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Effect of Foreign Assistance on the Economic Growth of Recipient Countries of Asia

ABSTRACT

This study examines how foreign aid affects the economic growth of developing countries in Asia. The data is collected from 1984 to 2013 from nine developing Asian countries. It is experienced that foreign aid and its influence on economic growth demonstrate significant ambiguity about the sign and magnitude. This study accentuated the policy role and the role of political stability for foreign assistance on countries' economic growth. This work establishes foreign aid contributes to growth through good governance, employing fixed effect in a static-panel context. It also supports the evidence of a negative relationship between foreign aid and economic growth. The finding suggest noticeably that foreign aid is growth-enhancing if there is a better policy situation along with political stability.

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Author's contribution in the article: 1- Conceived and designed the analysis, 2- Reviewed and compiled the literature, 3- Collected the data, 4- Contributed data or analysis tools, 5- Performed the analysis, 6- Wrote the paper, 7- Financial support for the conduct of the study, 8-Other

1. INTRODUCTION

Foreign aid performs a noteworthy role in the development of developing nations. In a true sense developing nations are capital famished and dependent on foreign assistance for supporting their socio-economic development schemes. It may include sectors like education, internal and external security, area of production, to reduce poverty, and construction projects. The main objective of foreign aid is economic growth and the betterment of the people, however political concerns cannot be ignored either.

The basis behind foreign support programs is, to support the less developed countries because it helps them for economic growth and welfare. Neoclassical theory of growth, mentions "Countries that start with low endowments grow faster than resource-rich countries''. So, foreign assistance may enhance the country's growth but if foreign assistance is used accurately. Empirical work about foreign aid and economic growth has unalike results, few researchers indicated that foreign aid is growth-promoting but other marked negative foreign aid relationships with economic growth (Griffin, 1970). The followers of aid, support in this way that it is very helpful for low-income countries to attain their advanced levels of economic growth because through aid these countries can utilize domestic resources in the best way (Dowling & Hiemenz, 1983). Moreover, foreign currency reserves are less in quantity, so foreign assistance helps to reduce the saving gap (Papanek, 1973). Although conferring the "gap theory" by (Chenery & Strout, 1966), foreign assistance can boost economic growth as it frequently surges foreign exchange (Islam, 2005; Easterly, 2003). On the other hand, (Radelet et al., 2005) found that countries that receive aid use it for consumption. So, these countries are aid-dependent. According to (Gomanee et al., 2005), aid receiver nations do not use this foreign assistance constructively and do not invests it because of the fungibility of aid. Therefore, we find enormous work about the aid-growth relationship but still, there is a gap for new work especially for underdeveloped South Asian countries.

This work examines the importance of aid for economic growth. It also determines the role of political stability and economic policies. Shreds of evidence demonstrated that a large amount of aid had been delivered to developing Asian economies but economic expansion is inactive. Because this foreign assistance has not been used appropriately. Weak economic policies and corrupt government are its major causes. (Burnside & Dollar, 2000) have conferred the effectiveness for the recipient countries. It is clarified that aid is more effective concerning policy variables when it is associated with good policies or governance. So, both economic policies and political stability are considered significant indicators for foreign assistance. This study identified that aid will be growth-enhancing if a country holds with political stability and sound economic policies.

This paper determines, "foreign aid encourages economic growth. It also analyzes the role of political stability and policy for aid to encourage growth". This study comprises developing Asian economies including the Philippines, Pakistan, China, Thailand, India, Bangladesh, Malaysia, Indonesia, Sri Lanka. The analysis is constructed on a static and dynamic panel framework. We evaluate the role of policy and political stability of the recipient country for aid on economic growth through panel data analysis. Moreover, simultaneous equation system-based analysis has been involved for policy, political stability, aid, and growth. However, these variables are often determined together. Further endogeneity in the growth equation is checked by instrumental endogenous variables by lag explanatory variables.

The significance of this work is to find the relation between foreign aid and growth imparting the role of economic policy and political stability conditions of the selected Asian countries. The reason for selecting these countries is that these countries intensely depend on foreign assistance, with instability in government and inappropriate economic policy systems. It is suggested that with the help of stable government and efficient policy measures, it can help to attain the desired outcome through foreign aid. It also analyzes, foreign assistance is growth-promoting when there is sound economic policy and recipient countries hold

political stability. Our results also reveal that when we introduce the variable of policy and political stability in the growth equation, we find a positive relationship between aid and growth. It suggests policymakers put keen attention towards political stability and create a better policy environment if they want to utilize external assistance for development purposes.

