The impact of foreign aid on corruption in pakistan

The growing gap between the developed and developing countries has dominated international relations and negotiation for a long time. This gap has led to constant capital inflow from the developed countries to those in the developing World including Pakistan; with the goal of helping them overcome their problems and reduce the gap. However, there is evidence that decades of foreign aid have done little in changing the destinies of these developing nations, most of which are currently experiencing low growth rates. This suggests to some extent that there is more to the problem than just sending money there as this is not likely to turn things around.

The fundamental idea of aid is transfer of resources on concessional terms i. e on terms softer than loans available in the worlds capital markets (Nafziger, 1990). Foreign aid includes all financial flows from developed nations to developing and transition countries, including official grants and loans, trade financing and military assistance and Assistance funded by non-governmental organizations (NGOs). OECD defines foreign aid as the official development assistance (ODA) which consists of official grants and highly concessional loans from bilateral or multilateral donors to developing countries aiming to promote economic development and welfare (DAC, 1970). There are three criteria that ODA should satisfy: (i) aid is given by the official sector of the donor country; (ii) with the objective of promoting economic development and welfare in recipient countries; (iii) loans are given with grant element. The OECD also makes a distinction between ODA and official aid (OA). The OA consists of aid flows that meet conditions of eligibility for inclusion in ODA, but the recipients are countries in transition, mainly from Eastern Europe and Former Soviet Union.

Foreign aid in historical perspective:

Two important developments – political factors and the progress of development thinking – have made crucial impact in the evolution of modern era foreign aid policy (Hjertholm and White, 2000 and Kanbur, 2006). In its modern form, foreign aid has its origins in the early 1940s and intensified after the disruption that followed the Second World War. Table 1. 1, taken from Akramov (2006), provides a helpful overview of the main developments in the history of modern foreign aid.

After World War II aid was given to war-devastated countries to rebuild the economies in the shape of Marshall Plan. Then in the early 1950s, it was used to strengthen the military capability and political ideologies. At end of the Cold War, in 1989, most aid has been targeted to promote economic growth and improve public wellbeing in the developing and underdeveloped countries (Foreign Aid, 2008). During the 1990s, aid was given to developing countries to promote economic growth, encourage the development of democratic institutions, and provide for humanitarian needs. After the 9/11 attack, the United States began giving huge amounts of bilateral aid to countries cooperating with its fight on terrorism. Billions of US dollars have gone to newly allied countries such as Pakistan, Afghanistan and Iraq. For instance, since September 2001 Pakistan has received about USD 8 billion for cooperating in a fight against terrorism and about USD 3 billion for economic and development assistance (CAP, 2009). This aid is usually given without the consideration of recipient countries' governance quality and economic conditions, as they agree to cooperate with the US in the fight again terrorism-e. g., by allowing the United States to use their country as a base to gather intelligence.

Table 1. 1 Overview of main developments in the history of foreign aid.

Decade

Dominant or rising institutions

Donor ideology

Donor focus

Types of aid

1940s

Marshal Plan and UN system (including World Bank)

Planning

Reconstruction

Marshall Plan was largely programme aid

1950s

USA, with Soviet Union gaining importance from mid 1950s

Anticommunist,

But with role for the state

Community Development Movement

Food aid and

projects

1960s

Establishment of bilateral programmes and regional

development banks (including ADB, AfDB and IDB)

As for the 1950s, with support for state in productive sectors

Productive sectors (e. g. support to the

green evolution)

and infrastructure

Bilateral donors gave TA and budget support; multilateral donors gave project aid

1970s

Expansion of multilateral donors (especially World Bank, IMF and Arab-funded

agencies)

Continued support for state activities in productive sectors and meeting basic needs

Poverty, taken as agriculture and basic needs (such as health and education)

Fall in food aid and start of import support

1980s

“ Washington Consensus” and rise of NGOs from mid-1980s

Market-based adjustment (rolling back the state)

Macroeconomic reform and liberalization

Financial and structural adjustment aid and debt relief

1990s

Eastern Europe and FSU become recipients rather than donors; emergence of corresponding institutions (EBRD)

Move back to the state toward end of the decade

Support to political and economic transition, poverty and governance

Move toward sector support at the end of the decade

2000s

Bilateral aid agencies expanded aid flows (especially USA, establishment of MCC) and surge in private aid (remittances)

Move toward performance based aid allocation

MDGs, global health (HIV/AIDs), security and governance

Continued sector support with special focus on social sector

Note: Entries are main features or main changes.

Source: taken from Akramov (2006), p. 16, Table 2. 1.

