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2013:94

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Unbreen Qayyum

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PIDE Working Papers
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Unbreen Qayyum
Pakistan Institute of Development Economics, Islamabad

PAKISTAN INSTITUTE OF DEVELOPMENT ECONOMICS
ISLAMABAD

Pakistan Institute of Development Economics
Islamabad, Pakistan

E-mail: publications@pide.org.pk
Website: http://www.pide.org.pk
Fax: +92-51-9248065

Designed, composed, and finished at the Publications Division, PIDE.

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ABSTRACT

This study attempts to explore the impact of foreign aid on the quality of governance and how conflicts, whether internal or external affect the overall situation. Conflicts affect governance directly by creating instability which adversely affects economic development as investment climate is fouled and output drops leading to fall in revenues. In this vicious cycle governance is left with no funds to improve institutional quality. Annual data from 1984 to 2010 have been used for the Asian developing economies. The results indicate a negative impact from the confluence of foreign aid in a climate of conflicts that leads to institutional deterioration. These results are robust for various alternative specifications.

JEL Classification: C33, F35, O11, O43, D74.
Keywords: Official Development Assistance, Governance, Conflict.

INTRODUCTION

Over the last two decades, governance and foreign aid have received a great deal of attention from the economists. Both of these variables play an important role in shaping the economic welfare of developing countries. However the exact relationship between these variables remains clouded, arousing researchers' curiosity. Experience suggests that higher level of aid inflows is associated with poor of quality governance. Good governance enables a country to achieve its targets and prosper, by enabling a conducive environment for high and sustained economic growth.[1] Aid is received to overcome problems like budget deficit or revenue constraints etc., which hinders growth in poor countries. There is sparse evidence to suggest that foreign aid significantly enhances economic growth of recipient countries and is effective only in the presence of sound macroeconomic policies and governance.[2] Most of the developing countries are suffering from low quality of governance; there is a need to investigate the underlying factors that lead to deterioration in governance quality and in turn hinder the process of economic growth. Countries that are receiving foreign aid and experiencing conflicts, internal or external, are also victim of low quality governance (see Figure 1). We urgently need to look for those hidden factors on account of which both foreign aid and governance fail to achieve the desired goal of sustained development. This study attempts to investigate, how aid dependency affects the quality of governance in developing countries in conflict situations. Conflicts, whether internal or external, adversely affect institutional performance. Cross border tensions, civil wars, coup threats, political violence, terrorism and foreign pressures make governments unstable and damage institutional quality. Conflicts arise from a complex mix of social, economic, historic and political factors of a country. The

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Acknowledgements: I must say thanks to Dr Musleh ud Din, for his kind and encouraging attitude, able guidance, thought provoking criticism, valuable suggestions and keen interest in the whole research work. I am grateful to him for his appreciation that really makes me work hard. I am also grateful to Dr Idrees Khawaja, Abdul Wajid, Sundus Saleemi, Rafat Mahmood and Muhammad Nawaz for their corporation and assistance.

[1]See, North (1990, 1992), Acemoglu (2005a), Acemoglu and Johnson (2005), Acemoglu and Robinson (2008).

[2]For instance see Boone (1995), Easterly (1999), Burnside and Dollar (2000), Easterly, *et al.* (2004), Islam (2005), Feeny (2005), Oechslin (2006), Murphy and Tresp (2006), Alvi, *et al.* (2008), Feeny and McGillivray (2010).

causes of these conflicts are numerous and varied and differ from country to country, but they invariably affect the social, political and economic fabric of the society. Conflicts affect the various components of governance like rule of law, quality of bureaucracy and corruption. The break down of the rule of law itself causes the incidence of conflict. The quality of governance in turn has serious repercussions for the economy. In an adverse law and order situation, investors—the key drivers of the economy—are dissuaded from investing, more importantly foreign investors who are scared away by the unpredictable outcome of the conflict. Moreover, conflicts divert government expenditure from much needed developmental projects to alleviating rifts and problems. Political instability as a result of conflicts promotes corruption and makes the civil society weak. The government in power and public officials try to grab all that they can lay their hands on, for themselves and their followers.