This study is ordered as follows: section 1 comprises an introduction, section 2 reviews existing literature, section 3 on data and methodology. Further section 4 contains empirical results and section 5 conclusion.

2. LITERATURE REVIEW

The role of Foreign aid for economic growth is a controversial area in the literature. Prior studies hold different views and empirical results on this topic. Work for aid started by (Chenery & Strout, 1966) with the "Two Gap Model" presented, the economic rationale behind foreign assistance, contended that due to lower financing strength developing nations could not achieve desired economic goals. This is because of an adequate level of saving to fill this gap, the developing nations have to accept foreign assistance.

For Bangladesh, Islam (1992) found a weak positive relationship between aid and economic growth. Asteriou (2009) has used both panels Mean Group (MG) and Pooled Mean Group (PMG) methods for five South Asian countries and conclude a positive aid-growth relationship.

Hansen & Tarp (2000) has observed aid enhances economic growth and these outcomes are not restricted to good policy. Although (Hansen & Tarp, 2000) study "three generations" cross country regression who demonstrate the finding as for first-generation, how aid affects domestic savings if it has a positive effect then its growth-promoting. Further second-generation assesses the association of aid and growth with the investment. The third one with the only relationship between aid and growth accomplishes a positive effect. Moreover, Gomanee et al. (2005) showed by their empirical work, aid contributes indirectly to the promotion of economic growth, it works through investment. Aid supports economic growth empirically explored by (Islam, 2005). Many analysts (Dowling, 1998) (Tendulkar, 1971) depict, foreign aid sometimes has no or maybe very debauched outcome concerning the recipient countries.

Moreover, the role of fiscal strategy for aid is observed by (Collier & Dollar, 2001; Burnside & Dollar, 1997, 2000, 2004). They have determined that the positive influence of assistance is conditional on the fiscal tactic of recipient countries. Although the importance of good governance and political stability for aid to improve growth is also remains a matter of concern. (Knack, 2001) depicts that assistance that is given for training and technical purpose leads to improve institutional proficiencies, which in turn increase the efficacy of governance and growth. (Bauer, 1976) has exposed that inflows of aid can protract corrupt behavior, make moral hazard along with a destabilization of their institutions, further burdened foreign debt. Work by (Islam, 2007) maintains that aid helps to promote growth for which stability of government (better political environment) is a necessary condition. (Dollar & Levin, 2006) introduced that donor countries provide financial assistance to those nations which have suitable economic environments.

Prior literature elucidates mixed results about both aid and growth relationship. This inconsistency may be due to different reasons: it may be by time, region, and methodology-specific differences. The researcher applied different economic techniques to figure out how does aid works to develop the economy. (Feeny et al., 2014) used the Nonlinear three-stage least square method on fragile economies and finding enclosed as aid is not used constructively by Papua New Guinea Government. (Basnet, 2013) has used a simultaneous equation system for five south Asian countries, by using variables including foreign aid, domestic savings, and economic growth. Although there exists an interest for new work in the literature thus through this paper tries to add new research work on the role of economic policy and political stability for aid focusing, developing Asian countries, because these countries heavily depend on foreign assistance. (Yakubu et al.

2020) studied determinants of economic growth in Kenya which explores capital openness and financial development hinders economic growth. While political stability positively influences economic growth. It has been determined; foreign aid is a debatable issue because foreign aid has not provided desirable results (Jia & Williamson, 2019).

A call for a rise in development assistance to developing economies expressed that aid is fundamental to equitable progress suggested by The United Nations Sustainable Development Goal (2016). External financing provokes economic growth (Bird & Choi, 2020) so it is important to consider external sources of finance to enhance economic growth. But this study fails to provide desirable results on the impact of foreign aid on the economic growth of developing economies. (Azam, 2021) explores that foreign aid tends to boost economic growth without discrimination of income groups. It is also suggested that for low-income countries exports tend to increase economic growth and in low-middle-income countries, economic growth is increased through foreign aid and foreign direct investment. For upper-middle-income countries, foreign direct investment upsurges economic growth while foreign direct investment does not contribute to raising economic growth.

