

Eradication of internal and external conflicts is necessary for effective utilisation of foreign aid and achieves sustainable growth

Improvement in governance and availability of foreign aid are generally claimed to have welfare enhancing effects on economies of developing nations. The ambiguity of relationship between the two, however, calls for further research in this respect.

Most of the developing countries are suffering from low quality of governance hence there is a need to investigate the underlying factors that deteriorate the governance quality and in turn hinder the process of economic growth.

Economic literature is resplendent with controversies regarding the inter-linkage between the foreign aid and institutional quality. Foreign aid can be used to improve the quality of governance by releasing the recipient government from binding earned revenue constraints. However, foreign aid may deteriorate the governance quality, government not being accountable to the general public may indulge in unproductive activities like rent seeking and moral hazard etc, that reduce the welfare of the society. Countries that are receiving foreign aid and experiencing conflicts, internal or external, are facing low quality governance. Conflicts, whether internal or external, have an adverse impact on the institutions. Cross border tensions, civil wars, coup threats, political violence, terrorisms and foreign pressures leave the government unstable and deteriorate the institutional quality.

Conflicts arise as a consequence of a complex mix of social, economic, historic and political conditions of a country. Conflicts affect the components of governance like the rule of law, quality of bureaucracy and corruption. Political instability as a result of conflict may induce more corruption and make the civil society weak. This study attempts to explore the impact of foreign aid on the quality of governance while also taking into consideration the role of both internal and external conflict. Conflict and foreign aid jointly determine the state of an economy and have a great impact on the institutional quality. Annual data from 1984 to 2010 have been used for the Asian developing economies, the

results indicate that aid as well as both external or internal conflict have negative impact on the institutional quality and these results are robust for various alternative specifications.

Figure 1: Aid and Governance

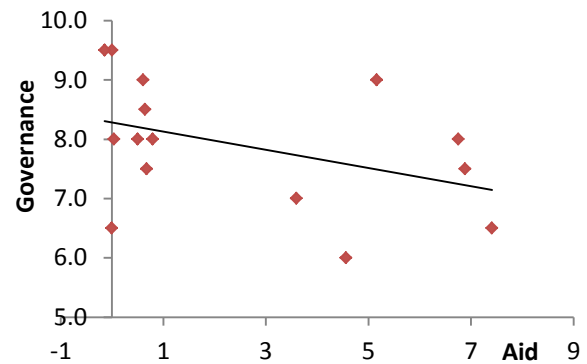
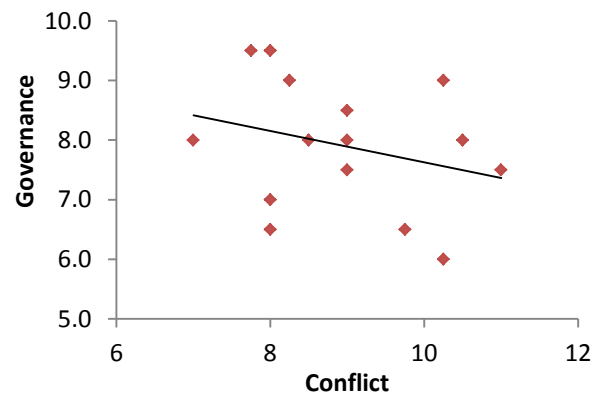


Figure 2: Conflict and Governance



For sustainable growth and effective utilization of foreign aid the government should try first to eradicate the external as well as internal conflict. If the government gets control over the conflict then it will be possible for recipient country to improve the quality of governance by strengthening the civil services, enforcing rules and regulation through independent judiciary. Strong bureaucracy and independent court system may discourage corruption, bribery and baseness.

Qayyum, U, (2013), "Institutional Quality, Conflict and Aid Dependency", *PIDE Working Paper (Forthcoming)*