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FOREIGN AID, CORRUPTION AND ECONOMIC DEVELOPMENT: AN EMPIRICAL ANALYSIS ON SELECTED ASIAN AND AFRICAN COUNTRIES

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ABSTRACT

Ahsan MN, Nasrin N, Akter A, Hashem T (2011) Foreign aid, corruption and economic development: an empirical analysis on selected Asian and African countries. *J. Innov. Dev. Strategy* 5(3), 1-8.

Most of the Least Developed Countries (LDC) especially Asian and African countries have received a sizable amount of foreign assistance (ODA) over the years in various forms. At the same time, corruption is a key national challenge to these LDCs for their development. This study examines the relationship among corruption, foreign aid and economic development of some selected Asian and African LDCs. A panel dataset of fifteen years (1995-2009) for these selected countries is used for analysis in this study. With a view to showing relationship among ODA, corruption and development a cross country analysis is conducted at first, where the above-mentioned relationship is examined separately for selected Asian and African countries. Then an aggregate analysis is performed where all the sample countries from Asia and Africa are considered. In aggregate analysis, the result shows that ODA is negatively related to corruption whereas GDP growth, GDP per capita and good governance is positively related. In case of cross country analysis, the study explores an interesting result that not only CPI but also GDP growth is negatively related to ODA for both the Asian and African countries. Finally, it is found that supply of ODA increases due to rise in per capita GDP, GDP growth and good governance of the selected LDCs. However, corruption negatively influences the ODA flow and hence, it can be concluded that corruption hampers foreign aid supply, which in turn hampers GDP growth, good governance and overall development.

Key words: *corruption, official development assistance (ODA), development, good governance, least developed countries (LDCs)*

INTRODUCTION

Foreign aid is usually associated with Official Development Assistance (ODA), which is a subset of the official development finance, and usually targeted to the Least Developed Countries (LDCs) (World Bank 1998). In the past, LDCs received huge external aid flows from the donor community aimed at promoting economic growth and reducing poverty. Today external resources constitute an integral part of development expenditure in the LDCs. These countries sometimes face major budgetary constraints and use aid inflows to cover any deficits. As mentioned that LDCs have received a sizable amount of foreign assistance over the years, even though official development assistance is still a significant source of foreign exchange. Official Development Assistance (ODA) contributes LDCs' national income, education, health and so on. Though ODA has continued to play an important role in LDCs, especially in Asia and Africa, it is interesting to note that after half a century of channeling resources to the third World, little development has been taken place (Ohno 2002). In almost all of sub-Saharan Africa there is a high degree of indebtedness, high unemployment, absolute poverty and poor economic performance (Njeru 2003). On the other hand, corruption and bribery are some of the oldest white-collar crimes known to mankind (Wells 2009). Corruption is defined by Transparency International and World Bank as abuse of public office for private gain (Iftekharuzzaman 2005; World Bank 2011). Corruption is a key national challenge for LDCs. It is remarkable that corruption affects almost everyone and it is hardly ever punished in the LDCs. On the contrary, corruption, especially political corruption is the fastest way to the levels of power. Corruption is also a key impediment to the realization of various development goals. Corruption deprives children of access to education and prevents access of the poor to basic health services and affects development of the country (Iftekharuzzaman 2005). In recent years the donor community has become more stringent about fiscal discipline and good policies, which have led to freezing of donor funds to governments that do not comply with aid conditionality (Njeru 2003). Under the circumstances, it is inferred that there is likely to be a close relation among foreign aid supply, corruption and economic development.

Corruption has multidimensional impacts (Pantzalis *et al.* 2008). It lowers productivity, efficiency of government which leads the countries towards economic stagnation and extreme poverty, permits few genuine economic freedoms, generates massive rent-seeking and allows little room for economic talents to flourish (Ahmad and Quibria, 2008). On the other hand, development effort is complex, involving many steps and people. Thus, rendering accurate oversight on development process is almost impossible. Many major recipients of aid suffer almost endemic corruption (Anon 2011). The dispensing of foreign aid (ODA) through the state makes it easier for recipient societies to fall into a rent-seeking trap. On the contrary, ODA is found to have a positive impact on economic growth as it increases investment, growth, per capita income and so on (Easterly 2003). It also increases the capacity to import capital goods or technology.

