. In 1978 however, the Governors agreed to open the capital stock of the Bank to subscription by non-regional states, and the participation of non-regional countries became effective on 30 December. It was agreed that African members should still hold 2/3 of the share capital, and the Bank's president should always be an African national.

Procedures

Eligibility:- Under the African Development Charter all regional member countries are equally eligible for development financing from the Bank's resources. However the Bank has singled out the

poorest countries as the main target for the allocation of its concessional funds, notably the African Development Fund (ADF) and the Nigeria Trust Fund (NTF) – Eligibility for NTF loans is further subject to case by case approval of the Federal Government of Nigeria. Since November 1994, a new ADB loan policy has been approved:- per capita Gross National Product (GNP) and loan absorptive capacity, the size of the countries (population, a minimum presence of the Bank Group in each regional country, unfavorable geographic location such as land locked countries: emergency situation and credit worthiness (newly introduced criteria) shall form the basis for the Bank’s lending.

Those countries that have per-capita GNP of more than US\$1050 and are assessed to be credit worthy and in good standing with the bank are eligible only to ADB resources. Those countries with GNP per capita of between US\$ 520 and US\$ 1050 and are assessed to be credit worthy are eligible to a blend of the Bank’s funding with concessional resources (ADB, ADF and NTF). Those countries that have GNP per-capita of less than US\$ 520 and assessed credit worthy are eligible only to the concessional resources of ADF and NTF. Ethiopia falls in this category and at present is not eligible to borrow from ADB source. (EUROPA, 2006)

Lending Instrument:- In the 1960’s and 1970’s Bank Group operations were oriented almost exclusively to project lending, which involves investment in discrete sectoral identification activities. Since 1980, in response to changing economic circumstances of regional member countries, however, the Bank Group has greatly diversified its lending, making use of several different lending instruments including sectoral investment loans and structural adjustment loans.

Terms of ADB Group Loans

ADB	- Interest rate	- variable
	- Commitment charge on undisbursed balance	- 1%
	- Repayment Period	- 20 years including a grace period of 5 years maximum.
ADF	- Interest rate	- No interest rate
	- Service charge	- 0.75%
	- Commitment charge	- 0.05% (newly added term)
	- Repayment period	- 50 years including a 10 year grace period

NTF	-	Interest rate	-	4%
	-	Commitment charge	-	0.75%
	-	Repayment period	-	25 years including a 5 year grace period

The Bank Group has instituted specific operations policies to guide its intervention in the major sectors in the member countries. These cover agriculture and rural development, policies on environment, education, health, population, industry, transport, water supply and sanitation; private sector development women in development and poverty. Once the country resource allocations are made on the basis of country categories comprehensive country programmes supported by country economic analysis are carried out to determine country specific orientation and priorities. The Bank Group project programming process begins with the preparations of the Economic Prospects and Country Programming paper (EPCP) which is prepared in three years cycles for each of the borrowing member countries. The EPCP is prepared by Bank mission in collaboration with the borrowing member country. The main purpose of the EPCP is to define a lending strategy or investment profile for each country. Country strategy emerges from the analysis of the country's policies, priorities and investment programme, its recent economic performance, its development potential and constraints, and the policies, priorities and financial resource of the Bank itself. Based on EPCP the recipient government is responsible for project formulation, and submission to the Bank for financing. The identification process is completed with the screening of all proposals and the creation of a pipeline of projects and inclusions of the projects in the Bank's medium term lending programme. Implementing agencies are responsible to prepare feasibility studies some times the Bank provides Technical Assistance Fund to finance feasibility and design studies.

Project appraisal is carried out by the Bank Groups with the assistance of the borrower. If the project/programme is accepted the loan committee of the bank will recommend the loan to be submitted to the Board of Directors subject to a satisfactory loan negotiation with the borrower. After loan/grant approved by the Bank Board, the borrower is allowed a maximum interval of 6 months to sign the loan /grant agreement with the Bank group.

Before disbursements commence, the loan/ grant must be entered in to force i.e. the standard conditions stipulated in the documents have to be fulfilled by the borrower when these condition,

generally described in the Bank “conditions precedent to first disbursement” have been full filled the loan is declared effective and the borrower may request disbursement.

One of the important conditions precedent to first disbursement is the submission of the legal opinion. Once the loan agreement is signed in Ethiopian case it will be presented to the Prime Minister Office (PMO) with the proclamation to be issued. The PMO will submit the signed agreement and proclamation draft to the Council of Ministers who are after reviewing the documents will forward them to the Council of the Peoples Representatives for ratification. The loan is ratified and authorization is given to publish the proclamation in the Federal Negaritt Gazeta.

Project implementation starts from the moment the project is declared effective, possible problems during implementation may be solved by ADB supervision missions. The Borrower also prepares quarterly progress reports on the implementation of the project, post Evaluation is the last stage in the project cycle. The purpose of this stage is to assess the project impact taking in to account its initial objectives and to make suggestion likely to improve the effective preparation appraisal, implementation of similar Bank Group projects in future. The borrower in collaboration with the Bank prepares the Project Completion Report (PCR).

European Union (EU)

European Union (EU):- aimed to increase intergovernmental cooperation in economic and monetary affairs, to establish a common foreign and security policy and to introduce cooperation in justice and home affairs. The EU was placed under the supervision of the European Council. European Council is the name used to describe summit meetings of the Heads of State of Government of the EU member States, their Foreign Ministers and Senior Officials of the European Commission. The Council meets at least twice a year, usually to adopt major policy decisions. The council was founded in May 1949 to achieve a greater unity between its members, to facilitate their social progress and to up hold the principles of parliamentary democracy, respect for human rights and the rule of law.

Membership: has arisen from the original 10 to 46. (EUROPA, 2006)

Committee of Ministers: consists of Ministers of Foreign Affairs of all member states (or their deputies) it decides with binding effect all matters of internal organization, makes recommendation

to governments and draws up conventions and agreements, it also discusses matters of political concern, such as European cooperation, compliance with member states commitments in particular concerning the protection of human rights and considers possible coordination with other institutions such as EU and the organization for security and cooperation in Europe.

Parliamentary Assembly

Members are elected or appointed by their national parliaments, at March 2005 the Assembly had 315 members, The Assembly submits recommendations to the Committee of Ministers, passes resolutions and discusses reports on any matters of common European interest. It is also a consultative body of the Committee of Ministers and elects the Deputy Secretary General and the Secretary General for the Assembly. (EUROPA 2006).

Finance: The budget is financed by contribution from members on a proportional scale of assessment (using population and gross domestic product as common indicators).

Cooperation Polices

The European Development Fund, constituted by contribution from all EU member states contribute, finances projects and programmes on the African, Caribbean and Pacific (ACP) Countries that are signatory to the Lome Convention. The latter is the legal framework that defines the various rules and principles for the management of the European Development Fund.

The cooperation is renewed each time a new convention is signed. The main cooperation assistance, as per the convention, the European Development Fund (EDF) allocated for convention period is divided among the ACP countries and regions for their national or regional development programmes taking into account the geographic, demographic and macro-economic nature of each ACP state.

The European Community's development cooperation policy with ACP countries is derived from the Maastricht Treaty indicated under article 130u. These are the following.

- ➡ The development and consolidation of democracy, and of the rule of law as well as respect for human rights and fundamental freedoms.
- ➡ The campaign against poverty.

- ➡ Sustainable social development, particular stress is given to the development of human resources, questions of gender and environmental protection.
- ➡ Integration into world economy, in particular through the promotion of the private sector and the development of trade.

ACP – EU cooperation is based on fundamental principles which are stipulated in the Lome Convention which are:-

- ➡ Equality between partners, respect for their sovereignty, mutual interest and interdependence,
- ➡ The right of each state to determine its own political, social, cultural and economic policy options.
- ➡ Security of their relation based on the “acquis” of their system of cooperation.

It is important to note that there is a special treatment provision to the Least –Developed, Land Locked and Island Countries (LDLLICS) ACP states when determining the volume of financial resources and the conditions attached thereto in order to enable the least –developed ACP states to overcome structural and other obstacles to their development. More over, in order to ensure flexibility in the implementation of the convention there is a provision for derogation (i.e. deviation from the normal rules and procedures) under special circumstances taking such factors as geographical location, rules of origin, costs, competition and etc.

Implementation Procedures

Upon receipt of the information on the financial allocation each ACP state shall draw up and submit to the community a draft National Indicative programme (NIP) which normally contains packages of proposed list of programmes and projects prepared on the basis of and consistent with the development objectives and priorities of the ACP state. Particular to the Lome IV second financial protocol or 8th EDF, only 70% of the indicative allocation will be firmly committed. The commitment of the second tranche is dependent upon the rate of commitment and disbursement of the initial allocation. Upon the identification stage project/programme document will be prepared and submitted to the Head of Delegation of the European community to the ACP state for financing. The appraisal of projects and programmes submitted for financing will be carried out jointly by the

ACP state and the community, for any project or programme financed by a grant from the fund a financing agreement shall be signed between the commission and the ACP state.

Project Management and Financial Execution

There are different institutions involved in the implementation of the Lome Convention at different levels. The National Authorizing officer (NAO) is a government official designated by the ACP country to cooperate with EU and to serve as a conduit for all major discussion with the ACP authorities related to the implementation of cooperation programmes and the Head of delegation (HOD) of the European Community to the ACP state, HOD heads the EU delegation which is established in the ACP state to facilitate late and expedite the preparation appraisal and execution of projects and programmes. And the chief Authorizing Officer (CAO). The CAO based on the Commissions head quarter is appointed by the commission and shall be responsible for managing the resource of the Fund.

Projects of programmes financed under EDF are Evaluated through a number of ways i.e through discussion and reporting. Evaluation of projects or programmes are carried out during execution and after completion.

3.2.2 Major Bilateral Donors

U.S. Aid Policy and Procedures

U.S. post war foreign policy were determined by a Liberal International Economic Order (LIEO), designed to foster economic growth and the diffusion of stable democratic governments (see. Isaak, 1995).

The \$13 billion Marshall Plan was the first massive government sponsored aid program, funding the post war reconstruction of Western Europe and other decimated societies. Though there were obvious differences between post war Western Europe and the former colonies of Africa, Asia, and Latin America, the Marshall Plan became a blue print for U.S. foreign aid. More than 90 percent of these funds were disbursed in the form of grants rather than low interest loans; about two – thirds were designated for economic rather than military purposes.

Compromises in these objectives emerged, however, soon after the Marshall Plan programs were terminated in 1952 and the mutual security act was passed. During Eisenhower administration-

tense Cold War years preceding the decolonization of Africa – military and development aid were separated, and the later became by far the more prominent. Where as military aid to friendly countries accounted for only one sixth of total U.S. foreign aid between 1949 & 1953, between 1953 and 1961 it constituted more than half (Eberstadt, 1988). Real and imagined communist threats not only in Europe but across Asia and in to the southern hemisphere compelled these changes. The United States designed its security aid, primarily in the form of support for police and paramilitary forces engaged in counterinsurgency, to help struggling governments maintain political stability and resist potential Marxist challengers.

President Kennedy's message to congress in March 1961 directly linked political and developmental objectives. Kennedy (1961) believed the United States freedom and the prospects for democratic development around the world depend "On the ability to build growing and independent nations where men can live in dignity, liberated from the bonds of hunger, ignorance and poverty. Congress approved Kennedy's ambitious aid program including the Peace Corps in the Foreign Assistance Act (FAA) of 1961, legal ground for U.S. aid policy is FAA of 1961 its subsequent amendments creating USAID to administer the growing volumes of economic assistance. According to institutional set up of FAA of the U.S. responsibility and authority for the formulation and execution of foreign development aid program was assigned to a single agency the (USAID) Agency for International Development with in the Department of Foreign State. USAID is headed by an Administrator of under Secretary rank reporting directly to the Secretary of State and the President. The field work of the aid operations is under the direction of single mission chief in host country reporting to the American Ambassador in that host country.

The shifting regional focus of U.S. foreign aid during the Cold War reflected the high priority of political over development objectives. Geopolitical priorities to U.S. aid began with the European recovery effort after World War II. South Asia and South East Asia became priority areas during the 1950s and remained such through out the Vietnam War. Israel and Egypt have received nearly half of U.S. economic aid since the signing of the Camp David accords in 1978. During the 1980s, U.S. assistance to Central America (particularly El Salvador, Guatemala, and Honduras) rose sharply to \$ 1.3 billion in 1989, surpassing aid to Asia. Flows to Sub-Saharan Africa, relatively modest given the regions large number of nation – states and high degree of human need. In the Cold War's immediate aftermath the geographic focus shifted once again to Eastern Europe. The United States

transferred \$ 1.4 billion to Russia despite worsening internal conditions in the country and an impending political and economic crisis. (Zimmerman, 1996)

The Multiple Goals of U.S. Aid

The primary global objective of U.S. foreign aid was – and remains – preserving the territorial and political security of the United States. During the Cold War this objective involved containing perceived threats to vital U.S. interests primarily from the Soviet Union and its Eastern European satellites but also from the People's Republic of China and other communist regimes in developing area of the world. The closely related second objective of U.S. aid was to ensure the political security and cooperation of strategically important allies. Such efforts include promoting friendly governments, strengthening military forces, providing food, and creating a supportive international environment – all in countries where the establishment of communist regimes was seen as directly threatening U.S. security.

Promoting economic growth constituted a third distinct foreign – policy priority of U.S. aid. This objective entailed active opposition to acts that harmed the U.S. economy or, more generally, the liberal international economic order (LIEO) established and led by the United States. The LIEO rested upon open markets, foreign investment opportunities, access to technology and raw materials, and limited government intervention in economic activity. The fourth major objective, promoting humanitarian concerns was the one most frequently proclaimed by U.S. leaders. It derived from long held belief that U.S. socio-economic and political system could be shared with foreign countries to their advantage. This goal required that the United States be willing and able to respond to human catastrophe. Where man made and natural any where in the world. Development aid was used to pursue each of these objectives in various ways. Underlying all the stated objectives was that appeal to the moral principles and cultural values of a country flushed with a new sense of destiny following the World War II. (Zimmerman, 1996)

Policy Conditionality

Conditionalities attached to the assistance provision vary from sector to sector. But there are some common policy conditionalities to be met by all sectors, Foreign Assistance Act of 1961 of the U.S. Government – dictates that recipient country needs to contribute 25% of the total cost of the project as a matching fund, prevalence of policy framework paper and policy reform agenda is also required

from the host country prior to grant provision. Existence of sector development strategies and programs are also mandatory to obtain aid from the USA, assistance from the USA comes in the form of development aid, which is extended, to foster economies only adherent to free market principles, USA seeks donor consensus on sustainable development priorities, Policies and programs of the recipient country in order to maximize the effective use of scarce resource, (U.S. government) also seeks the channeling of certain proportion of aid through NGOs, contract out the implementation of some projects to private firms (NGOs) in agreement with the recipient country.

US AID Management

The first step to start aid operation is the preparation of strategic plan. The strategic plan is prepared at the host country mission office or at the USAID/Washington (head office). The strategic plan distinguishes areas of focus, implementation modalities and evaluation criteria for progress on the basis of such strategic plan the aid mission develops “host country development strategy statement (CDSS) and lay out the objectives, strategies programs and project activities to be supported by aid resources.

All strategic plans and action plans are reviewed and approved by USAID/Washington. Once host country strategy is approved, the country mission is expected to develop assistance activities with government of the assisted country and NGOs to achieve the objectives identified in the strategy. Activities are expected to be highly participatory both with government agencies, local communities and NGOs.

Disbursement: USAID manages the grant fund. The country mission is responsible for the disbursement of fund. In some cases the host country co-signs project implementation orders and noting but payment order.

There are various instruments for Monitoring and Evaluation at various levels USAID (mission) conducts progress reviews at least once a year, USAID/Washington also conducts periodic program performance reviews, periodic reviews are supplemented assessments & reports, USAID also conducts joint assessment with the recipient country. At the field level, USAID conducts periodic project/ program monitoring review (PMR).

Across Africa and Latin America, it could hardly be said that U.S. economic aid had consistently helped promote constructive social economic and political change. Frequent support for repressive

dictators only fueled cynicism regarding aid efforts. (Zimmerman, 1996) USAID continue its struggle to justify its multiple, even competing objective, a condition masked for years by uncritical Cold War rationales revealed in endless amendments to foreign aid legislation. As a result U.S. leaders engaged in a virtually nonstop reexamination of aid objectives and program rationales. Each initiative from the Marshall Plan through Eisenhower's New Directions and Kennedy's Alliance for progress, reflected a distinct period in U.S. strategic interests and development thought. The Carter administration emphasized basic human needs and poverty alleviation and made a strong effort to establish human right as a criterion in judging the development performance of aid recipients. The Reagan administration revived the trickle – down theory emphasized military aid and promoted private enterprises as “the engine of growth”.

President Bush and Clinton placed greater emphasis on sustainable development defined by greater attention to environmental and population concerns and promotion of democracy broad based economic growth and humanitarian assistance. Though the emphasis on sustainable development suggested a possible new paradigm for U.S. foreign policy in the 1990s. in practice many established aid programmes remained unchanged. With only their rhetorical goals changing. Because of such constant changes, the U.S. foreign aid program has tried to serve multiple and often incompatible master. Foreign – aid proponents have offered every thing from feeding the hungry to opening new commercial markets for U.S. industry. Under successive administrators, USAID studied it self and changed directions under the watchful eye of a congress that imposed ever tighter controls and made amendments for especial interests. (Zimmerman, 1996)

Confronting the Development Dilemma

Economic aid clearly has advanced U.S. political objectives since World War II. Unfortunately, the United States too often has supported political leaders who resisted necessary reforms and postponed hard decisions about economic restructuring and reallocation of resources. As a result, many aid recipients became more rather than less dependent on foreign aid. (Zimmerman, 1996)

The considerable tension between U.S. political objectives and development objectives has severely limit the economic aid programs achievements as well as its prospects for the future.

In most other donor states development policy is more concerned with empowering mass publics and creating civil societies than with establishing intimate security ties between elites for the donor

and recipient states. Unfortunately, the fragmented U.S. economic aid program has hardly begun to elicit measurable progress toward such enlightened objectives (Zimmerman, 1996). Gaps between word and deed may have been, inevitable throughout the Cold War, their continuation since the collapse of the Soviet Union is more difficult to rationalize.

Leaders in many LDCs clearly recognize political linkages as the real precondition for obtaining U.S. foreign aid. Understandably, these LDCs often ignore US pressure to reform. This reaction may not be clearly visible, but the alienation of these LDCs from the United States is palpable to those in USAID who maintain regular contacts with their leaders. Greatly complicating matter is the fact that the overarching objectives have been coupled with specific secondary goals. For example diplomatic and political objectives almost invariably have included obtaining rights for U.S. military bases, gaining support for issues of importance to U.S. in the United Nations, and maintaining diplomatic access to recipient governments. (Zimmerman, 1996)

Ultimately U.S. foreign –policy self interest, such as regional stability, human rights, environmental protection, and free trade – all of which indirectly contribute to the security of the United States – depend on the progress other countries make toward building responsible political systems and self sustaining economies.

Prospects towards Millennium

The end of communism, the dismal record of past foreign aid programs and the Republican revolution in the U.S. congress have all worked against U.S. foreign aid. U.S. aid appropriation were being reduced dramatically in the mid 1990s, with only most established recipients (especially Israel and Egypt) continuing to receive substantial funding, prospects for a more toward development oriented aid become dimmer. Japan has become the world's leading donor of economic aid. All of these factors reduce the willingness of the U.S. public to increase support for aid. Nevertheless, there are new opportunities in the late 1990s for the United States to promote peace and human freedom and to use foreign aid for constructive socio political change rather than against foreign ideologies this include increased environmental degradation, the chronic debt crisis that reflects the failure of past aid programs mass emigration from the poorest parts of the world driven by the lack of economic, political and social opportunity, basic modernization of institutions and infrastructure to simulate significant social and economic development, but going beyond modernization and

creating self – sufficient political & economic institutions requires the active involvement of leaders and mass publics in the developing world. (Zimmerman, 1996)

Japan's Aid Policy

Japan quietly assumed the status of an aid donor early in the post war period while still a rapidly developing economy and a recipient of World Bank assistance. Japan's primary concern in 1950s involved industrialization and long term economic growth. Japan joined the Colombo Plan in 1954 concluded its first reparations agreement in the same year, and commenced yen loans in 1957. Since then its performance and reputation as an aid giver has fluctuated. Bilateral disbursement grew rapidly from \$ 145 million in 1960 to ten times that amount by 1977 in real terms (Zimmerman, 1996). From this early period Japan was widely perceived as providing assistance to LDCs primarily as a means to facilitate its own economic expansion. From the 1950s through the 1970s, export food and resource import were critical to Japan's domestic economic growth and were prime objectives of Japan's aid strategy through the 1970. Foreign aid played a relatively minor part in Japanese foreign policy since the early 1980s, However, Japan attained the status of a foreign –aid super power through aggressive increases in aid allocations in the 1980s and early 1990s, a time when the U.S. program reached its peak and began a precipitous decline. The Japanese government subsidized massive construction of economic infrastructure in LDCs, actively participating in the World Bank, the OECD, and regional development Banks. Its aid policy not only has adjusted to meet shifting recipient needs but has also responded to broader trends in international politics since the Cold War's demise. (Zimmerman, 1996)

Japan is no longer the export – driven aid donor of the past. It is increasingly respecting recipient demands, taking on the responsibilities of an aid leader and accepting grater intentional scrutiny of its aid program. In the emergent post Cold War, Japanese foreign aid has bolstered many former Soviet bloc countries efforts to reconstruct their economies and move toward market – oriented reforms. In this and other respects the Japanese government has carefully used foreign aid as a critical agent of global economic diplomacy. Japan rise during the 1980s and early 1990s as the world's leading aid donor has done more than increase the flows of aid; it has encouraged better aid clearer policies, and more openness. And the use of "strategic aid" has become and accepted feature of what had been a strictly economic policy. Foreign aid in a variety of forms became a central

component of Japan's foreign policy, especially given the country's heightened profile as the largest single donor to dozens of recipient states.

Japan's Aid Policy and Procedures

According to the ODA charter issued by the government of Japan in July 1992, Japan's ODA is extended on the basis of the following philosophy and principles, humanitarian consideration, recognition of independence among nations of the international community, environmental conservations, support for the self – help efforts of recipient countries.

Basic principles of Japan's ODA, promoting efforts for democratization and introduction of market – oriented economy and securing of basic human rights and freedom, avoiding the use of ODA for military purpose or for aggravation of international conflict: simultaneous pursuance of environmental conservation and development, and paying close attention to trends in recipient country's military expenditure, development and products of weapons of mass destruction and export and import of arms as per the revised Japanese ODA charter of 1992. Due to historical, geographical, politics and economic reasons, Asian countries in general and East Asian countries, especially members of the Association of the South East Asia Nations (ASEAN) in particular are the priority regions for Japanese assistance, due consideration is also given to the least developed countries of Africa and Latin America. Sectors eligible for Japanese aid are; economic infrastructure, agriculture forestry and fishery, water and basic human need categories such as medical service, public health, hygiene, poverty reduction environment and population, human resources development, women and development and social and economic adjustment programmes.

Implementation Arrangements:- Japan's grant aid and technical cooperation are implemented through the Japan International Cooperation Agency (JICA), a legally established governmental organization in 1974 with a view to contribute to economic and social development in developing regions; and to promote international cooperation. The bilateral ODA loan is implemented through Japan Bank for International Cooperation (JBIC), established in October 1999 and mandated to undertake lending and other Operations for the promotion of Japanese exports, imports, and economic activities overseas.

