African Journal of Applied Research
Vol. 3, No. 2 (2017), pp. 1-14
http://www.ajaronline.com

MACROECONOMIC EFFECTS OF FOREIGN AIDS ON POVERTY LEVEL IN NIGERIA

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ABSTRACT

This study examines the effect of foreign aids on poverty level in Nigeria using Autoregressive Distributed Lag (ARDL) approach. Data spanned from 1980-2015 were sourced from World Bank development indicators, Central Bank of Nigeria Statistical Bulletin and National Bureau of Statistics. From the ARDL Bound test approach to co-integration, the result of the study showed that foreign aids help in reducing poverty, but does not have a significant effect on the level of poverty in Nigeria. The study therefore argued that foreign aids could be effective in Nigeria if multilateral and multidimensional aids system were adopted which should be directed to different areas in the Nigerian economy. Also, proper care and monitoring needs to be put in place in order to checkmate any attempt for corruption especially in a situation where private individuals would divert foreign aids to solve private needs.

Keywords: *poverty, foreign aids, Nigeria, ARDL/bound test*

1.0 INTRODUCTION

Foreign aid is conventionally defined by the Development Assistance Committee (DAC), as the financial flows, technical assistance and commodities that are designed to promote the welfare of the citizens, the growth of the economy and to induce more rapid convergence between the developed and the developing economies through grants or subsidized loans from the government sector of a donor country to a developing economy. Historically, most aid has been given as bilateral assistance: directly from one country to another. In another form, donors also provide aid indirectly as multilateral assistance, involving the process of pooling resources together from many donors. At the level of multilateral assistance are major multilateral institutions such as the World Bank, the International Monetary Fund, the African, Asian, and Inter-American Development Banks, and various United Nations agencies like the United Nations Development Programme.

ISSN: 2408-7920

Foreign aid is intended to have beneficial macroeconomic effects; most notably to raise a country's rate of growth and reduce poverty. Gunning (2005) posed the question 'why give aid'? He argued that the question is about the aims behind giving aid from the point of view of the donors. Whether a country gets aid depends not so much on its needs and policies (is the country poor? or has it adopted 'good' policies?) but on political and strategic considerations such as the country's colonial past and it's voting behaviour in the United Nations by the would-be donors. However, beyond this possible justification for giving aid, donors have a variety of motivations for providing aid. While some are directly related to achieving macroeconomic objectives such as poverty reduction, others are based on political, economic and foreign policy factors among other things as the rationale for giving aid.

Meanwhile, foreign policy and political relationships have been mostly accepted as the important determinants of aid flows. Little wonder that countries such as the United States and the Soviet Union gave aid to support developing countries with little regard as to whether the aid actually was used to support development during the Cold War. Evidence shows that the two largest recipients of U.S. foreign aid (including both OA and ODA) from 1980 until very recently were Israel and Egypt. This was sequel to the decision of the U.S. to provide financial support to back the 1979 Camp David peace agreement. Most developed countries who were formerly colonial masters provide significant aid to their former colonies as a means of retaining some political influence (Alesina and Dollar, 2000). Afghanistan, Israel and Iraq became the largest recipients of foreign aid from US in recent years on the basis of military and economic needs (U.S. Bureau of Census International Database). Beyond the political and economic rationale for giving aid, it is widely believed that the main rationale for aid is the need to fight poverty.

Evidence abounds to suggest that donors often provide most concessional aid to the poorest countries, and some aid programs are put in place explicitly with this objective in mind. For example, the World Bank's concessional financing arm; the International Development Association (IDA) has an income ceiling ($965 per capita in 2004). Once countries reach that ceiling, in most cases they graduate from IDA to non-concessional IBRD loans. Size of the country is another reason why aid is given. Unexpectedly, some small countries receive very large amounts, though politically motivated reasons. For political reasons, donors generally

