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RESEARCH ARTICLE

THE RELATIONSHIP BETWEEN GOVERNANCE AND ECONOMIC GROWTH

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ABSTRACT

Using time serious data of forty Ethiopia spanning over 15 years this paper analyzes the relationship between governance and economic growth in Ethiopia. The descriptive result showed that the country achieved mixed result some dimension of governance improved while the other deteriorated like freedom of press and freedom of expression. In general the country performance showed it is below the African average. Moreover, consistent with most recent empirical works, the study found that good governance has significant direct impact on growth over the time under consideration. It was found that improvement in good governance has highly significant effect on the growth. Similarly, labor force growth is also significant positive effect on the recent growth. While the other variables like government education expenditure, openness and foreign direct investment were found to have no statistically significant effect on economic growth in Ethiopia. Thus, the government has to improve the governance at all dimension to benefited out of it.

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INTRODUCTION

African states are very weak as compared to any other developing countries. Rice and Patrick (2008), defined weak states as countries that lack the essential capacity (i.e. good governance) or lack to fulfill four set of critical governmental responsibilities: fostering an environment conducive for sustainable and equitable economic growth; establishing and maintaining legitimacy, transparent and accountable political institutions; securing their population from violent conflict and controlling their territory and meeting the basic human needs of their population.In economic growth literature the factors for most developing countries underperformance ranges from macroeconomic variables to the poor performance in their governance and the quality of political leaders.The formal political institutions are so young and most countries lack a tradition of mass political participation; and the political regimes are characterized by authoritarian structures in which the interest of majority cannot be taken into account within a pluralist regime and still the issue of democracy is a national agenda in most part of African countries including Ethiopia (Olukashi 2001; Malik, 2002; Ndulu and Connell, 1999). Governance play an important role in economic development and in growth processes. New institutional economists such as North (1995) consider the role of good governance as market enhancing. Good governance make economic environment more conducive and enable the market to function very well. As a constraint it also restricts the activities of states to the provision of necessary public goods to minimize rent seeking and government failure. There are common views among scholars regarding good governance role as an important determinant of economic growth and growth difference across countries. But there is disagreement on whether good governance comes first over the other determinants. The first category of scholars give good governance prior factor that explain economic growth, while others refute the supremacy of good governance over the other factors. In this connection, Sachs *et al*. (2004, 2005), Sachs (2002) and Gunalanch and Hartmann (2007) reject this hypothesis of supremacy of good governance for most developing countries by arguing that governance level in African continent was not worse than other countries at comparable level of per capita income. Even after controlling for governance the continent performs poorly and they conclude that Africa has other specific developmental problem and it needs a big push in its major service sector to come out of poverty trap. However, others found that good governance was first-order determinant of economic growth in developing countries like Ethiopia. For example, Acemoglu *et al*. (2000) found that good governance differences explain three-quarter income per capita difference across different countries in Africa. Cooray (2008), Easterly (2006), Bates and Nukurnziza (2003), Kaufmann and Kraay (2003) and Decker and Lim (2008) also support the supremacy of good governance hypothesis. They found governance to have strong positive impact on growth and recommend that developing countries need to improve their governance level. Ethiopia government undertook a series of policy reforms to achieve different developmental goals. Following this, some success

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has been observed in different sectors of the economy, which contributed to overall economic growth. In spite of the high levels of Ethiopia's growth, most of the people live in poverty. This indicated that Economic growth is not sufficient to end poverty or to benefit all people and reduce inequality. Growth must accompany with proper redistribution of its benefits to all sections of the society. In other words, to ensure SDGs achievement, both growth and inclusive benefits should also be targeted simultaneously (FAO, 2014a, b). Despite considerable efforts to combat poverty and inequality via growth these problems are continuing to be the main economic and social problems for the country.

In spite of the aforementioned levels of Ethiopia's growth, some communities of practice are still asking the question: "whether the growth attributed to good governance or other proximit causes of growth?" This is as much an ongoing debate as it is a controversial issue in recent literature. Indeed, the effectiveness of different policies and strategies are inconclusive in this regard. Studies are also scanty in this regard.The empirical study in this regard is very few in Ethiopia. In this connection, this paper focuses on governance factor and examines relationship with economic growth in Ethiopia. Studying the fundamental factors is important to understand economic growth of the country. In the words of Acemoglu (2008), "if part of our study of economic growth is motivated by improving the growth performance of certain nation and living standards of their citizen, understanding fundamental sources of growth is central to this objective". Focusing on the good governance does not mean that the other factors included in growth theories are unimportant in explaining economic growth of such country.