Japanese ODA which comprises two sub groups: grants and ODA loans, grant aid is extended by the government of Japan in the form of donation of funds required by the recipient/developing countries

for the procurement of equipment, materials, facilities (technology) and services needed for their economic and social development. The recipient country is obliged to deposit a counter part fund.

The implementation procedures of the grant aid are completed in five phases namely

1. Request from the recipient country is submitted to the Embassy of Japan.
2. The request is examined by the Ministry of Foreign Affairs (MOFA) of Japan.
3. MOFA instructs JICA or other interested agency to conduct a study of the requested project, if the decision is made to assist the proposed project, study of the project, appraisal and approval under this phase JICA submits a final report to MOFA, MOFA appraises the study report, agreement is made on the draft exchange of notes between the government of Japan and the government of recipient country. And the Japanese cabinet at the ministerial level meeting approves the project.

The Japanese government's budget is formulated and authorized on a single year basis, and all the steps involved in the provision of grant aid from the signing of the exchange of notes (E/N) , through the signing and execution of the contracts, to payment must in principle be completed within the same fiscal year. However, due to the fact that several years are normally required from submission of the project proposal to formation of the aid outcomes, there are some possibilities to extend the implementation period.

Bilateral ODA loan

The bilateral OAD loan is part of Japanese Overseas Economic Cooperation operations and executed by the Japan Bank for International Cooperation (JBIC) with the purpose to provide economic assistance for social and economic development on concessional terms i.e. the request for a Japanese ODA loan is expected to fulfill the following prerequisites:-

1. Assigning an official agency capable of executing the cooperation.
2. Administration of the cooperation towards promising economic development and welfare.
3. Acceptance of the concession of the loan and inclusion of a grant element of at least 25%.

Japanese ODA Loan is preferred by most developing countries because of its promising conditions, which include:-

1. Interest rate least than 3 %
2. Repayment period 25 – 30 years; and
3. Grace period 7 – 10 years.

ODA loan procedure

An ODA loan is normally extended in accordance with a standard procedure which generally involves the following.

- ✚ Identification is carried out depending on the development objectives, strategies and needs of the borrower country.
- ✚ Preparation:- The borrower by means of feasibility study, carries out project preparation (JICA) under its technical cooperation scheme on a grant basis, may also carry out a feasibility study.
- ✚ A request for an ODA loan, together with a feasibility study report and project implementation program will be submitted to the Japanese, government through the Japanese Embassy.
- ✚ Appraisal:- appraisal is made by four Japanese organizations namely Economic Planning Agency, the Ministry of Foreign Affairs, the Ministry of International Trade and Industry, and JBIC.
- ✚ The Japanese government then sends a mission to the borrower's country for general consultation. JBIC next sends an appraisal mission to conform the viability of the project based on the appraisal reports of JBIC the government of Japan arrives at decision as to whether the project requested is suitable for JBIC loan. If this is positive.
- ✚ The two governments enter in to negotiations on the formal agreement when the agreement has been reached, the two governments sign an exchange of notes confirming the matters agreed up on.
- ✚ JBIC and the borrower engage in loan agreement negotiation on the bilateral contract. Procurement of goods and services needed for the projects will be undertaken through international competitive bidding process.
- ✚ Disbursement of funds is made as project implementation progress in response to request for disbursement by the borrower.

- ✦ A JBIC supervisor mission team reviews project implementation progress, through discussion with the Executing Agency.
- ✦ JBIC undertakes post – evaluation of the project after completion analyzing the performances of the project in comparison with the project plan at the time of JBIC appraisal. The basis for the review the project completion report submitted by the borrower as required by the respective loan agreement.

Swedish Development Aid Policy and Procedures

Swedish Development Cooperation has the following goals:- economic growth, economic and social equality, economic and political independence, democratic development, care for the environment and equality between women and men. The over all goal of Swedish aid is poverty reduction. The Country Strategy prepared for each country is the most important instrument governing Sweden's development cooperation with a particular country. It states the Swedish governments views on cooperation with the country and stipulates the scope, focus, design and expected results of the operation programs. It serves for a period of up to five years and usually supplemented by a development cooperation agreement between Sweden and the partner country. In its annual letter of appropriations the government specifies these countries for which country strategies are to be produced. Normally a new strategy for each country is produced every third year. The criteria for securing Swedish aid are; the project must be given priority by the recipient country, the project has to full fill the objectives of Swedish assistance and the project has to fall with in SIDA's financing aid administrative capacity.

Procedures

- ✦ Project proposals are presented to the Swedish government through the Swedish International Development Authority (SIDA) for possible consideration.
- ✦ If the project proposal is accepted subsequent detail project document will be commissioned jointly by Swedish and recipient country experts and the result will be sent to Stockholm through SIDA for approval.
- ✦ The program review and consultation takes place by different sectors working groups of the two sides every budget year.

- ✚ In matters regarding implementation of agreement the concerned Ministry of the recipient side shall prepare plan of operation and SIDA shall make funds available for disbursement.
- ✚ The subsequent task is implementation as per the general and specific agreements.
- ✚ Procurement shall be performed in accordance with generally accepted principles and good procurement practices..
- ✚ Reports shall be provided by the recipient country on all financial aspects of the program.

The Netherlands aid policy and procedures

The Netherlands foreign policy focuses on promoting international law peace and security and promoting a more appropriate division of wealth in the world. The Netherlands builds its approach to development cooperation on three principles: ownership, utilization of domestic resources and poverty reduction. Like several DAC members, it promotes the use of country owned strategies, in particular the Poverty Reduction Strategy Paper (PRSP) as framework for implementation, monitoring and evaluation of aid as well as donor coordination and policy dialogue in priority countries.

The selection criteria for Netherlands aid includes degree of poverty, the recipient government commitment to good policies and good governance. Theoretically, Dutch fund is available to be used in any sector chosen by the recipient country. In reality, however, most partnership country mission have simplified their operations by concentrating on only three to four sectors. The most commonly accepted areas include basic education, basic health and rural development, Efforts have also been made to mainstream cross cutting themes, including good governance, poverty reduction, women in development, institution building and environment.

Dutch development assistance is given through the following channels; at head quarter levels, through the Ministry of Foreign Affairs, at field level, through Embassies who have direct implementation responsibility for the delegated funds, and other direct implementation agents including NGOs, private sector mechanisms.

Procedures

- ✚ Bilateral negotiation, the Netherlands development package program will be carried out and preliminary selection on priority sectors of intervention will be done between the two governments.
- ✚ Following this consultation, the sector choice will be conducted with civil societies and donors.
- ✚ Finalization of sector choices with the government through bilateral consultations.
- ✚ Submission of project proposals as per the chosen sectors.
- ✚ Appraisal and approval of the requests by the Dutch side.
- ✚ Negotiation and signing of implementation agreement for each project between the two governments.
- ✚ Based on nature of the project administrative arrangement contract will be signed between the implementing organizations of the two sides. This includes the preparation of the plan of operation.
- ✚ Then implementation of project starts.

German Development Assistance Policy & Procedures

Motives for German development assistance are, foreign policy motives (e.g. crisis prevention), foreign trade motives, ecological motives (conserving vital natural resources), The following are five criteria's for German official development cooperation, respect for human rights, popular participation in political decisions, the rule of law and legal certainty, a market – friendly social economic order and development – oriented state action. These serve as a reference point for defining the type and volume of development cooperation – preference is given to supporting those developing countries that are endeavoring to establish a socially equitable and economically efficient social order.

The German government currently changes its development cooperation policy towards the developing countries. It has recently reduced number of priority countries from 120 countries to 70. Ethiopia is still priority country for the German government. Moreover the development cooperation will concentrate on few focal areas.

On the basis of dialogue with partner, the focal areas of development cooperation are:- with the country in question are identified in the country strategy.

Focal areas selected by the representatives of the governments of Ethiopia and Germany for future Ethio-Germany development cooperation are:

- ➡ Sustainable utilization of natural resources for improved food security.
- ➡ Capacity building in governance (Participation, democratization, decentralization, judiciary, public administration, municipal development, civil society and vocational training).

Procedures of German Official Development Cooperation

- ➡ Developing country's government submits application to German government for assistance for a particular project.
- ➡ Selection (preliminary) of applications by German Ministry of Economic Co-operation and a project examination in consultation with implementing organizations like German Technical Co-operation Agency (GTZ).
- ➡ German Ministry of Economic Co-operation commissions, Implementing Organizations to examine project
- ➡ Implementing Organization examines the project and submits report to German Ministry of Economic Co-operation.
- ➡ German Ministry of Economic Co-operation analyzes the results of examination and decides whether a project eligible or not.
- ➡ German Ministry of Economic Co-operation commissions Implementing Organization to manage German contribution to project of partner developing country.
- ➡ Project executing agency in partner country implements project with support of Implementing Organization.
- ➡ During project implementation the Implementing Organization controls the German contribution and examines whether the project is being implemented according to plan German Ministry of Economic Co-operation supervises and intervenes where necessary.

- ➡ Once project assistance has ceased, German Ministry of Economic Co-operation, Implementing Organization and in some cases, the Federal Court of Audit examines its development impact and sustainability.

Italy Aid Policy and procedures

Italy is one of important actors in the international development cooperation system. The rationale for Italy's development cooperation program is set out in its basic law of 1987 and governmental guidelines, to provide effective, poverty oriented partnership development cooperation program in countries that have strong political & economic ties with Italy, In the Mediterranean, South –East Europe, the Horn of Africa, South Africa and other developing countries where Italy has been traditionally playing a key role. To contribute to stabilization on economic development of countries that are important to Italy's security and well – being to support Italian foreign policy aimed at protecting the environmental, addressing global population problems, and fighting drug trafficking, AIDS and other diseases humanitarian and disaster relief activities.

Procedures

A considerable progress has been made in the management of Italian aid through a reform process which includes:-

- ➡ Development of specific guidelines in a number of areas and sectors and a decision to mainstream poverty reduction in the Italian aid program consistent with the international development strategy.
- ➡ The improved and generalized application of project cycle management.
- ➡ Introduction of country strategy programs with recipient countries
- ➡ More open and competitive bidding procedures.
- ➡ The establishment of field offices in 20 countries and participants in aid coordination at local level.

The project cycle managing implies a substantial increase in the level of ownership through joint preparation a built in mechanism for joint management and monitoring by stakeholders. It also

identifies a project cycle that the parties must follow in order to prepare, approve and implement projects.

In the project preparation (identification and formulation) the Italian cooperation through its consultants and the partner countries jointly participate until its approval. Finally the project is approved by Italys Ministry of Economic Co-operation and project agreement is signed with partner countries to commence implementation of financial proposal for each program or project prepared according to the project cycle procedure.

Implementation Modalities:- Implementation modulation for Italian assisted projects follows the centralized or decentralized direct management by the Italys Ministry of Economic Co-operation, and the involvement of international organization such as (UNICEF, UNDP, ILO, World Bank) and Italian NGOs.

Another common procedure to Italian ODA is that it is in large part tied to procurement in Italy however Economic Co-operation it is improving with in the existing practices of Italys Ministry of Economic Co-operation.

3.3 Aid management and accounting

3.3.1 Aid management

The donor community have been concerned with growing evidence that, over time, the totality and wide variety of donors requirements and processes for preparing, delivering, and monitoring development assistance are generating unproductive transaction costs for, and drawing down the limited capacity of, partner countries. And donors' practices do not always fit well with national development priorities and systems, including their budget, program and project planning cycles and public expenditure and financial management systems. It is recognized that these issues require urgent, co-ordinated, and sustained action to improve effectiveness on the ground.

The 2002 UN Monterrey Conference on financing for development highlighted the importance of building partnership among donors and developing countries as a means of making more effective progress towards the MDGs. It called for donors to intensify their efforts to harmonize their procedures so as to reduce transaction costs and make ODA disbursements and delivery more

flexible by taking in to account national development needs and objectives under the ownership of the recipient country.

The Monterrey Consensus, emphasizes harmonization of donors policies, procedures, practices, terms and conditions as essential prerequisites for effective use of external assistance to alleviate poverty and to achieve for the MDGs. Partner countries on their part will undertake necessary reforms to enable progressive reliance by donors on their systems as they adopt international principles or standards and apply good practices. i.e. insure transparency and accountability, country analytic work, measurement of performance in public financial management, monitoring, reporting and evaluation and financial reporting and auditing.

So far two International High Level Harmonization Forums were undertaken. First, in Rome in February 2003 (Rome Declaration on Harmonization) and second, in Paris in February 2005 (Paris Declaration on Harmonization)

Paris Declaration states the commitment to accelerate progress in implementation especially in the following areas:-

- i) Strengthening partner countries national development strategies and associated operational formwork (e.g. planning, budget, and performance assessment frameworks).
- ii) Increasing alignment of aid with partner countries priorities systems and procedures and helping to strengthen their capacities.
- iii) Enhancing donor's and partner countries respective accountability to their citizens and parliaments for their development policies strategies and performance.
- iv) Eliminating duplication of efforts and rationalizing donor activities to make them as cost effective as possible.
- v) Reforming and simplifying donor policies and procedures to encourage collaborative behavior and progressive alignment with partner countries priorities systems and procedures.
- vi) Defining measures and standards of performance and accountability of partner country systems in public financial management, procurement, fiduciary safe guards and environmental assessments, in line with broadly accepted good practices and their quick and widespread application.

The special programme for Africa (SPA), supports the harmonization process in African countries.

Ethiopia was chosen as a harmonization pilot country of SPA. Accordingly, the SPA mission put a concrete foundation to carry out Monterrey Consensus.

The joint Government of Ethiopia (GoE)- DAG Task Force on harmonization had been established in November 2002, leadership of the harmonization efforts are in the hands of MoFED. And the Task Force is mandated to develop a prioritized action plan for harmonization and work to operationalize the plan. The broad mechanism for enhanced policy dialogue consists of quarterly high levels forums, The action plan was finalized in December 2004 after two years of consultative process.

The Harmonization effort requires aid co-ordination and management, donors' policies and procedures will need to be harmonized and aligned with the government systems, therefore, rather than establishing parallel systems for foreign aid, working with in government system would substantially improve the effectiveness of resource utilization, which enhance transparency and trust in accounting for the support provided. Such an approach entails that the procedures and management capacities of governmental institutions needs to be inline with the international standards and procedures.

However according to some evidences form MoFED the high level quarterly forums are not undertaken in line with the intended plan, and government systems are not inline with international systems and standards as required in the harmonization agenda. This might be because of the delayance of the various deep institutional reforms, especially in the capacity building and financial reform sectors.

Another reason for the delayance of the harmonization agenda in Ethiopia is that GoE has undertaken a programme of decentralization to regions and districts, which provides considerable fiscal and administrative autonomy to regions and districts.

Generally if we consider the two types of aid i.e Humanitarian aid and Development aid:-

Humanitarian aid:- aims to alleviate acute hunger by providing emergency relief following natural or man made humanitarian disasters and supplies food aid to people in developing countries to eradicate chronic under nourishment, to support social development and, to promote self reliant communities. And it requires no political requirement and conditionalities.

Development aid:- This form of aid modality requires, deep institutional reform processes and conditionalities required from the recipient countries as stated in global harmonization agenda. In the case of Ethiopia deep institutional reforms and conditionalities are being preformed in a delayed process. This indicates that development aid is at pre-developmental stage.

3.3.2 Aid Accounting

Foreign aid is conventionally measured on the basis of the organization for Economic Cooperation and Development (OECD's) Official Development Assistance (ODA), a concept introduced in the early 1970s.

The guardian of official information about aid is the Development Assistance Committee (DAC) of the OECD. Its annual volume development cooperation contains the most commonly used aid statistics. DAC defined ODA as loans and grants made on concessional terms from official sources with the objective of promoting economic development and welfare (for a loan at least 25 percent grant element).

There is a significant statistical discrepancy between domestic and international sources. ODA (OECD, CRS) is acknowledged to be an authoritative source on external aid figures. Hence the inconsistency of its data services with that of MoFED, a responsible body for aid in Ethiopia is of such concern. Most of the annual figures reported by OECD- DAC are significantly greater than those reported by MoFED.

According to World Bank Public Expenditure Review (PER, 2000) a large volume of external aid flows is still not captured in the budget. For example of the forecast amount of Birr 3.6 billion in external grant only about Birr 1.6 billion is captured in the fiscal year 99/2000 federal budget.

Generally there are no clear guidelines as to which projects and funds should be included when budgets are prepared. External loans are as a general rules, included in the budget, because of the legal obligation to repay them and also because government has to budget the matching counter part funds. For grants however, no clear pattern can be detected, MoFEDs own summary notes that there are a number of externally funded projects that are simply not included in the budget.

This is particularly the case where the externally funded projects don't require a contribution from the treasury. In practice this means that many of the projects funded by bilateral and multilateral

donors remain outside the budget. And the national budget give an imperfect account of the full extent i.e. imperfectly consolidated budget process. This implies the need for systematic guidelines as to how all ODA's should be shown in the budget, and also helps to ensure the budget preparation process to be transparent, accountable, comprehensive and predictable.

3.4 Aid and economic policy in Ethiopia

The current Ethiopian policy can be traced to 1945. The country was liberated from five years of Italian occupation in 1941. The period between 1941 and 1945 was taken up by efforts toward re-establishment of the central government and its authority over the entire country. By 1945, the structure for a stable state was completed and the government was able to face the challenges of socio-economic development.

When in 1945 the modern currency was issued it was made possible by the help of the US, who, through its lend-lease programme, provided the material (including copper and silver for the coins) and covered the minting, printing and the transport costs. These were followed by capacity enhancing projects such as rehabilitation and expansion of roads, development of communication in infrastructure and so on.

In the pre 1975 period, the basic economic policy was to rely both on aid and domestic economic possibilities. This could be seen from the Third Five – Year Plan outlined as, not all sectoral programs or projects are of a type commending themselves to aid givers; 30% to 40% of the entire public sector investment programmes are projects or activities which may not invite aid. (Imperial Ethiopian Government, 1968).

The stated policy shows that the major part of the public sector investment program requires aid. However, foreign resources were received not only in the form of development aid but more in the form of foreign capital and investment. The country “didn't developed polices for the mobilization of aid” and the government didn't pursued an active and effective campaign to get it (Befekadu , 1992).

The economic policy was suitable for foreign investment as there was a policy of promoting both private and public investment. Neither the private nor the public sector was given priority; both of them had equal rights, obligations and facilities.

The supervisory and control role of the government was limited to small parts of the total national economy such as “the maintaining of order and the extraction of sufficient resources from the economy” (through income taxes, import duties, excise taxes on urban consumers) “to support an expanding state apparatus” (Clapham, 1988). This limited role of government in the economy was a suitable environment for an inflow of foreign resources. Nonetheless, although the economic policy was appropriate for foreign capital, the government was not striving to get as much aid as it could have. It took what was offered and no more. Instead, what was attempted was to encourage more public and/or private foreign investment.

It received aid mainly from the United States. US supported its whole political structure. In fact, the U.S. was giving not only development assistance but also military assistance, and supported the whole political structure. “The regions strategic location” relative to the Red Sea, the Gulf of Aden, and the Indian Ocean; and “Ethiopia’s significant role in African affairs” were the main concerns for United States to provide the Ethiopian Imperial Government with military and economic assistance (Lyons, 1992).

The United States was also actively pursuing the policy of promoting U.S. private investment in Ethiopia. Ethiopia’s economic policy of promoting private enterprise was inline with U.S. foreign policy. The imperial government was pursuing a policy of attracting foreign investment more than aid. Thus, one can see that the U.S. was capable of implementing its foreign aid policy. The strategic and political aims, profit-oriented private investment, and control to pursue capitalist paths, etc were effectively implemented in Ethiopia.

The relationship with Swedish aid policy in the pre 1975 period was mainly focused on the land tenure system. Thus, the land reform became the major issue of policy intervention that resulted in considerable negative influence on the views of the Swedish aid constituency. The agreement on CADU (Chilalo Agricultural Development Unit) was signed on condition that the Ethiopian government would enact tenancy legislation. But, “when the first agreement expired in July 1970, no legislation had been enacted.” (Dejene, 1992). The imperial government employed different tactics such as delay and simulations to resist the insistence. Therefore, despite the Swedish persistent threat to discontinue aid to agriculture, the land reform never took place and as a result the attempt failed. The most radical land reform came in March 1975, not due to SIDA’s pressure, but because a revolution took place. After, the land reform, following the revolution, Sweden expressed

its support by contributing to the land reform, Hence in the pre-revolution period, the Swedes were known for their continuous attempt to bring about land reform. The other major multilateral donor to Ethiopia the IDA, however, was not trying to influence the imperial regime. Like the United States, the IDA was operating in harmony with the existing economic policy. In fact, IDA's roll in policy influence started mainly after the revolution.

1975 – 1991

After the 1974 revolution, the first policy measure taken by the military government in 1975 was the nationalization of land, industries, commercial farms, financial institutions, houses, etc. This measure accounted for all of the major foreign –owned enterprises (concerns), and no compensation was paid at the time. The government curtailed the market and instituted central planning as the means of allocating resources.

The new government declared an economic policy which divided the economy into “areas of exclusive government activity, activities which might be undertaken jointly by the government and foreign capital, and activities which were to be left to the private sector.” The first category included financial services and basic industries, expanding mainly to large scale enterprises. The second encompassed sectors for which foreign expertise would be needed, including mining, the manufacture of plastics and tourism. The third left in the private hands a wide variety of small scale activities. (Clapham, 1988)

The establishment of an expanded bureaucracy and state administration and the conduct of endless “campaigns” has resulted in large public economy with in a short span of time.

In fact the role of the state in the economy was such that the state over – extended it self, attempted centralized guidance, pursued strategies that were inimical to growth, and stifled private initiative i.e. there was no instance of new private foreign investment in the country during the Derg period, perhaps because the government has not made compensation for foreign owned assets nationalized in 1975.

The major state agency of state in agriculture was the AMC (Agricultural Marketing Corporation) which was established in 1976. Having the basic task of regulating grain prices and production quotas in rural areas, and the transport of grains to the towns. It exercised state monopoly power and turned the market in a controlled one. The government also favored the development of state

farms and producers cooperatives. The state farms absorbed a very high proportion of the capital available for agricultural development. However the campaign to get peasants to form cooperatives voluntarily was a failure. Given the failure to achieve anything approaching the desired level of cooperativization voluntarily, the government started villagization, which was considered as a necessary step in providing government services to peasants. (Calpham, 1988)

Despite all these abnormal economic policies of the military government which were unsuitable for an inflow of aid from the developed market economies, the government did not face a total prohibition of aid from most donors. The only major aid program affected after the revolution was United States development assistance (except relief & emergency aid) previously one of the largest sources of aid to Ethiopia, which was formally terminated in July 1979. The major reason for the total termination of US development aid was the refusal by the military government to compensate for the properties of American citizens nationalized during the revolution.

The United States regarded nationalization as a matter for decision by the Ethiopian government; all the United States asked was that compensation be accorded American citizens, as required by international law. Thus it seems that the US emphasized more on its policy of insurance for the investment of its citizens. Nevertheless, the Ethiopian government still refused to agree on compensation, and "in July 1979 the American development aid program was formally declared terminated" (Korn, 1986). By 1977 a reversal of alliances had taken place. The US, for over 30 years, Ethiopia's main supplier of economic and military aid was replaced by the Soviets. The reorganization of the economy and society was pursued on the basis of the classic Soviet model. (Korn, 1986)

However, the soviets did not give grants for development purposes, and their credits were not soft loans (equivalent to non concessionary loans). The Soviets block loans, where the repayment period is short (Maximum of 10 years) and the loans carry a relatively higher interest rate, with very little if any grant element. This is compounded by the diminution of credit from the west which is characterized by a high grant element as well as generous grace periods. (Befekadu, 1992). Though briefly distracted by the devastating 1984-85 national famine, when GDP contracted by 13.2 percent, the Derg consolidated its power in the second half of the decade. It formulated a Ten – Year Perspective Economic plan (1985 – 94) with an unrealistic expectation of receiving foreign aid to finance more than half of the planned investment (World Bank, 1987). With the termination of U.S.

development aid, the military governments policy relationship on aid was mainly with the remaining four major donors to Ethiopia: Sweden, Italy, World Bank and EEC. The governments dialogue with these donors was focused mainly on agricultural policy.