Conferring to the neoclassical growth theory, nations that work with low endowments nurture faster than developed countries. In production functions where labor and capital are input, introduce foreign aid as input. The Production function is written as follows:

$$Y = f(L, K, A) \tag{1}$$

Here Y is the gross domestic product in real terms, L is labor input, K is used for domestic capital stock, and A is used as an abbreviation of stock of foreign aid. If foreign stock is used effectively, it leads to economic growth. The country will grow faster and move towards economic and social development. As the foreign stock is used for investment purposes. It increases the domestic capital which is the primary source of economic development. The empirical study of (Gomanee et al., 2005) showed that aid contributes indirectly to the promotion of growth, it works through investment. it also helps to reduce the saving gap of a country. In developing nations individuals have less capability to save, that's why the investment process in these countries is slow down. Worked by (Papanek, 1973) depict that foreign currency reserves are less in quantity in these nations so foreign assistance is the source to reduce the foreign exchange as well as the saving gap.

Moreover, if this assistance is given to educate people and make them technically advance which will be helpful for a country to make their labor skilled. Skilled labor is a growth-promoting agent. Along this good policy and strong governance are needed to use the foreign assistance effectively otherwise in most countries, foreign aid just increases consumption. (Radelet et al., 2005) provides evidence, countries use aid for consumption purposes. Thus, the analysis of good policy and better governance for aid provide strong evidence about the importance of both. There is the significance of stable government and suitable economic policy, aid to promote growth. For such a purpose, steady government stability is an obligatory condition, donor countries provide financial assistance to only those countries having a stable economic environment proposed by (Islam, 2007), (Dollar & Levin, 2006). We find the answer about the significance of governance and economic policy, how both are necessary for the effective use of foreign assistance.

3. DATA

Within the framework mention in the previous section the relationship between growth and aid should have the following structure:

$$Y_{it} = \alpha_i + \sum_{i=1}^{t} \beta_i X_{it} + \mu_t + \varepsilon_{it} \tag{2}$$

Where Y_{it} is the per capita GDP of a country i and period t, α_i, and μ_t is the country-specific effect and period-specific effect, ε_{it} is an error term. In the vector, X_{it} contains growth determinist, includes physical capital, budget deficit, labor-force participant, human capital, inflation, and endogenous variables include aid, policy, and political stability. In the aid model, equation 3, includes the following variables:

$$Aid_{it} = \delta_0 + \delta_1 GGDP_{it-1} + \delta_2 \log(POP)_{it} + \delta_3 HK_{it} + \delta_4 POL_{it-1} + \delta_5 A_{it-1} + \varepsilon_{it} \quad (3)$$

The dependent variable is Aid/GDP ratio and on the left side, there is a lag of growth GDP per capita and log of policy index, a log of population, human capital, and the lagged aid variable. In literature, considerable limits of aid are described, where most important are strategic interests of donors and aid is given to low-income countries with small populations. (Schneider & Frey, 1985) have established the obligation of the World Bank and assistance is related to better policies. The policy equation 4 is written as:

$$POL_{it} = \alpha_0 + \alpha_1 TO_{it-1} + \alpha_2 BD_{it} + \alpha_3 INF_{it} + \alpha_4 GGDP_{it-1} + \alpha_5 A_{it-1} + \varepsilon_{it} \quad (4)$$

The policy equation 4 contains TO as Trade openness (import + export/GDP), BD as the budget deficit and INF is inflation. To cope with endogeneity, this equation 4 is instrumented by, lagged value of GGDP and lagged Aid. We are expecting a positive coefficient for trade openness and growth of GDP whereas a negative coefficient for the budget deficit and inflation.

$$PS_{it} = \beta_0 + \beta_1 ED_{it} + \beta_2 DEM_{it} + \beta_3 GGDP_{it} + \varepsilon_{it} \quad (5)$$

In this equation 5, we took proxies as ED for education, it is considered as an opinion. In the countries where people have aptitude and trends toward education, it leads to good governance (see, Mina & Ndikumana, 2008). DEM stands for democracy dummy and GGDP as the growth of GDP. Political stability for low developing countries is an obligatory condition for aid to indorse economic growth.