Related Literature

Theories of Growth

Most of growth analysis started in the neoclassical growth model of Solow (1956), which is based on Cobb-Douglas aggregate production function that relates output to capital input, labor input and a state of technology . The Solow growth model assumes closed economy with perfect competition in the market but ignores the public sector. Furthermore, technical progress, population growth and saving rates were assumed to be exogenously determined in the model. Using these proximate causes of growth it analyzes the growth process and variation of growth across countries and predicts convergence among nations. The model predicts that a country that has higher saving rate should have higher level of income per capita and that has higher population growth should have lower level of income per capita. Technological progress, which is exogenously given, is considered as the driving force of growth in this model. The long-run growth only depends on technological progress and growth from other factors is only temporary. The model also predicts income variation across countries. As explained in Romer (1996), it identifies two possible sources of variation, i.e., either over time or across part of the world in output per worker. This looks into differences in capital per worker and difference in effectiveness of labor. However, the only difference in effective unit of labor leads to permanent growth in output per worker. The other important prediction of the Solow model is the *convergence hypothesis*, in which countries that have equal steady state parameter, i.e., population growth rate, rate of depreciation, saving rate, rate of technological change and technological level should converge in their economic growth (Valdase, 1999). Though some of the model's predictions were consistent with empirical data and compatible with some of stylized facts of growth, some did not tally with the facts. Mankiw *et al*. (1992) argue that the relationship among variables are stronger than the prediction of Solow model and they further argue that the model did not account for important features of cross country income differences observed today. They strongly argue that cross countries income variations and growth are more consistent with the standard Solow growth model after the inclusions of human capital in the model. As a result, they developed human capital augmented neoclassical production function. Empirically Mankiw *et al*. (1992) tested augmented Solow growth model and found that the model accounts for 80% of cross-country income variation and they concluded that augmented Solow model provides a complete explanation of why some countries are richer than others. In human capital-augmented neoclassical growth model the steady state growth of per capita income depends on the rate of human capital investment. Unlike the neoclassical growth model the New (endogenous) growth models assume growth as endogenous outcome of economic system. It incorporates technological progress as a product of economic activities and also assumes knowledge and technology are characterized by increasing returns to scale. In endogenous growth model, accumulation of knowledge, which ranges from greater scientific abstraction to the simple one, with its nonrivalry and excludability features, is considered as the driving force of economic growth (Romer 1996).

Furthermore, the New growth model stresses the importance of economic institutions for economic growth by providing incentives to encourage people to invest in both physical and human capital and also creating conducive environment for invention and innovations. By so doing it accelerates the accumulation of knowledge. Similar to the Solow model, the growth rate of income per capita is directly affected by the rate of saving in the economy. It also predicts that the country that has higher population growth rate and rate of deprecation of stock of capital grow more slowly in per capita terms. The other important prediction of the New growth model is that economic integration will raise growth of integrated economic space permanently but this is transitory in neoclassical growth model (Valdase 1999). Both neoclassical and New growth models explain the difference in living standard and economic growth across countries by using proximate causes of growth (such as labor force, population growth rate, capital accumulation, saving rate, human capital and technological progress). Therefore, to understand these differences we need to go beyond this proximate cause and look for fundamental sources of growth. In order to answer questions such as why some countries accumulate more human and physical capital than others, why technology differences occur across nations, and why some countries are more effective and productive than others, the emphasis should be given to the deeper determinants of growth such as geography, openness and institutional qualities after the prominent works of Krugman (1998), North (1995), Rodrick (1997, 2002) and Sachs and Warner (1997).