Aid is a voluntary transfer of resources from one country to another, with the objective of benefiting the recipient country (Sandor *et al.* 2009). Corruption impairs prospects for economic growth, undermining the rule of law and damaging the legitimacy of the political process (Santiso 2001). There have been a number of studies attempting to answer the link between corruption and aid. Many of such studies have found a positive correlation between corruption and aid. Alesina *et al.* (2002) show that corruption and aid are significantly and positively correlated. They conclude that more corrupt governments receive more aid from developed countries. This same idea is argued by Alesino and Weder (1999) that more corrupt government receives more foreign aid and there is no evidence that an increase in foreign aid reduces corruption. In this context, Ahmad and Quibria (2008) explain the failure of aid due to endemic corruption.

Krueger (1974) shows that due to dispensing of foreign aid, it becomes easier for recipient societies to fall into a rent-seeking trap. Stvensson (2000) supported this idea by using game theory and providing some empirical evidence in support of the hypothesis that foreign aid and windfall are on average associated with higher corruption. He finds no evidence that the donors systematically allocate aid to countries with less corruption. On the other hand, Johnson (1967) claims that aid is unambiguously preferable to import-absorption as a way to increase national income in a developing country. Aid, in contrast, can be used much more flexibly and can be applied in a manner that will yield the greatest benefit at the margin (Osborne 2002).

However, a number of studies have found negative relationship between aid and corruption. For instance, in the words of Tavares (2003), it is argued that aids are negatively related to the level of corruption. He shows that an increase in aid inflows of 1% leads to a significant decrease in corruption by 0.2 point out of a possible range of 0-10. He depicts several possibilities behind such relationship. First, foreign aid may be associated with rules and conditions that limit the discretion of the recipient country's officials, and thus, decrease corruption; which is defined as a conditionality effect. Second, if foreign aid alleviates public revenue shortages and facilitates increased salaries for public employees it may diminish the supply of corruption by public officials, which is defined as a liquidity effect.

Njeru (2003) studied the impact of foreign aid in public expenditure in Kenya and found that there is a positive and statistically significant relationship between the share of government expenditure in GDP and the share of net disbursement of ODA. While the study finds relatively little evidence that aid leads to tax relief, there are strong indications that the government renders aid fungible by financing recurrent expenditures.

Waker (2005) explains why humanitarian aid is at risk from corruption. The author argues on types of corruption that can potentially affect the provision of humanitarian aid are- fraud, embezzlement, misuse of aid agency assets, diversion of aid resources and bribery. He suggests various approaches for tackling corruption in humanitarian aid can broadly be grouped into preventive, enforcement and ownership-based mechanisms.

Good governance is the prerequisite for all kind of development and assurance of democracy and disbursement of aid to the right place. It also augments growth, per capita income. Various studies show the relation between growth and corruption.

Although Alesina *et al.* (2002) show that more corrupt governments receive more aid, many of the countries with poor governance aid still contributes high percentage of the government budget (Bräutigam and Knack, 2004). Studies from developed countries show the negative correlation between corruption and aid due to differences in governance quality. Knox (2009) explores that corruption undermines the rule of law and damages the legitimacy of the political process. He examined the people's experiences of using health and education services in Bangladesh and concludes that the poorest communities are most victimized by corruption. Ahmad and Quibria (2008) explain the failure of aid because it prevents the need for hard choices and genuine reforms, and thus leads to the persistence of bad policies, poor governance, and widespread corruption.

There also exists relationship among corruption, foreign aid and development. A study by Alesina *et al.* (2002) shows the positive correlation between aid-flow and GDP despite differences in productivity levels among recipient countries. It is optimal for donors to give more aid to countries with low productivity; however, it turns out that corruption is the main factor behind such low productivity. Hence, Croix and Delavallade (2011) concludes that aid and corruption are positively correlated at equilibrium when productivity is the main source of difference in development pattern across countries. One the other hand, Burnside and Dollar (2000, 2004) report that aid is uncorrelated with the recipient country's economic growth or poverty incidence. If aid is not channeled to productive uses or to poverty reduction, it may be going somewhere else. One possibility is that aid is channeled to uses that promote corruption. Knox (2009) explores corruption impairs prospects for economic growth. Dreher and Herzfeld (2005) reported that corruption affects economic growth, the level of GDP per capita, investment activity, international trade and price stability negatively. An increase of corruption by one point reduces GDP growth by 0.13 percentage points and GDP per capita by US$ 425.