Good governance ensures a predictable, unprejudiced and persistent enforced set of rules in the form of effective governance which is essential for a sustainable economic development process,[3] while aid dependence can potentially weaken the quality of governance by undermining accountability and transparency, promoting rent-seeking and corruption and alleviating pressure to postulate efficient policies and institutions.[4] Economic literature is resplendent with controversies regarding the inter-linkage between foreign aid and institutional quality in terms of effective governance. Foreign aid can be used to improve the quality of bureaucracy, establish rule of law and lessen corruption by releasing the recipient government from worries relating to revenue constraints.[5] South Korea and Taiwan present a good example in this respect. However, foreign aid may affect governance quality, since the government not being accountable to the general public may indulge in unproductive activities like rent-seeking and moral hazards etc., that reduce the welfare of the society.[6] Foreign aid may also reduce tax receipts, shrinking government revenues as foreign aid financed projects are usually designed to use imported goods which are exempted from paying import duties. Officials of aid agencies and NGOs are exempted from income tax, depriving the government of revenues. Foreign assistance may erode political stability and shorten the time horizon for each government as it now tries to grasp whatever it finds in ascendancy.[7] On the other hand, foreign aid can improve governance quality through conditionality; such conditionalties present an incentive for recipient countries to improve the governance by implementing public sector reforms. But studies demonstrate that

[3]See, North (1990,1992), Keefer and Knack (1995,1997).

[4]For instance see, Keefer and Knack (2001), Brautigam and Knack (2004), Busse and Groening (2010).

[5]See for example, Carlsson, *et al.* (1997).

[6]See, North (1990), Klitgaard (1990), Maren (1997), Karl (1997), Brautigam and Kwesi (1998), Dollar and Pritchett (1998), Moore (1998) and Brautigam (1992, 2000).

[7]See, Grossman (1992).

conditioning aid on policy and institutional quality is ineffective as the recipient country tries to improve and reveals indicators that make the donors happy but behind the scene the picture does not look too pretty as has been shown.[8]

In the light of the foregoing discussion, it can be argued that the net impact of aid on governance is ambiguous; thus the question regarding the impact of foreign aid on the quality of governance is no doubt potentially worthwhile. Durbarry, *et al.* (1998) found that aid provided even up to 40 percent to 45 percent of GDP boost to economic growth and development, when given to countries with strong institutions and macroeconomic policies. The positive level of growth will in turn open new channels of revenue generation, which can be used for funding improvements in governance quality. Knack (2001) provides evidence that higher aid inflows weaken the governance quality based on a purely cross-sectional data set of developing countries. Brautigam and Knack (2004) based on 32 African countries, conclude that foreign aid makes government not answerable to the people for their actions which absolves it from the need to govern well through maintenance of the rule of law, assurance of a predictable judiciary, contract enforcement and controlling corruption. Busse and Groning (2009), based on 106 aid dependent countries using ICRG index for governance indicators, found that aid had a negative rather than positive impact on the quality of governance. However it is not argued that governance could be improved by lowering aid flows, rather it is recommended that the donors and the recipient governments should reassess the current aid configuration, its effectiveness and its possible drawbacks that affect governance at both country and project level while increasing aid flows. Rajan and Subramanium (2007) demonstrate that aid donors and recipients must not take aid inflows as an unadulterated blessing since aid ineffectually used, can in reality impede a country in its path to development. It is seen that in countries that receive more aid, industries that are dependent on this aid grow virtually at a snail's pace.

Figure 1 depicts the situation very clearly; the relationship of foreign aid and conflict with governance quality is negative while that of government stability is associated positively.