Politicization of Neoclassical Growth Model

In most of economics literature, economic growth, defined as increase in income per capita, is the primary macroeconomic objective of every country. It is a mechanism by which the

well-being of society has been uplifted. For the country like Ethiopia, where poverty has been its prime identification, economic growth may serve as a means to solve its fundamental problems. Economic growth has long history in the economics discipline. However, the discussion in modern growth theories is a recent phenomenon. For example, Elias (1992) explained that many countries have experienced a significant level of economic growth only since the beginning of the nineteenth century and after 1950 many countries have registered strong and rapid economic growth, i.e., doubling their GDP per capita income in a very short period of time. In growth literature, the issues of modern economic growth have been associated with the emergence of industrial revolution. In 18th and 19th centuries, economic growth had been largely confined to a small number of countries such as the Great Britain. Gradually modern economic growth spread from its origin to other countries, following European expansion. Since the time of industrial revolution, some countries grew rapidly than others, which led to growth variation across countries and time (Snowdon and Vane, 2005 and Hoist, 2006). Income per capita in countries such as USA, Germany and Japan exceeded those suchas Bangladesh and Zaire by a factor of twenty or more[1]. According to Hoist (2006), the ratio of average per capita income of developed nations to developing countries is 10:1or 11:1 before World.

War II and increased to 15:1 in the late 1980s. In 1987 the highest per capita income among the developed countries was recorded for Switzerland at more than US$26,000. Among the developing countries, there were several in Africa and Asia for which per capita income of well under US$200 were recorded. Thus, the investigation of growth is important not only for understanding the growth process but also to the analysis of the sources of cross-country income differences. That is, we need to understand why such differences occur among those countries and the factors that contribute to these dispersions. Researchers on the field develop theories, models and use data to search for answers that are related to growth questions such as cross-country income differences and growth factors. However, the empirical results and theoretical predications are still quite mixed.Both neoclassical and New growth models explain the difference in living standard and economic growth across countries by using proximate causes of growth (such as labor force, population growth rate, capital accumulation, saving rate, human capital and technological progress). Therefore, to understand these differences we need to go beyond this proximate cause and look for fundamental sources of growth. In order to answer questions such as why some countries accumulate more human and physical capital than others, why technology differences occur across nations, and why some countries are more effective and productive than others, the emphasis should be given to the deeper determinants of growth such as geography, openness and institutional qualities after the prominent works of Krugman (1998), North (1995), Rodrick (1997, 2002) and Sachs and Warner (1997). Both neoclassical and New growth models focused on the proximate causes of growth and they keep aside the fundamental determinants of growth from the models. However, politicization of neoclassical growth model was the first advance in this area to incorporate institutional quality in neoclassical growth model. As indicated in Hibbs (2001), the theory emphasizes the stock of human capital, labor available for production as well as the efficiency with which factor inputs are transformed to output depend decisively on politics, policy and institutional arrangement that affect the security of property right, innovation and investments. The politicized neoclassical growth model made a greater contribution on methodological ground. Using these methodologies a lot of empirical works have been done. Based on this, they try to link economic growth and institution through total factor productivity (Solow residuals). To start with, the contribution of capital and labor to growth is given by neoclassical aggregate production.

Economic Growth and the Role of Governance

Recently there is a general consensus on the importance of governance for growth and consider it as one of the fundamental determents of economic growth and growth variation across countries. Good governance provides individuals incentive to invest in technology, human and physical capital thereby affecting economic performance of a given country. Governance theory predicts that societies with good governance facilitate and encourage factor accumulation and innovation should prosper relative to societies that do not have good governance.It is also suggests that those societies that have good governance are prosperous today and tend to be prosperous in the future. In developing countries, states do too much in the economy thereby create unproductive rent-seeking activities and crowding out of productive market. Thus, good governance can guide the activities of states in the provision of necessary public goods to minimize rent-seeking and government failure (Bates, 1995; North, 1995; khan, 1995; Acemoglu, 2008; Acemoglu *et al*., 2002). Recently western countries, donors and international development assistance organizations (like World Bank, UN and IMF) gave more emphasis to the governance quality in developing countries. For several years these organizations spend huge amount of money (in the form of aid and loan) on various developmental programs in developing countries. However, most of those programs did not provide satisfactory result in most of developing countries. World Bank research team (e.g., Dollar and Levine, 2005) made an assessment on various project and concluded that aid ineffectiveness in developing countries were associated with poor governance besides their poor policy. Then onward the World Bank emphasizes and gives financial support to constructing good governance and improves its performances.Furthermore, terrorist attack against US on September 11, 2001 was another important factor that attracted the attention of the Western world to developing countries. US and other western countries recognize that the weakest states around the world deserve special attention because they believe that those states are the breeding ground for transnational security threats (Rice and Patrick, 2008). Among the world weakest states more than half are in SSA countries, Somalia being the first weakest state in their rank. Based on this, currently these countries spend large capital to strengthen the governance of these weakest states (Rice and Patrick, 2008).

