

# Can Aid Both Help and Hinder Governance?

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## What is Governance?

- ADB & World Bank: "the manner in which power is exercised in the management of a country's economic and social resources for development"
- Political Scientist Goren Hyden defines governance as "the conscious management of regime structures, with a view to enhancing the public realm."
- Governance signifies "the capacity to define and implement policies." (Kjaer, 1996: 6, emphasis omitted)
- Governance is "an interactive process by which state and social actors reciprocally probe for a consensus on the rules of the political game." (Bratton and van de Walle, 1992: 30)

## Kaufmann, Kraay, and Zoido-Lobaton's Definition

"[The] traditions and institutions by which authority in a country is exercised." This includes:

- (1) the process by which governments are selected, monitored, and replaced,
- (2) the capacity of the government to effectively formulate and implement sound policies, and
- (3) the respect of citizens and the state for the institutions that govern economic and social interactions among them.

## How Can Measuring Governance Be Subjective?

- KKZ: "survey questions can be interpreted in context-or culture-specific ways. For example, a response regarding the prevalence of 'improper practices' is coloured by country-specific perceptions of what 'improper practices' are perceived to be."
- Our own Clay Wescott: "in comparison to economic issues, governance is more culturally-specific, with greater cross-country differences."

## Why Governance?

- "The main cause of misery and poverty in the world is bad government." George Soros
- "Ultimately, better governance requires political renewal. This means a concerted attack on corruption from the highest to lowest level. This can be done by setting a good example, by strengthening accountability, by encouraging public debate, and by nurturing a free press. It also means ... fostering grassroots and non-governmental organizations such as farmers' associations, co-operatives, and women's groups." World Bank (1989)

## Governance and Development: Literature Review (1)

- KKZ (1999): One SD increase in governance leads to "between a 15 and 25 percentage point improvement in literacy" and between a 2.5 and 4 times increase in "per capita income... [and] a strong negative impact on infant mortality, of proportionally the same magnitude as for per capita income."
- Barro (1991) studied cross-country growth and investment regressions for 98 countries for the 1960-85 period, and found that coups, revolutions, and political assassinations are associated with slower growth and lower investment rates.

No surprises here...

## Governance and Development: Literature Review (2)

- Ades and di Tella (1996): corruption negatively affects investment, and is associated with the lack of competition in the product market and with less independent judicial systems.
- Ahrens and Meurers (2001): high quality governance (as measured by factor analysis of 26 indicators ranging from democracy to delayed payments) is positively associated with development outcomes.
- Wei (2001): natural openness (determined by a country's geography and size) leads to good government, such as lack of bureaucratic corruption

## Why Study Aid's Relationship to Governance?

- Good governance is needed for good development outcomes
- Aid intends to produce good development outcomes
- What is aid's relationship to governance?
- Can aid both help and hinder governance?
- If so what kind of governance?
- And (in future research) what kind of aid?

## Knack (2000): More Aid Dependent a Country, the Lower the Quality of Governance: Why?

Independent Variable	Intervening Variable	Dependent Variable
Aid dependence as measured by ODA/GDP, ODA/Gov't Budget or EDA/GDP, EDA/Gov't Budget	<ul style="list-style-type: none"> <li>⇔ Weakening institutional capacity</li> <li>⇔ Siphoning off scarce talent from the bureaucracy</li> <li>⇔ Weakening accountability</li> <li>⇔ Encouraging rent seeking and corruption</li> <li>⇔ Fomenting conflict over control of aid funds</li> <li>⇔ Alleviating pressures to reform inefficient policies and institutions</li> </ul>	Quality of governance as measured by International Country Risk Guide (ICRG)

Source: Adapted from Knack (2001).

Note: ODA, EDA, and GDP are Official Development Assistance, Effective Development Assistance (as measured by Chang et al. 1999),<sup>11</sup> and Gross Domestic Product, respectively.

<sup>11</sup> EDA focuses on the overall grant equivalent of official financial flows and allows meaningful comparisons of recipients or donors.

## How Has Aid Influenced Governance? The Lit Review (1)

- Alesina and Weder (2002) found that FDI over the 1970-95 period is reduced by host-country corruption levels, using one corruption indicator, but no relationship is found when using any of six other corruption indicators.
- Burnside and Dollar (1997) found that aid has a positive impact on growth in developing countries with good fiscal, monetary, and trade policies. Aid does not appear to affect policies systematically either positively or negatively.
- In contrast, Tarp and Hansen (1999) conclude that aid does have a positive impact on growth even in countries with a *poor* policy environment.