Since independence Pakistan has had to depend on foreign assistance in its development efforts and to balance its international debt payments. The main sources of foreign aid in Pakistan are consortium, non consortium and the Islamic countries with first being the major source. In the early 1950's, foreign economic assistance to Pakistan was to supplement the scarce domestic resources and made towards higher and sustainable economic growth. Most of the aid was in the form of project and budget support. Between 1950 and 1999, the international donor community contributed nearly 58 billion dollars to Pakistan. Now Pakistan is receiving aid for development, stability and security purposes. From 2002-2010, Pakistan received approximately 18 billion in military and economic aid from the United States.

The inability of Pakistan to not effectively use the foreign aid is attributed to various factors; the inadequate absorptive capacity and widespread and systematic corruption are pointed out as the major binding constraint on the efficient allocation of aid flows (Ishfaq, 2004).

Corruption is defined by the World Bank, and Transparency International as the use of public power for private benefit. It is the misuse of public office by public officials for personal gains. The motive of corruption is to provide some one unfair advantage at the expense of another individual or a country or province. Corruption in Pakistan is systematic and badly affecting the economy of country. In Pakistan, much of the funds allocated for development purposes are wasted due to corruption. Corruption has not only eroded the quality of infrastructure but also provided inadequate infrastructure. It has diverted the funds from education and health sectors to public consumption activities.

Pakistan’s decline continue in Corruption Perceptions Index (CPI) of transparency international and now its Index Score is 2. 3 against 2. 4 in 2009, and out of 178 countries, its ranking as most corrupt country has slipped 7 ranks, from 42 in 2009 to 34 most corrupt country in 2010. The main reason of corruption in Pakistan is that corruption is supported by leaders and politicians of country who are the most corrupt people of this country. (Hashmani, 2010).

Significance of study:

Foreign aid has important implication for poverty reduction in Pakistan. The voluntary transfer of funds from richer to poorer countries in 2009 has been provisionally estimated at $119. 6 billion. Total DAC (development assistance contribution) Net disbursements to the developing nations is 16 964. 75 USD millions (constant prices) & about 705 USD millions is for development purposes. Total Net disbursements to Asia are 44 159 million USD. Amongst that Pakistan stood at 7th number and receives 1539 USD million. But there is hardly found any evidence that this aid has had any impact on the poverty reduction or development of the country. One reason might be the wide spread corruption in the region. Corruption in Pakistan is increasing with rapid pace and it not only destroying the society of country but also the economy. Pakistan is continuously performing poor on the CPI. Much of the foreign aid for development and a significant portion of the operations allocations are lost due to bribery and other related illegal and unethical activities. So it is important to find out whether the huge sums of aid coming from the donor countries and organizations are contributing to the corruption in Pakistan or the widespread corruption is attracting more and more aid in Pakistan as it provides a support to the donor's incentives.

Objectives:

The purpose of the study is to determine the impact of foreign aid on corruption in Pakistan. The objectives of the study are:

To estimate the causality relationship between foreign aid and corruption.

To find out whether foreign aid decreases or increases corruption in Pakistan.

To find out the effect of foreign aid on GDP in Pakistan.

To find out the effect of corruption on GDP in Pakistan.

Hypothesis:

Theoretical background:

An important objective of aid is to promote the economic development and welfare of recipient countries. Aid effectiveness is usually measured by its impact on economic growth. There are two contrasting sides of aid effectiveness: one which argues that aid has a positive effect on economic growth, with even more impact in countries with sound economic and trade policies; and another which contends that foreign aid causes corruption, encourages rent-seeking behavior, and erodes bureaucratic institutions.

Growth in developing countries, sometimes, needs a thrust to initiate and speed up and some scholars pointed towards aid as it would provide such effective source to help developing countries to move out of their poverty trap and made them able to self-sustain (Sachs, 2005).

Foreign aid and economic growth has a causal link that is foreign aid enhances economic growth, so long as " good" fiscal policies are in place (World Bank, Craig Burnside and David Dollar, 1997). These policies include maintaining small budget deficits, controlling inflation, and being open to global trade. Also, to improve living standards, poor countries must produce more. To produce more, poor countries must initiate and maintain long run growing processes to build physical and human capital, acquire technology, and nurture institutions that facilitate growth. The role of aid for development is to support these long run collective processes. Increase in aid helps in building infrastructure and access to health and education services and increase in saving and investment (Rodan 1961) which will increase growth (Arndt et al. 2007).