The empirical works exploded to investigate the impact of this factor on growth and their contribution for income difference across countries. Acemoglu *et al*. (2000, 2002), Rodrick, (2002), Kaufmann and Kraay (2003), Dollar and Kraay (2002), Arndt and Oman (2006), Barro (1991), Hall and Jones (1998), Knack (2002) and Sachs (2003) are few of these studies. Generally agree that governance quality is one of the critical factors explaining the divergence in performance across

[1]Romer, (1996, p. 5); Kaufmann, (2003); Snowdon and Vane (2005)

countries. However, there are different views among economists in terms of the importance of governance relative to other factors especially for the developing countries. Some economists consider institutions as prime factor that explain growth in developing countries, while others emphasize that other factors need greater attention in countries such as those in SSA. However, Sachs *et al*. (2004), (2005); Sachs (2003) and Gundlach and Hartmann (2007) do not accept the explanation on Africa that poor economic growth has emanated from its poor governance. They argue that Africa's governance indicators (as a measure of institutional quality) are not systematically worse than those of other countries at comparable levels of income per capita. They found that even after controlling for governance, the SSA countries perform poorly. They concluded that more policies on governance reform by themselves are not sufficient to overcome its poverty trap and the problem of growth. To help the entire region to escape from these needs deliberate, evidence-based, and cooperative international effort and big push in major sectors of the economy and overall they reject the supremacy of institutions hypothesis.

In sharp contrast to these conclusions, Acemoglu *et al*. (2002) found that in the former colonies, including Africa, governance quality difference explains three-quarters of income per capita difference across these countries. Easterly (2006) uses three widely used measures of governance quality, i.e., measure of democracy, the Freedom House measure of political liberties and Economic Freedom, to assess its impact on growth and found that all measures of governance quality are strongly significant predictors of growth over the estimated time. That is, growth increases with more income at low economic freedom, but decreases slightly at high economic freedom. However, Khan (2007) and Meisel and Aoudia (2007) found very weakpositive relationship between the quality of governance and economic growth. The failure of any policy in developing countries is the failure of the country to address the necessary governance requirements that would be required to accelerate growth and achieve more rapid development. Thus, developing countries have to work more in improving governance quality to get rid of its developmental problems.

Empirical literature on Causality between Growth and Governance

Most previous empirical studies (e.g. Sachs,2003; Gundlach and Hartmann, 2007; Heinrich, 2008; and Cooray, 2008) of interrelationships between measure of institutions and economic growth have concentrated on only one aspect and ignored any feedback or bilateral relationships between economic growth and good governance. Some of the growing literature stresses that good governance is the cause rather than the consequence of economic growth. The proponents of this view stresses that poor governance is itself one of the reasons that some countries are poor and have low economic growth. For example, Kaufmann and Kraay (2003) test this using data from 153 countries using OLS and instrumental variable methods and found that growth has no positive impact on the good governance. They concluded that this happen because of the resistance to change from elite on the power even as the economy grows. However, Arndt and Oman (2006), using similar method and by including more explanatory variables in the specification, found that economic growth has positive impact on governance indicators. However, Khan (2007) argues that this may arise due to pooling of data from both developed and developing countries, which leads to misleading justifications because developed countries have better governance capability than developing countries. Thus, if separately investigated the direction of causality may be inconclusive. Farr *et al*. (1998) investigate bilateral relationship between economic freedom and economic growth and found significant bilateral feedback between these variables. That is, the two variables are endogenously related. Overall the causality that runs from growth to governance has less empirical support as compared to the causality that runs from governance to economic growth. In this line, this study dynamically models and investigates the relationship between economic growth and governance measures to see if there exists any causal relationship between these variables using Granger causality test procedure.