## How Has Aid Influenced Governance? The Lit Review (2)

- Burnside and Dollar (1998) showed that a linear relationship exists between the quality of governance and development outcome, and that aid spurs growth and poverty reduction only in a good policy environment.
- In developing countries with weak economic management, there is no relationship between aid and change in infant mortality. Where economic management is stronger, there is a relationship between aid and change in infant mortality.

# How Does This Study Fit-In?

- It uses KKZ's six dimensions of governance to determine the impact of aid. This led to 166 countries in the data.
- To increase the reliability of measurements, rolling average were used to smooth out outliers and shocks such that the available data years 1996, 1998, 2000, 2002 were averaged into three: 1996-1998, 1998-2000, and 2000-2002.
- A five-year delay in the impact of institutional change from aid was introduced in the independent variables, since aid is unlikely to impact governance in the same year in which it is given. This also reduces the potential for reverse causality since aid is given ex-ante.
- $gov(t) = \alpha oda\_gdp(t-5) + \beta gdp\_percap(t-5) + \gamma illit(t-5) + \psi trade\_gdp(t-5) + constant$

## 6 Dependent Variables (Numbered 1-6)

<i>Process by which governments are selected, monitored, and replaced</i>	<i>Capacity of the government to effectively formulate and implement sound policies</i>	<i>Respect of citizens and the state for the institutions that govern economic and social interactions among them</i>
<b>1) Voice and Accountability</b>	<b>3) Government Effectiveness</b>	<b>5) Rule of Law</b>
Indicators measuring various aspects of the political process, civil liberties and political rights, and independence of the media	Perceptions of the quality of public service provision, the quality of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government's commitment to policies	Perceptions of the incidence of both violent and non-violent crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts
<b>2) Political Stability</b>	<b>4) Regulatory Quality</b>	<b>6) Control of Corruption</b>
Indicators which measure perceptions of the likelihood that the government in power will be destabilized or overthrown by possibly unconstitutional and/or violent means, including terrorism	Measures of the incidence of market-unfriendly policies such as price controls or inadequate bank supervision, as well as perceptions of the burdens imposed by excessive regulation in areas such as foreign trade and business development	Perceptions of corruption, conventionally defined as the exercise of public power for private gain. Despite this straightforward focus, the particular aspect of corruption measured by the various sources differs somewhat, ranging from the frequency of "additional payments to get things done," to the effects of corruption on the business environment, to measuring "grand corruption" in the political arena or in the tendency of elite forms to engage in "state capture"

Source: Adapted from KKZ (1999b) and (2002).

# Independent Variables

Variable		Definition
Official development assistance and official aid (% of GDP)	Official development assistance and official aid (current US\$)	Official development assistance and net official aid record the actual international transfer by the donor of financial resources or of goods or services valued at the cost to the donor, less any repayments of loan principal during the same period. Grants by official agencies of the members of the Development Assistance Committee are included, as are loans with a grant element of at least 25 percent, and technical cooperation and assistance. Data are in current U.S. dollars and dollar exchange rates
	GDP (current US\$)	GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources. Data are in current U.S. dollars. Dollar figures for GDP are converted from domestic currencies using single year official exchange rates. For a few countries where the official exchange rate does not reflect the rate effectively applied to actual foreign exchange transactions, an alternative conversion factor is used."
GDP per capita (constant 1995 US\$)	GDP per capita is gross domestic product divided by midyear population. GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources. Data are in constant U.S. dollars.	
Illiteracy rate, adult total (% of people ages 15 and above)	Adult illiteracy rate is the percentage of people ages 15 and above who cannot, with understanding, read and write a short, simple statement on their everyday life.	
Trade (% of GDP)	Trade is the sum of exports and imports of goods and services measured as a share of gross domestic product.	

Source: Adapted from World Development Indicators 2003 CD-Rom. Data for official development assistance and official aid is from OECD (2003).

## Cross-Sectional Regression Analysis Results

- In 2/3 periods (1996-98 and 1998-2000), Rule of Law is hurt by aid, that is  $\alpha$  is negative, at the five percent ( $p < 0.045$ ) and ten percent level ( $p < 0.060$ ) of significance, respectively.
- Government Effectiveness is negatively impacted by aid ( $p < 0.065$ ), but only in the 2000-02 rolling average period.
- Even while the coefficient for aid on governance is not significant, its sign and approximate size for a given dependent variable is consistent from period to period.
- This results in increased confidence in the findings beyond those of statistical significance itself, and justifies doing pooled times series cross-section analysis next.