The Swedes opposed the governments' villagization and grain marketing and pricing policies, which "was considered as unnecessary disruption of small holders productivity." Discontinuation of the Arsi –Bale Rural Development Project was the major threat that SIDA used to make to push its policy suggestion. In fact SIDA left the region, but moved to the drought stricken Wello region. Moreover, SIDA increasingly moved towards policy neutral programs such as soil conservation, community forestry and land use planning (Dejene, 1992).

Italian aid policy relationship with the government of Ethiopia, on the other hand, was based on successive policy dialogues of the Joint Steering committee of Ethio- Italian cooperation. Using this dialogue, "the Italian aid program to Ethiopia seemed a sly trickery, a kind of neapolitan sleight of hand. They promise enormous sums, yet little is materialized" (Korn, 1986).

In each of the meetings of the committee, both sides of the Ethio-Italian joint steering committee present their own strategies and list of projects. In most cases, however, disagreements arose due to policy differences. For example, during the meeting of the second Ethio – Italian Joint Steering Committee in 1984 the Italian side had strategy aimed at creating initiatives in social sectors such as health. But this was not fully implemented due to lack of effective policy dialogue. However, these sectoral disagreements were probably created by the Italians as a pretext to deny aid.

Moreover, besides the failure to fulfill the initial amount of money they promise the Italians were also supporting programs that were opposed by other donors. For instance, "in 1985, they had given birr 307.5 million to finance a major settlement scheme package in Pawe Metekel region" (Dejene, 1992).

Thus one may say that the Italians, unlike other donors had supported the villagization program of the military government.

Strong policy influence on the military government, however, had come from the World Bank, which was concerned not only with the way its loans were used but also with the compensation of the nationalized US firms, disagreements between the Bank and the government arose when the latter refused to compensate for the nationalized foreign owned assets.

This has resulted in a slow down of IDA lending until the issue was settled. Yet in the mid – 1980's "the government agreed on compensation amounting to about Birr 10.31 million (Clapham, 1988), and IDA continued its lending to Ethiopia.

An important source of disagreements between the World Bank and the Ethiopian government in the late 1980s had been agricultural pricing and marketing policies. From the early 1980s, the World Bank and other donors such as EEC had proposed a program called PADEP (Peasant Agriculture Development Extension Programme) which favored private farmers. The government, however, "not only refused this proposal but also had as its program the additional obstacle on the villagization campaign." Such a program, linked to the government's energetic promotion of agricultural producers co-operatives, had negated the proposed program" based on peasant farming (Clapham, 1988).

Thus, the Bank expressed reservations with the villagization and resettlement programs, and agreement was not reached on the PADEP issue of course, the PADEP controversy raised critical issues about the relationship between domestic policy making and external funding.

Nevertheless, the Bank threatened the "if agreement can't be reached by July 1988, that funds earmarked to support PADEP will revert to the general fund and the project abandoned by the Bank." (Dejene, 1992) Therefore, in 1988, agreement on PADEP had been reached with the pressure of not only the World Bank but also other major donors such as the EEC. After reaching agreement, the World Bank responded by giving the aid. Thus, the PADEP – 1 project was approved in 1988 after agreement was reached on the policy issue. However, in all the years before 1991, the World Bank did not give structural adjustment loans to Ethiopia. This was because of the absence of a major policy reforms undertaken.

Unlike the World Bank, that EEC (European Economic Community) had a more or less smooth relationship with the military government. It did not have a significant policy disagreements. With EEC, a policy dialog takes place before the signing of a new convention, Lome III, however, was followed by 18 months of sectoral policy dialogue. It was following this dialogue that the government announced a first set of agricultural reforms in January 1988 (EEC, 1979). Like the World Bank, EEC supported the policy reforms by giving aid. The 33 million Birr EDF (European Development Fund) aid under agricultural import program III in 1991 was a contribution to support the policy reforms in the agricultural sector. The aid was intended among others:-

To support the economic liberalization process launched in March 1990, and in particular to promote the concept of a mixed economy;

Assist with the restructuring of the AMC (Agricultural Marketing Cooperation) which had to adjust to a new context of free marketing for grain etc. (EEC, 1979)

However, unlike the World Bank, the EEC policy pressure on the government was not strong. The EEC engaged in a broader policy dialogue only on the eve of the governments declaration of the mixed economy reforms.

The last years of the military government (1990 and 1991) were marked by policy dialogue on the programming of EEC – Ethiopia cooperation from Lome IV. Following the fall of the regime in May, and the establishment of the Transitional Government in August 1991, the EEC and the new government jointly decided to review Lome IV in order to take in to account the new policy orientations that emerged.

Post 1991

The first policy framework paper, covering 1992-93, marked the formal start of an extensive stabilization and structural adjustment program for poverty reduction and transition to a market economy. A number of donors coordinated by the World Bank provided US \$680 million for the economic recovery and reconstruction program, followed US \$250 million structural adjustment credit (World Bank 1997b). Key element of the various rounds of the first – stage reforms included;

- ➡ Prudent fiscal policies (mainly through retrenchment of the army and civil servants, tax reform, and lower defense spending) and monetary policies (limiting monetization of the fiscal deficit).
- ➡ A substantial correction of the overvalued nominal exchange rate
- ➡ Decontrol of many prices
- ➡ Liberalization of the foreign trade and foreign exchange regime
- ➡ Autonomy of state – owned enterprises (SOEs) and privatization of small and medium enterprises.
- ➡ Financial market reform, including the licensing of local private banks and insurance companies so far, and interest – rate liberalization.

- ➡ A liberal investment code with an investment authority that is organized as a “one – stop shop.

The last two policy framework papers paid greater attention to agriculture and rural development, social sectors, infrastructure, energy, export, private sector development, and the financial sector.

A civil service reform program is also underway. It encompasses the areas of financial management, judicial reform, human resource management, top management system, and service delivery. Critical decision concerning external trade and foreign exchange system reform, financial reform, privatization of public enterprises, land reform and civil service reform were postponed until after 1995 national election.

Ethiopia enjoys a relationship with the community of multilateral and bilateral donors. IDA assistance was devoted in the early phase of the Transitional Government of Ethiopia reform program to economic recovery, structural adjustment, and the preparation of policy framework papers as well as technical documents. Emphasis then switched in 1997 to Sector Investment Programs (SIPs), primarily externally funded and spanning five to ten years. Other multilateral donors active in these programs include the African Development Bank, the European Union, and the United Nations agencies. Several bilateral donors also provide active support for these programs.

Overall, the donor assistance program to Ethiopia has been directed at four policy clusters. The first cluster focused on policy dialogue together with economic and sector work designated to emphasize the importance of macro – economic stability, private sector development and improvements in capacity for implementing projects or policies.

A second cluster is devoted to infrastructure development with a special emphasis on expanding the road network and the supply of electricity. The third cluster concentrates on agriculture (mainly provision of improved seeds and fertilizer), export (designed to diversify the export basket and reduce dependence on large flows of aid) and small enterprises development. A fourth cluster of reforms is aimed at the alleviation of poverty with the help of ambitious sector investment programs in education and health and modest projects in the areas of population, gender equality, food security and water supply. Presently, there are Sector Investment Programmes (SIPs) in three priority sectors i.e. transport (roads subsector), education, and health. They are integrated into the governments budget and implemented by government agencies in collaboration with the private sector.

The mechanisms for aid coordination in Ethiopia are, at both external and country levels. At the external levels aid coordination is carried out through consultative group meetings. At the country levels, MoFED is the overall external assistance delivery to Ethiopia. Other key participants include the Prime Minister's Office, the National Bank of Ethiopia, and the Council of Ministers. Frequent consultation between local representatives of donors and the government is now routine.

More than 21 donor countries are active in Ethiopia; their areas of emphasis include relief and rehabilitation, food aid, social sector development, infrastructural development and adjustment support in collaboration with the multilateral development institutions. Japan, Italy, the United States, Sweden, the Netherlands, and Germany are the leading bilateral donors. Other donors include France, Ireland, UK, Switzerland, Austria, Australia, China S.Korea, Canada, Greek, Norway, Kuwait, Belgium, S-Arabia etc.

Regarding multilateral institutions more than 19 multilateral institutions are active in Ethiopia, UNDP, UNFPA, UNICEF, WFP, ADB, IDA and EU are major donors, whereas IMF, IFAD, OPEC, BADEA, EIB, NDF, UNCDF, GEF, FAO, UNIDO UNSO and Global Fund Project are among the smaller donors.

Post Derg economic reform in Ethiopia has so far been undertaken in two stages: rehabilitation, stabilization and basic liberalization during 1990 – 95; and infrastructure – oriented Sector Investment Programmes (SIPs) financial liberalization and improvements in public sector management during 1996 – 2006.

During 1992 – 94, the World Bank made it clear that the coordinated support for recovery and stabilization was being provided with the expectation it will be followed with an expanded program of assistance tightly leashed to a number of policy “triggers”. It is fair to say that many of the structural reforms would not have been considered seriously, much less fully implemented, without the infusion of substantial policy loans and grants (Abegaz 2002: World Bank 1997a).

Consistent with the experiences of many countries, in Ethiopia there appear to be few cases where conditionality overcame stiff government resistance (collier and others 1997: Leonardo and others 1999). The following examples pertain the disagreements involving national security issues, or the regime's power base, or its view of the optimal mix between the public sector and the private sector (as in the case of certain conditionality). The three year \$ 127 million Enhanced Structural

Adjustment Facility (ESAF) loan (1996 -99) was not fully implemented because of a row between the government and the IMF (IMF 1998 a).

The IMF argues that the low level of financial intermediation and poor securities markets in Ethiopia, even by African standards, are due to largely policy imposed “structural rigidities”, the barriers to financial deepening. (IMF 1999 B. Demekesa1999; Harvey 1996)

The expectation of donors was to satisfactorily implement four ambitious sets of interconnected reforms simultaneously; fiscal devolution, civil service reform, sector development program, and Banking reform. The Ethiopian experience suggests that aid followed rather than led the initial wave of reforms. (Abegaz, 2002).

The government has now begun to confront, albeit less decisively, the second generation of reforms in the areas of financial deepening ,competition, managerial capacity, transfer of technology, diversification of exports, and labour – intensive private small enterprise development. (Stiglitz, 1998). The World Bank laments the reluctance to radical transformations to a market economy in these terms. The careful consideration of policy options and the “ownership” that it reflects are welcome but, in general, the government tends to be over –cautious in understanding the second generation of reforms that are needed now. The boldness and decisiveness of the initial phase of reforms has given way to an all round cautiousness on virtually all fronts. Also weaknesses in implementation capacity need to be addressed if the absorption of concessional resources is to rise substantially and the economy is to move to the “frontier” of the balance between stabilization and growth (World Bank 1997).

The IMF expresses similar sentiments in more specific terms – after a number of ambitious “first generation” reforms in the early years of the present regime, the structural reform efforts slowed some what in subsequent years. An anti-export bias persisted in the trade regime, exchange and trade regulations remained burdensome, foreign direct investment was limited to a narrow range of activities, and capacity building in the government was considered by slow implementation of the civil service reform. Moreover, despite the establishment of the Ethiopian Privatization Agency, in 1994 the sale of State owned Enterprises (SoEs) continued to be undertaken at a slow pace. The rudimentary state of the financial sector and the outdated reach of the legal and regulatory framework also hindered private sector development. (IMF 1999b).

Donors complaints appear to have been largely confined to the more programmatic issues of public sector efficiency, transparency, and a blanket appeal for stake holder – participation and respect for basic human rights. (World Bank 1999d:IMF 1999b) A number of donors for example suspended program aid in 1999 for fear that fungible resources might be diverted to finance the Ethio – Eritrean war, which claimed 20 percent of the 1999 budget (World Bank 1999d; IMF 1999b; The Economist 1999).

Similarly, in connection with the problems that arise in May's 2005 election, many of Ethiopia's donors, including the World Bank and the European Union, suspended direct budget support to the government amounting to nearly 400 million dollars.

Some Ethiopian economists have suggested that financial stability has been attained largely through budgetary restraint and significant increases in aid flows. (Befekadu and Berhanu 1999/2000). The upshot is that Ethiopia is at a crossroads between the easy phase of liberalization and the hard phase of deep institutional reform. The sequencing of Ethiopian reform is the traditional one of progression from the easy and immediately necessary to the hard. The reform program began with emergency recovery and stabilization and move on to marketization and modest privatization. While other post –socialist reformers (Tanzania and Mail, for eg.) have made some head way in the transition between first generation and second generation reforms. Ethiopia continues to hesitate as it ponders the difficult jamb in to a full fledged market economy. (Maxwell,1988).

A striking feature of the landscape of reform in Ethiopia is the absence of an institutionalized mechanism for subjecting economic policy proposals to discussion or debate between the government and the various business and civic organizations. (Abegaz, 2002)

The overall conclusion is that the aid reform linkage in Ethiopia is rather complex: aid appears to have induced or cemented some reforms but not others.

3.5 Inflow of foreign aid to Ethiopia (source and volume)

3.5.1 Multilateral

UNDP

The United Nations Development Program (UNDP) is the largest source of technical assistance to Ethiopia in the UN system. Ethiopia has started cooperation with UNDP since 1975. UNDP since its first cooperation with Ethiopia has started disbursed 1818.64 million Birr for the implementation of development programs/projects in the country through the following country programs. ICP (1975 – 1979), IICP (1980 – 1982), III CP (1983 – 1986), IVCP (1987 – 1991), VCP (1992 – 1996), CCF2 (1997 – June 2002), CCF2 (2003 – June 2006).

The support was given to carry out development projects and programs under different sectors such as agriculture, water, industry, energy, mining, education, health, natural resources, human resource development, trade and tourism, science and technology, construction and urban development, public services, employment, planning, disaster management, governance, environment and the like, these have evidence that both the completed and currently ongoing UNDP assistance is multisectoral in nature. Currently around 17 programs/ projects have been financed from UNDP sources.

Table 3.5A Major Multilateral Donors

disbursement in millions of Birr

YEAR G.C.	Un Agencies - Grant				ADB		IDA		EU Grant	TOTAL
	UNDP	UNFPA	UNICEF	WFP	Loan	Grant	Loan	Grant		
1952										
1953										
1954										
1955										
1956										
1957										
1958										
1959										
1960										
1961										
1962										
1963			27.5				33.8			61.3
1964										0
1965										0
1966							18.7			18.7
1967										0
1968							19.3			19.3
1969							8.8			8.8
1970							18			18
1971							34.8			34.8
1972							38.9			38.9
1973			27.6				153.7			181.3
1974							65.2			65.2
			55.1				391.2			446.3
1975	11.8				24		254.6			290.4
1976	11.8						64.2			76
1977	11.8				11.5		66.2			89.5
1978	11.8						49.7			61.5
1979	11.8		77		51.6		20.7			161.1
1980	28		22.8		66.4		66.2		20	203.4
1981	28	1.64	22.8		21		58.4		80.2	212.04
1982	28	2.46	22.8	36.33	49.8		62.1		231.1	432.59
1983	32.25	3.66	22.8	36.33	116.5		200.8		1004.5	1416.8
1984	32.25	4.1	24	36.33	47.4		281.5		470.1	895.68

YEAR	Un Agencies – Grant				ADB		IDA		EU	TOTAL
G.C.	UNDP	UNFPA	UNICEF	WFP	Loan	Grant	Loan	Grant	Grant	
1985	32.25	1.28	24	36.33	89.4				167.8	351.06
1986	32.25	1.18	24	36.33	123.5		232.9		474.6	924.76
1987	27.55	1.2	24	36.33	44.4		95.2		654.4	883.08
1988	34.9	3.08	24	3.35	39.3		213.2		847.1	1164.9
1989	31.38	3.79	47.3	2.36	226.7		325		438.3	1074.8
1990	29.62	5.05	21.55	2.55		8.9	155.7		434.8	658.17
1991	27.7	3.58	13.12	3.19		28.6			315.8	391.99
	423.15	31.02	370.17	229.43	911.5	37.5	2146.4		5138.7	9287.9
1992	25.13	3.15	37.84	9.34	107.25	3.58	134.65	2.9	472.5	796.34
1993	50.97	9.14	65.41	18.19	365.92	25.32	359.09	4.95	543.2	1442.2
1994	61.42	19.92	77.61	29.65	709.67	29.45	1415.4	44.29	766.6	3154
1995	48.88	40.75	89.19	28.44	495.98	50	908.14	176.33	349.4	2187.1
1996	132.55	43.78	79.41	32.85	784.04	32.41	828.2	172.98	1155.9	3262.1
1997	194.89	40.37	71.44	81.32	459.34	19.18	413.96		459.9	1740.4
1998	136.46	42.67	88.71	132.13	430.93	17.55	497.49		403.8	1749.7
1999	84.5	18.63	94.04	167.95	413.79	14.27	1125.9	326.73	989.7	3235.5
2000	97.14	12.05	108.22	201.53	226.93	6.12	847.89		325.9	1825.8
2001	119.51	45.3	140.99	145.74	236.09		2251.5		305.7	3244.9
2002	111.56	11.87	172.22	269.17	669.05		3740	152.83	755	5881.7
2003	61.01	9.44	200.79	273.65			3108.5		562	4215.4
2004	96.89	29.74	193.94	134.29	368.49		2099.5	1550.9	633.6	5107.3
2005	97.75	26.97	280.4	100.23			1538.4	1680.9	666.4	4391.1
2006	76.83	7.27	439.78	250.32	418.14	61.2	1234.6	1384.6	920.4	4793.1
	1395.49	361.05	2139.99	1874.8	5685.6	259.08	20503	5497.4	9310	47027
	1818.64	392.07	2565.52	2104.23	6597.1	296.58	23040	5497.4	14449	56761

Source:- Ministry of Finance and Economic Development various annual reports (revised).

UNFPA

UNFPA began its support to Ethiopia in 1973, however it came in program approach starting from 1981, and since then it has supported five programme cycles, i.e, ICP (1981 – 86), IICP (1987 – 92), IIICP (1993 – 97), IVCP (1998 -2001), VCP (2002 -2006).

UNFPA, since its first cooperation to date has allocated a total amount of 392.07 million Birr for the implementation of development program/ efforts to reduce poverty levels and to improve the health and well being of the Ethiopian people by strengthening the implementation of policies and programs in the fields of population and development, including reproductive health. The three thematic areas of the program are; reproductive health, population, development strategies and advocacy. (See Table 3.5A)

UNICEF

Ethio-UNICEF cooperation started in 1952, however it came in program approach starting from 1979.

The Ethio-UNICEF cooperation can be divided in to three periods, cooperation period (1952 – 1980) was a period of humanitarian assistance and it is only after 1980s that UNICEF becomes a major development partner.

Country Programme Cooperation (CPC) (1980 – 2006) period of development assistance and bridging program periods (occurred between two country programs). Since its first cooperation to date UNICEF has disbursed a total amount of 2562.52 million Birr through the following Country Programs ICP (1980 – 83), IICP (1984 – 88), IIICP (1989 – 91), BP (1992 – 94) IVCP (1995 -99), BP (Bridge) (2000 – 2001), VCP (2002 – 2006). (See Table 3.5A)

WFP

WFP has started its operation in Ethiopia in 1965 by giving support to chronically food insecure areas of Ethiopia. Originally its support was mainly focused on refuge feeding and emergency operation. It is only since 1980's that WFP has become a major development partner, who really contributes to the country's development endeavor. Even then its focus was only on rehabilitation of degraded land activities related to dairy development. However, from 1994 on words, WFP has extended its intervention to other sectors like education, Urban development and recently to HIV/

AIDs as well. WFP projects are in line with different macroeconomic and sectoral policies and development strategies of the country such as food security strategy and the SDPRP, overview of WFP assistance,

1. Rehabilitation of Rural Lands: I. (1982 – 87), II (1988-92), (1995 – 98), IV (1999 – 2003).
2. Development of Diary Products: (1998 – 94).
3. Emergency Food Security Reserve: (1992 – 1994).
4. School Feeding: Pilot program: (1994 – 98), Expanded S.F (1998 – 03).
5. Urban Food Assistance: I, (1994 – 98), II (1998-2003).
6. Ongoing program (2003 – 2006).

WFP has disbursed 2104.23 million Birr since 1980's for the country's development endeavor, (See Table 3.5A)

World Bank – IDA

World Bank lending to Ethiopia from its concessionary sources IDA, was started in 1963, but lending declined immediately after the revolution, pending settlement of compensation claims by foreign- owned assets nationalized during the early stage of the revolution, settlement of compensation claims in the 1980s was again constrained by disagreements over economic policy and, in particular, policies regarding agricultural pricing and marketing. Agreement on these issues in 1988 provided the basis for an increase in lending to Ethiopia's agricultural sector.

IDA lending radically increased starting from 1992 in the EPRDF's regime government, because of the various reforms undertaken in two stages, rehabilitation, stabilization and basic liberalization during 1990 – 95 and Infrastructure oriented Sector Investment Programs (SIPS), financial liberalization and improvement in public sector management 1996 – 2006.

In the years 1963 – 2006 IDA has disbursed concessional loans 23040 million Birr and grant 5497.4 million Birr. (See Table 3.5A)

ADB – ADF

From 1975 to 1991, the African Development Fund (ADF) approved 911.5 million Birr in support of 33 projects in different sectors. ADF is the Bank Group's concessionary arm. Ethiopia is in fact

one of the largest beneficiaries of ADF resources (ADB/ADF, 1991). In post 1991 the ADF loan has increased significantly, 5685.60 million Birr, 84 percent greater than the pre 1991 regime. From 1975 to 2006 total concessional loan 6597.10 million and Grant 296.58 million Birr has been disbursed from ADF. (See Table 3.5A)

EU

Since 1975, Ethiopia has been a signatory to Lome I, II, III and IV. It has been the largest ACP recipient of development aid under the first three conventions. It was the imperial government of Ethiopia which entered in the negotiations with EEC for the first Lome convention, but the final document was signed by a representative of the new revolutionary government (EEC, 1997)). Lome II was signed in 1979, while Lome III was negotiated and signed in 1986 between the Ethiopian government and the commission (EEC, 1989). The EEC not only gives development aid but also facilitates trade between aid recipients and the community.

EDF has disbursed 14449 million Birr grant to Ethiopia in the years 1980 – 2006. (See Table 3.5A)

Other Donors

Besides the major multilateral donors, there were also other multilateral donors who gave some aid to Ethiopia i.e. IFAD, OPEC, BADEA, EIB, NDF, UNCDF, GEF, FAO, UNIDO, UNSO and Global Funds project.

3.5.2 Major bilateral donors

USAID

The first post war economic assistance to Ethiopia from the United States was probably in 1945. The official point four technical assistance program to Ethiopia from the United States, however, was started in 1951. Since 1952, the U.S. has extended assistance in the form of loans and grants to Ethiopia. American aid was the largest in scope and magnitude in the pre – 1975 period.

As shown Table 3.5B aid from the US to Ethiopia was mainly in the pre 1975 period, a total of 447.3 million Birr (225.3 million Birr grants and 222 million Birr in the form of foreign loans).

In the years 1975 – 1991, aid from the USAID was only up to its 1978 level, with a total amount of 65.6 million Birr (33 million Birr grants and 32.6 million Birr loans). This is due to the official termination of USAID in the year 1979 – 1991).