Sources of Slow Growth in Developing Countries

In growth literature the factors for its underperformance ranges from macro economic variables to the poor performance of its political and economic institutions including the quality of political leaders. Easterly and Levine (1995) argue that Africa's economic history since 1960 fits the classical definition of tragedy, with unfulfilled potentials, instability, poorly developed financial systems, and large disastrous consequences. These performances were strongly associated with low schooling, political instability, under-developed financial systems, distorted foreign exchange market, high government deficits, low infrastructure, ethnic fractionalization and spillovers from neighbors. Ethiopia is also landlocked; large fraction of their land area falls in tropical latitudes; there exist high dependence on natural resources, greater ethno-linguistic fractionalization and short life expectancy. In addition to these,weak political and economic institutions and ethnic fragmentation also exert pressure on the growth process in the country like Ethiopia.Ethiopia is the most ethnically diverse country in the world and this resulted in social unrest and conflict among ethnic groups for political positions and resources. Most of conflict that has happened target the productive sectors of the economy which affect growth process of the continent (Alemayehu and Befekadu, 2005; Olukashi, 2001; Alence, 2004). Malike (2002) and Easterly and Levine (1995) also emphasize that in ethnically diverse societies there is difficulty in agreeing on public policies such as provision of infrastructure, education and health.

Furthermore, political institutions are very weak. Most countries lack a tradition of mass political participation and the political regimes are often characterized by authoritarian structures. In a country like Ethiopia multiparty election had been held but manipulated by the elites in the power. The interest of majority cannot be accommodated within a pluralist regime. Leaders are, in most of the cases, corrupt, driven by their own interest. This may affect the interest of the majority of their population and undermine growth and development of institutions (Olukashi, 2001; Malik, 2002; Ndulu and Connell, 1999; Acemoglu, 2008 and Collier and Gunning, 1999).

Methodology

The study uses secondary data collected by different institutions. Data for governance will be collected fromMoIbrahim governance index. Where a country's annual score is available for the year between 2000 to 2017. The data is annually reported for several variables, like participation of

different political parties, free election, competitive and corruption free, freedom of speech, freedom of religion, association and freedom of press and many others. Society who feels freedom in those respect motivated to invest in human capital and physical capital and posses business, thus good governance can positively influence economic growth. The other variables are taken from World Bank's World development Indicators 2017database.

Empirical Model

The empirical estimable model is specified based on the factor that affect the growth of a nation. Such as governance qualities, openness to international trade and government policy was the major interest in this study. It is assumed that a country more open to trade would transfer more technological know-how and various types of knowledge to the economy, and this in turn would improve technological progress, thereby economy growth. A country that has good governance is expected to have better protection of property rights and law enforcement capacity. This can attract foreign direct investment, through which knowledge would be transferred, thereby affecting the growth rate of the economy (Barro and Sala-i-Martin 1995; Romer, 1996; Valdes, 1999). A country which lacks support to the private sector and/or to the foreign investor, for example through taxation, may impede technological diffusion and adoption. This government influence is captured by government policy, which is a proxy by government consumption expenditure. In related empirical work, for example, Connell and Ndulu (2000) assume that government consumption expenditure is financed by tax and this suggestion is also considered in this study. Based on the above explanations, the initial level of technology approximated by its determinate gives the estimable equation as follows.

$$y_t = B_0 + B_1\left(FDI\right)_t + B_2\left(EducEX\right)_t + B_3\left(n\right)_t + B_4 OPN_t + B_6 G_t + \varepsilon_t$$

The above equation implies that the log of per capita income is a function of FDI, human capital, labour force growth, openness to international trade, measure of good governance and government consumption expenditure. $\varepsilon_{i,t}$ is normally distributed random disturbance terms. Representing all explanatory variables by a vector X, the dynamic growth model that includes lagged dependent variable as regressor is given by:

$$y_t = \delta\, y_{t-1} + B\, X_t + \varepsilon_t$$

With the existence of endogenous effect, OLS methods of estimation would result in inconsistent and biased estimates therefore, the appropriate estimation techniques will be employed (Baltagi, 1988; Blundell and Bond, 1998).

RESULTS AND DISCUSSION

In this section, the quantitative analyses results are presented in two subsections. The first subsection provides descriptive analysis of fundamentals growth and governance indicators via showing its trend for the past decade. It is followed by the econometric result on the governance and economic growth relationship.