There exists extensive empirical evidence on aid dependency and the quality of governance regarding various developing countries but no such study has been carried out for Asian developing aid dependent countries. Further, these countries are also facing the problems regarding governance as well as conflicts; it is worthwhile therefore to explore the relationship of foreign aid, conflict and governance. This study aims to fulfil the literature gap by analysing the impact of foreign aid and conflict on the quality of governance.

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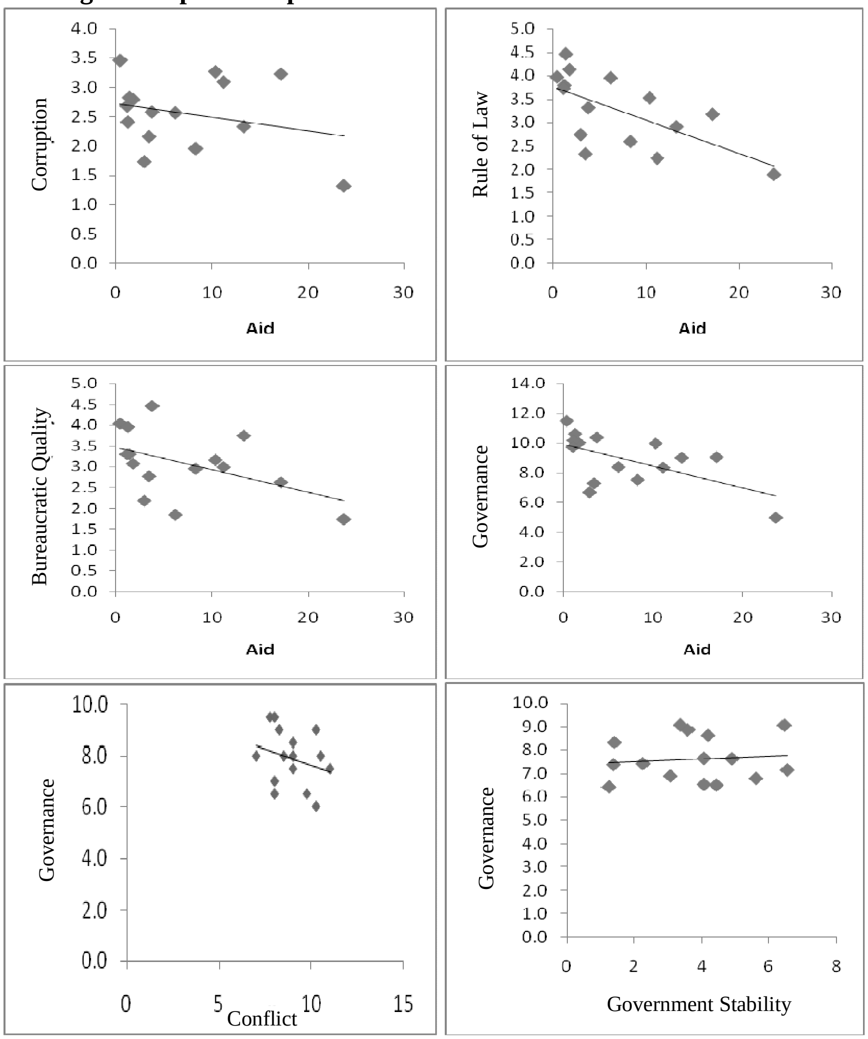
[8]See for example, Kapur and Webb (2000), Stiglitz (1999), Dollar and Pritchett (1998), Collier (1997) and Crawford (1997).

Fig. 1. Graphical Representation of Correlation between Variables



DATA DESCRIPTION AND ANALYSIS

The concept of governance is widely discussed among policymakers and scholars but there is no consensus on a single definition of governance or institutional quality. Various authors have produced a wide array of definitions. Some are so broad that they cover almost everything, such as the definition of "rules, enforcement mechanisms, and organisations" offered by the World Bank's 2002 report. Others more narrowly focus on the public sector management issues, including the definition proposed by the World Bank in 1992 as "the manner in which power is exercised in the management of a country's economic and social resources for development". Good governance is the process of decision making and process of implementation of these decisions. It relates to a pluralistic and holistic view where responsibility is jointly shared by players in public sector, the corporate private sector, and civil society by addressing the issues of accountability, transparency, participation, openness, rule of law and predictability.