In the years 1992 to 2006 USAID grant has increased significantly to 3656.10 million Birr which is 86 percent grater than pre 1991.

The USAID’s long term development program in Ethiopia began in 1994. The program is defined by the USAID’s strategy presented in the concept paper known as “Back to the Future”. This strategy was developed in consultation with the concerned Ethiopian government institutions and approved by USAID/ Washington in April 1994. The first phase of the long term development program of USAID (1994 – 2001) focused on basic education, essential health service good governance and democracy. Phase II (2002 – 2007) is the continuity of phase 1. Phase III (2004 – 2009) is new coalition for food security.

Table 3.5B Major Bilateral Donors

disbursement in millions of Birr

YEAR	USAID		SWEDISH	ITALY		JAPAN	GERMANY	NETHERL	TOTAL
G.C.	Grant	Loan	Grant	Grant	Loan	Grant	Grant	Grant	
1952	29.8								29.8
1953	3.2								3.2
1954	48.1	3.7							51.8
1955	8.1								8.1
1956	11								11
1957	8.8								8.8
1958	10.4	1.9							12.3
1959	6.1								6.1
1960	22	1.3							23.3
1961	7.2								7.2
1962	4.4	14.9							19.3
1963		10							10
1964	7.8								7.8
1965	22.6	12.3							34.9
1966	5		7.48						12.48
1967		19.6	3.84						23.44
1968	1.5	0.8	5.37						7.67
1969	1.8	25	8.03						34.83
1970	2.7	116	12.19						130.99
1971	4	6.5	7.8						18.3
1972	1.8		8.74						10.54
1973	16.1	9.9	8.05						34.05
1974	2.9		8.51						11.41
	225.3	222	70.01						517.31

YEAR	USAID		SWEDISH	ITALY		JAPAN	GERMANY	NETHERL	TOTAL
G.C.	Grant	Loan	Grant	Grant	Loan	Grant	Grant	Grant	
1975	0.2	31.1	9.92						41.22
1976	13.1		10.18						23.28
1977	7.2	1.5	11.54						20.24
1978	12.5		31.69						44.19
1979			12.78						12.78
1980									0
1981			16.7	17.18	23				56.88
1982			14.1						14.1
1983			18.03	22.2					40.23
1984			16	23.2	66.2				105.4
1985				126.3	213				338.9
1986				32.3	118				150.2
1987			117.9	912.9	20.1				1050.91
1988			8.4				12.8		21.2
1989			32.8		15.1		0.5		48.4
1990			0.8				174.5		175.3
1991							27.5		27.5
	33	32.6	300.84	1134	455		215.3		2170.73
1992	108.05		41.5			24.63			174.18
1993	292.48		116.27			213.32		113.57	735.64
1994	297.38		146.09			166.13		153.6	763.2
1995	498.16		67.38	19.38		276.33		184.49	1045.74
1996	333.58		7.14	1.9		20.85	54.52		417.99
1997	213.87		102.78	122.2		100.5		92.96	632.32
1998	296.6		137.63	120.6		311.74	125.25	189.25	1181.11
1999	292.18		115.67	148.6		263.11	35.15	133.7	988.43
2000	174.25			115.4		271.47	74.5		635.6
2001	112.76		56.96	246.7		281.9	79.95	74.12	852.36
2002	240.98		51.77	14.18		235.94	363.48	91.49	997.84
2003	264.63		121.51	193.1		136.78	150.42	62.3	928.71
2004	240.58		205.84	280.7		343.92	111.97	258.59	1441.64
2005	277.6		419.8	86.2		136.4	157.1	100.2	1177.3
2006	13					144.6		49.4	207
	3656.1		1590.34	1349		2927.62	1152.34	1503.67	12179.06
									0
	3914.4	255	1961.19	2483	455	2927.62	1367.6	1503.67	14867.06

Source:- Ministry of Finance and Economic Development various annual reports (revised).

Sweden

The first Swedish – financed project in Ethiopia was the Ethio – Swedish Institute of Building Technology (ESIBT). Since 1954 a number of projects and programs have been agreed up on and they were almost entirely oriented towards economic and social development in the rural areas

(Norbergetal, 1977). Towards the latter part of 1980s Swedish support was cut back and some programmes were discontinued.

These included the integrated rural development program in Arsi and Bale (on out growth of CADU) and the soil conservation and rehabilitation program in wello. Moreover, support to the forestry sector declined substantially in size (SIDA, 1992).

As shown in the Table 3.5B, Swedish development aid to Ethiopia was in grant form. Before 1975, Ethiopia received 70.01 million Birr development aid from Sweden. This level increased to 300.84 million Birr in the post revolution period. Thus, although Sweden was an early donor, its assistance was largely given in the year 1975 – 1991.

In post 1991 Swedish aid has increased significantly 1590.34 million Birr which is 77 percent greater than the pre 1991 regimes. Totally Swedish aid amounts 1961.19 million Birr starting from 1966- 2006). (See Table 3.5B)

Italy

Cooperation between Italy and Ethiopia started in 1979. Before 1979 aid was very small and unclear. But, a more structured cooperation between the two countries began in 1981 with the first Ethio – Italian joint commission, when the Italian government gave Birr 17.18 million grants, and Birr 23.0 million loans. In 1984, the second Ethio-Italian joint commission agreed up on the 1985 – 1987 cooperation program, In 1987 the third Ethio- Italian Joint commission agree on the 1988- 1989, programme, in 1990 there was a meeting of the fourth joint Ethio – Italian commission which negotiated on the three year (1990- 1992) program and identified 25 projects. But this fourth phase of cooperation was not implemented due to government change.

As shown in the Table 3.5B development aid from Italy was concentrated in the 1980s. More than 70% of Italian aid was in grant form. However, Italian aid to Ethiopia was considerably slower at the end of 1990 and in the early years of 1991 because of the political upheavals in the country. The subsequent political changes necessitated a revision of negotiations for the cooperation programs, to review the priorities with the new authorities. (Italian Cooperation, 1990)

In the post 1991 period Italy started giving aid in 1995 since then the volume of aid has been increased i.e. 1349 million Birr. Totally 2483 million Birr grant and 455 million Birr loan have been

obtained from Italy for poverty oriented partnership development cooperation programmes. (See Table 3.5B)

Japan

Being foreign aid super power through aggressive increases in aid allocation in the 1980s and early 1990s Japan has provided huge volumes of aid to LDCs, Ethiopia being one of the LDCs has got 2927.62 million Birr grant in the years (1992 – 2006). (See Table 3.5B)

For Netherlands and Germany (See Table 3.5B).

Other Bilateral Donors

Besides the major bilateral donors, there were also other bilateral donors who gave some development aid to Ethiopia. These are Ireland, U.K, China, Canada, Finland, Switzerland, Greece, Norway, Austria, S. Korea, Kuwait, Belgium, S. Arabia.

3.6 Concessionary debt

External concessionary debt is associated with foreign aid inflows, particularly in the form of loans result in massive debt and debt servicing burden and there by exacerbate LDCs balance of payment deficits. Concessionary debt problems stems directly from foreign concessionary loans. A loan bear's interest and depending on the terms of the loan, the payment of interest and amortization of the loan is a burden to the recipient's economy. This financial burden, moreover, is escalated by the economic dependency of the underdeveloped countries as the suppliers of only food and raw materials to the developed countries.

This situation often create frequent deficits. Borrowing from the creditor countries finances the deficits. Servicing the debt payment of interest and amortization requires that a portion of further exports is devoted for this purpose instead of buying needed imports. Hence further borrowing is inducted to pay for regular import (Krueper, 1997). In turn, debt servicing and deficits in balance of payments are said to be impediments to the country's development. As (Krueper, 1997), puts it: "increasing public resources to service debt will be likely to reduce incentives and resources available to the private sector sufficiently to preclude the necessary investment response. The higher

the debt service payments which have been very costly to some developing countries, the less would be the resources available for development as it restricts imports of capital and intermediate goods.

In Ethiopia, the debt service problem is a post revolution phenomena. Prior to 1975, larger export earnings and low interest rates meant the problem was minor. Since 1975 however, with stagnant or declining foreign exchange earnings in the face of increasing debt service requirements, the economy was forced to divert resources from other uses to pay the principal and cover the interest payments. (Befekadu, 1992).

One of the most important indexes (OSei, 1995) used to asses the debt burden is debt to GDP ratio, the higher the ratio the greater the burden. (All the concessionary debt figures are outstanding and disbursed)

The extent of Ethiopia’s concessionary indebtedness is shown in the following table (3.6A).

Table 3.6A Concessionary Debt

in millions of Birr

YEAR	CONCESSIONARY DEBT	GDP	DEBT/GDP	AVERAGE DEBT/GDP
1960				
61		2883.8		
62		3003.8		
63		3130.1		
64	133.93	3424.4	3.91105	
65	161.94	3718.2	4.355333	
66	199.39	4023.5	4.955636	
67	217.5	4261.6	5.103717	
68	256.95	4530	5.672185	
69	281.6	4794.2	5.873764	
70	311.15	5218.9	5.961984	
71	349.54	5529.6	6.321253	
72	381.16	5576.4	6.835234	
73	393.22	5823.7	6.752065	
74	498.65	6414.6	7.773673	
				5.774172
75	504.3	6427.8	7.845608	
76	524.8	6874.2	7.634343	
77	635.9	7872.8	8.077177	
78	705.8	8308.3	8.495119	

YEAR	CONCESSIONARY DEBT	GDP	DEBT/GDP	AVERAGE DEBT/GDP
79	800.6	9286.5	8.621117	
80	932	9865.4	9.447159	
81	963.9	10079	9.563449	
82	1035.9	10635.8	9.739747	
83	1165.9	11775.4	9.90115	
84	1245	10987.6	11.33095	
85	1420.3	13026.5	10.90316	
86	1723.8	13575.2	12.69816	
87	2037.2	14391	14.15607	
88	2323.2	14970.5	15.51852	
89	2607.1	15742.1	16.56132	
90	2825.9	16827.5	16.79334	
91	3140.5	19195.3	16.36078	
				11.39101
92	16933.8	20792	81.44382	
93	35709	26671.4	133.885	
94	51277.2	28328.9	181.0067	
95	58648.4	33885	173.0807	
96	59871.9	37937.6	157.8168	
97	61703.3	41465.1	148.8078	
98	66060.9	44840.3	147.3248	
99	75141.8	48803.2	153.969	
2000	42977.45	53189.7	80.80032	
2001	44736.6	54262.5	82.44478	
2002	52236.5	51493.2	101.4435	
2003	57360.74	55702.1	102.9777	
2004	61350.2	70047.7	87.58346	
2005	48860	79114.9	61.75828	
				121.0245

GDP at constant 1980/81 price

Source: Ministry Finance and Economic Development various annual reports (revised)

By 1964 the country utilized Birr 133. 95 million (outstanding debt) by 1974 the cumulative disbursement was Birr 498.65 million. Thus over the year 1964-74 concessionary debt increased by more than 350 percent. Concessionary debt to GDP ratio of the period on the average was 5.77 percent.

During the post revolution period, concessionary debt increased from Birr 504.3 million in 1975 to 3.1 billion in 1991. The volume of concessionary debt increased by more than 6 fold, concessionary debt to GDP of the period increased on the average from 5.77 percent to 11.39 percent which shows an increasing burden.

During the post Derg period (1992 - 2005), concessionary debt increased from 16.9 billion in 1992 to 48.9 billion in 2005 here the volume of concessionary debt increased more than 300 percent. Concessionary debt to GDP ratio on the average has increased from 11.39 percent to 121.02 percent showing a radical increase in debt burden. Which is 21.02 percent greater than GDP.

Concessionary debt was 498.65 million in 1974, 3.1 billion in 1991 and 48.8 billion in 2005 shows a radically significant increase in debt burden.

During the post Derg period the radical increase in concessionary debt is because of the significant increase in concessionary loan associated with the various reforms and sector development programmes.

The trend of concessionary debt to GDP ratio shows increase steadily in the 1980s, 1990s and a significant reduction in the year 2000 and 2005, which indicates debt reduction of HIPC or HIPC initiatives. Generally, despite rescheduling, the 48 billion concessionary debt service difficulties shows that the country has severe debt service obligations.

3.7 Government budgetary systems

The concept of budgeting

To implement its economic functions government raises revenues through taxation, fees and charges and spend them in different programs and activities. This process of raising revenues and spending by government is performed through budgeting. Budget thus stand for the yearly plans/forecasts of government revenues and expenditures. The budgeting process starts from the initial stage of preparing the annual revenues and expenditures forecast and ends at the stages of approval by the higher government body followed by its implementation. This process have gone through major modifications both in principle and in actual practice since the 1930s

Budgetary process is central for the fiscal effects of aid, the government budget represents a plan/forecast by government of its expenditures and revenues for a specified period. Commonly government budget is prepared for a year, known as financial year or fiscal year. In Ethiopia the Fiscal Year is from July 7 of this year to July 6 of the coming year. (Hamle 1 - Sene 30 in Ethiopian calendar).

Further more, budget also address the issue of the budget deficit (i.e. the excess of outlays over domestic revenues).

When government revenues raised from taxation and non-tax resources other than borrowing fully cover government expenditures during the year, the budget is said to be balanced. However, government expenditures often exceed actual government revenues other than borrowing. The difference between government's expenditures and revenue over a year is referred as budget deficit. Conversely, a budget surplus prevails when government revenues exceed expenditures during the year.

Revenue Budget

It represents the annual forecast of revenues to be raised by government through taxation and other discretionary measures.

In Ethiopia, the revenue budget is usually structured into three major headings ordinary revenue, external assistance and capital revenue. Hence, the fund expected from these three sources are proclaimed as the annual revenue budget for the country. The revenue budget is prepared by the MoFED for the federal government and by BoFED for regional governments. Ordinary revenues include both tax and non tax revenues. The tax revenues being direct taxes: personal income tax, rental income tax, business income tax, agricultural income tax, etc. Indirect taxes (excise tax on locally manufactured goods, service sales tax, stamps and duty): and taxes on foreign trade (custom duty on imported goods, excise tax on imported goods, sales tax on imported goods, duty and tax on coffee export). Non tax revenues include charges and fees; investment revenue; miscellaneous revenues and pension contributions.

The second major item in revenue budget is external assistance. It includes cash grants, these are grants from multilateral and bilateral donors and technical assistance in cash and material form. The third item is capital revenue. This could be from domestic (sales of movable properties and

collection of loans), external (loan from multilateral and bilateral creditors mostly for capital projects, and grants in the form of counter part fund).

Tax Revenue

An important element in the domestic revenue system is taxation. Government revenue consists of tax revenue, which is the largest component of the overall revenue, and non tax revenue. Tax revenue is the sum of direct tax, indirect tax and foreign trade tax.

The available documents show that tax has been the major source of domestic revenue for a long period of time. The dominance of tax as a source of domestic revenue has also been maintained in the post reform period of 1990s.

A main factor behind the rising trend of tax revenues has been the discretionary changes introduced around 1964 and 1974, i.e the tax reforms that were introduced during the mid 1960s, the tax reforms made during the mid 1970s which are thought to have contributed to a considerable increase in tax yield included the rural land use fee and agricultural activities.

Tax reform has been one of the components of the ongoing economy wide reforms undertaken in Ethiopia since 1991/92. These reforms include the restructuring of the tax system, the broadening of tax-base, improvement in administration and collection of taxes, the restructuring of public enterprises the introduction of new type additional tax (VAT) reducing the marginal tax rate and other measures have contributed for performance of revenue during the period. (Teshome, 1993).

Domestic Borrowing

Government borrowing from the domestic banking system constitutes a most important means of financing government deficit in recent years. Although the monetary and Banking Proclamation 206/1963 permitted the government to use the borrowing facility, it did not make an extensive use of it during the pre 1974 years. This was because inter alia, government deficits had been relatively small and use is more of less inflationary means of deficit financing in those years. However, since 1974 the government was hard-pressed for cash to cover its growing levels of deficits and resorted to an extensive use of the borrowing provisions of the Banking laws. (Teshome, 1993).

The practice of government bank borrowing shows the application of diverse borrowing instruments. Short term loans are financed by means of treasury bills, which are issued by the

government and purchased and held as security by the Bank and other financial institutions. Direct advances constitute the other important, indeed most important, instrument for short term borrowing. On the other hand, government bonds has been used to finance long term loans.

According to the Monetary and Banking Proclamation 206/1963, the ceiling for "direct advances" made by the bank to the government, was 15 percent of the ordinary revenue of government in previous fiscal year. This ceiling was raised to 145 percent of the actual ordinary revenue collected during the previous fiscal year in the council of state special Decree No. 22/1990.

The ceiling for government cash borrowing from the Bank in exchange of treasury bills was 50 percent of the (capital and general reserve fund) of the Bank according to proclamation 206/1963. This ceiling was raised to the level of 35 percent of the ordinary revenue according to the council of state special decree 22/1990. Similarly for bonds, in proclamation 99/1976 the loan ceiling was set at 50 percent of the ordinary revenues of government in the year preceding the borrowing year. The ceiling was raised to 70 percent of ordinary revenue in the council of a state special Decree 22/1990.

The development apparent from this trend of debt financing is that the government is moving in the direction of "soft financial management by loosening the right borrowing procedures, raising the loan ceiling, reducing the interest payment obligation, expanding the loan base and introducing special government bodies. This process eroded the "Financial discipline" that was during the pre 1974 years. (Teshome, 1993).

Expenditure Budget

Government expenditures for administration and developmental activities are handled through the expenditure budget. These expenditures are categorized in to recurrent and capital expenditures. This categorization gained acceptance since the Great Depression of the 1930s. The recurrent budget which covers the current expenditures is financed in principle by taxation (more broadly by domestic revenue from tax and non tax sources), and the capital budget which covers the acquisition of newly produced assets in the economy is financed through external borrowing and grants.

As stated in 1992/93 – 1995/96 policy framework paper, the objectives of fiscal policy with regard to government expenditure were reducing government expenditure by curtailing out lays with litter economic and social benefit, reducing subsidies and ensure their transparency, and prioritize and rationalize recurrent expenditure and investment.

The budget process

Budgeting from the initial stage of forecasting the annual revenues and expenditures, to the final stage of approval of the annual budget by the council of peoples representatives, passes through a sequential and an iterative process. These budgeting process include:

- ➡ Preparation of the macro – economic and fiscal framework.
- ➡ Revenue forecast determination of expenditure budget ceiling.
- ➡ Allocation of expenditure budget between federal and regional governments.
- ➡ Allocation of federal government expenditure budget between recurrent and capital budgets.
- ➡ Budget call and ceiling
- ➡ Budget review by MoFED
- ➡ Budget hearing and defense
- ➡ Review and recommendation
- ➡ Submission of the budget to the Council of Ministers
- ➡ Submission of the budget to the Council of Peoples Representatives
- ➡ Notification and publication of the budget and
- ➡ Allotment

The budget process thus includes all these stages which obviously are sequential (one after the other) and iterative.(MEDAC, 1998).

Budget being a one year plan prepared for the coming fiscal year it requires a time schedule (deadlines) for each and every processes that should strictly be adhered to. The time schedule is usually handled through the budget calendar. In effect the budget calendar is the major instrument to manage the budgetary process. Thus far we don't have an authoritative and binding budget calendar that could force all public bodies involved in the process of budgeting. The only dates proclaimed by law are the final approval and notification dates of the budget. Financial proclamation 57/1996 states that "the budget appropriation shall be approved by the Council of Peoples' Representatives by Sene 30th (July 6) and all public bodies shall be notified by Hamle 7 (July 13)." The other deadlines in the process of budgeting will be set by the MoFED who is responsible for the preparation of the recurrent and capital budgets, MoFED will notify the spending public bodies a head of time about the important deadlines, the budget ceiling and other information through the

budget circular. The budgeting process usually took between six to eight months, and the MoFED will release the budget circular around November to December.

At Present three types and/or levels of closely related planning exercises are being practiced in Ethiopia:

- a) budgeting a one year plan – which has been practiced for a very long period and is well established as discussed above;
- b) public investment program (PIP) a three year rolling plan of investment to be updated annually is part of the planning process that allows the government to allocate resources to sectors and public bodies in accordance with policies and strategies (Ministry of Economic Development and Cooperation 1998);
- c) Sector development programs (SDPs) which are five-to-ten years rolling development investment plans for particular sectors and so far three SDPs (health, education and roads) have been launched. The later two planning practices are quite recent and have different procedures and processes in relation to budgeting. On the other hand both PIP and SDPs are in principle supposed to be implemented through the annual budget, more specifically through the capital budget. For better performance of the budget and SDPs it is therefore essential to harmonize the three planning practices.

Integration of aid flows in to the planning and budgeting process

For strategic expenditure planning purposes it is important that donor aid is integrated in to the planning and budgeting processes of a country. Planning of aid flows is also important for implementing agencies who wish to have an early indication of sources of funding available so that they can prepare for fulfilling the especial condition, if any. Inclusion of aid flows in the planning and budgeting has become a key principle of sound public finance management especially in those developing countries whose (capital) budget is largely funded through external grants and loans, as is the case in Ethiopia.

External assistance supplements the governments own revenues and thus increase the available resource envelope. At the same time, however aid flows are mainly directed towards capital expenditures and entail important consequences for the governments recurrent budget, which is typically almost entirely funded by domestic resources. As, such discussions on donors resources

clearly preempt decisions on the use of domestic resources. In order to be able to assess the consequences of the inflow of external assistance for the allocation of resources among different priority development sectors, it is of strategic importance for countries to produce a multi-annual rolling MTEFs (Medium Term Expenditure Framework) and to incorporate as much information as possible on aid flows in to the planning documents. The inclusion of aid flows in to the MTEF will facilitate strategic expenditure management and improve the quality of the annual budget which should be based on MTEF. Furthermore donors, on their part, should allow the government to be fully involved in the programming of aid, so as to ensure that aid is aligned with the governments strategic priorities.

All levels of public expenditure management (macro control, strategic allocation, operational efficiency) require that donor aid is integrated in to the planning and budgeting processes of a country. "Integration" may be a matter of degree:- complete integration occurs when aid resources are treated in just the same way as the governments internal revenues at each stage of strategic planning, budget preparation, budget implementation and reporting, when complete integration is not feasible it is still important:

- a) to take aid fully in to account at the planning and programming stages, so as to ensure that aid and other resources are fully complimentary and equally focused on the same national priorities;
- b) to record and report actual aid flows and disbursements, so that all resources are effectively monitored, and the implementation picture is comprehensive.

As already noted, government expenditure regulations require that all aid flows be brought to account. This means that even flows which are not disbursed through the budget should be reported to the parliament along side regular consolidated fund expenditure.

As a step towards strategic planning of expenditure, making aid forecasting more accurate and timely is necessary, but not sufficient. Government also needs to improve the dialogue in the planning and budgeting process by sharing the draft PIP and their supporting assumptions with the donors. This would give donors the opportunity to check and react to assumptions made by government and external assistance. Publication of the consolidated forecast could create peer pressure among donors to provide timely information. (World Bank 2000).

The institutional framework for planning and budgeting

Ethiopia was one of the first countries in Africa to recognize the constitutional role of the budget and to embark up on comprehensive development planning. The foundations of the budgetary process was outlined and the role of the various ministries defined. It was in 1945 that the first government budget was published in Ethiopia. The country's first –five-year plan (1959 – 64) was prepared during the mid 1950s by a planning board presided over by Emperor Haile Selassie. The second five year plan (1963 – 67) was also prepared by the same planning board. In 1966, a new Ministry of Planning and Development was established and was responsible for the preparation of the third five-year plan (1969 – 73). The organizational structure of this Ministry was found unsatisfactory and this, together with the unclear standing of this ministry in relation to other Ministries, led to the creation of the Central Planning Commission. This organization began work on a fourth five year plan when events were overtaken by the 1974 revolution. (World Bank 1985)

Prior to the 1974 revolution, the relationship between the Planning Authority and the Ministry of Finance had been organized along traditional line. The national plan was prepared and submitted to the government by the Planning Authority while the national budget was prepared by the Ministry of Finance.