## Pooled Time Series Cross-Section Analysis

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Governance Index	Voice and Accountability	Political Stability	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
Aid (% GDP)	-0.002 (0.463)	0.008 (0.077)+	0.003 (0.556)	-0.005 (0.065)+	-0.004 (0.276)	-0.008 (0.008)**	-0.003 (0.243)
Real GDP/cap	0.000 (0.000)**	0.000 (0.004)**	0.000 (0.000)**	0.000 (0.000)**	0.000 (0.000)**	0.000 (0.000)**	0.000 (0.000)**
Illiteracy	-0.005 (0.000)**	-0.014 (0.000)**	-0.005 (0.016)*	-0.003 (0.062)+	-0.005 (0.001)**	-0.002 (0.147)	-0.002 (0.188)
Trade (%GDP)	0.002 (0.014)*	-0.001 (0.606)	0.005 (0.000)**	0.002 (0.028)*	0.001 (0.454)	0.002 (0.002)**	0.002 (0.030)*
Constant	-0.384 (0.000)**	0.005 (0.966)	-0.575 (0.000)**	-0.477 (0.000)**	-0.147 (0.124)	-0.551 (0.000)**	-0.599 (0.000)**
Observations	360	360	348	358	360	360	358
R-squared	0.403	0.177	0.265	0.395	0.253	0.510	0.477

Robust p values in parentheses + significant at 10%; \* significant at 5%; \*\* significant at 1%

## Summary of Findings

- Both the cross sectional (period by period) and the pooled times-series cross section analysis share at least two statistically significant and common findings, aid has a negative impact on the Rule of Law and Government Effectiveness.
- For the cross sectional analysis this is true of the rolling average for periods 1996-98 and 1998-2000.
- The finding that Voice and Accountability is helped by aid emerges only at a statistically significant level in the pooled time-series cross section data.

## Discussion of Results (1)

- *Government Effectiveness follows, but why not Control of Corruption?*
- For GE, hypothesized intervening variables such as the weakening of institutional capacity or the siphoning off of scarce talent from the bureaucracy could conceivably damage the quality of the bureaucracy and the competence of civil servants.
- In 1996, Wolfensohn declared war on corruption and this may have shown some results. The World Bank has launched more than 600 anti-corruption programs in nearly 100 countries.
- Today, what is likely measured as corruption is investment climate corruption, in the form of a "bribe tax" or "unofficial payments" rate

## Discussion of Results (2)

- *Why Could Aid Hurt the Rule of Law?*
- Golub (2003) critiques "Rule of Law Orthodoxy" which he identifies as "most prominently practiced by multilateral development banks" and defines as a "'top-down,' state-centered approach [that] concentrates on law reform and government institutions, particularly judiciaries, to build business-friendly legal systems that presumably spur poverty alleviation."
- He adds that the most obvious example might be where foreign-funded consultants/lawyers in a given country help to rewrite laws and revise systems land registration. These revisions are in turn exploited by well-connected persons to engage in de facto land theft, under the color of the law.

## Discussion of Results (3)

- Why More Aid May Have Improved Voice and Accountability?
- By the early 1990s, calls were made of a right to democratic governance with a basis in international law (Franck, 1992)
- In 1994 the US Agency for International Development (USAID) began focusing on democratic governance, giving \$85 million to Haiti.
- In 1993, the United Nations Development Programme (UNDP) launched a Human Development Report themed on People's Participation.
- By January 1997, UNDP issued a policy document that called for "Governance for Sustainable Human Development."

## Policy Implications (1)

- Since the coefficients attached to aid's impact on various dimensions of governance were very small in size and statistical significance was weak, this suggests that many individual countries do in fact succeed in improving their governance.
- On the other hand, President of Uganda Yoweri Museveni did say that "Aid is life support for a system that is already dead." Not surprisingly, Uganda was the first HIPC country.

## Policy Implications (2)

- Decreasing illiteracy and/or increasing trade will have a positive impact on virtually all dimensions of governance
- Increases in aid could logically focus on (a) human development and/or (b) private sector development, as these are proxies for improved literacy and increased trade
- If aid does indeed hinder rule of law and to a lesser extent government effectiveness, aid in that realm should be re-examined perhaps taking cues from aid targeted at dem. gov. (VA)

THANK YOU

Requests for Draft of Paper,  
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