The data for quality of governance has been taken from the International Country Risk Guide (ICRG). It is an 18-point scale index, formulated by adding up three 6-point indexes i.e., corruption, bureaucratic quality, and rule of law. Data for government stability, internal and external conflict has also been taken from ICRG that ranges from 0 to 18; the lower value for government stability indicates that government is unstable while the higher value for conflict shows more violence or conflict. Official development assistance as percentage of imports, per capita GDP growth, and population has been taken from World Development Indicator (WDI) 2011. The data set for Asian developing countries has been taken for the period of 1984 to 2010; selection of the countries is based on the availability of data.[9] Table 1 describes the summary statistics that describe the mean, median and standard deviations etc., while Table 2 shows the correlation matrix that indicates the existence of negative correlation of governance with foreign aid and conflict, while it is positively related to per capita GDP growth, population and government stability.

Table 1

Summary Statistics

	GOV	GS	CF	PGDPG	POP	AID
Mean	8.93	7.61	4.75	2.98	143000000	7.08
Median	9.33	7.83	4.47	3.35	55068880	3.71
Maximum	14.50	12.00	15.00	15.27	1340000000	57.60
Minimum	1.00	1.00	0.00	–16.51	1467846	–1.01
Std. Dev.	2.53	2.33	3.02	4.45	296000000	9.50

Table 2

Correlation Matrix

	GOV	GS	CF	PGDPG	POP	AID
GOV	1					
GS	0.36	1				
CF	–0.44	–0.45	1			
PGDPG	0.15	0.10	–0.11	1		
POP	0.03	0.13	–0.10	0.39	1	
AID	–0.38	–0.37	0.27	-0.19	-0.18	1

[9]Countries that have been included in the study are Bangladesh, China, Indonesia, India, Jordan, Sri Lanka, Mongolia, Malaysia, Oman, Pakistan, Philippine, Papua New Ghana, Syria, Thailand and Turkey.

Empirical Evidence

The empirical model has been estimated using the fixed effect as well as the random effect model; the houseman test has been applied as well that provides evidence in favour of the fixed effect model (see Table 3). In order to tackle the issue of endogeneity, the two stage least square (2SLS) method has been applied. Table 4 and Table 5 indicate that foreign aid is affecting the governance quality, rule of law and the quality of bureaucracy negatively and these results are highly significant as well. The reason is quite obvious as now government is not answerable to the general public; they are not dependent on the earned revenue which is why this attitude will affect governance quality adversely. Government will not enforce the rule of law in the country as a result higher aid inflows will only lead to eroding the rule of law. In case of bureaucratic quality, the sign is according to the expectation as donors may hire public officials on higher salaries and employ them on foreign aided projects. In case of Asian economies an increase in foreign aid by 1 percent will decrease the governance quality by 0.07 points, rule of law by 0.03 points and the bureaucratic quality by 0.05 points; these results are highly significant as well. Foreign aid is promoting corruption which implies that whenever government officials get access to foreign funds, they would fall for corrupt practices weakening governance.

Table 3

Correlated Random Effects—Hausman Test

Test Summary	Chi-Sq. Statistic	Prob.
Cross-section Random	28.626	0.000

Cross-section Random Effects Test Comparisons

Variable	Fixed	Random	Var (Diff.)	Prob.
GOV(–5)	0.141	0.225	0.000479	0.0001
AID	–0.039	–0.035	0.000075	0.7087
PGDPG	0.053	0.054	0.000010	0.6427
POP	–0.000	–0.000	0.000000	0.0078