The political structure of the society was altered radically, economic relations, through the nationalization of production and distributions were redefined, and the objectives of the development process re-examined.

It was only by August 1977 that the new government was able to focus on the institutional framework for development planning. A Central Planning Commission was established with authority to take decisions on specific matter relating to the approval of plans, budgets and projects.

This commission was replaced in September 1978 by the National Revolutionary Development Campaign and Central Planning Supreme Council (CPSC). The CPSC was composed of a congress, an executive committee, a secretary consisting of professionals and technical staff, and regional/provincial and district committees and planning offices.

Instead of following the traditional practice of preparing five-year plans the CPSC launched a series of one year development campaigns called “Zemetchas”

On June 7, 1984, the central planning function was reorganized and redefined by proclamation No 262/1984. By virtue of the proclamation the office of the National Committee for Central Planning (NCCP) was created to transform the institutional framework from an essentially “campaign type” one to a form which would be capable of more systematized and integrated short, medium, and long term planning.

The major duties of NCCP are:

- ➡ To prepare the directive, strategies, standardized planning procedures and the time frame for the preparation of short, medium, and long term plans.
- ➡ To formulate plans regarding the volume and source of foreign technical assistance and loan: sectoral, social and regional allocation and the magnitude and distribution of surplus capital accumulation and similar matters with regard to production, service rendering and distribution.

The post – Derg period saw the establishment in 1991 of the Ministry for External Economic Cooperation (MEEC) that coordinated external assistance focusing primarily on bilateral cooperation and principally on project by project basis. During this time, the government was handling more than 500, generally uncoordinated, donor – funded projects. This created a multiplicity of problems and stretched the government’s project implementation capacity. During the same period the Ministry of Finance was mandated to perform the national budget.

According to Federal Negarit Gazeta, proclamation No. 471/2005, The major powers and duties of the Ministry of Finance and Economic Development are the following:

1. Establish a system for the preparation of development plan of the Federal Government: prepare the plan in cooperation with concerned organs and follow up implementation of same;
2. Establish systems of budgeting: accounting, disbursement and internal audit for the Federal Government, and follow up implementation of same;
3. Prepare the Federal Government budget and follow up implementation of same,
4. Mobilize, negotiate and sign foreign development aid and loans, and follow up implementation of same;

5. Submit, annually and when ever necessary, to the council of ministries general reports on the financial performance and status of the Federal Government.
6. Evaluate the performance of development plans of the Federal Government; prepare and submit to the Council of Ministers annual national reports incorporating summarized reports of regional states.
7. Initiate fiscal policy of the Federal Government that particularly serve as a basis for taxes and duties.

Proclamation No. 256/2001 on the House of Representatives empowers MoFED to borrow from internal and external sources and mobilize grants. Article 17 of the Proclamation states that MoFED shall formulate strategies that will help increase development assistance (both loans and grants). The Ministry is also empowered to negotiate and sign aid and loan agreements and, in cooperation with the concerned organs follow up their implementation.

All loan agreements are approved by the Council of Ministries and ratified by the House of People's Representatives following detailed scrutiny by the Economic and Legal Committee of the House. The Foreign Operations Department (FOD) of the National Bank of Ethiopia (the Central Bank) services loan disbursements and maintains them in separate loan accounts and disbursements are effected on request and the Treasury Department at MoFED is advised accordingly. The debt service payments are initiated by the Credit Administration Department and the payments are effected by FOD when they are due. The local currency equivalents are normally debited by the Accounts Department of NBE and MoFED's Treasury Department is advised accordingly. The recording of loan transaction; the maintenance of the loan database; the production of periodic statistical reports, and reporting to the World Bank's Debtor Reporting System continues to be the responsibility of Credit Administration Department which also prepares debt analysis, and work under the enhanced HIPC.

3.8 Identified problems

- ➡ Volatility and uncertainty of ODA flows; fragmentation of donor efforts; project proliferation and duplication, conflicting or dominant donor agendas, competition for staff, and a high administrative and oversight costs.
- ➡ The sheer number of donors in the country, the multiplicity of their projects and their different and yet uncoordinated planning and reporting requirements as well as diverse

disbursement, administrative and legal demands have resulted in aid fragmentation and, quite often a threat to local ownership. The uncoordinated and unharmonized donor –by – donor and project by project approach has, in effect, significantly worsened rather than strengthened, the capacity to meaningfully absorb and account for what is received. As MoFEDs report of December 2002 Consultative Group (CG) Meeting acknowledged:-

At present, each multilateral and bilateral donor in Ethiopia applies different rules and procedures in its approval, disbursement, procurement, monitoring and evaluation, and reporting systems. These, in turn, increase the transaction costs for government and reduced the speed, efficiency and effectiveness of externally funded projects and programs.

- ➡ Generally, multiple and inconsistent donor policy conditions, targets and procedures have resulted in disharmony in development support and has resulted in considerable transaction costs.
- ➡ Absence of clear aid policy and strategy in all the three regimes of Ethiopia i.e. Imperial, Derg and EPRDF.
- ➡ Weaknesses in government's institutional systems (with in which ODA is received and administered) have retarded the ability to better manage and account for resource use.
- ➡ Absorptive capacity is increasingly becoming a binding constraint on the full utilization of plagued aid.
- ➡ There exists capacity limitations in a number of areas in which external assistance is less solicited, accommodated, managed, reported, monitored and evaluated.
- ➡ There exists shortage of skills and organizational ability at both Federal, Regional and Woreda Levels.
- ➡ In countries like Ethiopia where the absorptive capacity is a limiting constraint, the bulk of long-term credit mobilized externally were allocated to improve the physical and human infrastructure, rather than directly to productive activities
- ➡ Weakness in institutionalized mechanism for subjecting economic policy proposals to discuss or debate between the government and the various business and civic organizations or stakeholders. (Abegaz, 2002).

- ➡ In Ethiopia aid appears to have induced some reforms but not others i.e. the country is at crossroads between the easy phase of liberalization and the hard phase of deep institutional reform. (Abegaz, 2002).
- ➡ Serious difficulties and delay often occur in the implementation phase of externally funded projects. Even after a project agreement is signed, delays occur due to shortcomings on both donor and government side. The procedures on the donor side for approval (e.g. on tenders, awarding of contracts, etc) are often lengthy and bureaucratic. Implementing agencies, especially at regional level, complain that projects are delayed because of donor imposed conditions which government finds difficult to fulfill.

Even after a project becomes effective, the complexity of implementation procedures (e.g. on disbursement, procurement, reporting and monitoring) combined with capacity constraints at all levels of government, make it very difficult for implementing agencies to meet specific donor requirements.

- ➡ Despite rescheduling, the 48 billion concessionary debts service difficulties shows that the country has severe debt service obligations.
- ➡ Large volume of external aid flows is still not captured in the budget i.e. Many of the projects funded by bilateral and multilateral donors remain outside the budget. There are no clear guidelines as to which projects and funds should be included when budgets are prepared.
- ➡ In Ethiopia as in most other countries there is no tradition of donor agencies providing multi – annual forecasts on a periodical and timely basis.
- ➡ A part from the problems on aid forecasting, MoFED also doesn't have sufficient data on actual aid disbursements, indeed the general lack of good quality consolidated data on aid flow is alarming to have dialog and coordination framework.
- ➡ The recurrent expenditure is defined as a residual of the capital expenditure in both the financial administration law and regulation. What is to be included in recurrent budget is not explicitly defined.

- ➡ So far, we don't have detailed budget calendar which is proclaimed by law. The only dates proclaimed by the financial regulations are the budget approval and the budget notification dates.
- ➡ Foreign loans are ratified by Council of Peoples Representatives and authorization is given to publish the proclamation in the Federal Negarit Gazeta. However, grants are not ratified in the same pattern as loans.

3.9 Likely solutions and policy implications

- ➡ To make aid co-ordination and management more effective, it will be good if MoFED tries to develop aid policy and strategy.
- ➡ To prevent the proliferation of conditions imposed by individual donors, cooperation partners need to strengthen aid Harmonization and Alignment efforts.
- ➡ To raise the level of its own systems and procedures to the level of international systems and standards government seeks to develop a comprehensive framework for harmonization.
- ➡ The study suggests that it is better if the government continues deep institutional reforms at federal, regional and Woreda levels.
- ➡ It would be much better if government undertakes continuous capacity enhancement measures on the human resource development.
- ➡ To ensure the predictability of aid flows, donors are required to provide relevant and timely information on commitments and disbursements, over a multi-year timeframe which is consistent with the financial planning horizon of the government as defined in the budget calendar.
- ➡ For the optimal allocation and utilization of both domestic and external resources, it is essential to strengthen, national planning, budgeting, financial management, reporting and monitoring mechanisms.
- ➡ To ensure accurate, reliable, timely and user friendly data, MoFED's information and data generation capacity needs to be strengthened.
- ➡ To ensure that public resources are accounted for, in an effective and transparent manner, government requires an effective and well supported auditing function.

- ➡ To ensure favorable country rating, the government needs to strengthen and maintain a coherent, prudent and sustainable foreign borrowing policy.
- ➡ To increase the effectiveness of foreign loan funds it is better for government to use it for high priority development activities that are productive or those that build essential social and physical infrastructure.
- ➡ To keep debt to a manageable levels and to ensure new borrowing is in the right amounts and in appropriate terms the government is expected to apply prudence in debt management.
- ➡ In accordance with OECD-DAC definition of ODA, it is better for the government, to negotiate foreign loans that will have a minimum grant element of 25 percent.
- ➡ Capital expenditure is defined in the financial proclamation 17/1997, it will be more practical to define recurrent expenditure in the same pattern as capital expenditure.
- ➡ It would be much better to have an authoritative and binding budget calendar that will set the necessary time tables for all stages of the budgetary process.
- ➡ It will be necessary for MoFED to prepare systematic guidelines as to how all ODA's should be shown in the budget.
- ➡ As foreign loans are ratified and publicized it will be good for grants to do it in the same pattern, as this enhance ownership and transparency.

CHAPTER FOUR

METHODOLOGY AND MODEL SPECIFICATION

4.1. Fiscal response model

Mosley et al. (1987) and Gang and Khan (1991), inspired by Heller (1975) attempted to model the public sector fiscal response to foreign aid inflows. The Heller (1975) approach is predicated on the observation that a basic task facing public sector decision-makers in all countries is to allocate revenue among various expenditure categories subject to budget constraints. To keep the exposition simple they can distinguish two categories of public expenditure: recurrent expenditure or government consumption (G) and capital expenditure or public sector investment (I_g). Government revenue is obtained from domestic sources in the forms of taxation (T) and borrowing (B). In these models, aid (A) is treated as exogenous; aid is external source of revenue that enters the budget constraint. The utility function of public sector decision-makers can be represented as:

$$U=U(I_g, G, T, B) \quad (1)$$

Public sector policymakers are assumed to act in a rational, utility-maximizing manner. In the standard approach, contributors have assumed that governments set targets for various expenditure headings and set revenue targets for tax and borrowing. Governments maximize their utility by attaining these revenue and expenditure targets. Following Mosley et al (1987) and Binh and McGillivray (1993), the utility function in (1) can be represented as a quadratic loss function.

$$U = \alpha_0 - \frac{\alpha_1}{2}(I_g - I_g^*)^2 - \frac{\alpha_2}{2}(G - G^*)^2 - \frac{\alpha_3}{2}(T - T^*)^2 - \frac{\alpha_4}{2}(B - B^*)^2 \quad (2)$$

Where the asterisks denote exogenous target levels of the endogenous variables and $\alpha_i > 0$ for $i = 1, \dots, 4$. It is clear from (2) that government maximizes its utility if it achieves all targets, the maximum unconstrained value being α_0 . Also, as $\alpha_i > 0$ the principle of diminishing marginal utility is ensured for all levels of I_g , G, T and B. What the government now wants to do is maximize U subject to the budget constraint that expenditures cannot exceed (all) revenues. In the standard Heller-type analysis the utility function given by equation (2) is maximized subject to the following constraints:

$$I_g = (1 - \rho_1)T + (1 - \rho_2)A + B \quad (3)$$

$$G = \rho_1 T + \rho_2 A \quad (4)$$

Where $(1 - \rho_1)$ represents savings from the recurrent budget and ρ_2 represents the proportion of aid allocated to consumption spending. Equations (3) and (4) are of course a decomposition of the overall public sector budgetary constraint.

$$I_g + G = T + B + A \quad (5)$$

Standard fiscal response studies maximized (2) subject to (3) and (4). There are two significant problems with this approach. The first is the interpretation given to ρ_2 , which is taken to present the extent of fungibility of aid. In other words, it is implicitly assumed that donors grant aid for investment purposes only (and that all investment expenditures are captured in I_g) hence any aid allocated to G (proportion ρ_2) is an ex post measure of fungibility (i.e., $\rho_2 = 0$ ex ante). As there are elements of G which donors would be willing to support, notably various social sector expenditures, $\rho_2 > 0$ ex ante and the estimated value of ρ_2 is a measure of maximum fungibility.

The second problem is that this representation over-constrains the model, not necessarily allowing the government to reach α_0 even in the case where aid revenues are sufficient to meet all targets. The problem arises because although total revenue may be sufficient to meet (5), the constrain allocation so that specific expenditure targets in (2) cannot be met. One possible solution is to use a single budget constraint like that in equation (5), which will always ensure that the model can attain α_0 when revenues are sufficient to meet each target. This solution does, however, result in intuitively unrealistic structural equations (McGillivray, 2000).

Gang and Khan (1991), unlike Mosley et al (1987) whose regressions were in the aid growth tradition, actually estimated the model, using time series data for India. This work has stimulated a debate on the appropriate basis on which to model public sector behaviour in the presence of aid inflows (Binh and McGillivray, 1993; Gang and Khan, 1993, 1994, 1999; Khan, 1994, White, 1994). Recent papers endogenize aid (Franco-Rodriguez et al, 1998; McGillivray and Ahmed, 1999); governments have a target for aid revenue, and this expected revenue is incorporated into their fiscal planning. That is, when determining revenue and expenditure allocations, anticipated aid revenue is taken into account. Making aid endogenous does not require the assumption that

recipients have control over the aid they are allocated by donor; instead it requires that they have effective control over the amount that is actually spent. The models with endogenous aid overcome many of the problems inherent in the standard fiscal response models those earlier papers with exogenous aid). In Franco-Rodriguez et al (1998) the loss function (2) is replaced by:

$$U = \alpha_0 - \frac{\alpha_1(I_g - I_g^*)^2}{2} - \frac{\alpha_2(G - G^*)^2}{2} - \frac{\alpha_3(T - T^*)^2}{2} - \frac{\alpha_4(A - A^*)^2}{2} \quad (6)$$

The specification in (6) differs from standard fiscal response models by treating aid as a choice variable for the recipient, and hence endogenous. The general justification for treating aid as exogenous from the perspective of recipients is that the level is determined by donors purely on the basis of supply-side criteria. In practice, however, donors commit a certain amount of aid to recipients each year, and it is ultimately up to recipients to determine how much of that commitment is disbursed (actually spent) in the year. Recipients do have large degrees of choice over the amount disbursed, and hence allocated among expenditure categories. Consequently, it is appropriate to treat disbursed aid as an endogenous variable.

Given this reasoning, A is disbursements while the target A^* can be represented by commitments. Under-spending an aid commitment in any given year is undesirable as it implies an inability to utilize all aid (limited absorptive capacity) and may result in decreased commitments in subsequent years. Overspending is also undesirable as, in practice, if disbursements exceed commitments it means either delayed spending of post commitments (suggesting limited absorptive capacity) or, more often, that emergency aid was granted during the year (thus, it is a proxy for an adverse shock, such as famine).

In principle, (6) is maximized subject to the constraints (3) and (4) with the attendant problems outlined above. One possible option may be to maximize subject to (5). However, (5) alone implies no constraints on how revenues are allocated thus implicitly aid is completely fungible; this may not be a realistic representation of public sector fiscal behavior. Public sector fiscal decisions are subject to pressures from a number of quarters: politicians, pressure groups and donors all seek to influence the allocation of revenues (and electoral consideration will be important if democratic institutions are effective). These pressures are likely to culminate in outcomes which are sub-optimal in terms of the government's own preferences. Such constraints on public sector fiscal behavior can be incorporated by replacing (3) and with:

$$G \leq \rho_1 T + \rho_2 A + \rho_3 B \quad (7)$$

The rationale for the inequality is that there are external constraints that limit the manner in which the public sector in developing countries allocates revenues. The actions of donors or domestic interests cause the values of the ρ 's in (7) to be imposed on those involved in setting targets and allocating revenue, with there being no guarantee that targets can be met even though revenues may satisfy (5). In other words, external constraints prevent the attainment of α_0 (because at least one expenditure target cannot be met). The analysis of Franco – Rodriguez et al (1998) is premised on this assumption. If (7) is not binding the government is not prevented from reaching specific expenditure targets, utility is maximized subject to (5) only and the government can attain α_0 if revenues are sufficient.

In sum, the fiscal response model allows governments to set revenue and expenditure targets, and to attempt to raise and allocate the revenues required to meet these targets so as to maximize utility. Aid, like tax and borrowing, is treated as one of the form of revenue. If for some reason they fail to raise adequate revenue, for example a fall in commodity prices reduces export tax revenue, then clearly utility is not maximized. Similarly, if their discretion to allocate revenues across different expenditures is constrained, such that (7) is binding, utility will not be maximized (more strictly, in both cases, there is constrained maximization and α_0 is not attained). To analyze the impact of aid, in a model where governments expect to receive aid, one can derive the structural equations from maximizing (6) subject to (5) and (7), assuming (7) to be binding, and then derive the reduced form equations. These can then be estimated.

It is worth noting that, at least conceptually, fiscal response models can be viewed as encompassing categorical fungibility. In principle if adequate data were available, expenditure headings could be disaggregated in (6), with (7) becoming a set of equations for different expenditures, and the ρ 's in (7) would provide estimates of (maximum) fungibility. In practice, this would place too great a demand on the data:

Fiscal response models, in effect, sacrifice the detail on categorical fungibility so as to focus on the time series impact of aid on fiscal aggregates. As such models typically distinguish investment (or development) from recurrent (or consumption or non-development) expenditures, they do capture 'general' fungibility. In terms of aid effectiveness, this general fungibility is more important than

categorical fungibility (which is most relevant to donor monitoring). But fiscal response models offer more as they attempt to identify the impact of aid on tax and borrowing in addition to spending. Such aggregate fiscal effects over time are likely to be important determinants of aid effectiveness.

4.2 Fiscal response model in the VAR framework

Traditionally, macro-econometric forecasts and hypothesis tests were conducted using large scale macro-econometric models. Usually, a complete set of structural equations was estimated one equation at a time. Then, all equations were aggregated in order to form, overall macro economic forecasts.

Further more unless these set of equations are considered as a system in the process of specification, the behavioral implications of the restrictions on all equations taken together may be less reasonable than the restriction on any one equation taken by it self (Enders, 1995).

Fiscal response models describe the relationship between fiscal aggregates, governments raise revenue from different sources (e.g taxes, aid, domestic borrowing) and allocate them to different expenditures (e.g. capital or recurrent), attempting to meet some revenue and expenditure targets.

Franco. Rodriguez, McGillivray and Morrissey (1998) provide a full description of FRM's in which aid is treated like the other forms of revenue, governments have expected values (targets) for aid, other revenue and expenditures, and their fiscal behavior is an attempt to meet these targets subject to the budget constraint.

A characteristics of FRM's that some might view as a serious limitation, is that they are not predictive theories. In the sense that they do not generate specific testable hypotheses of the effect of aid on fiscal behavior, for e.g. FRMs do not predict that aid will increase investment spending or will reduce tax efforts; aid is posited to have effects as fiscal variables are related, but in a manner that can only be determined empirically. It is more appropriate to think of FRM's as a representations of the fiscal relationship that suggest an empirical specification to test if aid leads to an increase (or not) in other fiscal variables. However, empirical applications of FRM's have their short comings.

The most serious problem with the FRM approach is that the theory is adhoc and does not attempt to explain how the targets or the parameters in the utility function and budget constraints are generated. Furthermore FRMs are notoriously difficult to estimate and highly sensitive to the quality of the data, reveal only direct effects whilst ignoring interactions between variables, and in consequence results often lack robustness, studies frequently yield inconsistent estimates /Franco Rodriguez, 2000), three stage non linear econometric techniques can be difficult to estimate, the major empirical problem however is that there is no accepted means of estimating the revenue and expenditure targets.

We circumvent these empirical problems by estimating the FRM with in a vector auto-regression (VAR) modeling framework. This situation of interrelated variables is particularly suited to estimation using a VAR approach, as in essence the VAR is posited on their being a relationship between the variables in the system and lets the data reveal the nature of the relationship. Although different (exogenous) factors influence the values of each fiscal variable, the fiscal aggregates must maintain a relationship with each other and this can be generally described as a VAR model. Sims (1980) and others, such as Doan (1992), argue that the goals of VAR analysis is to determine the interrelationships among the variables, not the parameter estimates or not to make short term forecasts (Enders, 1995).

Further more, the VAR approach facilitates policy simulation, taking into account the linkages between the components of the budget. (Enders, 1995)

A VAR model is a system of equations, where each variables is allowed to affect the dependent variable with a number of lags. VAR approach assumes all variables in the system are potentially endogenous so each variables is explained by its own lags and lagged values of other variables, it also assumes that there is no a priori direction of causality among the variables; this is particularly useful for fiscal variables which are often codetermined. (Enders, 1995)

The rational for VAR

The idea of FRMs and the VAR approach is that fiscal variables are jointly determined by the government, and therefore budget out comes are the result of fiscal behavior. The benefit of the VAR/VEC approach is that it treats the fiscal variables as determined with in the same system, without any prior assumptions about the nature of the inter-relationships. Budgetary decisions are

generally made within a budget year, but past levels of fiscal variables can guide future decisions. Aid may induce change in fiscal (aggregates) for instance due to conditionality. Such effects will be captured by a VAR model with lagged impacts. It is also usual that recipient countries lack perfect foresight about donors' disbursements, and that they base their budget estimates on their past experience of promised and actual disbursements via a process of adaptive expectations. As the approach concentrates on government behavior, the estimation should use information that is known to the government. However, aid disbursed outside the budget can also affect government spending decisions, for instance by lowering expenditure on items funded by non-budgeted aid inflows.

VAR method offers a number of advantages in the current context, first as our aim is merely to investigate the dynamic effect of aid on the component of the budget. Estimation of the reduced form rather than a complete structural economic model is sufficient for our purposes. Specifically, the theoretical nature of VAR models means one does not have to maintain the existence of, or estimate, the targets as they are only required for the structural representation. Second, assumption about exogeneity can be directly tested within the VAR using the data and can then be applied to simulate the effect of injections of aid via impulse response analysis.

Fiscal aggregates are highly interlinked, and therefore likely to be endogenous. Unlike structural models, which make restrictions about the direction of causality between variables and can be difficult to estimate. A standard VAR method treats all variables in the model as endogenous. And therefore capture the linkages between different forms of expenditure and sources of finance. The use of a VAR model avoids the need to speculate about the appropriate specification of the utility function. Unlike in the case of simultaneous equations models, ordinary least squares (OLS) estimates for VAR are consistent. It is also possible to add exogenous variables such as dummies for external shocks to each equation. In the current context we use these techniques to evaluate the role played by foreign aid in the national budget of Ethiopia.