ISSN: 2408-7920

want to influence as many countries as possible, which tend to lead to a disproportionate amount of aid going to small countries. Some countries with large size such as Bangladesh, Indonesia, Nigeria, and Pakistan receive relatively small amounts of aid on a per capita basis, despite the prevalence of hundreds of millions of people living in poverty in these countries. By contrast, many donors "tie" portions of their aid by requiring that certain goods and services be purchased from firms in the donor's home country, or that it should be used for specific purposes that support groups in the donor countries (such as universities or business consulting firms). For instance, U.S. requires that food aid be purchased in the U.S. and shipped in U.S. carriers to recipient countries. Whatever be the immediate rationale behind aid giving, the overall aim is to promote development. Hence, this study intends to evaluate the effectiveness of aid in reducing poverty using the case of Nigeria.

2.0 LITERAURE REVIEW

Growing disparity between the developed countries and developing countries is largely notable despite decades of massive inflow of foreign aid to developing countries especially in Nigeria. This has resulted in many studies in the empirical literature on the effectiveness of foreign aid in achieving its main objectives such as: promotion of economic growth, poverty alleviation and welfare in developing countries. Over the years there had been an increase in aid flows from developed to developing countries, though with a lot of controversy over the effectiveness of aid (Lesink and White, 2000).

Nevertheless, different positions could be identified from the literature. The first position is that foreign aid will have positive impact on growth and development, if certain conditions or policies are inherently put in place. Such policies such as right monetary and fiscal policies are said to be capable of enhancing effectiveness of foreign aid, if it is judiciously used and could also make aid non- impactful on growth and development, if it is not put in the right direction. Burnside and Dollar (1997) examines the interaction between aid and policies that promotes growth in a neoclassical growth framework. They draw on the recent empirical growth literature to incorporate a range of institutional and policy distortions that have been found to help explain the growth performance of poor countries using panel OLS for 40 low income and 16 middle-income countries from 1970-73 to 1990-93. They find that aid has a positive impact on growth in developing countries with good fiscal, monetary and trade

ISSN: 2408-7920

policies, but has little impact on countries where such policies are poor. The position of Burnside and Dollar (1997) was corroborated by the findings of Tsikata (1998) who found that aid has had positive effects where the policy environment has been conducive to growth.

Similarly, Durbarry, et al (1998) assesses the impact of foreign aid on growth for a large sample of developing countries. Using an augmented Fischer-Easterly type model, in which macroeconomic and policy variables in addition to foreign aid and other (domestic and foreign) source of investment are allowed to affect long-run growth rates. The results strongly support the view that foreign aid does have some positive impact on growth. This is conditional on a stable macroeconomic policy environment as argued by the earlier studies. The authors' findings went further than the earlier works and find that effects of aid comparatively vary according to income level, levels of aid allocation and geographical location.

Another study by Burnside and Dollar (2000) confirm their earlier position. Using a panel of fifty-six countries between 1970 and 1993, the study concluded that aid is effective only in countries where the "quality" of policies is high. That is, foreign aid has positive effect only in economies in which it is combined with good fiscal, monetary and trade policies, but that aid itself does not play a role in producing policies. The authors argued that reallocating aid toward countries with "good" policies would result in a substantial improvement in those countries' growth performance.

In a more related study, Guillaumont and Chauvet (2004) find that aid effectiveness: (i) positively depends on the quality of present economic policies, but also negatively depends on the quality of past economic policies, suggesting that the greater the prospects of policy improvements, the more effective aid will be; (ii) negatively depends on internal political instability; (iii) positively depends on external economic and political shocks, suggesting that aid can dampen the negative impact of these shocks on economic growth.

Collier and Dollar (2002) in their study argued that positive impacts of aid on economic growth is not subject to diminishing return, though use the World Bank's Country Policy and Institutional Assessment (CPIA) index as a measure of conditions upon which effectiveness of aid depends. Similar to this argument is the claim that objectives and the kinds of aid

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determine its effectiveness (see the works of Masud and Yontcheva. 2005, Minoiu and Reddy 2007, Mishra and Newhouse 2007).