But some economists also argued that aid does not always have any positive impact on growth of recipient country and in some cases; it actually has worsen the growth (Friedman and Bauer 1976). They have pointed towards the dependency effect of development aid which does not allow the poor people to come out the vicious circle of poverty and contribute to growth. Boone (1994) found that aid-intensive African countries experienced zero per capita economic growth in the 1970s and 80s, despite foreign aid actually increasing (as measured by share of GDP). One reason that aid has such a disappointing effect is massive corruption in developing countries (Walle, 2007). An explanation for a negative effect of aid that offsets the benefits of resource transfers is that aid undermines or weakens governance by increasing the returns to corruption and/or increasing rent seeking activities (Djankov et al. 2008). Additionally, Knack (2001) found that high levels of foreign aid can erode bureaucratic and institutional quality, triggering corruption, and encouraging rent-seeking behavior.

Corruption has been common and deep-rooted in most aid recipient countries. And some observers even believe that aid may actually exacerbate it-that increases in the amount of aid may indeed increase corrupt activities because there are more resources for the interested people to fight over (Brautigam and Knack, 2004). Foreign aid increases the corruption in recipient country through many ways. Increase in foreign aid increases the government revenues which are used to provide public goods. But such an increase also increases the rent seeking behavior of corrupt bureaucrats who allocates much of the aid for consumption purposes and not for productive public spending (Svensson, 1998) which causes increase in poverty and income inequality and inequality is a cause of corruption in developing countries (Kwabena, 2000). Also, aid helps developing countries by increasing their access to international capital markets. In developing countries, there are no savings and taxes, and the population size is very large which leads to fall in capital per person and hence affects growth negatively. If foreign aid substitutes domestic saving, it will affect growth negatively. Decrease in growth causes an increase in corruption (Hansen and Tarp 2000, Michael 1998). Instead, if foreign aid increases savings and investment, such an increase will have positive impact on growth and

Human capital formation (Hansen and tarp 2000; Mavrotas 2003). But Boone (1995) stated that aid did not increase investment and growth nor helped in poverty alleviation, but it increased the size of the government and size of the government increased corruption in developing countries (tanzi 1998). When aid dependence increases, recipient states are expected to become less accountable for their own actions, and increases incentives for domestic corruption by increasing conflict over aid funds and essentially compensates for economic policies and weak government institutions by offering a ' crutch' (Knack 2001, 2004 & 2005).

The relationship between corruption and economic growth could partly explain why billions of dollars of aid have not produced the expected effects. And corruption may be one of the main causes to blame for the failure of economic growth in aid recipient countries. Rose-Ackerman (1999), one of the well-known corruption scholars, contends that " a country is poorer overall if corruption levels are high".

Corruption has been found to be a major obstruction to economic growth (Mauro, 1995); it causes a misallocation in resources, decreases foreign direct investments, private investment in both human and capital, increases transaction costs, distorts free market incentives, and reduces economic efficiency (Gyimah and Camacho, 2006).

Corruption is found to have relationships with important determinant of economic growth. It hinders economic growth indirectly by decreasing investment as corruption increases the risks associated with making investments (Mauro, 1995). Mauro argued that corruption acts as a tax on the returns to private investment thereby reducing the quantity of investment and it redirects scarce investment capital to less productive uses, thereby damaging the quality of investment. From these two channels, corruption decreases the GDP growth.

Corruption also affects negatively on growth by weakening political stability and lowering human capital accumulation (Mo, 2001; Gyimah and Camacho, 2006). Corruption lowers government's revenue by reducing tax collection and increasing the size of underground economy thereby reducing the efficiency and growth of the economy. This reduction causes severe impacts on the income level of poor people. It also contributes to poverty by reducing investment expenditures on health and education (Hessel and Murphy).

The effect of corruption on economic growth is also transmitted through trade openness channel. A low degree of trade openness is significantly associated with higher level of corruption (Ades and Di Tella, 1994; Pelligrini and Gerlagh, 2004). It also limits new goods and technology, and directs money into unproductive uses hence lowers growth (Tanzi, 1998). Corruption increases the dependency on foreign aid as it affects the GDP growth of the country. It increases inequality, poverty and reduces human capital formation in a country which causes the growth rate to decrease thus making a country more dependent on foreign assistance (Tavares, 1999).

In short, foreign aid affects economic growth negatively in most of the aid recipient countries because of the prevalence of corruption which makes the negative effect on growth more severe.

Methodology:

Model Specification:

Two models will be analyzed:

GDP growth = Î²o + Î²1 aid / gdp + Î²2 population growth + Î²3 inflation + Î²4 ethno + Î²5 trade openness + Î²6 initial gdp + Î²7 education + Î²8 investment/ gdp + Î²9 corruption + Î²10 M2/ gdp + Î²11 political stability + Î²12 institutional quality + Îµ

GDP growth per capita is a function of: Aid as a percentage of GDP, annual population growth, annual inflation, ethno-linguistic fractionalization, trade openness, log initial GDP, Human capital, ratio of investment to GPD, corruption level, M2/GDP, political stability, institutional quality.