Limitations of VAR model

Despite the advantages, VAR models can easily become over-parameterized, as each variable is allowed to affect each other variable at a number of lags. The results can also be sensitive to the chosen lag length, although there are significant tests that can be used to determine the appropriate number of lags to be chosen.

4.3 Standard VAR model

In recent years, vector autoregressive methods have become the “tool of choice” in much of empirical macor-econometrics. Given the familiarity of VAR, according to Johansen and Juselius (1992) and Enders (1996) A VAR in standard form is represented as;

VAR (k) model, of lag length k.

X=A1X-1+A2X-2+-----AkX-k+μ+φD+E-----(4.1)

Where X_t = an (nx1) vector of stochastic I (1) variables

μ = vector of deterministic component (i.e constant and trend)

A_i = (nxn) matrices of coefficients (i=1----k)

E_t = an (nx1) vector of error terms

and t=1 ----- T (T is the number of observation)

D = is a vector of dummies

Variables used in the study

The variables included in a VAR are selected according to relevant economic model i.e. FRM, and are:

- C - Capital expenditure
- R - Recurrent expenditure
- T - Tax
- D - Domestic borrowing (net)
- F - Foreign loans (net)
- G - Grants
- ODA - Official Development Assistance (net)

This paper deals with three standard VAR models.

As described in the definition part ODA = Grant + Foreign loan

To avoid estimating an identity and to see the individual effects of ODA, grant and foreign loan as well as to save degrees of freedom, 3 separate VAR models are estimated. (see annex 3)

The first model is intended to show the fiscal effects of grant, and includes grant, tax, domestic borrowing, recurrent expenditure, and capital expenditure. The second model is intended to show the fiscal effects of foreign loan and includes foreign loan, tax, domestic borrowing, recurrent expenditure, and capital expenditure. Due to the high correlation between ODA and the sum of grants and foreign loans, ODA may well proxy for the joint impact of the two forms of external financing. However in the third model that includes ODA, the set of variables no longer forms a budgetary identity as ODA is much larger than the sum of grants and foreign loans recorded in government budgetary operations. As explained above, ODA contains substantial volumes of aid that are off budget, and modeling the impact of ODA may reveal something about the effects of off – budgetary aid on the budget. Therefore, the third model is intended to show the fiscal effects of ODA, and includes ODA, tax, domestic borrowing, recurrent expenditure, and capital expenditure. (see annex 3).

In all the three models the issues of structural breaks or shifts in the trends of variables have been addressed by using appropriate dummy variables. In all the three models VAR analysis is undertaken by using.

- ✱ Standard VAR model
- ✱ VEC model and
- ✱ Impulse response analysis

4.4 VEC model

If the variables to be included in a VAR are non-stationary, Integrated of the same order and co-integrated, they can be represented by a VEC. A variable is non-stationary when its mean and variance are time dependent and there is no long run mean to which the variable converges. The assumptions of classical regression model requires that variables are stationary. If non stationary, variables are rendered stationary by differencing. Since models with differenced variables do not cater for existing long – run relationships, the differenced variables must be modeled in a VEC frame work. A VEC model for co-integrated variables takes in to account both the short- run relationships between variables and deviations from the long run equilibrium relationship.

A principal feature of co-integrated variables is that their time paths are influenced by the extent of any deviation from long – run equilibrium. In an error-correction model, the short –term dynamics of the variables in the system are influenced by the deviation from equilibrium.

The above model (4.1) can be reparameterized to give a vector error correction model (VECM). That is adding and subtracting $(A_{k-1}, \dots, A_2 - A_1 - I) X_{t-k}$ from equation (4.1) I being the identity matrix results the following specification

$$\Delta x_t = \Gamma_1 \Delta x_{t-1} + \dots + \Gamma_{k-1} \Delta x_{t-k+1} + \Pi X_{t-k} + \mu + \varphi D_t + E_t \dots \dots \dots (4.2)$$

Simplifying equation 4.2 gives

$$\Delta x_t = \sum_{i=1}^{k-1} \Gamma_i \Delta x_{t-i} + \Pi X_{t-k} + \mu + \varphi D_t + E_t \dots \dots \dots (4.3)$$

Where $i=1, \dots, k-1, \Gamma_i - (I - \sum_{j=1}^i A_j) = \Gamma_i$ is allowed to vary with our restriction

$$\Pi = -(I - \sum_{j=1}^k A_j)$$

The term Πx_{t-k} contains information about the long run relationship between the variables in the vector. Information about the number of co-integrating vectors is also found in the rank of Π (i.e. the maximum number of linearly independent stationary columns in Π).

4.5 Impulse response

The coefficients of VAR/VEC models only reveal the direct, ceteris paribus effects. They do not take account of the fact that the lagged explanatory variables in each equation are interlinked (both with a lag and contemporaneously and therefore do not reflect the full impact of one variable on another. For this reason, the analysis relies to a great extent on impulse response functions to estimate the total short and long run impacts of an increase in aid. Impulse response functions represent the time profile of the effect of a shock to one variable on the contemporaneous and future values of all endogenous variables. They capture both the direct and indirect or feed back effects caused by endogeneity over time.

However, given the interrelationships that characterize economic system, it is often more informative to under take an impulse response analysis when short and long run impacts are of key

interest. In cases where variables are interrelated, a shock to one variable may set off a chain reaction of knock on and feed back effects as it permeates through the system, impulse response analysis estimates the net effect of the direct and indirect effects of a shock not only in the long run but at all periods following the shock.

The impulse response model is represented as:-

$$X_t = \mu + \sum_{i=0}^{\infty} \phi_i E_t - i \text{-----(4.4)}$$

(for details of the derivation see annex 4)

Where: ϕ_i are the one period responses of X_t of unit change in E_{t-i}

The accumulated effects of unit impulses can be obtained by an appropriate summation of the coefficients of impulse response functions. Letting n-approaches infinity yields the long run multiplier, since X_t sequences are assumed to be stationary it must be the case that for all j and k.

$$\sum_{i=0}^{\infty} \phi_{jk}^2 \text{ (i) is finite}$$

Plotting the impulse response functions.

Plotting the coefficients of $\phi_{jk}^{(i)}$ against time (t) i.e years after the initial simulated shock is a practical way to visually represent the behavior of X_t series in response to the various shocks.

This study uses generalized impulse response functions, and in each case the shock to aid is one standard error shock. The response functions estimated in this study are those of Pesaran and Shin (1998), where the initial shock occurs to a residual in one equation (in our models the aid equations). The impulse response function shows the increment to each variable due to one standard error shock to aid taking in to account all interactions between variables. The impulse responses are eventually expected to converge to a level that is consistent with the estimated long run co-integrating relationship.

4.6 Data sources

The data used in this study come form different sources. In particular, the study uses annual time series data. Data on Tax (T), Domestic- borrowing (D), Capital expenditure (C), Recurrent expenditure (R), Grants (G), Foreign loans (F) (net) and outstanding disbursed concessionary debt figures are drawn from various issues of the annual report of the Ministry of Finance and Economic

Development. ODA (Official Development Assistance) is obtained from the various publications and data base diskettes of the OECD/DAC, CRS data.

4.7 Stationarity and unit roots

The standard classical methods of estimation are based on the assumption that all variables are stationary.² However, most economic variables are not stationary. Models containing non-stationary variables will often lead to a problem of spurious regression, where by the results obtained suggest that there are statistically significant relationships between that variables in the regression model when in fact all that is obtained is evidence of contemporaneous correlations rather than meaningful causal relations. Furthermore, inferences based on the standard statistical tests (i.e. t and F tests) will be invalid. Therefore it is necessary to test for stationarity of time-series variables before running any sort of regression analysis.

Often, non- stationary variables become stationary after differencing. Such a variable is said to have difference stationary process (DSP). Thus, it is possible to estimate using difference of variables if the differences are stationary. But such a procedure gives only the short run dynamics. And there would be a loss of considerable long run information. Among the methods of testing the presence of unit roots in the variable, Augmented Dickey – Fuller (ADF) and Phillip Perron tests are used in this study. The simplest DF test starts with the following first order autoregressive model.

$$Y_t = \Phi Y_{t-1} + U_t \text{-----} (4.7.1)$$

Subtracting Y_{t-1} from both sides gives

$$\Delta Y_t = \delta Y_{t-1} + U_t \text{-----} (4.7.2)$$

Where $\delta = (\Phi - 1)$,

The test for stationarity is conducted on the parameters δ . If $\delta =0$ or $(\Phi=1)$ it implies the variable Y is not stationary the hypothesis is formulated as follows

$$H_0 = \delta =0 \text{ or } (\Phi=1)$$

$$H_1 = \delta <0 \text{ or } (\Phi<1)$$

² A given Variable (a stochastic) process is said to be stationary if it has constant mean, constant variance over time, and if the covariance between observations in two time periods depends only on the distance of the lag between the two period rather than the actual time that the covariance is computed. (see Gujrati, 1995).

If including a constant (drift) to the regression is suggested, that is

$$\Delta Y_t = \alpha + \delta Y_{t-1} + U_t \tag{4.7.3}$$

Where α is a constant term

However, if a series contains a deterministic trend, testing for stationarity using equation 4.7.3. is not valid. Therefore it is important to incorporate time trend as follows.

$$\Delta Y_t = \alpha + \delta Y_{t-1} + BT + U_t \tag{4.7.4}$$

Where T is the trend element.

For the above equations the parameter δ is used while testing for stationarity where the decision is made using a τ -statistics. If the calculated value of τ is less than the critical value (reported by Dickey and Fuller) the null hypothesis is accepted and not if otherwise. Rejecting the null hypothesis implies that there exists stationarity. If a variable that is not stationary in levels appears to be stationary after n^{th} difference, then the variable is said to be integrated of order n I (n). However, the DF test has a series limitation in that it suffers from residual autocorrelation. To amend this weakness, the DF model is augmented with additional lagged first differences of the dependent variable. This is called Augmented Dickey Fuller (ADF). Thus, incorporating lagged first differences of the dependent term in the above equations gives:-

$$\Delta Y_t = \delta Y_{t-1} + \sum_{i=1}^k \theta_i \Delta Y_{t-i} + \mu_t \tag{4.7.5}$$

$$\Delta Y_t = \alpha + \delta Y_{t-1} + \sum_{i=1}^k \theta_i \Delta Y_{t-i} + \mu_t \tag{4.7.6}$$

$$\Delta Y_t = \alpha + BT + \delta Y_{t-1} + \sum_{i=1}^k \theta_i \Delta Y_{t-i} + \mu_t \tag{4.7.7}$$

Where α is constant (drift), T is a trend, K is the lag length and $\mu \sim \text{IID}(0, \sigma^2)$

Taking the variables in first difference form presents only the dynamic interaction among the variables with no information about the long run relationship.

Phillips and perron –test

Phillips and Perron developed a generalization of the DF procedure that allows for fairly mild assumptions concerning the distribution of the errors. Phillips Perron procedure can be applied to

mixed processes in the same way as the DF tests. But there is no requirement that the disturbance term is serially uncorrelated or homogeneous, instead of DF assumption of independence and homogeneity, the Phillips- Perron test allows the disturbances to be weakly dependent and heterogeneously distributed. The Phillips – Perron test statistics are modifications of the DF test statistics that take in to the account the less restrictive nature of the error process. Enders (1996).

4.8 Co-integration

Co-integrated variables presuppose that a linear combination of their data set is stationary even though the individual series are non stationary. Time series variables may be non stationary but their linear combination may be stationary. In such cases, we say there is co-integration (long run relationship) between the variables involved. In testing for co-integration, the Engle Granger two step procedures and the Johansen’s maximum likelihood estimation procedure are often used.

In the Engle-Granger two-step procedure, variables entering the co-integrating vector are tested for integration of the same order, order one $I(1)$. The first step in this procedure is pretesting the variables for their order of integration. The second step is estimate the long run equation relationship and obtain the residual. If this residual, which is the linear combination of the variable is stationary then the variables are said to be co-integrated, i.e they do have long run relationship. The third step in this procedure is to estimate the error correction model (ECM) that is the first difference of the dependent variables regressed on the first differences of the explanatory variables with their appropriate lags and the first lag of the residual obtained in the first step.

The Engle – Granger two- step method is believed to be weak in the testing co-integration among variables for the following reasons. First, it assumes that there is one co-integrating vector eventhough more than one equilibrium relationship governing the joint evaluation of the variables could be identified. Second, it categorizes variables as endogenous and exogenous with implication of simultaneity problem.

Co-integration test in this paper are conducted by Johansen maximum likelihood estimation procedure since the method is claimed to be superior to the Engle – Granger two step method. The Johansen method does not require a priori endogenous exogenous distinction among variables and it can also identify multiple co-integrating vectors.



The Johansen procedure sets out to a maximum likelihood procedure for the estimation and determining the presence of co-integrating vectors in VAR system. Vector auto-regression (VAR) is one form of multivariate modeling where no variable in the system is assumed to be exogenous a priori. The starting point in this procedure is formulation of VAR model.³ (See equation 4.1, 4.2 & 4.3).

The term ΠX_{t-k} contains information about the long run relationship between the variables in the vector. Information about the number of co-integrating vectors is also found in the rank of Π (i.e. the maximum number of linearly independent stationary columns in Π).

In this connection, there are three cases worth mentioning.

- (i) If the rank of Π is zero, $r=0$, then all the elements of X_t , are non- stationary, Thus, there is no con-integrating relationship between the variables.
- (ii) If, however, Π is full rank that is $r=p$, then all elements of X_t are stationary (the variables are stationary at levels and no error correction formulation is required).
- (iii) In the intermediate case $r < p$, there is r non-zero co-integrating vectors among the elements of X_t and $p-r$ common stochastic trend. If non-zero relationship is indicated by the test, a stationary long run relationship is implied. In the case where $0 < r < p$, Π can be factored as $\alpha\beta'$ ($\Pi = \alpha\beta'$) where, α and β' are both $p \times r$ matrices.

The matrix α contains the adjustment parameters while the matrix β' is called the co-integrating matrix has the property the $\beta'x_t \sim I(0)$ where $I(0)$ indicates integrated of order zero. Thus we can interpret the relations of $\beta'x_t$ as stationary relations among potentially non-stationary variables, that is, as co-integrating relations. Hence, in a VAR models consisting of p variables there can be $r=p-1$ co-integrating vectors.

³ The discussion is taken from Johansen and Juselius (1992) and Enders, (1996)

In identifying the number of co-integrating vectors, the Johansen procedure provides n eigen value tests* denoted by λ (also called characteristic roots) whose magnitude measures the extent of correlation of the co-integration relations with the stationary elements in the model.

In general, to identify the number of co-integrating vectors in the system, the Lambda max (λ max) and Lambda trace (λ trace) statistics are used and to determine the rank of Π , the maximum likelihood estimation procedure developed by Johansen (1988) and Johansen and Juselius (1992) are used. In the case where the rank of $\Pi=r<p$ is true and we have $\Pi=\alpha \beta'$, the column of β' after normalization represents long run parameters relating the variables in their equilibrium situation.

The matrix α represents the error correction parameters, which measures the speed of adjustment from temporary disturbances in the equilibrium relation.

The test for the number of eigen values that are not insignificantly different from unity can be conducted using the following two test statistics.

$$\lambda_{\text{trace}}(r) = -T \sum_{i=1}^n \ln(1 - \lambda^i) \text{-----} (4.8.1)$$

$$\lambda_{\text{max}}(r,r+1) = -T \ln(1 - \lambda^{r+1})\text{-----}(4.8.2)$$

Where $\lambda^{\wedge}$ are estimated eigen values obtained from estimated Π matrix.

λ_{trace} tests the null hypothesis that the numbers of co-integrating vectors is $\leq r$ against a general alternative.

λ_{max} tests the null that the number of co-integrating vector is r against the alternative $r+1$, T is the sample size.

The distribution of this test is non standard and depends only on the degrees of freedom $(n-r)$. Johansen and Juselius (1992) provide the critical values of λ max and λ trace statistics obtained using simulation studies. (Harris, 1995), to test the hypothesis, compare the calculated statistics above with the tabulated ones.

* Trace test statistics tests for the null hypothesis that there are at most r distinct co-integrating vectors. This restriction can be imposed for different values r and then the log of the maximized likelihood function for the restricted models is compared to the log of the maximized likelihood function unrestricted models and a standard likelihood ratio test computed (Harris, 1995).

Weak exogeneity test

As explained in Cuthbertson et al (1992) fully efficient estimation and inference can take place conditional on the fundamentals if these variables are weakly exogenous for parameters of interest.

A likelihood ratio test (LR – test) for weak exogeneity is employed by imposing a zero restriction on the α coefficients. This is simply a test of whether the speed of adjustment α is significantly different from zero in the equations for the variables tested.

CHAPTER FIVE

MODEL APPLICATION AND RESULTS

5.1 Model description

Before model estimation, the first step is to establish whether the variables are stationary or non stationary. For this purpose both the Augment Dickey- Fuller and Phillips-Perron tests are used. The results for the tests can be found in Annex - 1.

Using both tests all the variables are tested as non-stationary and integrated of order one i.e. they are stationary at first difference.

Standard diagnostic tests (autocorrelation, hetroskedasticity and normality tests are performed for each model).

In each of the models optimal lag length was judged to be one. Adding so many lags entails the estimation of additional coefficients and an associated loss of degrees of freedom. There exists appropriate lag length selection criteria, the appropriate lag length (K) of the VAR is determined using standard model selection criteria. Akaike Information Criteria (AIC) and Shewartz Bayesian Criteria (SBC), adoption of the general to specific modeling approach and using AIC the selected lag length is one. The issues of structural breaks or shifts in trends of variables have been addressed with the use of appropriate dummy variables.

5.2 Model I the fiscal effects of grant

The first model (1) to be estimated uses the following set of variables: Grant (G) Tax (T) Domestic borrowing (net) (D) Capital expenditure (C) and Recurrent expenditure (R) as all the variables have a unit root, they may be co integrated. The Johansen trace and maximum eigen value tests are used to test for number of co-integrating relationships. The problem of small sample has also been mentioned, and Reimers (1992) cited in Harris (1995) suggests that in such a situation the Johansen procedure over-rejects when the null is true. Thus he suggests taking account of the number of parameters to be estimated in the model and making adjustment for degrees of freedom. Since the sample size is small in this study the adjusted test for degrees of freedom is conducted. In the adjusted case T is replaced by T-kn in both the formulas for λ_{trace} and λ_{max} .

Estimating the model, the following test results on the number of co-integrating vectors are obtained from the PC Fim 9.0 out put.

Table 5.2A Test for number of co integrating vectors of Model I

Ho. rank = P	- T log (1-/mu)	Using T-nm	95%	-T/sum log(.)	Using T-nm	95%
P=0	42.07**	36.54*	33.5	103.6**	89.94**	68.5
P<=1	16.76	14.55	21.0	27.02	23.47	29.7
P<=2	10.14	8.803	14.1	10.26	8.91	15.4

The asterisks * and ** indicate that the null hypothesis of p co-integration relations ship is rejected at 5 and 1 percent level of significance respectively. When the computed value of the test is grater than the critical value the null hypothesis is rejected.

As far as the diagnostic test for this vector is concerned, the results depicted no problem of normality and autocorrelation. From the above results the null hypothesis of no co-integration (P=0) among the variables (Table 5.2A) is rejected by both λ trace λ max and T-nm statistics at 1 percent and 5 percent level of significance. The λ trace, λ max developed by Johansen (1988) identified one co integrating vector. Hence a single co-integrating vector is identified. This implies, there is only one relevant linear combination of the variables, represented by the first row of β' matrix (and hence the first column of α matrix) that is stationery. (see annex 2)

Once testing for co-integration rank, the next procedure is weak exogeneity test. As explained in cuthbertson etal (1992) fully efficient estimation and inference can take place conditional on the fundamentals if these variables are weakly exogenous for the parameters of interest.

A likelihood ratio test (LR-test) for weak exogeneity is employed by imposing a zero restriction on the α coefficients. This is simply a test of whether the speed of adjustment α is significantly different from zero in the equations for the variables tested. Results reported in the following Table (5.2B) shows, the LR-test of the zero restriction on the α coefficients, and indicate that the null hypothesis that $\alpha = 0$ is rejected at 5% significance but not for the other variables. When testing for weak exogeneity all explanatory variables, happened to be weakly exogenous, except the dependent

variable which needs to be endogenous. In fact, this is a requirement for the dependent variable, to be endogenous. The validity of a single equation estimation of the unique co integrating vector is already confirmed by the weak exogeneity condition established for all the explanatory variables in the model.

Table 5.2B Test for zero-restriction on α coefficients

Variable	LG	LT	LD	LR	LC
Coefficient	-0.22263	-0.00023	-0.66538	0.02646	0.03167
LR-Test	5.0393	0.03098	0.02880	0.31850	0.11796
P- value	0.02485*	0.86030	4.78140	0.99524	0.73130

** Rejection at 1% level of significance

* Rejection at 5% level of significance

Testing the significance of the long run coefficients is the next procedure. This is used to determine which variables uniquely constitute the co-integration vector. The LR-test of zero restriction test on these coefficients is given in Table (5.2C) below.

Table 5.2C Test for zero restriction on β coefficients

Variable	LT	LD	LR	LC
Coefficient	10.0240	0.80035	-6.39050	-4.59390
LR-Test	8.6098	3.77090	5.26380	3.84180
P- value	0.00330**	0.052210*	0.02180*	0.05000*

** and * indicate rejection at 1% and 5% level of significance respectively.

The LR-test statistic used for the restrictions is given by $-2 \log (Q) = TE \log (1-\lambda_i^*) / (1-\lambda_i)$ where, Q =(restricted maximized likelihood) / (unrestricted Maximized Likelihood), T = number of observations, r = rank, and λ_i and λ_j^* eigen values for unrestricted and restricted model, respectively (Harris, 1995).

The co integrating relation shows one co integrating vector in its λ trace, λ max and in its adjustment for degrees of freedom component ($T-nm$).

The unrestricted co integrating relation found is:

$$LG + 10.024T + 0.80035D - 6.3905R - 4.5939 C = 0 \dots\dots\dots 5.2.1$$

The co integrating relation shows a long run relation ship between the variables. It implies that in the long run, *ceteris paribus*, capital expenditure and recurrent expenditure are positively related to grants. Whereas tax and domestic borrowing are negatively related to grants. This suggests that, in the long run, grants should be seen as a substitute for domestic borrowing and tax. And some of the variables may not behave according to the relation. Even though grants and domestic revenue appear to be negatively related, it is still possible for tax revenue to rise as a result of an increase in grants, as long as changes in other variables balance the long run relation. This would be the case if domestic borrowing were to fall substantially.

As we mentioned above the fact that the variables are co-integrated indicates that a VEC model can be formulated to assess the linkages between the variables. The error correction term in the model will allow us to assess which variables move to balance the long run relation. If the error correction term is insignificant, the estimated co-integrating relation table (5.2D) is unlikely to be valid or strong.

For each dependent variable, the adjustment coefficient on the lagged error correction term in the estimated model measures the response of the dependent variable to a previous period imbalance in the budget.

Error correction model I

The following table (5.2D) shows the results of the unrestricted VEC model, including the dummy variable. There are five dependent endogenous variables that are affected by lags of themselves and the other endogenous variables. In the table a D in front of a variable stands for difference. Conclusions about the significance of each coefficient are based on 5% significance level.

The coefficients in the error correction model show the short run, direct effects between variables but not the total effect resulting from both direct and indirect impacts. If the coefficient on the lagged error correction term (EC (-1)) in table (5.2D) is significant that particular variable reacts to

deviations from the long run equilibrium relation occurring in period $t-1$ according to the relationship identified in equation (5.2.1).