This study has empirically estimated the aid-growth relationship of growth recipient countries from 1983 to 2013. The developing countries in this study include Malaysia, Pakistan, the Philippines, Thailand, Bangladesh, China, India, Indonesia. Foreign aid is given to Asian countries to boost economic growth and the nation's development. World Development Indicators is the data source of desire variables like GDP per capita, growth of GDP, aid (Official development assistance) population growth, labor force participation, human capital. To solve the economic size problem, we took the ratio of the variables like foreign aid to GDP ratio. The human capital variable is taken as the Average year of schooling (25+) and further political stability from ICRG. We have employed the GMM method to handle endogeneity among variables. According to Boone (1994), Hansen and Tarp (2001), Rajan and Subramanian (2005), economic growth and foreign aid have an endogenous relationship which implies that aid itself depends on the income level of the recipient economy and its economic policies. Considering that economic growth also depends on aid inflows can increase the reverse causality problem in the aid-growth relationship. As suggested by many studies, instruments variables can be used to minimize endogeneity problems in panel data. While analysis, we can overcome the endogeneity issue by taking lags of variables.

We have followed Burnside and Dollar (2000) to assess the effect of foreign assistance on the economic growth of recipient countries of Asia. We have used Principal Component Analysis (PCA) for index construction. Following the literature, we have added inflation, budget surplus, and trade openness as policy variables to construct a policy index for recipient countries. The following equation represents the construction of index whereas α_1, α_2, α_3, show the weights of the first components of PCA:

Policy Index = α_0 + α_1 (TO) - α_2 (BD) - α_3 (INF)

The signs of each variable represent the economic association of that variable with economic growth.

By applying the panel data estimation technique. First, calculate the values of each equation 3, 4, and 5 separately (political stability, aid, and policy), and then minimize the endogeneity bias, the predicted values of these endogenous variables (aid, policy, and political stability) are used in the growth equation. By using panel data estimation (GMM), need to clarify that the individual effect is taken as common or fixed, or random. We compared the common effect model and fixed effect, the Redundant fixed model, by the Hausman test. Fixed effects model and random-effects model as this method tackles the issue of endogeneity if any exist. We applied the Redundant Fixed Effects tests to check whether intercepts are common or not across the cross-sectional entities.

Further, we introduce the aid-policy interaction term and the aid-political stability interaction term in the growth equation and estimated separately both interaction terms in the growth equation by fixed effect. The next step to finding the relation of aid and growth excluded the political stability and policy variable. Further endogenous variables aid, political stability, and policy are incorporated in the aid equation and estimated with lag economic growth per capita in the dynamic panel data model.

4. RESULTS

Table 1 represents the results of Equations 3, 4, and 5. Apply the fixed-effect method using the Panel data estimation technique. Column 2 (AID-EQ, Model-1) shows the results of the aid equation, GGDP, Aid is given to low-income countries. Aid is associated negatively with the population. The negative coefficient of the population shows that if the population increases, per capita aid decreases. The coefficient of variable human capital is negative which indicates that as the human capital of the country increases aid tends to decrease. Countries with technical advance human capital are fewer aid recipients. Further to explore whether aid is allocated in favor of good policy we have introduced a policy index as mentioned above. Following (Burnside & Dollar, 2000) aid policy interactive terms imply the effectiveness of aid in the existing macroeconomic policy environment.

Column 2 (PS-EQ, Model-2) reports the result of equation 4. There is a positive association between education and political stability, these results are not similar (Barro, 1996). A democratic form of government is supposed to be more appropriate for political stability rather than another form of government and better economic conditions are anticipated to be positively correlated with stable politics. Education and growth have a positive relationship at a one percent significance level. The effect of educational quality on economic growth is significantly higher in countries that have been fully open to international trade as compared to countries that have been fully closed. Moreover, the quality of the institutional environment and quality of education is important for economic growth. It has been observed, knowledge capital on growth is largely in the countries where the institutional framework is organized hence education quality and institution can reinforce each other. The macroeconomic impact of education depends on complementary growth-enhancing policies and institutions (Hanushek, 2020).