Descriptive Statistics

First the relationship among different variables of interest presented using the result from Spear Man correlation coefficient. The estimation result was presented hereunder. The correlation coefficient from the estimation result is presented in Table 1. The correlation evidence indicated the sign of the relationship is as expected and consistent with the previous findings. All variables have a positive correlation including the overall governance indicator and other specific indicators like rule of laws. Among the variable considered here rule of law, education indicator, labour force, and overall governance indicators have highly and positively correlated with the economic growth with the correlation coefficient of 0.62, 0.55, and 0.5, respectively. Figure 1 showed that trends in economic growth and governance in Ethiopia for the past years. As the result portrayed economic growth is fluctuating until 2003 despite its positive recorded in most of the cases as compared to the previous regime. Since 2004 the government achieves the double digit clamed with little oscillation during these periods. The figure of economic growth is divisive among the practitioner and large financial institutions like the World Bank and International Monetary Fund. Whatever the exact figures may be, one cannot deny the fact of continuous economic growth in recent years. Regarding the governance the trend showed that Ethiopian achieve an improvement over time in different governance dimension but still the country is below the African average of 50 as observed in Figure 1.

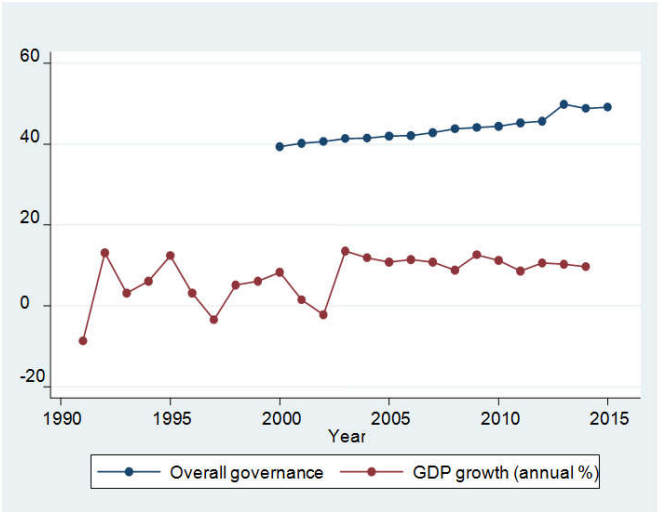
Table 1. Correlation among the Governance and Economic Growth

	Growth	Labor	Education	FDI	Governance	Safety	Ruleoflaw
Growth	1.0000						
Labor	0.5507	1.0000					
Education	0.6162	0.5355	1.0000				
FDI	0.2190	0.4360	0.0181	1.0000			
Governance	0.5105	0.9950	0.5079	0.4026	1.0000		
Safety	0.4003	0.8398	0.3776	0.1735	0.8569	1.0000	
Rule of law	0.6185	0.2819	0.4905	-0.3620	0.3067	0.4863	1.0000

Source: Own Computation based on WDI and Mo IBRAHIM (2016) data

However, the disaggregation of index in two its sub indicators showed mixed results the country showed good progress in public sector accountability index and national security as shown in Figure 2 and 3 respectively. However, press freedom and freedom of expression highly deteriorating than ever. This figure expected to be worsening following the recent social unrest and political instability. Similarly, safety and rule of law index showed a constant for long time with little improvement above African average since 2013. Among the proximit causes of growth FDI in one of the important factors that may have a close link with the governance status of the country. In general FDI flow to Africa countries only took small proposition like 1 percent of the world FDI flows. Despite large effort was done in improvement in investment policy the FDI flow was too little even with fluctuation over the period under consideration. The flow is also low even from the African share. This may

attributed to a number of factors including poor governance performance that does not much the African average. When the relationship examined between FDI and governance Table 1 depict that there is positive correlation between these two variables with the correlation coefficient of .40. The other governance indicator considered here is that women political participation and women equality index.



Source: Own Computation based on WDI and Mo IBRAHIM (2016) data

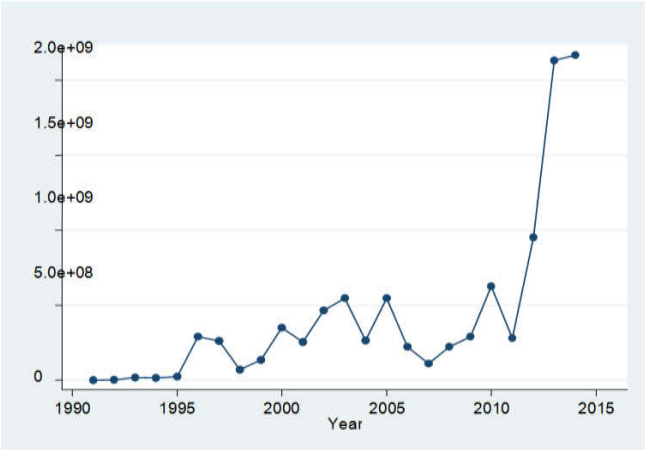
Figure 1. Trend in Economic Growth and Good Governance