In the model, GDP growth per capita is the dependent variable and it is regressed on a series of independent variables described below.

The independent variable, aid as a percentage of GDP is used because most empirical studies use aid as a percentage of GDP to study the effect of aid on economic growth (Boone, (1996), Burnside and Dollar, (2000)).

Trade openness is used because GDP growth per capita is found to have a positive relationship with trade. Trade openness of developing countries helps increase economic growth using comparative advantage they have (Sachs and Warner, 1995). This result is confirmed by Burnside and Dollar (2000). Developing countries would benefit from the increased economic activities and economy of scale. That would create more jobs for the people. Thus openness to trade in developing countries could potentially help them increase GDP growth per capita.

Percentage of population having secondary education- a measure of human capital- is also important for economic growth. Barrow (1991), for example, using school education as proxy for human capital, finds that economic growth is positively related with initial human capital.

Financial depth was also found to have a positive relationship with percentage change in GDP per capita; that is as the ratio of liquid liability to GDP increases, the economy will more be likely to grow (Burnside and Dollar, 2000).

Ethno-linguistic fractionalization negatively affects the rate of economic growth. The higher the probability that two randomly selected people from a country do not belong to the same ethnic or linguistic group, the lower the economic growth would be (Burnside and Dollar, 2000). A country with heterogeneous population would be less likely to grow than the more homogenous one.

Economic growth was also found to have a positive relationship with investment as a percentage of GDP (Boone, 1994). Similarly, based on Solow growth model, an increase in population can potentially increase the economic growth as more population could supply a larger labor force for the economy.

Economic growth was also found to have a negative relationship with the annual inflation (Fisher, 1993). Inflation distorts incentives to invest and reduce productivity growth, thus high inflation will reduce economic growth.

Corruption also decreases economic growth (Mauro, 1995); it makes return uncertain and takes away the incentive to invest.

Political instability is also associated with a decrease in economic growth as it increases the likelihood of internal conflict and distorts investors' confidence. In Brautigam and Knack (2004), they found that political stability is likely to affect the rate of economic growth.

Log initial GDP by convergence theory is negatively related with economic growth, as country with low initial GDP will growth at a faster rate than the one with higher.

Corruption = Î²o + Î²1 aid / gdp + Î²2 inflation + Î²3 ethno + Î²4 trade openness + Î²5 education + Î²6 political stability + Î²7 institutional quality + Î²8 demo + Î²9 law and order + Î²10 inequality + Îµ

Corruption is a function of: Political stability, democratic accountability, annual inflation, trade openness, law and order, ethno-linguistic fractionalization, Aid/GDP, Human capital, institutional quality.

In this model, corruption level the independent variable, will be regressed on a series of independent variables described below.

Controlling the effects of these variables will enable the model to distinguish the effect of aid on corruption.

The more democratically accountable a government is the less corruption there likely will be within the country. Intuitively, democratic government is an accountable government, and therefore government that is more likely to take initiative to curb corrupt activities. So the relationship between corruption variable and democratic accountability should be negative.

The institutional quality of the government and corruption should also have negative relationship. High quality government would mean highly capable government; with strong capability the government should be able control corrupt activities within the country and punish the wrongdoers.

Law and order should be negatively related with corruption. A country having proper law enforcement and good social order should be able to control the adverse activities of its people, especially corruption.

Similarly, the percentage of people having secondary education- measure of human capital- and corrupt activities should be negatively related. Better educated people should be less likely to exercise any activity that would harm a society as well as themselves comparing to the ones with lower education. This relationship can be seen in the real word as well; developed countries with larger population having high educations have less corruption than the less developed ones.

Further, annual inflation and corruption should have a positive relationship. High annual inflation typically indicates that a country has weak social and economic institutions to manage its economy. Such conditions may even lead to economic disorder if the annual inflation is very high.

Similarly, the trade openness relationship with corruption is also negative. Pellegrini and Gerlagh (2004) find that the more open the country is to trade, the less corrupt the country is.

Finally, Brautigam and Knack (2004) find that political instability is also likely to affect the quality of governance. And that reduction in the quality of governance is likely to increase corruption.

Expected Result:

I expect to find a negative relationship between foreign aid and corruption on average, as most aid is now delivered in Pakistan with stress on accountability and transparency.