Table 1: Results of Aid, Policy and Political Stability Equation

	AID-EQ (Model-1)	**PS-EQ (Model-2)**	**POL-EQ (Model-3)**
Constant	0.0111*	2.5411***	1.2821***
	(0.097)	(0.0071)	(0.0092)
lGDP	-0.0130		-1.51E-12
	(0.0090)		(0.0001)
HK	-0.0090		
	(0.0071)		
LPOP	-0.0020*		
	(0.068)		
EDU		0.0139***	
		(0.0080)	
GGDP		0.0798***	
		(0.0093)	
DEM		0.1480	
		(0.1430)	
TO			0.0201**
			(0.040)
BD			-0.0202***
			(0.0020)
INF			-0.1801***
			(0.0080)
lPOL	-0.3420e-3		
	(0.5110)		
lAID	0.9030***		-5.02E-12*
	(0.0012)		(0.0901)

Note: Significance level 1%, 5%, 10% are represented by ***, **, * respectively. Values in parentheses are P-values.

Results of Equation 5 (POL-EQ, Model-3) are presented in column 4. In policy index independent are regressed on GDP per capita growth, followed by (Islam, 2005) and (Burnside & Dollar, 2000). Policy index implies the effectiveness of aid in the policy environment.

The Policy index = 1.2821 + 0.0201*TO - 0.0202*BD - 0.1801*INF

Budget deficit and inflation have a significantly negative effect on economic growth. High inflation and budget deficit decrease productivity growth and the upsurge inflation leads to a reduction in capital investment. Trade openness with a positive effect explains, increase in trade openness upsurges economic growth, the findings are not similar (Redmond & Nasir 2020). In Table 2 we will discuss the results with interaction terms.

In column 2 (AID-EQ, Model-1) interaction term aid with political stability: aid has a positive impact on economic growth. It makes clear aid is growth encouraging when countries hold with a stable government. The results represent, political stability is a necessary condition to enhance growth consistent with the findings of (Islam, 2005) and (Ramadhan, 2016). According to the results growth per capita increases 0.1070 percent due to a one percent increase in aid. Moreover (United Nations, 2016) suggested that aid is the key element to the economic progress of developing countries.

Other variables like trade openness are significant with the positive sign which directed us to more open countries to develop, these outcomes do not match with the findings of (Yakubu et al. 2020) who only studied one country Kenya. (Harrison, 1996) proposed democratic nations develop more rather than another system of government (Barro, 1996). The human capital variable in all three models is insignificant. This relationship specifies that in Asian countries economic growth may not depend on a higher level of education, because the economies of these states heavily depend on the agrarian sector. Other variables budget deficit and inflation are negative and significant. Stable macroeconomic policies for example low inflation and less budget deficit are assurance to enhance growth. Moreover, the stock of physical capital is essential for economic growth. These countries heavily depend on physical labor because the physical capital is significant and positive towards growth. Political institutions are grave to the growth of an economy in a financial reform policy which ultimately leads to a conducive environment for financial development and economic growth. Asian countries with a better democracy have vast market based financial systems. The established democratic environment reduces political risk, eventually leads to economic growth through financial development.

Table 2: Results of Growth, Policy and Political Stability model

	PS	**POL**	**AID-GROWTH**
Dependent variable	**GGDPc (Model-1)**	**GGDPc (Model-2)**	**GGDPc (Model-3)**
Constant	-53.3901***	-56.4001***	-66.4010***
	(0.0010)	(0.0081)	(0.0024)
Aid	0.1070*	-20.9410***	-0.3711***
	(0.0790)	(0.0061)	(0.0054)
TO	0.0130**	0.0160	0.0322
	(0.030)	(0.670)	(0.240)
BD	-0.2111***	-0.2411***	-0.2661
	(0.0023)	(0.0024)	(-45.56)
INF	-0.1880***	-0.1730***	-0.0010***
	(0.0010)	(0.0097)	(0.0067)
HK	-1.2110	-1.2980	-1.1622
	(-0.8722)	(0.8171)	(0.65)01
PK	6.6201***	7.0301***	7.6661***
	(0.0011)	(0.0073)	(0.0011)
DEM	1.0401*	0.0511	0.7890
	(0.0601)	(41.721)	(11.540)
Aid * PS	5.3490*		
	(0.041)		
Aid * POL		2.6920	
		(72.87)	
R^2	0.555	0.494	0.460
Adjusted R^2	0.524	0.46	0.420
T-Test	17.8	15.3	13.1
P value	0.001	0.001	0.001

Note: Significance level 1%, 5%, 10% are represented by ***, **, * respectively. Values in parentheses are P-values.