On the relationship between foreign aid and increasing poverty level in developing countries, Ijaiya and Ijaiya (2004) use cross-country data to specifically examine the relationship between foreign aid and poverty reduction in Sub-Saharan Africa. The result obtained shows that foreign aid has no significant influence on poverty reduction in Sub-Saharan Africa because of the countries weak economic management evidenced by high levels of corruption, bad governance, political and economic instability. Contrary to Ijaiya and Ijaiya (2004), Abiola and Olofin (2008), argued that food supply and multilateral aid supply can help reverse poverty trend in Nigeria. However, the confidence in conclusions of the earlier studies that aid promotes growth in countries with sound policies was watered down by the findings of Easterly, Levine and Roodman (2004). They argued that economists and policymakers should be less sanguine about concluding that foreign aid will boost growth in countries with good policies.

Another line of argument is the position that aid always have positive impacts on growth and that such positive impacts are not conditional on certain policies indexes. Hansen and Tarp (2000) differ from the previous works. They examine the relationship between foreign aid and growth in real GDP per capita as it emerges from simple augmentations of popular cross-country growth specifications. The authors claim that, it is premature to rely on policy indexes, such as the one proposed by Burnside-Dollar, in the allocation of aid. It is shown that aid in all likelihood increases the growth rate, and this result is not conditional on 'good' policy. This position was also supported by the findings of Dalgaard, et al (2004) who argued that aid in general is growth promoting. However, their findings differ away from the work of Hansen and Tarp (2000) who argued that though, aid will always be effective in general but find evidence that aid has been less effective in countries located in tropical areas and concluded that size and direction of the impacts may depend on policies, 'deep' structural characteristics and the size of the inflow.

Kurihara (2014) examined the relationship between foreign aid, international trade and economic growth in developing countries for the period 1985 – 2012. The data collected were regressed on each country and the results showed that international trade rather than foreign aid is more effective to impact economic growth in many of the countries. Although, we cannot conclude that foreign aid is not necessary in case of emergency, but it is sometimes

ISSN: 2408-7920

regarded as been too much or wasted on some recipient governments. The study further examined the effect of aid on economic growth with aggregate data using vector autoregressive analysis. The result further confirmed that openness impact significantly on economic growth than foreign aid. The study then concluded that too much dependence on foreign aid should be avoided for sound and sustainable economic growth.

Moreira (2005) examined a large panel data set, as an attempt to achieve greater accuracy and improve upon existing procedures which were viewed as possible causes of ambiguous macro results underlying the "micro-macro paradox". The findings support the claim that foreign aid has a positive impact on economic growth of developing countries. He argued further that less importance should be attributed to the "micro-macro paradox" as an overall appraisal of aid effectiveness and time-lag in the aid-growth relationship should not be ignored.

Kargbo (2012) examined the impact of foreign aid on economic growth in Sierra Leone using a triangulation of approaches involving the ARDL bounds test approach and the Johansen maximum likelihood approach to cointegration for the period 1970-2007. The study found that foreign aid has a significant contribution in promoting economic growth in the country. This finding is found to be robust across approaches and specifications. While aid may have been associated with improvement in economic growth in the country, its impact during the period of war is found to be either weak or non-existent. Furthermore, aid during the pre-war period is found to be marginally more effective than aid during the post-war period. The latter results suggest that the impact of aid may change with time.

Another position in the literature is that aid has negative impacts on economic growth. Meanwhile, the theoretical rationale behind this is that aid substitutes for, rather than supplementing, domestic savings and investments and by exacerbating LDC balance of payments deficits as a result of rising debt repayments obligations and the linking of aid to donor-country exports. Another theoretical position against foreign aid is that, it focuses on stimulating growth in modern sector, thereby increasing the income gaps between the rich and the poor. Critics of foreign aid argued that it retards growth through reduced savings and worsening income inequalities.

