Institutional Quality, Conflict and Aid Dependency

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Abstract

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 does affect the governance directly by inducing instability and volatility in the economy, this precariousness gives rise to inauspicious climate that puts off the investment. Low level of investment and output will in turn decrease the required tax revenues or the available funds that can be used to improve the quality of governance. 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.

Key Words: Official Development Assistance, Governance, Conflict.

JEL Classification: C33, F35, O11, O43, D74.

1. Introduction

Over the last two decades, governance and foreign aid have attracted a lot of attention of economists. Both these variables play an important role in shaping the economic welfare of developing nations while the exact relationship between these variables has been clouded with uncertainty leading to curiosity of researchers. Experience suggests that higher level of aid inflows is associated with lack of quality governance. Governance enables a country to achieve its targets and prosper, by enabling a conducive environment for high and sustained economic

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growth[4]. "Aid is received to overcome problems like budget deficit or revenue constraints etc, which hinders the growth in the poor countries and there is sparse evidence suggesting foreign aid significantly enhance the economic growth of the recipient countries which works only in the presence of sound macroeconomic policies and governance.[5] Most of the developing countries are suffering from low quality of governance; there is a need to investigate the underlying factors that deteriorate the 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 facing low quality governance (see Figure 1). It is becoming immensely important to search out those hidden facts due to which the foreign aid and governance both collapse to achieve the common target of sustained development. This study attempts to investigate, how aid dependency affects the quality of governance in developing nations by taking into consideration conflict. Conflicts, whether internal or external, have an adverse impact on the institutions. Cross border tensions, civil wars, coup threats, political violence, terrorism and foreign pressures leave the government unstable and abate the institutional quality. Conflicts arise as a consequence of a complex mix of social, economic, historic and political conditions of a country. Causes of these conflicts are numerous and varied in nature, and these conflicts in turn have implications for the social, political and economic fabric of the society. Conflicts affect the components of governance like the rule of law, quality of bureaucracy and corruption. More accurately the break down of the rule of law is directly manifested in the incidence of conflict. The quality of governance in turn has serious repercussion for the economy. With adverse law and order conditions in a country, investors the key drivers of the economy are dissuaded from investing, more importantly foreign investors are scared away from the unpredictable outcomes of conflicts. Moreover, conflicts divert government expenditures from much needed developmental projects towards alleviating rifts and problems which they engender. Political instability as a result of conflict may induce more corruption and make the civil society weak. Government in power and the public officials try to grasp all that they find for themselves and their followers.

Good governance ascertains a predictable, unprejudiced and persistent enforced set of rules in the form of effective governance and it's

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

[5] 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) and Feeny and McGillivray (2010).

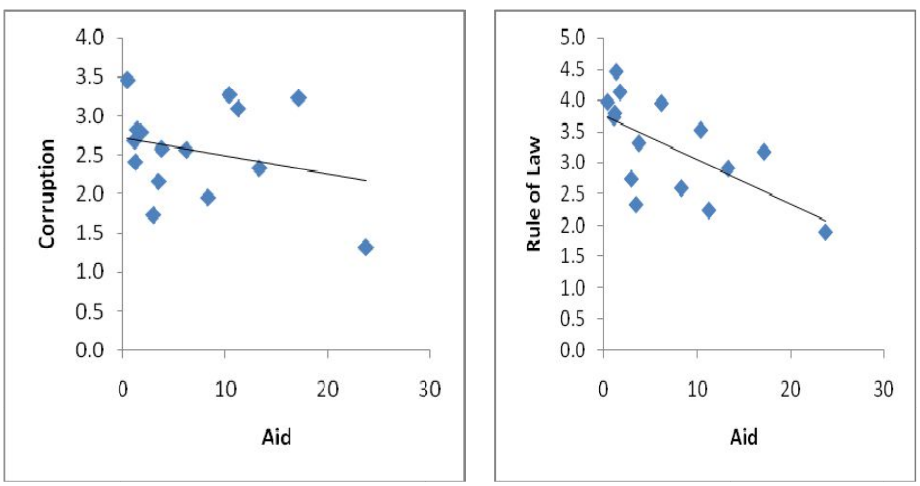
essential for the continual of economic development process,[6] while aid dependence can potentially weaken the quality of governance by undermining accountability and transparency, promoting rent seeking and corruption and alleviating pressure to postulate efficient policies and institutions.[7] Economic literature is resplendent with controversies regarding the inter-linkage between the 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 erode the corruption by releasing the recipient government from binding earned revenue constraints.[8] South Korea and Taiwan present a good example in this respect. 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.[9] 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 shortens the time horizon for each government as it now tries to grasp whatever they find in ascendancy.[10] 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 conditioning aid on policy and institutional quality is ineffective as the recipient country tries to improve and reveals the indicator to make the donor's happy but behind the scene the picture does not look too pretty as has been shown.[11]