Alesina and Dollar (2000) use bilateral trade data to show that the amount of aid is weakly related to the recipient country's economic performance. Ahmad and Quibria (2008) show the failure of aid and impact of corruption on aid. They argue that aid ineffectiveness arises due to a lack of domestic capacities to handle large amounts of aid or imposing cumbersome reporting requirements from different donors. If the flow of aid is substantial, it can also fail because of the emergence of Dutch disease, that is, the flow of aid may cause the real exchange rate to appreciate and thereby impede the growth of exports. Osborne (2002) depicts the negative relation between aid and growth using the performance of industrial nations in development. Yeats (1982) found that both aid and exports have a significant and positive impact on economic growth in developing countries, although exports were somewhat more effective than aid.

Aid is given to the LDCs for developing and ensuring their democracy, health, education and human right. But corruption very often impedes all the efforts to obtain the above-mentioned milestones. In this respect, Ahmad and Quibria (2008) explore that aid may fail to ensure hard choices and genuine reforms, which leads to the persistence of bad policies, poor governance and high level of corruption. The governance problem is greatly compounded by the absence of enlightened leadership with a grand vision and a sophisticated understanding of the economic development process.

Lambsdorff (1999) investigates that corruption has an impact on flows of bilateral trade and donor assistance. As, the large exporting countries and donors exhibit a different propensity to pay bribes and to accept illegitimate payments. It concluded that corruption commonly goes along with policy distortions, inequality of income and lack of competition.

Considering the above-mentioned perspective this study revolves round the question- does corruption hinder foreign aid flow and development or what is the relation among aid and corruption, economic development? Hence, this study investigates the relationship between foreign aid, corruption GDP and good governance. This relationship is, indeed, a complex one which has drawn the attention of many scholars in recent years. The effect of ODA on 'good governance' indicators like democracy, bureaucratic quality or corruption remains strongly debated in the literature. Hence, we attempt to test the empirical relationship of ODA with corruption, GDP growth, per capita GDP and good governance of the selected LDCs.

MATERIALS AND METHODS

Conceptual framework

ODA: It is defined as 'Flows of official financing administered with the promotion of the economic development and welfare of developing countries as the main objective, and which are concessional in character with a grant element of at least 25 percent (using a fixed 10 percent rate of discount). By convention, ODA flows comprise contributions of donor government agencies, at all levels, to developing countries (bilateral ODA) and to multilateral institutions. ODA receipts comprise disbursements by bilateral donors and multilateral institutions' (OECD 2011).

Corruption: It implies abuse of power for personal benefits as defined by Transparency International. There is a close relationship between power and corruption, though not everyone in positions of power is involved in corruption. Corruption is also a behavior or act that breaks away or contradicts from ethical and moral standard, laws and civic virtues. Corruption has been defined as 'behavior' which deviates from the formal duties of a public role, because of private-regarding pecuniary or status gains (personal, family, private clique). This behavior includes bribery, nepotism and misappropriation of public funds. Other definitions include the misuse of public office for personal gain (Islam 2004). The destructive effects of corruption on development are not limited to the misuse of the public money of donor taxpayers; corruption in private business activities also creates major problems. Corruption can take different forms but is frequently associated with exploitation of natural resources, which in many developing countries are the greatest economic assets.

Corruption Perception Index (CPI): According to the Transparency International (TI), CPI is an aggregate indicator that combines different sources of information about corruption in a given period of time. CPI ranks countries according to perception of corruption in the public sector. It measures corruption by giving weight 1 to 10. Values closer to 1 denote highly corrupted countries and values closer to 10 indicate lesser corruption. The CPI of the various years draws on different assessments and business opinion surveys carried out by independent and reputable institutions. It captures information about the administrative and political aspects of corruption. The CPI is therefore one of many TI measurement tools that serve the fight against corruption (TI 2010).

Good governance: As a concept, it is applicable to all sectors such as the government, legislature, judiciary, the media, the private sector, the corporate sector, the co-operatives, societies registered under the Societies Registration Act, duly registered trusts, organizations such as the trade unions and lastly the nongovernment organizations (NGOs). Public accountability and transparency are as relevant for the one as for the other (Godbole 2001). The concept of 'good governance' often emerges as a model to compare ineffective economies or political bodies with viable economies and political bodies. Because the most 'successful' governments in the contemporary world are liberal democratic states concentrated in Europe and the America, those countries' institutions often set the standards by which to compare other states' institutions (World Bank 2010). In this study voice and accountability; and political stability are taken into consideration with a view to representing good governance.

Data type, source and sample size

This study is based on panel data of selected Asian and African countries for the period of fifteen years (1995 to 2009). Asian countries are Bangladesh, India, Pakistan, China; and African countries are South Africa, Uganda, Cameroon, Kenya, Egypt and Nigeria. Relevant data are collected from the data-bases of the World Bank and Transparency International.