Another position that could be found in the literature is that aid does not have any effect, be it negative or positive on the economic growth. Rajan and Subramanian (2005) supports this position and find little robust evidence of a positive (or negative) relationship between aid

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inflows into a country and its economic growth. Similar to this position is the argument that aid does have mixed effects on the economy of the developing countries. This position was supported by the findings of Ekanayake and Chatrna (2008). Using annual data on a group of 85 developing countries covering Asian, Africa, Latin America and the Caribbean for the period1980-2007, the results indicated that foreign aid has mixed effects on economic growth in developing countries. The variable used was positive for the African region indicating that foreign aid has a positive effect on economic growth in African countries. The foregoing shows that little attentions have been given to foreign aid-poverty nexus, while much attention is given to foreign aid- growth nexus. Using Nigeria situation, this study intends to examine the effect of foreign aids on poverty in Nigeria.

3.0 RESEARCH METHODOLOGY

Sources of Data and Model specification

For the purpose of examining the effect of foreign aid on poverty, we employed secondary data sourced from World Bank Development indicators and Central Bank of Nigeria. Data spanned from 1980-2015 were utilised for the study. Based on previous literature and various arguments on the determinants of poverty reduction, we specify that

$$Poverty\ reduction = F(Foreign\ aids, control\ variables) \quad (1)$$

Previous studies in the literature provide determinants of poverty to include growth, financial development, exchange rate among others (Olofin, 2013; Woldekidan, 2015). Therefore, we control for the level of economic growth, financial development and exchange rate in our model as re-specified in equation 2.

$$Pv = f(faid, fd, er, gr) \quad (2)$$

Where *pv* is the poverty, *faid* is foreign aids, *fd* is financial development, *er* is the exchange rate, and *gr* is growth rate. In specific form, we transform equation (2) and adopt autoregressive distributed lag (ARDL) framework by Pesaran and Shin (1995, 1999), Pesaran *et al.* (1996) and Pesaran (1997). The ARDL approach to cointegration is applicable in testing the relationship between foreign aid and poverty irrespective of whether the variables are purely I(0), purely I(1) or mixture of both. Fundamentally, the ARDL approach to cointegration of Pesaran, Shin & Smith, 2001 involves estimating the conditional error correction version of the ARDL model for poverty and its relative determinants such as foreign aids, financial development exchange rate and economic growth. This is as specified in equation 3.

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$$\Delta PV_t = \propto_0 + \sum_{i=1}^{k} \prod_i \Delta PV_{t-i} + \sum_{i=0}^{k} \gamma_i \Delta \text{faid}_{t-i} + \sum_{i=0}^{k} \theta_i \, \Delta fd_{t-i} + \sum_{i=0}^{k} \psi_i \, \Delta er_{t-i} + \sum_{i=0}^{k} \delta_i \, \Delta gr_{t-i} + \alpha_1 pv_{t-1} + \alpha_2 faid_{t-1} + \alpha_3 fd_{t-1} + \alpha_4 gr_{t-1} + \alpha_5 er_{t-1} + \epsilon_t \quad (3)$$

Where Δ is first-difference operator and ***k*** is the optimal lag length of poverty***(PV),*** foreign aids ***(faid),*** financial development ***(fd),*** exchange rate (***er***) and economic growth (***gr***) while ε_t is the white noise which is used to capture other factors that can affect poverty that are not accounted for in the study. In testing for the existence of long-run relationship between the variables, the null hypothesis of no cointegration among variables in equation (3) is specified thus: H_0: $\alpha_1 = \alpha_2 = \alpha_3 = \alpha_4 = \alpha_5 = 0$ against the alternative hypothesis H_1: $\alpha_1 \neq \alpha_2 \neq \alpha_3 \neq \alpha_4 \neq \alpha_5 \neq 0$. Given a relatively small sample size in this study of 34 observations, the critical values used are as reported by Narayan (2004). The test involves asymptotic critical value bounds, depending whether the variables are I(0) or I(1) or a mixture of both. Two sets of critical values are generated, in which one set refers to the I(1) series and the other for the I(0) series. Critical values for the I(1) series are referred to as *upper* bound critical values, while the critical values for I(0) series are referred to as the *lower* bound critical values. If the *F* test statistic exceeds their respective upper critical values, we can conclude that there is evidence of a long-run relationship between the variables regardless of the order of integration of the variables. If the test statistic is below the upper critical value, we cannot reject the null hypothesis of no cointegration and if it lies between the bounds, a conclusive inference cannot be made without knowing the order of integration of the underlying regressors. Therefore, if the results show the existence of co-integration, we can then proceed to estimate the Error correction model (Pesaran et al, 2001). The essence of error correction model is to show the speed of adjustment back to long run equilibrium after shock.