In the light of the forgoing 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 flooded even up to 40% to 45% of GDP boost economic growth and development, when given to countries with strong institutions and macroeconomic policies. Positive

[6] See, North (1990;1992), Keefer and Knack (1995;1997).
[7] For instance see, Keefer and Knack (2001), Brautigam and Knack (2004) and Busse and Groening (2010).
[8] See for example, Carlsson, *et al.* (1997).
[9] See, North (1990), Klitgaard (1990), Maren (1997), Karl (1997), Brautigam and Botchwey (1998), Dollar and Pritchett (1998), Moore (1998) and Brautigam (1992; 2000).
[10] See, Grossman (1992).
[11] See for example, Kapur and Webb (2000), Stiglitz (1999), Dollar and Pritchett (1998), Collier (1997) and Crawford (1997).

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 by considering purely cross-sectional data set of developing countries. Brautigam and Knack (2004) based on 32 African countries, conclude that the foreign aid make the government not answerable for their actions in front of their citizens which may reduce its need to govern well which leads to the irresponsible behavior regarding the maintenance of rule of law, assurance of a predictable judiciary, contract enforcement and limit corruption. Busse and Groning (2007), based on 106 aid dependent countries using ICRG index for the governance indicators, found that aid has a negative rather than positive impact on the quality of governance. It has been even argued; they don't recommend that governance could improved by lowering aid flows, rather the donors and the recipient should reassess current aid configuration, aid effectiveness and the possible drawback of aid on governance at both country and project level while escalating aid flows. Rajan and Subramanion (2007) demonstrate that aid donors and recipients must not take aid inflows as an unadulterated blessing as if aid ineffectually used, can in reality impede a country in its path to development. Countries that receive more aid, their aid dependent industries grow fairly at a snail's pace".