The results of the various diagnostic tests are reported and the tests didn't detect problem of Heteroscedasticity (ARCH-Autoregressive Conditional heteroscedasticity test), non normality (normalize $\chi^2(2)$ test), and test for serial auto correlation AR1-2F.

The adjustment coefficient on the error correction term is significant for grant and domestic borrowing, this indicates that grant, and domestic borrowing responds to budget imbalances in the previous period.

According to results of the error correction coefficients, grant responds 16.7% and domestic borrowing responds 35% to budget imbalance in the previous period. This implies that domestic borrowing is the main financing source to the previous period budget imbalance and both are correctly signed according to the long run relation in equation 5.2.1.

We shall not try to draw many inferences of the fiscal effects of grant from table (5.2D) but a few direct effects are described for illustrative purposes:

Grant has a significant and positive effect on tax revenue, domestic borrowing is negatively and significantly affected by lagged domestic borrowing. And capital expenditure is negatively and significantly affected by lagged domestic borrowing.

The positive sign of the dummy variable implies the importance of policy changes to the fiscal effects of grant.

The final conclusion about the impact of grants will be largely based on the impulse response functions presented in fig (5.2A)

Table 5.2D Vector Error Correction Model I

Explanatory variables	Dependent Variables					
		D(LG)	D(LT)	D(LD)	D(LR)	D(LC)
	EC(-1)	-0.16740*	-0.028549	-0.35628*	-0.0009372	-0.053394
	D(LG(-1))	-0.34305*	0.048164*	0.011376	0.033124	-0.013578
	D(LT(-1))	0.19111	0.20175	-1.8116	0.27885	-0.30677
	D(LD(-1))	-0.039185	-0.0016264	-0.4822**	-0.027945*	-0.058087*
	D(LR(-1))	-0.61655	0.021699	2.4269	0.096715	0.20031
	D(LC(-1))	0.070407	-0.0017221	-0.20998	-0.04322	0.035838
	Constant	0.32341*				
	Dummy	0.028227*				

** - Significant at 1% level of significance

* - Significant 5% level of significance

Test Summary

Diagnostic Tests

Vector Portmanteau lag 1.

ARI-2F (2,27)= 0.50723 (0.6078)

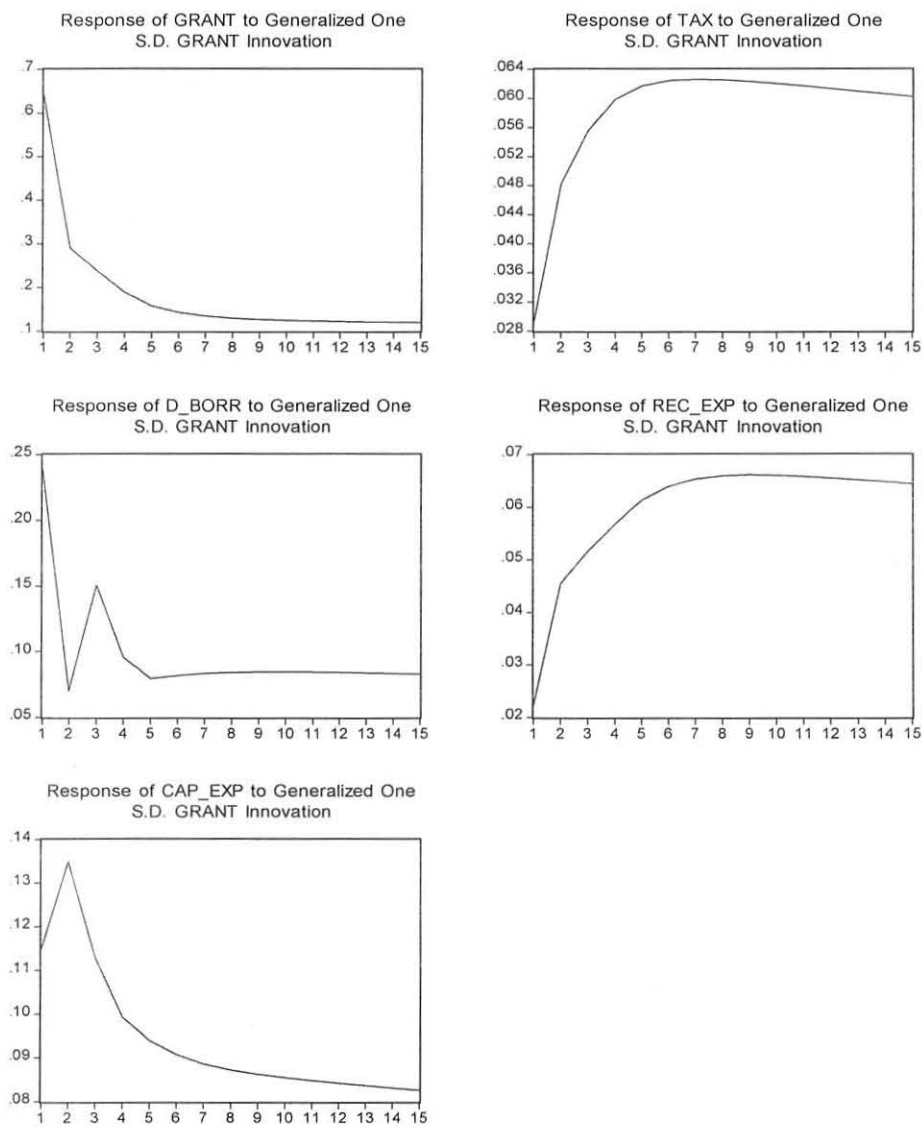
ARCH1F (1,27)= 2.96225(0.0967)

Normality $\chi^2(2) = 2.8509(0.2404)$

Impulse Response Analysis (Model I)

Shows that the impulse responses of each of the variables to a permanent one standard error shock in grants. The horizontal axis refers to years after the initial simulated shock. The vertical axis refers to impulse response coefficients (ϕ_i) which shows the increment to each variable due to an additional increase in grants, taking in to account all interactions between the variables. The shock will have a permanent effect on the levels of the other variables, but the impact gradually stabilize at a new level that is consistent with the long run co-integrating relationship as a result of feed back effects from other variables.

Figure 5.2A The fiscal effects of grants
 (results are obtained from Eviews – 5 output)



The vertical axis refers to impulse response coefficients (ϕ_i) and the horizontal axis refers to years after the initial simulated shock.

As shown in fig 5.2A, an increase in grant results in an increase in recurrent budget expenditure in both short and long run. In the short run capital expenditure increase up to period 2 and there by continuously declining in the long run.

An increase in grants results in an increase in tax revenue in both short and long run. And an increase in grants results initially a fall in domestic borrowing up to period 2 and there by a rise and a fall in domestic borrowing i.e. domestic borrowing is volatile up to period 5, after period 5 domestic borrowing rises and stabilizes.

Impulse response in the early periods following the shock are quite volatile for domestic borrowing and capital expenditure. Therefore it is advisable to use long run results as conclusion and policy implications.

Generally in the long run an increase in grants results in an increase in recurrent budget expenditure and a decrease in capital budget expenditure. And an increase in grants results in an increase in tax revenues. Finally in the long run an increase in grants results in an increase in domestic borrowing.

In the long run the grant stock is not associated with higher total expenditure, the composition of spending however shifts in favor of recurrent budget expenditure at the expense of capital budget expenditure.

5.3 Model II the fiscal effects of foreign loan

The second model (2) uses the same set of variables as model (1) but replaces grants with foreign loan. It uses the following set of variables: Foreign loan (net) (F), Tax (T), Domestic borrowing (net) (D) Capital expenditure (C) and Recurrent expenditure (R). As all the variables have a unit root, they may be co integrated.

Estimating the model, the following test results on the number of the co-integrating vectors are obtained from the Pc Fiml 9.0 out put.

Table 5.3A Test for number of co-integrating vectors of Model II

Ho: Rank = P	- T log (1-/mu)	Using T-nm	95%	T log/sum log (.)	T-nm
P=0	44.48**	38.13*	33.5	90.62**	77.68**
P<=1	19.48	11.70	27.1	46.14	39.55
P<=2	15.15	12.99	21.0	26.65	22.85

The asterisks* and ** indicate that the null hypothesis of P co-integration relationship is rejected at 5 and 1 percent level of significance respectively.

As far as the diagnostic test for this vector is concerned the results depicted no problem of normality and autocorrelation.

From the above results the null hypothesis of no co-integration ($p=0$) among the variables, in table (5.3A) is rejected by both λ trace λ max and T-nm statistics at 1 percent and 5 percent level of significance. The λ trace λ max developed by Johansen (1988) identified one co-integrating vector. Hence a single co-integrating vector is identified. Once testing for co-integration rank, the next procedure is weak exogeneity test.

A likelihood ratio test (LR – test) for weak exogeneity is employed by imposing a zero restriction on the α coefficients. This is simply a test of whether the speed of adjustment α significantly different from zero in the equations for the variables tested.

Results reported in the following table (5.3B) shows the LR test of the zero restriction on the α coefficients, and indicate the null hypothesis that $\alpha=0$ is rejected at 1 % significance.

The validity of a single equation estimation of the unique co-integrating vector is already confirmed by the weak exogeneity condition established for all the explanatory variables in the model.

Table 5.3.B Test for zero restriction on α coefficients

Variable	LF	LT	LD	LR	LC
Coefficient	-0.37873	-0.00018	-0.83678	-0.00160	-0.01749
LR-Test Rank= $\chi^2(i)$	9.3024	0.00010	0.0002	0.005946	0.28966
P-value	0.0023**	0.9920	0.13717	0.9385	0.5904

** rejection at 1% level of significance

* rejection at 5% level of significance

Testing the significance of the long run coefficients is the next procedure. This is used to determine which variables uniquely constitute the co-integration vector. The LR test of zero restriction test on these coefficients is given in table (5.3C) below.

Table 5.3.C Test for zero restriction on β coefficients

Variable	LT	LD	LR	LC
Coefficient	6.9194	1.1060	-6.7628	-1.7169
LR-Test	10.122	22.216	14.864	3.9821
P-value	0.0015**	(0.0000)**	0.0001**	0.0460*

** and * indicate rejection at 1% and 5% level of significance.

The co-integrating relation shows one co-integrating vector.

The unrestricted co-integrating relation found is of the form

$$LF+6.9194LT+1.1060LD-6.7628LR-1.7196C=0$$

----- 5.3.1

The co-integrating relation shows a long run relationship between the variables. It implies that in the long run, *ceterisparibus* capital expenditure and recurrent expenditure are positively related to foreign loans where as tax and domestic borrowing are negatively related to foreign loans. And this relationship is similar to that of Model I.

The fact that the variables are co-integrated indicates that a VEC model can be formulated to assess the linkages between the variables. The error correction term in the model will allow us to assess which variables move to balance the long run relation.

Error correction Model II

The following table (5.3D) shows the result of the unrestricted VEC model, including the dummy variable. There are five dependent (endogenous variables that are affected by lags of themselves and the other endogenous variables. In the table D in front of a variable stands for difference. Conclusion about the significance of each coefficient are based on 5 percent significance level.

The coefficients in the error correction model show the short run direct effects between variables but not the total effect resulting form both direct and indirect impacts.

The results of the various diagnostic test’s didn’t detect a problem of hetroscedasticity, normality, and autocorrelation.

The adjustment coefficient on the error correction term is significant for foreign loan and domestic borrowing. This indicates that foreign loan and domestic borrowing responds to budget imbalances in the pervious period.

According to the results of the error correction coefficient. foreign loan responds 29.04% and domestic borrowing responds 55.16% to budget imbalance in the previous period. This implies that domestic borrowing is the main financing source to the previous period budget imbalance and both are correctly signed as indicted in the long run equation 5.3.1.

We shall not try to draw many inference of the effects of foreign loan from table (5.3D). But a few direct effects are described for illustrative purposes. Recurrent expenditure is significantly and positively affected by lagged tax revenue, domestic borrowing is significantly and negatively affected by lagged domestic borrowing. And lagged capital expenditure has a significant and negative impact on foreign loans.

The positive sign of the dummy variable indicates the relevance of the policy changes to the fiscal effects of foreign loans.

The final conclusion about the impact of foreign loans will be largely based on the impulse response functions presented in fig (5.3A).

Table 5.3D Vector Error Correction Model II

		Dependent Variables				
Explanatory variables		D(LF)	D(LT)	D(LD)	D(LR)	D(LC)
	EC(-1)	-0.29046**	-0.018304	-0.55165**	-0.0095624	-0.0051773
	D(LF(-1))	-0.22730*	-0.031244	0.29161	-0.14990	-0.012083
	D(LT(-1))	1.6394	0.21178	0.33143	0.50087*	0.087446
	D(LD(1-))	0.060111	0.00976	-0.29680*	-0.016097	-0.041208
	D(LR(-1))	-0.16111	-0.003639	1.6512	0.19696	0.14469
	D(LC(-1))	-1.1826*	0.13662	-0.93332	-0.11694	-0.18411
	Constant	0.13573				
	Dummy	0.055680*				

** ~ Significant at 1 % level of significance

* ~ Significant at 5% level of significance

Test summary

Diagnostic tests

Vector portmanteau lag 1

AR1-2F(2,27) = 0.4077 (0.6692)

$$\text{ARCH}_1 F(1,27) = 1.5467 (0.2243)$$

$$\text{Normality } \chi^2(2) = 1.7159 (0.4240)$$

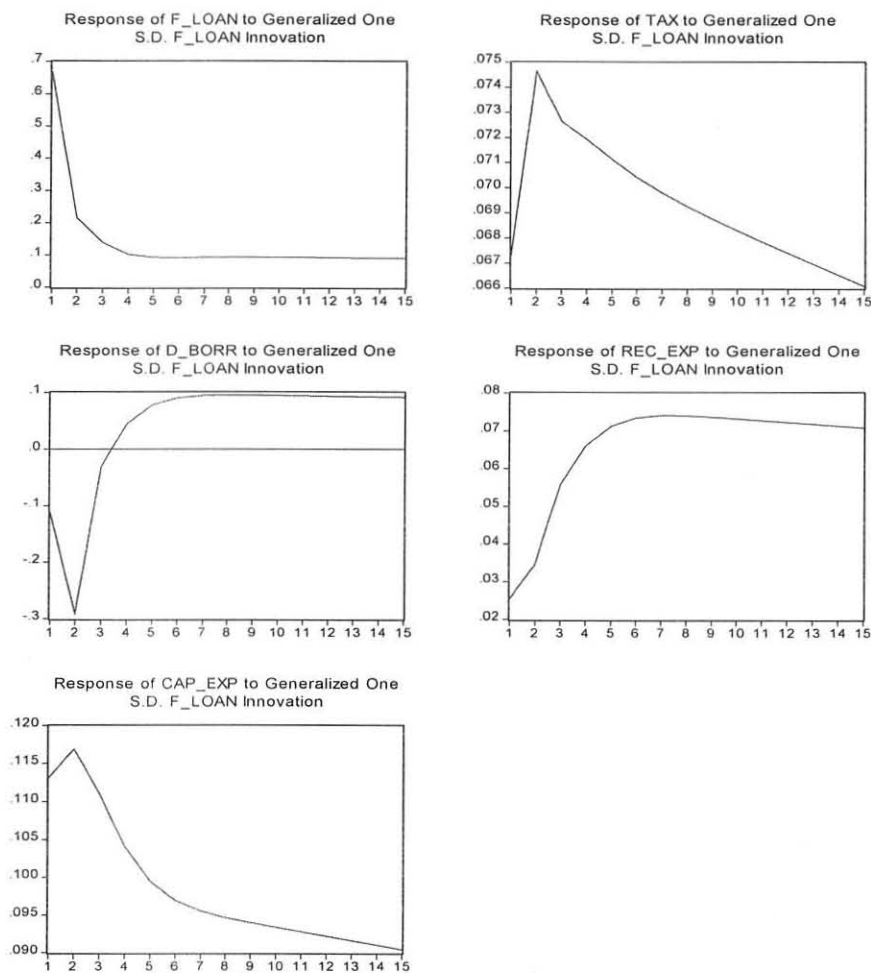
Impulse Response Analysis Model II

Impulse response shows that the impulse response of each the variables to a permanent one standard, error shock in foreign loans.

Generalized impulse response functions are again used to capture the total contemporary and cumulative effects.

Fig 5.3A shows the cumulative impulse response to a one – period shock on foreign loans.

Figure 5.3A The fiscal effects of foreign loans
(results are obtained from Eviews – 5 output)



The vertical axis refers to impulse response coefficients ϕ_i and the horizontal axis refers to years after the initial simulated shock.

As shown in Fig. 5.3A, an increase in foreign loan results in an increase in recurrent budget expenditure in both short and long run. An increase in foreign loan results in arise in capital expenditure in the short run up to period 2, and there by a continuous decline in capital expenditure in the long run. The impact of foreign loans shock on tax in the short run, particularly up to period 2 is increasing and there by continuously declining in the long run.

An increase in foreign loan leads to a fall in domestic borrowing up to period 2 and a continuous rise after period 2 and the effect becomes positive after period 3.

The impulse response in the early periods following the shock are quite volatile for tax, capital expenditure and domestic borrowing as the foreign loans shock stabilizes in the long run it may be advisable to pay attention in the long run effects.

Generally, there exists an increasing impact on both domestic borrowing and recurrent expenditure and clearly a decreasing impact on capital expenditure and tax.

The difference between results of mode I and II is that in model II tax has declined and in models I tax has increased.

In the long run foreign loan in not associated with higher total expenditure, the composition of spending however shifts in favor of recurrent budget expenditure at the expense of capital expenditure.

5.4 Model III the fiscal effects of ODA

The third model (3) to be estimated uses the following set of variables, ODA net (ODA), Tax (T), Domestic borrowing net (D) Capital expenditure (C) and Recurrent expenditure (R).

As all the variables have a unit root, they may be co-integrated. Estimating the model, the following test results on the number of co-integrating vectors are obtained form the Pc film 9.0 output.

Table 5.4A Test for number of co-integrating vectors of model III

Ho: rank=P	T long (1- /mu)	Using 9- num	95%	-T/sum log(.)	using T- nm	95%
P=0	38.23 *	32.77	33.5	83.58**	71.64*	68.5
P<=1	20.78	17.81	27.1	45.36	38.88	47.12
P<=2	14.86	12.74	21.0	24.58	21.07	29.7

The astrics * and ** indicate that the null hypothesis of p co-integration relationship is rejected at 5 and 1 percent level of significance respectively.

As far as the diagnostic test for this vector is concerned the results depicted no series problem of normality and autocorrelation.

From the above results the null hypothesis of no-co-integration ($p=0$) among the variables in table (5.4A) is rejected by both λ trace and λ max statistics at 1 and 5 percent levels of significance. The λ trace λ max developed by Johansen (1988) identified one co-integrating vector. Hence a single co-integration vector is identified. Once testing for co-integration rank, the next procedure is weak exogeneity test.

A likelihood ratio test (LR-test) for weak exogeneity is employed by imposing a zero restriction on the α coefficients. This is simply a test of whether the speed of adjustment α is significantly different from zero in the equations for the variables tested.

Results reported in the following table (5.4B) shows the LR-test of the zero restriction on the α coefficients, and indicate that null hypothesis that $\alpha=0$ is rejected at 5%.

The validity of a single equation estimation of the unique co-integrating vector is already confirmed by the weak exogeneity condition established for all the explanatory variables in the model.

Table 5.4B Test for zero-restriction on α Coefficients

Variable	LODA	LT	LD	LR	LC
Coefficient	-0.051894	-0.00011	-0.40805	0.00671	-0.008656
LR-test	5.9868	0.00013057	0.0029	0.29041	0.22886
P - value	0.0144*	0.9909	0.8772	0.5900	0.6324

** rejection at 1% level of significance

* rejection at 5% level of significance

Testing the significance of the long run coefficients is the next procedure. This is used to determine which variables uniquely constitute the co integration vector. The LR test of zero restriction test on these coefficients is given in table (5.4C) below.

Table 5.4C Test for zero-restriction on β -coefficients

Variables	LT	LD	LR	LC
Coefficient	19.684	2.3193	-17.317	-4.1710
LR-test	13.038	15.425	14.529	3.2788
P – value	0.0003**	0.0001**	0.0001**	0.0702*

** and * indicate rejection at 1% and 5% levels of significance

The unrestricted co-integrating relation found is of the form

$$\text{LODA} + 19.684\text{LT} + 2.3193\text{LD} - 17.31\text{LR} - 4.1710\text{C} = 0$$

The co-integrating relation shows a long run relationship between the variables. It implies that in the long run, ceteris paribus capital expenditure and recurrent expenditure are positively related to ODA where as tax and domestic borrowings are negatively related to ODA.

Error correction Model III

The fact that the variables are co-integrated indicates that a VEC model can be formulated to assess the linkages between the variables. The error correction term in the model will allow us to assess which variables move to balance the long run relation. The following table (5.4D) shows the results of the unrestricted VEC model, including the dummy variable. There are five dependent (endogenous variables that are affected by lags of themselves and the other endogenous variables. In the table a D in front of a variable stands for difference. Conclusions about the significance of each coefficient are based on 5% significance level. The model passes all diagnostic tests.

The coefficients in the error correction model show the short run direct effects between variables but not the total effect resulting from both direct and indirect impacts.

The results of the various diagnostic tests didn't detect a problem of the hetroscedasticity, normality, and autocorrelation.

The adjustment coefficient on the error correction term is significant for ODA and domestic borrowing, this indicates that ODA and domestic borrowing responds to budget imbalances in the previous period.

According to the results of the error correction coefficient ODA responds 6.53% annually and domestic borrowing responds 41.11% to budget imbalance in the previous period. This implies that domestic borrowing is the main financing source to the previous period budget imbalance and both are correctly signed as stated in the long run relationship of equation 5.4.1 We shall not try to draw many inferences of the effects of grant from table (5.4D) butt a few direct effects are described for illustrative purposes.

Tax revenue and capital expenditure both are significantly and positively affected by ODA, tax revenue is significantly and negatively affected by lagged – tax revenue. Domestic borrowing and capital expenditure both are negatively and significantly affected by lagged domestic borrowing. And lagged recurrent expenditure has a significant and positive effect on capital expenditure.

The positive sign of the dummy variable indicates that the relevance of policy change to the fiscal effects of ODA.

The final conclusion about the impact of ODA will be largely based on the impulse response function presented in fig 5.4A.

Table 5.4D Vector Error Correction Model III

Dependent Variables						
Explanatory Variables		D (LODA)	D(LT)	D(LD)	D(LR)	D(LC)
	ECC(-1)	-065383*	-0.024549	-0.41100**	-0.0051077	-0.017339
	D(LODA(-1))	-0.44601*	0.11465*	-0.59727	-0.057714	0.26524*
	D(LT(-1))	0.17111	-0.35005*	-0.46598	0.39153	0.11325
	D(LD(-1))	0.029206	-0.0038126	-0.38014*	-0.024160	-0.084665*
	D(LR(-1))	-0.34801	0.10285	2.319	0.27582	0.50367*
	D(LC(-1))	-0.16968	0.04898	-0.25129	0.046575	-0.12510
	Constant	0.24037**				
	Dummy	0.01968*				

**Significant at 1% level of significance

* Significant at 5% level of significance

Test Summary

Diagnostic Tests

Vector portmanteau lag 1.