Variables Measurements

Data on foreign aid, agriculture value added per worker, life expectancy at birth, gross domestic product per capita, real gross domestic product, inflation rate and exchange rate were sourced from World Bank Development Indicator Database (2015).Moreover, poverty

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index (PV) was generated through the help of Principal Component Analysis (PCA) from the frequently used proxies for poverty, which include Per capita consumption, agriculture value added per worker, life expectancy at birth, and gross domestic product per capita while economic growth was measured as the growth rate of gross domestic products per capita. Also, we measure foreign aids as the natural log of foreign aids flows into Nigeria, financial development is proxied using natural log of $^{M_2}/_{GDP}$, while exchange rate is the real exchange rate.

4.0 RESULTS AND DISCUSSION

Table 1 show the unit root results of the variables after conducting Augmented Dickey-Fuller (ADF) test. This pre-test is necessary to know the properties of the variables and to further determine if the methodology adopted is appropriate for the study. It could be observed from table 1 that all the variables are stationary at first differencing.

Table 1: Unit Root test results

Variables	ADF Statistics	Critical value @ 5%	Remarks
PV	-7.6406	-2.954021	I(1)
Faid	-5.8659	-2.95711	I(1)
Fd	-3.196 2	-2.963972	I(1)
Er	-5.1961	-2.954021	I(1)
Gr	-3.3787	-2.954021	I(1)

Source: Authors computation from E-views

Since all the variables are stationary at first differencing, we proceed to test for the existence of long run relationship among the variables. The result of the co-integration using bound test is reported in Table 2. The result of the bound test showed that it is inconclusive since the F-statistic of 3.048031 falls between the upper bound and lower bound at 10% and even at 5%.

Table 2: Bound test with Critical Value Bounds

Significance	I(0) Bound	I(1) Bound
10%	2.45	3.52
5%	2.86	4.01
2.5%	3.25	4.49
1%	3.74	5.06
Null Hypothesis: No long-run relationships exist		
F = 3.048031 K = 4		

Source: Authors result obtained from E-views

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Since the F-statistic falls between the lower bound and the upper bound of the critical value, the study further confirm the evidence of long run relationship among the variables using the coefficient of error correction (CointEq(-1)) and its significant level as reported in Table 3. In Table 3, the coefficient of CointEq(-1) is negatively signed and significant at 1% level of significance which shows the existence of convergence among the variables.

Table 3: Result of the effect of foreign aid on poverty

Dependent Variable (PV)				
Selected Model: ARDL (1, 0, 0, 0, 0), ARDL				
Cointegrating Form (Short Run Coefficients)				
Variable	Coefficient	Standard Error	t-Statistic	Prob. Value
D(faid)	-0.02656	0.03489	-0.76118	0.4529
D(gr)	0.106593	0.16332	0.652665	0.5193
D(fd)	-0.00241	0.00891	-0.27097	0.7884
D(er)	0.00099	0.001017	0.974082	0.3384
CointEq(-1)	-0.39858	0.11398	-3.49696	0.0016

Table 4: Long Run coefficients

Variable	Coefficient	Standard Error	t-Statistic	Prob. Value
Faid	-0.06663	0.89742	-0.74245	0.464
Gr	0.26743	0.412053	0.649017	0.5216
Fd	0.00606	0.02266	-0.26731	0.7912
Er	0.00099	0.002556	0.971916	0.3394
C	4.566218	3.246725	1.406407	0.1706

Source: Authors result obtained from E-views

A divergence among the variables in the previous year can be resolved in the current year with the rate of convergence of about 40%.