Figure 1



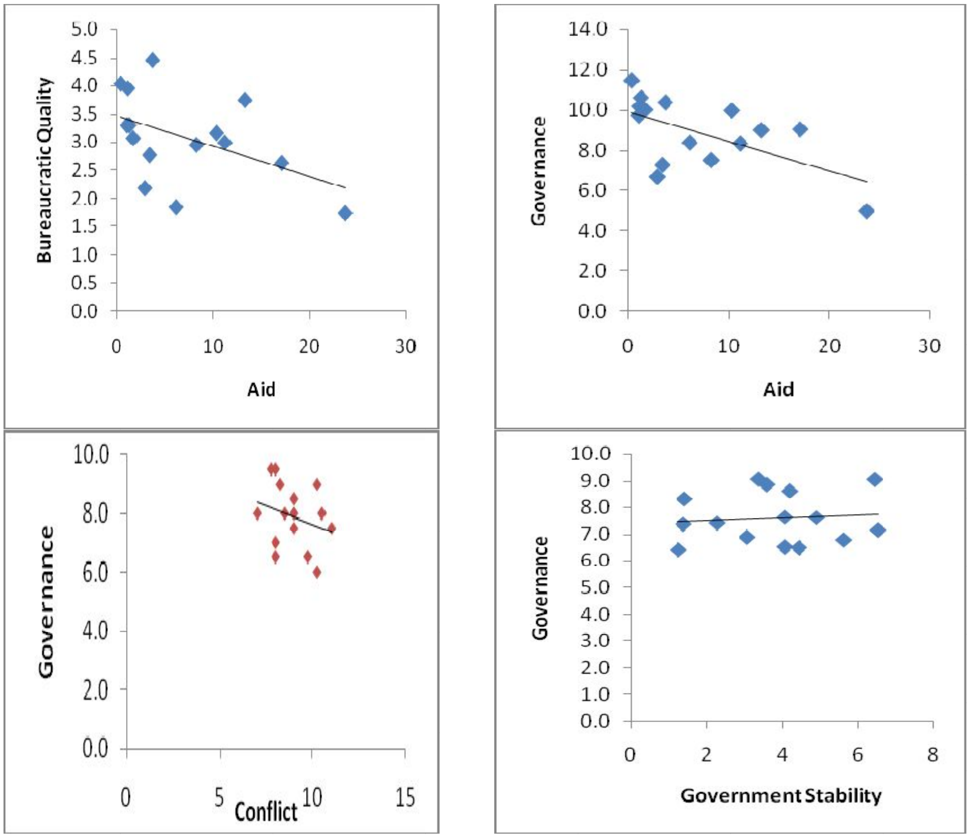


Figure 1 depicts the facts very clearly; the relationship of foreign aid and conflict with the governance quality is negative while that of government stability is associated positively.

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 confronting the conflict so it is worthwhile to explore the relationship of foreign aid, conflict and governance; this study aims to fulfill the literature gap by analyzing the impact of foreign aid and conflict on the quality of governance.

2. 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 organizations" offered by the World Bank's 2002. 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.

Data for the 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. 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[12]. Table 1 describes the summary statistics that describes the mean, median and standard deviation 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

[12] 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.

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

3. Empirical Evidence

Empirical model has been estimated using the fixed effect as well as the random effect model, houseman test has been applied as well that provide evidence in favor of fixed effect model (see table 3). To tackle the issue of endogeneity 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 obvious as now government is not answerable to the general public; they are not dependent on the earned revenue so this attitude will affect the governance quality adversely. Government will not indulge in those activities that enforce the rules and law in the country as a result the higher aid inflow will erode the rule of law. In case of bureaucratic quality, the sign is according to the expectation as donors may take away the public officials by paying them high and get involved them in those projects that are financed through foreign aid. In case of Asian economies an increase in foreign aid by 1% 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 affecting the corruption positively that means when ever government official get access to foreign funds, this will induce more corruption in the system.

"It's not only the aid inflows that affect the governance quality; the past level of governance quality also plays an important role in determining the current institutions. To capture the impact of past institutions 5-year lag has been introduced in the regression equation; results show that it has positive impact on the current level of governance. If a country had enjoyed good institutions in the past then it will have sound institutions in its future but if these institutions are bad then it will certainly have bad impact on the current level of institutions. Per capita GDP growth is positively linked with the 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 conflict irrespective of its type whether it is internal or external conflict. When we include conflict in the regression equation it makes the foreign aid parameter insignificant although the sign of parameter is still negative that means if a country is suffering from the internal or external conflict then it has great adverse impact on the institutional quality then foreign aid (see table 5). Population is negatively associated with the governance while that of 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 regression equation. To find out the robustness of the main variable of concern, sensitivity analysis is required. Results can be challenged by the omitted variable bias, so various regressions have been estimated to tackle this issue (as shown in table 6). By 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.

4. 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 conflict. "Results indicate that foreign aid erodes the 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 contributes a lot in the development of institutional structure. Countries that are fighting against conflict are facing weaknesses in their institutional structure which in turn deteriorate the quality of governance. For sustainable growth and effective utilization of foreign aid it is necessary that the government should try first to eradicate the external as well as internal conflict. If the government get 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 dissuade the corruption, bribery and baseness”. Donors may even put some conditions 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 deserve these funds.

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

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%, 5% and 10% respectively.

Table 5

	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%, 5% and 10% respectively

Table 6

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%, 5% and 10% respectively.

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