Source: Own Computation based on WDI and Mo IBRAHIM (2016) data

Figure 2. Trend in Selected Governance Indicators

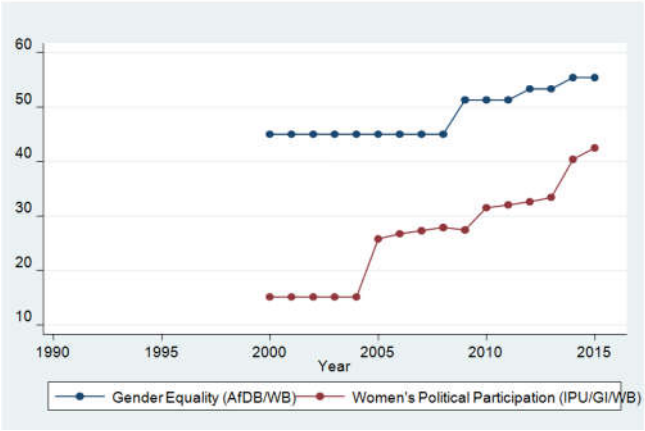
Source: Own Computation based on WDI and Mo IBRAHIM (2016) data

Figure 3. Trends in Selected Governance Indicators



Source: Own Computation based on WDI and Mo IBRAHIM (2016) data

Figure 4. FDI Inflow to Ethiopia



Source: Own Computation based on WDI and Mo IBRAHIM (2016) data

Figure 5. Women Empowerment

Table 2. Regression Estimation Results

Variables	Coefficients	t-value
Lag growth	.183	0.30
Labour force	.45	2.29**
FDI	.331	0.31
Openness	4.4	0.54
Education	.93	.270
Governance	8.8	2.30**
Constant	263	

Standard errors in parentheses * p<0.05, ** p<0.01, *** p<0.001
Source: Own Computation based on WDI and Mo Ibrahim Index (2016) data

Ethiopia is one of the country with high gender inequality observed this is mostly associated with the cultural and social influence in majority of ethnic groups mail dominance is observed. As observed in figure 5 the index for gender equality showed the for the long time the country showed no progress and constant overtime. But recently the trend showed a little bite increment in this index. Similarly, women political participation index showed the worst score for long time despite the recent improvement in the index. The score showed still below the African average in all index.

Econometrics Result

The econometric result depicts among the variables considered in the regression result only labour force and good governance found to be statistically significant. Trade and finance are the major ways through which Africa is linked with the rest of the world for long time (Alemayehu, 2002). As documented in different works, openness has an important impact on

economic growth through promoting competition and efficiency, accumulation of physical and human capital. However, in Table 2 from regression result the estimated coefficient of openness was positive but statistically insignificant for Ethiopia. Similarly, FDI inflowlaged GDP per capita were statistically insignificant. The estimated coefficient of government education expenditure was also statistically insignificant. This is one of the surprising resultspartly attributed to data problem. However, for governance index, which was constructed as the average of the overall indexes considered in Mo Ibrahim governance index. The estimated coefficient of governance was found to be positive and statistically significant at 5% level. This shows that governance has greater impact on the current economic performance. Consistent with previous empirical findings (for example Rodrick, 1997; Heinrich, 2008; Cooray, 2008 and Easterly, 2006 few among others) institution found positive and significant impact on economic growth). In magnitude, a percentage improvement in the overall governance index would result in 8 percentage increase in economic growth. Overall improvement in good governance is good for economic growth in general this is consistent with new growth theories and new institutional economics which assert that good governance promote economic growth.

Conclusion

Most scholars agree that good governance is one of the critical factors explaining the divergence in economic performance across countries. The estimation results showed that the governance was positively associated with economic performance measured as GDP per capita. The study also found that demographic characteristics, which are measured by labour force of the country, exert significance pressure on economic growth of country. Government education expenditure was found to have insignificant effect on economic growth. Moreover, in this study openness to international trade FDI and lagged growth were found to have statistically insignificant effect on economic growth. This suggests that these factors would have little or no effect on economic growth of Ethiopia, but the government has to give emphasis on fundamental causes of growth like improving in good governance in all dimensions.

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