Main variables

The variables of interest of this study are Official Development Assistance (ODA), Corruption Perception Index (CPI), GDP per capita, GDP growth and Good Governance. Of these mentioned variables, ODA is taken as dependent variable and the rest of the variables are considered as independent variables. GDP growth is taken in log term. An interaction term between voice and accountability, and political stability is constructed as a proxy for good governance.

Model specification

The general form of econometric model used in this study is-

$ODA = \beta_0 + \beta_1 CPI + \beta_2 \ln(GDP\ Growth) + \beta_3 GDP\ Percapita + \beta_4 Good\ Governance + u$………..(1)

The above-mentioned model (equation 1) is used separately for both Asian and African sample countries and then aggregately for all the countries in the sample. The statistical package called STATA is used for running the econometric models in this study.

RESULTS AND DISCUSSION

Regression analyses are performed in two parts- firstly, a cross country analysis is conducted where equation 1 is tested separately for Asian and African sample countries; and then secondly, the same equation is tested for all the sample countries *i.e.* both for Asian and African countries.

Cross country regression analysis

Panel data of selected Asian and African countries for the period of 1995 to 2009 is used for this cross country analysis. Table 1 represents the result of simple linear regression test. The result shows that there is a relationship between ODA, CPI, GDP Growth, GDP per capita and good governance of the selected Asian countries. ODA and CPI are negatively related to each other. That indicates due to one point increase in CPI in selected Asian countries ODA will be decreased by US$ 28 million. This result is not statistically significant. On the other hand, GDP growth also shows an inverse relationship with ODA. It denotes that if GDP growth rises by one percent, then ODA will be declined significantly by US$ 3.1 million.

GDP per capita and good governance are also positively related with the supply ODA to the selected Asian countries. The result demonstrates that one US$ increase or decrease in the GDP per capita and one unit increase or decrease in good governance of the selected countries; ODA will be increased or decreased by US$ 0.1 million and US$ 24 million respectively. However, for Asian countries results on impact of CPI, GDP per capita, good governance on ODA are not significant.

Table 1. Result of multiple regression model (equation 1) for cross countries

	1	2
VARIABLES	oda_asia	oda_af (WLS)
cpi_asia	-28.53	
	(92.20)	
lngdpgrowth_asia	-307.7**	
	(128.3)	
gdppercapita_asia	0.1000	
	(0.122)	
goodgovernance_asia	23.85	
	(83.75)	
cpi_af		-230.8***
		(40.78)
lngdpgrowth_af		-143.4***
		(30.34)
gdppercapita_af		0.112***
		(0.0150)
goodgovernance _af		539.5**
		(221.8)
Constant	2,110***	1,389***
	(280.9)	(187.5)
Observations	59	84
R-squared	0.110	0.760

Standard errors in parentheses *** p<0.01, ** p<0.05, * p<0.1

Second column of Table 1 shows the result of the selected African countries. In this case, a Weighted Least Square (WLS) is conducted due to heteroscasdicity problem in the model. It demonstrates a significant inverse relationship between ODA and CPI, which implies one point increase in CPI will result a decrease in ODA supply by about US$ 231 million. Similarly GDP growth also affects ODA negatively but GDP per capita and good governance influence positively the supply of ODA to the selected African countries. Result denotes an increase in the GDP growth by one percent will cause a significant decrease in the US$ 1.43 million. However, an increase in the GDP per capita and good governance by one US$ and one unit respectively, ODA will significantly increase by US$ 0.11 and US$ 539 million respectively.

From the light of above result, it can be concluded that in case of Asian countries GDP growth is the only significant variable with expected sign in the model, although the signs of coefficients of other explanatory variables are similar with expected signs. On the other hand, for African countries all the variables are statistically significant and with expected signs. The common conclusion from Table 1 is that more GDP growth result in lesser ODA supply to both the regions. Besides, for the Asian countries the model is explained 11% variation in ODA by the independent variables whereas for the African countries it is 76%.

Regression analysis for all sample countries (aggregate analysis)

Conducting the regression model separately for Asian and African sample countries, now we would like to conduct the same regression model (equation 1) aggregately for all the sample countries. Table 2, column 1 shows the overall result of the selected Asian and African countries. It explores ODA and CPI is inversely related to each other. It denotes that one point increase in CPI would cause ODA to decrease by US$ 150 million. This result shows that GDP growth, GDP per capita and good governance positively influence the ODA. When GDP per capita is enhanced by one US$, supply of foreign aid also boost up by US$ 0.0002 million. Again, if GDP growth is escalated by one percent, ODA will be increased by US$ 358 million. Good governance, which is a proxy for voice, accountability and political stability in this study; shows that one unit increase in the good governance would induce escalate ODA flow by about US$ 161 million.