The aid-policy interaction term which is incorporated in column 3 (GGDPc Model-2) shows a negative relationship. It indicates that better economic policy holding countries have an extensive volume of aid. Our results are consistent with (Islam, 2007) and (Armah & Nelson, 2008), that foreign assistance is growth encouraging when countries are politically stable in government. (Azam, 2021) also confirmed that foreign

aid helps to enhance economic growth without any discrimination of income groups, not consistent with our findings.

In model 3 (AID-GROWTH, GGDPc) column 4 the two variables policy and political stability drop from the model and run the regression with simply aid and growth. We find aid has a negative relationship, elaborates that if nations want to utilize their external resources there must be government stability and a better economic policy environment. Our findings support the evidence of a negative relationship between aid and growth (Bird & Choi, 2020). Table 3 incorporate the fixed effect static and dynamic growth model results.

Table 3: Results of Static and Dynamic Growth Model

	Static Growth Model (Model-1)	**Dynamic Growth Model (Model-2)**
Dependent variable	**GGDPc**	**GGDPc**
Constant	-59.4401***	-20.6010***
	(0.0011)	(0.0012)
lGDP		-0.479***
		(0.0023)
Aid	0.9261*	0.1532*
	(0.060)	(0.0703)
Pol	0.3360*	0.3601*
	(0.073)	(0.0303)
PS	0.9801*	10.3811***
	(0.3720)	(1.5702)
HK	-1.800***	-0.0530
	(0.0071)	(0.871s)
PK	6.4601***	0.7621
	(0.0021)	(0.7601)
DDEM		12.8110***
		(0.0014)
Lab	0.0520	
	(0.661)	
R^2	0.40	0.250
Hausman (P-Value)	0.13	
Sargan J test (P-value)		0.001

Note: Significance level 1%, 5%, 10% is represented by ***, **, * respectively. Values in parentheses are P-values.

Column 2 in table 3 (Static Growth Model, Model-1), presents results of the Fixed Effect model-static panel estimate. It includes the estimated value of three variables (political stability, aid, and policy) further include growth's traditional variables as physical capita, labor force participation, and human capital. The result shows that aid, policy, and political stability are significant with a positive effect on growth, findings are in line with (Yakubu et al. 2020). Good policy is a necessary condition for growth but itself (policy) does not give satisfactory outcomes for aid to enhance growth but coupled with political stability it works meaningful. The coefficient of human capital is negative and significant, specify human capital declines growth. In column 3 (Dynamic Growth Model, Model-2) we extended it by taking lag on the right-hand side to handle endogeneity and used the generalized method of the moment. The lag explanatory variables are used as instruments and the Sargan J test confirms the validity of the instruments. Aid has a positive coefficient and further policy and political stability are positive and significant. It has been inferred that foreign aid provokes economic growth while (Bird & Choi, 2020) found undesirable results on the impact

of foreign aid on the economic growth of developing economies. However, our findings of foreign aid and economic growth are in line with (Azam, 2021) without any discrimination of income groups.

5. CONCLUSION

This study aimed to find the effect of foreign assistance on the economic growth of recipient countries of Asia using data set of 1984 to 2013. From empirical findings it is clear, with fixed-effect aid is growth-promoting in Asian countries. Growth is conditional on good policy and a stable political environment. Indeed, the findings are consistent with (Islam, 2007) that political stability is necessary for aid to encourage growth. By introducing aid political stability interaction term, we found the aid is significant and positive to growth. This indicates that if a country wants to get the desired outcome from external resources it holds with good political conditions. In our results for the static Fixed Effect model, we found growth has a positive and significant association among aid, policy, and political stability. These results indicate that for better use of external resources a country must hold better economic policies and good political conditions. Moreover, as we skip the two variables (policy and political stability) from the growth equation the aid coefficient becomes significantly negative. That makes sure these two variables are important for aid to promote growth. Aid with a negative and significant sign points out if countries want to best utilize their external resources there must be political stability and a better economic policy environment. Our finding supports the evidence of a negative aid growth relationship in line with (Bird & Choi, 2020). We conclude the whole study as the effect of aid can be positive or negative, but few factors may play a significant role to enhance growth, for the countries utilize external resources for development purposes.

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