Cross-section Random Effects Test Equation

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	10.1225	0.8675	11.6683	0.0000
GOV(–5)	0.1414	0.0499	2.8310	0.0049
AID	–0.0386	0.0169	–2.2798	0.0233
PGDPG	0.0526	0.0237	2.2158	0.0274
POP	–1.3E-08	4.9E-09	–2.7825	0.0057
R-squared	0.42	F-statistic		12.43
Adjusted R-squared	0.39	Prob (F-statistic)		0.000

Table 4

Impact of Foreign Aid on Law, Bureaucracy and Corruption

Variable	Law	Bureaucracy	Corruption
C	2.732935	1.9814	3.5250
	(0.3740)*	(0.3322)*	(0.4051)*
Index(–5)	0.118913	0.4185	0.1400
	(0.0477)**	(0.0463)*	(0.0554)**
AID	–0.024958	–0.0161	0.0002
	(0.0081)*	(0.0069)**	(0.0071)
PGDPG	0.01827	0.0163	0.0003
	(0.0113)	(0.0098)***	(0.0103)
POP	3.06E-09	–8.93E-11	–9.03E-09
	(0.25E-09)	(0.21E-11)	(0.22E-09)*
N	329	329	329
Mean Dependent Var	3.47	3.19	2.56
R_sq	0.51	0.55	0.36
adj. R_sq	0.49	0.52	0.32
S.E. of Regression	0.82	0.71	0.73
F-statistic	18.26	20.85	9.53
Prob(F-statistic)	0.0000	0.0000	0.0000

Note: All the values in the parenthesis denote the standard errors. The * ,**and *** indicates the significance level at 1 percent, 5 percent and 10 percent respectively.

Table 5

Impact of Foreign Aid on Governance

	Fixed Effect Model		2SLS Model	
Variable	1	2	3	4
C	10.1224	10.9695	15.4832	16.8738
	(0.86)*	(0.8219)*	(2.1090)*	(1.9352)*
Gov(-5)	0.1413	0.1303	0.3089	0.2499
	(0.0499)*	(0.0468)*	(0.0760)*	(0.0718)*
AID	–0.0386	–0.0105	–0.0746	–0.0648
	(0.0169)**	(0.0164)	(0.0274)*	(0.0275)**
PGDPG	0.0526	0.0404	0.1935	0.1689
	(0.0238)**	(0.0223)***	(0.0928)**	(0.0904)***
POP	–1.38E-08	–1.14E-08	–6.15E-08	–6.16E-08
	(0.50E-08)*	(0.47E-08)**	(1.43E-08)*	(1.38E-09)*
CF		–0.3007		–0.2019
		(0.0450)*		(0.0666)*
N	328	328	328	328
Mean Dependent Var	9.26	9.25	9.26	9.26
R_sq	0.42	0.49	0.18	0.25
adj. R_sq	0.39	0.46	0.13	0.21
S.E. of Regression	1.62	1.59	2.02	1.93
F-statistic	12.44	15.79		
J-statistic			1.76	3.88
Prob(F/J-statistic)	0	0	0.41	0.15

Note: All the values in the parenthesis denote the standard errors. The * ,**and *** indicates the significance level at 1 percent, 5 percent and 10 percent respectively.

It's not only the aid inflows that affect governance quality; the past level of governance quality also plays an important role in determining the current quality of governance. To capture the impact of past institutions a 5-year lag has been introduced in the regression equation; the results show a positive impact on the current level of governance. If a country had enjoyed good institutions in the past then it will definitely have sound institutions in its future but if these institutions were bad then it will certainly have an adverse impact on the current quality of institutions. The per capita GDP growth is positively linked with governance quality, rule of law as well as bureaucratic quality and, these results, are significant as well. It has been observed that governance quality gets worse in the presence of conflicts irrespective of its type, whether it is internal or external. When we include conflict in the regression equation it makes the foreign aid parameter insignificant, although the sign of the parameter is still negative. This implies that if a country is suffering from internal or external conflicts, its institutional quality would be more adversely affected compared to the adverse effects of aid. (see Table 5).