However, in this model (column 1 of table-2) only one explanatory variable (GDP growth) is significant. For this same model tests for multicolinearity and heteroskedasticity are performed. Results show that there is no multicolinearity problem with the model since the mean Variance Inflation Factor (VIF) is 1.74 which is less than 10. However, the associated p-value of Breusch-Pagan test confirms heteroscadascity problem in the model.

Due to existence of heteroscadasticity the model is reconstructed by giving an analytical weight to regression equation (equation 1). This analytical weight is equivalent to 1/(good governance)^2; where good governance is the interaction term of multiplication between voice and accountability, and political stability. Correcting the model for heteroscadisticity problem, the regression equation/model (equation 1) is rerun as a Weighted Least Square (WLS). The results of WLS are reported in second column of table 2.

Table 2. Result of multiple regression model (equation 1) for all sample countries

	(1)	(2)
VARIABLES	Oda	Oda (WLS)
Cpi	-150.4	-262.6***
	(142.1)	(36.32)
Gdppercapita	0.0160	0.0373**
	(0.125)	(0.0187)
Lngdpgrwth	358.2**	191.9**
	(151.5)	(74.22)
Goodgovernance	160.9	399.2**
	(142.9)	(169.3)
Constant	963.9**	1,352***
	(405.9)	(196.3)
Observations	143	143
R-squared	0.067	0.484

Standard errors in parentheses *** p<0.01, ** p<0.05, * p<0.1

Table 2, second column demonstrates an inverse relation between ODA and CPI. Numerically it refers to one point increase in corruption would decline foreign aid flow by around US$ 263 million. On the other hand, one US$ increase in the GDP per capita and one unit increase in good governance would escalate ODA flow by US$ 0.04 million and US$ 399 million respectively. Similarly, GDP growth also influences the ODA positively, which indicates due to one percent increase in GDP growth will also raise ODA flow by US$ 1.92 million in the sample countries. All the explanatory variables are found significant in this case. This model is explained 48% variation in ODA by the explanatory variables.

Contrast between cross-country and aggregate result

By analyzing the cross country result, we conclude that in Asian countries corruption and foreign aid flow are inversely related, which is expected; however, the relationship is not significant. The reason might be insufficiency in required data for Asian countries. Similar inverse relation exists between GDP growth and ODA for Asian countries; however, in this case the relationship is significant. Hence, the conclusion from this result (Table 1, column 1) is that gradual increase of GDP growth would decline foreign aid supply in the Asian countries. This finding corresponds to the findings of Osborne (2002) and Knox (2009). However, GDP per capita and good governance may attract ODA flow in Asian countries. On the contrary, for African countries corruption and good governance seem to be more influential factors for supply of ODA. For these countries an increase in corruption level will affect ODA negatively and significantly. Like Asian countries, GDP growth and ODA are also inversely related for African countries. Lastly, it can be concluded that corruption and GDP growth influence ODA negatively whereas GDP per capita and good governance influence ODA positively for the selected African countries.

However, in the aggregate or overall analysis only the corruption level is inversely related with ODA flow where this relationship is significant. The other explanatory variables- GDP growth, GDP per capita and good governance possess significant positive relationship with ODA flow.

In fine it can be stated that corruption hampers the supply of ODA to the LDCs significantly. On the other hand, if the GDP growth rises, then it will be helpful for the LDCs to get more ODA from the donors. A country with better governance quality, ensuring political stability along with voice and accountability throughout the country, would obviously be more capable of getting greater amount of ODA from the donors.

CONCLUSION

Major findings from this study explore that corruption obstacles the supply of foreign aid (ODA) to the LDCs to a great extent. On the other hand, higher level of GDP growth and GDP per capita, and better governance are conducive for getting more foreign aid. Our study concludes that with a better governance situation *i.e.* when the right to speak as well as accountability can be ensured, both corruption and political instability are less likely to persist in LDCs. Such a situation may induce sustainable growth of the concerned LDCs by suppressing corruption opportunity and escalating GDP growth rate and per capita income. All these factors then create room for greater flow of ODA from donors. This study has attempted briefly to show the dynamic interrelation among ODA, corruption and development. However, this study has not focused on a more complete data set covering most of countries from the above-mentioned continents. Hence, there is ample scope for future research to investigate the empirical relationship between ODA and other important economic and non-economic variables.

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