AR1-2F(2,26)=0.15804 (0.8546)

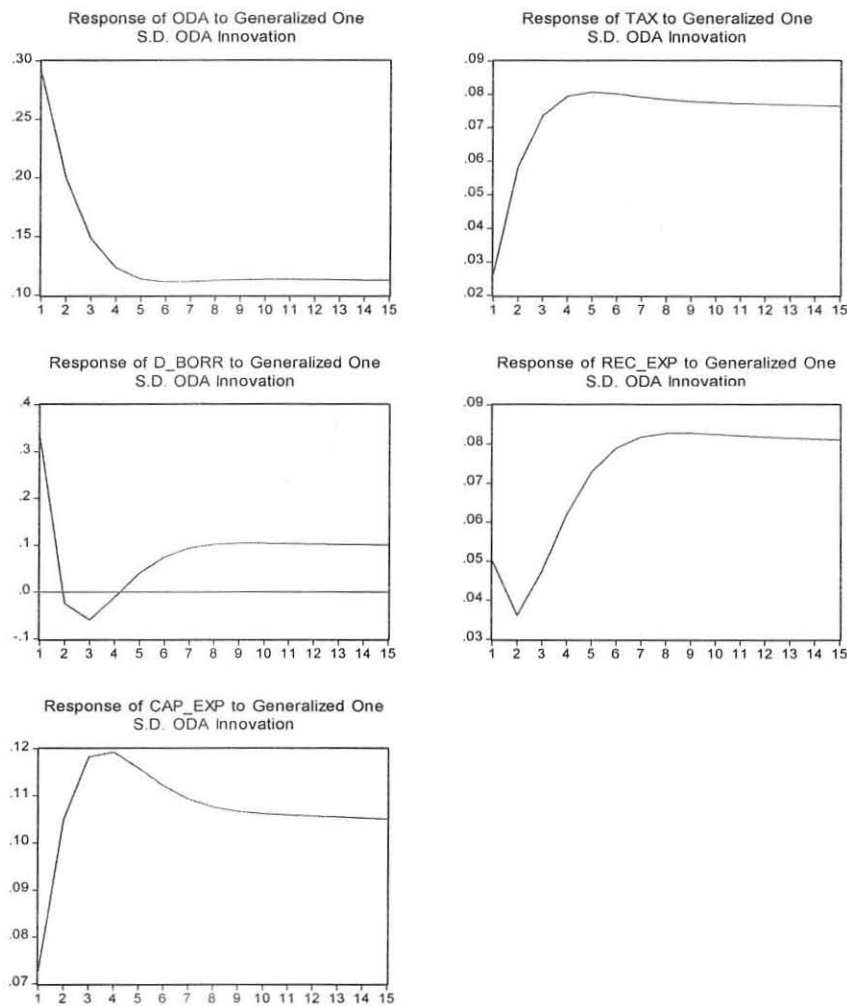
$$\text{ARCH 1F (1,26)}=0.42289 (0.5212)$$

$$\text{Normally Chi}^2(2) = 0.14246(0.9312)$$

Impulse response analysis model III

Impulse response shows that the impulse response of each of the variables to a permanent one standard error shock in official development assistance. Generalized impulse response functions are again used to capture the total contemporary and cumulative effects. Fig 5.4A shows the cumulative impulse responses to a one period shock on ODA.

Figure 5.4A The fiscal effects of ODA
(results are obtained form Eviews – 5 out put)



The vertical axis refers to impulse response coefficients (ϕ_t) and the horizontal axis refers to years after the initial simulated shock.

As shown in fig. 5.4A, an increase in ODA results in an increase in capital expenditure and tax revenues in both short and long run. The impact of ODA shock on recurrent expenditure is decreasing up to periods 2 in the short run and there by continuously increasing in the long run. An increase in ODA results in a decrease in domestic borrowing up to periods 3 in the short run and there by a continuous rise in the long run. The impulse response following the shock are quite volatile for recurrent expenditure and domestic borrowing, as the shock to ODA stabilizes in the long run it may be advisable to pay attention in the long run effect.

In the long run an increase in ODA results in an increase in all fiscal aggregate variables of the model. i.e, an increase in tax, domestic borrowing, capital expenditure and recurrent expenditure.

ODA in the long run is associated with higher total expenditure as it is stated in the hypothesis, ODA inflows have induced large increase in expenditure.

CHAPTER SIX

CONCLUSION AND POLICY IMPLICATION

6.1 Conclusion

The main empirical findings in this paper can be summarized as follows:

- ➡ All the variables namely, grant, foreign loan, ODA, tax, domestic borrowing, capital expenditure and recurrent expenditure form a long run relationship.
- ➡ The results of the error correction models reveal that: in the error correction coefficient of model I, grant and domestic borrowing respond 16% and 35% respectively on annual basis to the budget imbalance of the previous period. Whereas in model II, foreign loan responds 29.4 % and domestic borrowing responds 55.16% annually to the budget imbalance of the previous period. And in model III, ODA responds 6.53% and domestic borrowing responds 41.11 % to the budget imbalance of the previous period. Furthermore, all this variables are correctly signed on the basis of long run relationships. From this, it is possible to suggest that domestic borrowing is the main financing source for the budget imbalance of the previous period.
- ➡ Results of error correction in Models I and III indicate that an increase in grant and ODA results in an increase in tax revenue. This implies that, in the short run, grant and ODA encourage taxation efforts.
- ➡ Error correction in Model III indicates that, an increase in ODA results in an increase in capital expenditure as short run direct effect. This implies that ODA has a direct positive and significant short run effect on capital expenditure.

For it shows the total effect both in short and long run, the analysis of the study relies to a greater extent on impulse response models.

Results from the impulse response models indicate: -

First an increase in grants and foreign loans results in an increase of a recurrent budget expenditure and a fall in capital budget expenditure. This might show the existence of fungibility.

Second, an increase in grants, foreign loans and ODA results in an increase in the domestic borrowing. Such an increase, to some extent, may be associated with the rise in counter part fund. However, in the long run, compliance with donors' requirements implies a reduction in domestic borrowing. Contrary to this effort the rise in domestic borrowing may be caused by excess spending, which is consistent with the consumption spending.

Third, an increase in grants results in an increase in the tax revenue and on the contrary an increase in foreign loans results in a decrease in tax revenue. This unclear effect might have been caused by the nature of grants and foreign loans. As the total effect is represented by the ODA, a rise in ODA results in an increase in the tax revenue, which implies that ODA does not discourage taxation efforts.

Fourth, unlike the first two models an increase in ODA results in an increase in tax revenue, domestic borrowing, recurrent expenditure, and capital expenditure. That means a rise in all fiscal aggregates. This could probably be the effect of part of the ODA which is not included in the budget.

Fifth, contrary to the hypothesis, in the long run, grants and foreign loans are not associated with higher total expenditure. However, ODA has a positive impact on the total spending, an over proportional increases in the spending.

6.2 Policy Implication

1. In the long run, an increase in grants and foreign loans results in the increase of the recurrent budget expenditure and a fall in the capital budget expenditure. This might indicate the existence of fungibility. As it is stated in the hypothesis, aid inflows have been associated with an increase in development budget, and to some extent the recurrent budget, (as the recurrent budget includes some social programs in health and education).

If aid, intended for investment, is actually diverted to a consumption spending, then the potential growth impact of aid may be reduced. According to World Bank PER (2000), if aid finances any activity that the recipient country would otherwise have financed by itself, the resources that the recipient would have spent on that activity become available to finance something else. i.e. fungibility does not refer to what is directly done with the funds, but to an indirectly financing. (this assertion is made to mean that aid is given primarily to help increase capital expenditure).

Thus, this may require the need to take policy measures which try to significantly increase the capital expenditure, and to some extent the recurrent expenditure.

2. An increase in grants, foreign loans and ODA results in an increase in the domestic borrowing. Such an increase, to some extent, may be associated with the rise in the counter-part fund. However, in the long run, compliance with donors' requirements implies that, a reduction in domestic borrowing. Contrary to this efforts, the rise in the domestic borrowing may be due to the excess spending which is consistent with the consumption spending, And may require policy measures towards the decrease in the domestic borrowing.
3. Unlike the first two models, a rise in ODA, in the long run, results in a rise in capital expenditure, recurrent expenditure, tax and domestic borrowing, i.e. a rise in all fiscal aggregates.

This could probably be the effect of part of ODA which is not included in the budget. This means, the national budget may give an imperfect account of the full extent.

This implies the need for developing systematic guidelines as to how all ODA's should be indicated in the budget, and also helps to ensure the budget preparation process to be transparent accountable, comprehensive and predictable.

CHAPTER SEVEN

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7.1 Bibliography

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Annexes

Annex 1 Results for the augmented Dicky - Fuller Test for Unit roots

Variables	Constant (C) Trends (T) No of lags	Value of test statistic	99% of Critical Value	95% of critical Value	Order of Integration
G	C,1	-1.32	-3.62	-2.94	I(1)
F	C,1	-1.19	-3.68	-2.97	I(1)
ODA	C,1	-0.007	-3.62	-2.94	I(1)
T	C,T,1	-2.82	-4.23	-3.54	I(1)
D	C,1	-2.11	-3.62	-2.94	I(1)
R	C,T,O	-2.51	-4.22	-3.53	I(1)
C	C,T,O	-2.87	-4.22	-3.53	I(1)

I(1) = Non- stationary and integrated of order 1.

i.e. Stationery at first difference

Results of Phillips -Perron Test

Variables	Constant (C) Trend (T)	Value of test statistics	99% Critical Value	95% Critical Value	Order of Integration
G	C,	-0.58	-3.62	-2.94	I(1)
F	C	-1.74	-3.62	-2.94	I(1)
ODA	C	-0.25	-3.62	-2.94	I(1)
T	C,T	-2.24	-4.22	-3.53	I(1)
D	C	-2.93	-3.62	-2.94	I(1)
R	C,T	-2.63	-4.22	-3.53	I(1)
C	C,T	-2.87	-4.22	-3.53	I(1)

I(1)= Non stationary and integrated of order 1

i.e. Stationary at first difference

N.B All variables have unit root at both 99% and 95% significance level and are integrated of order one, i.e. stationary at first difference.

Annex 2 Standardized β' eigen vectors and Standardized ∞ coefficients

Standardized β' eigen vectors for model I

LG	LT	LD	LR	LC
1.0000	10.024	0.80035	-6.3905	-4.5939
-1.2899	1.0000	0.68946	-3.6740	3.3157
1.4904	-18.500	1.0000	19.319	-4.6212
-0.46524	2.6212	-0.010593	1.0000	-1.9982
0.16377	-0.84287	-0.28852	2.1576	1.0000

Standardized ∞ coefficients for model I

LG	-0.22263	0.27809	-0.034057	0.31766	-0.0071457
LT	-0.00023056	-0.0048787	0.0041138	-0.036051	-0.00222069
LD	-0.66538	-0.60151	-0.14866	-0.034972	0.0012006
LR	0.026467	-0.027122	-0.016867	-0.026814	-0.00086080
LC	0.031677	-0.11054	0.0043125	0.076694	-0.0031568

Standardized β' eigen vector for model II

LF	LT	LD	LR	LC
1.0000	6.9194	1.1060	-6.7628	-1.7169
-0.15845	1.0000	0.038954	-0.55219	-0.17649
-1.0708	-8.3630	1.0000	10.313	-1.9272
0.22206	0.90524	-0.085533	1.0000	-1.6346
-0.23338	-2.9971	0.11622	0.63450	1.0000

Standardized ∞ coefficients for model II

LF	-0.37873	2.0361	0.072268	0.0095358	0.023536
LT	-0.00018246	-0.15939	0.0042876	-0.033585	0.0074981
LD	-0.83678	-0.38085	-0.21422	-0.099535	-0.0070706
LR	-0.0016034	0.31495	-0.020857	-0.023056	0.0037667
LC	-0.017492	0.10049	0.0030755	0.23170	-0.0095248

Standardizes β' eigen vector for model III

LODA	LT	LD	LR	LC
1.0000	19.684	2.3193	-17.317	-4.1710
0.030379	1.0000	-0.070649	-0.66691	-0.19085
-7.8093	-3.6571	1.0000	-6.1724	15.399
-0.97272	1.5644	0.082167	1.0000	-0.93537
-1.1216	-1.2534	0.17555	0.13687	1.0000

Standardized α Coefficients for Model III

LODA	-0.051894	0.066522	0.0090356	0.14282	0.010713
LT	-0.00011378	-0.089040	-0.0085026	-0.089020	0.0040674
LD	-0.40805	3.2516	0.090289	-0.038922	0.0084351
LR	0.0067145	0.38688	0.0071144	-0.025348	0.0039449
LC	-0.0086562	0.10235	-0.033049	0.034745	0.0062583

Annex 3 Process of data organization and analysis

- 1. Definition and measurement of variables :- is stated from page 1 -5
- 2. Basic model used in the study:- Fiscal Response Model (FRM)
- 3. Selection of Variables of the study:- based on FRM
- 4. Method of analysis:- FRM in VAR framework
- 5. Tools used in VAR model:-
 - 1. Standard VAR model
 - 2. VEC model
 - 3. Impulse response model

6. Description of method of analysis:-

$$ODA = \text{grants} + \text{foreign loans}$$

 see page 1-5 of the study

- ➡ As ODA is much larger than the sum of grants and foreign loans recorded in government budgetary operations, the set of variables no longer form a budgetary identify.
- ➡ To see the individual effects of each variable, and to save degrees of freedom 3 separate VAR models are estimated.

6.1 Model I is intended to show the fiscal effects of grant and includes grant, tax, domestic borrowing, capital expenditure and recurrent expenditure.

- ➡ All the tools of VAR model i.e. standard VAR model, VEC models and impulse response are used in the analysis.

6.2 Model II is intended to show the fiscal effects of foreign loans, and includes foreign loan, tax, domestic borrowing, capital expenditure and recurrent expenditure.

- ➡ All the tools of VAR model i.e. Standard VAR model, VEC models and impulse response are used in the analysis.

6.3 Model III is intended to show the fiscal effects of ODA, ODA contains substantial volumes of aid that are off budget and modeling the effect of ODA may reveal something about the effects of off budgetary aid on the budget and includes:-

ODA, tax, domestic borrowing, capital expenditure and recurrent expenditure.

- ➡ All the tools of VAR model i.e. standard VAR model, VEC model and impulse response are used in the analysis.

Annex 4 Impulse Response

Simple two variable first order VAR is useful for illustrating the multivariate higher order systems. In the two variables case, we can let the time path of (Y_t) be affected by current and past realizations of the (Z_t) sequences and let the time path of the Z_t sequence be affected by current and past realizations of the (Y_t) sequence. Consider the simple bivariate system.

$$Y_t = b_{10} - b_{12}Z_t + \alpha_{11}Y_{t-1} + \alpha_{12}Z_{t-1} + E_{yt} \quad (4.5.1)$$

$$Z_t = b_{20} - b_{21}Y_t + \alpha_{21}Y_{t-1} + \alpha_{22}Z_{t-1} + E_{zt} \quad (4.5.2)$$

Where it is assumed:-

- ➡ Both Y_t and Z_t are stationary
- ➡ E_{yt} and E_{zt} are white noise disturbance with standard deviations σ_y and σ_z , respectively.
- ➡ (E_{yt}) and (E_{zt}) are uncorrelated white noise disturbances. Equations 4.5.1 and 4.5.2 constitute a first order vector autoregression (VAR) since the longest lag length is unity.

The structure of the system incorporates feed back since Y_t and Z_t are allowed to affect each other.

Equations 4.5.1 and 4.5.2 are not reduced form equations since Y_t has a contemporaneous effect on Z_t and Z_t has a contemporaneous effect on Y_t . Fortunately, it is possible to transform the system of equations in to a more useable form. Using matrix algebra, we can write the system in the compact form.

$$\begin{pmatrix} 1 & b_{12} \\ b_{12} & 1 \end{pmatrix} \begin{pmatrix} Y_t \\ Z_t \end{pmatrix} = \begin{pmatrix} b_{10} \\ b_{20} \end{pmatrix} + \begin{pmatrix} \alpha_{11} & \alpha_{12} \\ \alpha_{21} & \alpha_{22} \end{pmatrix} \begin{pmatrix} Y_{t-1} \\ Z_{t-1} \end{pmatrix} + \begin{pmatrix} E_{yt} \\ E_{zt} \end{pmatrix}$$

$$\text{Or } BX_t = \Gamma_0 + \Gamma_1 X_{t-1} + E_t$$

$$\text{Where } B = \begin{pmatrix} 1 & b_{12} \\ b_{21} & 1 \end{pmatrix} \quad X_t = \begin{pmatrix} Y_t \\ Z_t \end{pmatrix} \quad \Gamma_0 = \begin{pmatrix} b_{10} \\ b_{20} \end{pmatrix}$$

$$\Gamma_1 = \begin{pmatrix} \alpha_{11} & \alpha_{12} \\ \alpha_{21} & \alpha_{22} \end{pmatrix} \quad E_t = \begin{pmatrix} E_{yt} \\ E_{zt} \end{pmatrix}$$

Pre-multiplication by B^{-1} allows us to obtain the vector auto regressive (VAR) model in Standard form.

$$X_t = A_0 + A_1 X_{t-1} + e_t \quad (4.5.3)$$

$$\text{Where } A_0 = B^{-1} \Gamma_0 \quad A_1 = B^{-1} \Gamma_1$$

$$e_t = B^{-1} E_t$$

We can rewrite 4.5.3

$$Y_t = a_{10} + a_{11} Y_{t-1} + a_{12} Z_{t-1} + e_{1t} \quad (4.5.4)$$

$$Z_t = a_{20} + a_{21} Y_{t-1} + a_{22} Z_{t-1} + e_{2t} \quad (4.5.5)$$

Equations 4.5.1 & 4.5.2 are called structural VAR and 4.5.4 & 4.5.5 are called VAR in standard form.

It is important to note the error correction terms e_{1t} & e_{2t}

$$e_t = B^{-1} E_t$$

$$= \begin{bmatrix} 1 / (1 - b_{12} b_{21}) & \begin{bmatrix} 1 & -b_{12} \\ -b_{21} & 1 \end{bmatrix} & \begin{bmatrix} E_{yt} \\ E_{zt} \end{bmatrix} \end{bmatrix}$$

$$e_{1t} = (E_{yt} - b_{12} E_{zt}) / (1 - b_{12} b_{21}) \quad (4.5.6)$$

$$e_{2t} = (E_{zt} - b_{21} E_{yt}) / (1 - b_{12} b_{21}) \quad (4.5.7)$$

Since E_{yt} and E_{zt} are white noise processes, it follows that both e_{1t} and e_{2t} have zero means, constant variances, and individually serially uncorrelated. A critical point to note is that e_{1t} and e_{2t} are correlated. In the especial case where $b_{12} = b_{21} = 0$ (i.e. there are no contemporaneous effects of y_t on z_t and z_t on y_t) the shocks will be uncorrelated.

Just as an autoregression has a moving average representation, a vector autoregression can be written as a vector moving average (VMA), a vector moving average representation of 4.5.3 is

$$X_t = \mu + \sum_{i=0}^{\infty} A_1^i e_{t-1} \text{ -----} \quad (4.5.8)$$

$$\text{Where } \mu = (\bar{Y} \bar{Z})'$$

In this case the variables (i.e y_t and z_t) are expressed in terms of the current and past values of the two types of shocks (i.e e_{1t} & e_{2t}) it allows to trace out the time path of the various shocks on the variables contained in the VAR system.

For illustrative purposes 4.5.4 & 4.5.5. in matrix form

$$\begin{pmatrix} Y_t \\ Z_t \end{pmatrix} = \begin{pmatrix} a_{10} \\ a_{20} \end{pmatrix} + \begin{pmatrix} a_{11} & a_{12} \\ a_{21} & a_{22} \end{pmatrix} \begin{pmatrix} Y_{t-1} \\ Z_{t-1} \end{pmatrix} + \begin{pmatrix} e_{yt} \\ e_{zt} \end{pmatrix} \quad (4.5.9)$$

Or using 4.5.8

$$\begin{pmatrix} Y_t \\ Z_t \end{pmatrix} = \begin{pmatrix} \bar{Y} \\ \bar{Z} \end{pmatrix} + \sum_{i=0}^{\infty} \begin{pmatrix} a_{11} & a_{12} \\ a_{21} & a_{22} \end{pmatrix}^i \begin{pmatrix} e_{1t-i} \\ e_{2t-i} \end{pmatrix}$$

Equation 4.6.0 expresses y_t and z_t in terms of the e_{1t} and e_{2t} sequences. However it is insightful to write 4.6.0 in terms of the (E_{yt}) and (E_{zt}) sequences.

From 4.5.6 & 4.5.7 the vector errors can be written as

$$\begin{pmatrix} e_{1t} \\ e_{2t} \end{pmatrix} = \begin{pmatrix} 1 / (1 - b_{12}b_{21}) \\ 1 / (1 - b_{12}b_{21}) \end{pmatrix} \begin{pmatrix} 1 & -b_{12} \\ -b_{21} & 1 \end{pmatrix} \begin{pmatrix} E_{yt} \\ E_{zt} \end{pmatrix} \quad 4.6.1$$

So that 4.6.0 & 4.6.1 can be combined to form

$$\begin{pmatrix} Y_t \\ Z_t \end{pmatrix} = \begin{pmatrix} \bar{Y} \\ \bar{Z} \end{pmatrix} + \begin{pmatrix} 1 / (1 - b_{12}b_{21}) \\ 1 / (1 - b_{12}b_{21}) \end{pmatrix} \sum_{i=0}^{\infty} \begin{pmatrix} a_{11} & a_{12} \\ a_{21} & a_{22} \end{pmatrix}^i \begin{pmatrix} 1 & -b_{12} \\ -b_{21} & 1 \end{pmatrix} \begin{pmatrix} E_{yt} \\ E_{zt} \end{pmatrix}$$

We can simplify the notation by defining the 2X2 matrix ϕ with elements $\phi_{jk}^{(i)}$:

$$\phi_i = \begin{pmatrix} A_{11}^i / (1 - b_{12}b_{21}) & A_{12}^i / (1 - b_{12}b_{21}) \\ A_{21}^i / (1 - b_{12}b_{21}) & A_{22}^i / (1 - b_{12}b_{21}) \end{pmatrix} \begin{pmatrix} 1 & -b_{12} \\ -b_{21} & 1 \end{pmatrix}$$

Or more compactly

$$X_t = \mu + \sum_{i=0}^{\infty} \phi_i E_{t-i}$$

The coefficients of ϕ_i can be used to generate the effects of E_{yt} and E_{zt} shocks on the entire time paths of the y_t & z_t sequences, it should be clear that elements of ϕ_{jk} are impact multipliers that means ϕ_{ij} are the one period responses of unit changes in E_{t-i} updating by one period indicates that ϕ_{ij} also represent the effects of unit changes in E_{yt} & E_{zt} on y_{t+1} . The accumulated effects of unit impulses in E_{yt} and or E_{zt} can be obtained by the appropriate summation of the coefficients of the impulse response functions.

Letting n approach infinity yields the long run multiplier. Since the (y_t) and (z_t) sequences are assumed to be stationary, it must be the case that for all j & k .

$$\sum_{i=0}^{\infty} \phi_{jk}^2(i) \text{ is finite}$$

Plotting the impulse response functions:-

Plotting the coefficients of $\phi_{jk}(i)$ against time (t) is a practical way to visually represent the behaviour of the (y_t) and (z_t) series in response to the various shocks.

(the discussion is taken from Enders, 1996).

Declaration

I the undersigned, declare that this thesis is my own work and has never been presented in any other university. All source of materials used for this thesis have been duly acknowledged.

Declared by:

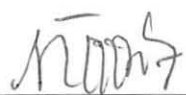
Name **Berhanu Alemu**

Signature 

Date 30/3/07

Confirmed by Advisor:

Name **Professor Teshome Mulat**

Signature 

Date 30/3/07

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