Population is negatively associated with governance while government stability is positively linked with governance quality. Values of R-square and the F-statistic are also good and indicate the best fit of the regression equation. To find out the robustness of the main variable of concern, sensitivity analysis is required. The results can be challenged by omitted variable bias, so the various regressions have been estimated to tackle this issue (as shown in Table 6). The inclusion and exclusion of different variables in the main regression equation does not affect the expected sign and the significance of the concerned variables. It becomes very clear from Table 6 that the sensitivity analysis confirms the robustness of the results.

Table 6

Robustness Check

Variable	1	2	3	4	5	6	7	8
C	8.3533	8.1488	10.1224	10.0656	10.9695	10.5238	11.0342	11.0517
	(0.5027)*	(0.5049)*	(0.86)*	(0.8651)*	(0.8219)*	(0.8473)*	(0.8180)*	(0.8184)*
Gov(–5)	0.1219	0.1272	0.1413	0.1038	0.1303	0.1355	0.1303	0.1298
	(0.0512)**	(0.0502)**	(0.0499)*	(0.0541)***	(0.0468)*	(0.0485)*	(0.0465)*	(0.0465)*
AID	–0.0319	–0.0288	–0.0386	–0.0296	–0.0105	–0.0244	–0.0094	–0.0085
	(0.0170)**	(0.0167)***	(0.0169)**	(0.0176)***	(0.0164)	(0.0167)	(0.0162)	(0.0163)
PGDPG		0.0494	0.0526	0.0522	0.0404	0.0430	0.0441	0.0425
		(0.0239)**	(0.0238)**	(0.0237)**	(0.0223)***	(0.0232)***	(0.0222)**	(0.0222)***
POP			–1.38E-08	–1.70E-08	–1.14E-08	–1.23E-08	–1.17E-08	–1.15E-08
			(0.50E-08)*	(0.53E-08)*	(0.47E-08)**	(0.48E-08)**	(0.46E-08)**	(0.46E-08)**
GS				0.1016				
				(0.0572)*				
CF					–0.3007			
					(0.0450)*			
ECF						–0.2033		–0.0506
						(0.0459)*		(0.0526).
ICF							–0.2491	–0.2266
							(0.0357)*	(0.0427)*
N	329	328	328	328	328	328	328	328
R_sq	0.38	0.41	0.42	0.43	0.49	0.45	0.50	0.50
adj. R_sq	0.35	0.37	0.39	0.39	0.46	0.42	0.47	0.47
S.E. of Regression	1.76	1.72	1.62	1.70	1.59	1.65	1.58	1.58
F-statistic	12.05	12.44	12.44	12.03	15.79	13.53	16.15	15.39
Prob (F-statistic)	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000

Note: All the values in the parenthesis denote the standard errors. The * ,**and *** indicates the significance level at 1 percent, 5 percent and 10 percent respectively.

CONCLUSION AND POLICY IMPLICATIONS

This study attempts to investigate the impact of foreign aid on the quality of institutions in the form of effective governance by taking into consideration the factor of conflict. Results indicate that foreign aid erodes institutional quality in case of Asian developing countries. Despite this fact, developing countries must not ignore the other important factor i.e., internal and external conflict that contribute a lot in the development of institutional structure. Countries that are facing a conflict situation are experiencing weaknesses in their institutional structure which in turn cause deterioration in the quality of governance. For sustainable growth and effective utilisation of foreign aid it is necessary that governments should try first to resolve the external as well as internal conflicts. If the government is able to control the conflict then it will be possible for the recipient country to improve the quality of its governance by strengthening the civil services, enforcing rules and regulations through an independent judiciary. A strong bureaucracy and an independent court system may dissuade officials from corruption, bribery and other corrupt practices. Donors may even put some conditionalities while giving the funds in the form of aid; they may put some restrictions or formulate a criteria through which they can select the country that qualifies for these funds.

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