Looking at the short run coefficients, the result confirmed that there is negative relationship between foreign aids and poverty reduction but not significant after controlling for growth, financial development and exchange rate. This implies that as foreign aids flows into the Nigerian economy, it has the tendency of reducing poverty but not as effective as expected. The long run coefficient as shown in table 4 also confirms this assertion. This confirmation could be attributed to the level of corruption in the system because some high profile individuals can divert the aid into private use or there insufficient foreign aid flows into the economy from abroad. This claim further buttress the findings of Ijaiya and Ijaiya (2004) who provide evidence that foreign aid has no significant influence on poverty reduction is

ISSN: 2408-7920

Sub-Saharan Africa because of the countries weak economic management evidenced by high levels of corruption, bad governance, political and economic instability.

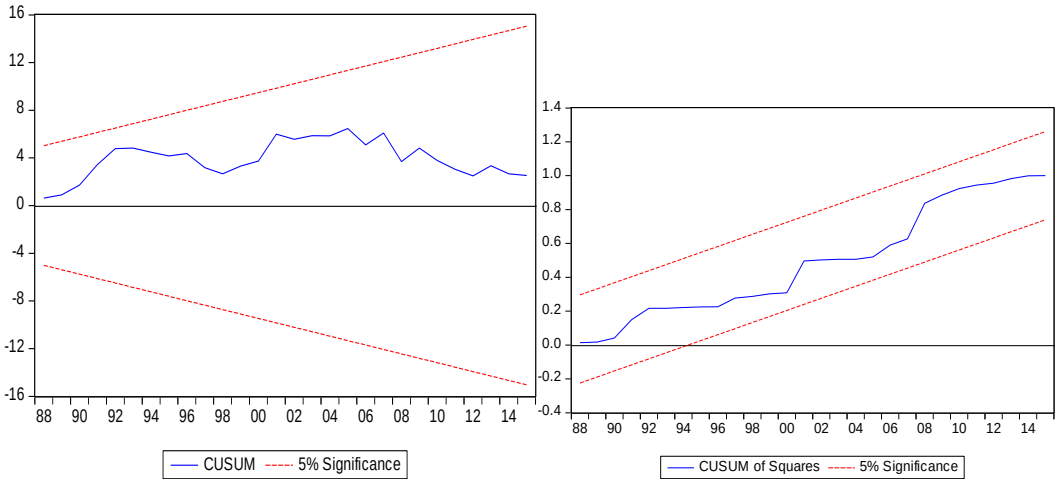

Fig. 1: CUSUM test and CUSUM of Squares Test

Table 5: Diagnostic Tests

B-G(Serial Correlation, LM Test)
F-stat.=1.993033(prob. Val=0.1566)
B-P-G(Heteroskedasticity Test)
F-stat=0.502710(Prob. Val=0.7716)

Series of diagnostic tests were performed as reported in Table 5. The results pass serial correlation test and heteroskedasticity test. Also stability test was performed on the model as reported in Figure 1. It is very clear from the figure that the model is stable since the blue line in both the cusum and cusum of squares test lies between the red lines.

5.0 CONCLUSION

This study investigated the relationship that existed between foreign aid and poverty in Nigeria for the period 1980 – 2015 in both the short run and the long run. This is done in order to determine if foreign aid has been effective in alleviating poverty in the country. The study employed Autoregressive Distributed Lag (ARDL) to cointegration (bound testing) approach. The result of the study showed that foreign aid does not significantly influence the level of poverty in Nigeria, though it helps in reducing it. The study therefore concluded that foreign aids giving to the country are not effective in alleviating poverty as expected based on

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the results obtained from the analysis. This may be as a result of the high level of corruption in the country. Also, some of the funds might have been diverted by some individuals for private use. The study therefore recommended that foreign aid to the country should be in terms of economic aid to support education and training skills rather than political aids which may not benefit majority of the population.

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ISSN: 2408-7920