FOREIGN AID AND GOVERNANCE
IN PAKISTAN

ADEEBA SARWAR, MUSHTAQ HASSAN AND TAHIR MAHMOOD*

Abstract. This study analyzes the effect of foreign aid on governance in Pakistan by employing ARDL approach using annual data from 1984 to 2012. The study provides empirical evidence that foreign aid in Pakistan erodes the quality of governance, which has been measured by using indices of bureaucratic quality, corruption and rule of law in Pakistan. Aid dependence possibly damages the quality of governance by increasing corruption, weakening accountability, creating moral hazard, weakening policy learning, draining off talent and ability from the bureaucracy, and relieving burdens to restructure inefficient institutions and policies. Foreign aid programmes should be clearly understood and taken as a temporary and short-term development tool. There should be aid "exit strategy" and motivation for self-help.

I. INTRODUCTION

Foreign aid and governance have been widely discussed by economists over the last three decades. Both variables play a vital role in determining the

*The authors are, respectively, Lecturer in Economics at the University of Education, Bank Road Campus, Lahore; Lecturer (on contract) at the Department of Economics, University of the Punjab, Lahore-54590; and Associate Professor of Economics at the University of Veterinary and Animal Sciences, Lahore (Pakistan).
  Corresponding author e-mail: sarwar.adeeba@gmail.com

economic prosperity in developing countries. Still the exact relationship between foreign aid and governance remains clouded and, hence, creates an interest for the researchers. Good governance creates conducive environment for sustained and high economic growth that enables a country to attain its goals and become prosper. There is low quality of governance in the most of the developing countries. There is a need to explore the main reasons that lead to worsen quality of governance and resultantly hamper the process of development.

Pakistan is getting aid and also has become a victim of bad quality of governance. There is an immediate need to look for those hidden elements that are the causes of failure to attain our desired goal of sustainable development through foreign aid and quality of governance. This study tries to explore the effect of aid dependency on governance in Pakistan.

Foreign aid is a key source of income in Pakistan like many developing countries. Foreign aid inflows fill saving and investment gap and increase productivity by transmitting modern technology that promotes growth. However, it has been observed that foreign aid has not benefited the country, as is evident from poor state of social indicators, like education, health and employment, etc. As the foreign aid inflows are not used for development of the economy, therefore, as a result the savings and investment gap is enlarged. Apparently, the aid is used in the vested interests of powerful people.

Two views prevail about foreign aid. One view is that aid undermines government accountability to citizens because it goes into the pockets of corrupt bureaucrats and politicians. Foreign aid is used to import unsuitable technology, expand government bureaucracies and encourage a larger, unproductive and corrupt government in developing countries or it is just misused.

The other view is that aid contributes to improve critical administrative and fiscal capacity that supports governments to better serve for their people. In fact, neither view is entirely right or wrong.

International financial institutions, in particular the International Monetary Fund (IMF) and World Bank, emphasize much on issue of governance and mainly on corruption in developing countries. After the failure of structural adjustment programme initiated in 1988, importance of good governance was recognized to overcome the economic problems. The World Bank was the first to use the notion of good governance in its report "*From Crisis to Sustainable Growth – Sub Saharan Africa*: *A Long-Term*

Perspective Study" (World Bank, 1989). In this report aid ineffectiveness is connected with governance issues. Later on, Africa became the center of discussions on governance related issues. In the next years, the Bank considered good governance as a main part of its development policy. However, the World Bank in its report "*Assessing Aid*: *What Works, What Doesn't, and Why*" (Dollar and Pritchett, 1998), considered good governance as a selectivity criterion for granting aid. In above-mentioned report, the Bank described the collaboration between developmental aid and the quality of governance. The report highlighted the importance of quality of institutions and claimed that the effect of foreign aid on economic growth depended on the effective institutions and sound economic management. The report recommended that policy performance and reform commitment should be taken as selectivity criteria for the disbursement of aid instead of the considering developmental wants or level of poverty of borrowing country. The report also recommended that the Bank should focus on giving more expertise and financial resources on governance issues to achieve developmental objectives in the fellow countries.

Other important international financial institutions including IMF, OECD, UNDP, ADB, regional developmental and multilateral agencies etc. are also actively endorsing governance issues. The variety of World Bank's programmes of governance that are related to conditionalities include public sector restructuring, civil service reorganizations, transparency, reorganization of delivery system, and judicial and legal reforms.

The effectiveness of foreign aid is a debatable issue. There are many countries like Republic of Korea, Uganda, Indonesia, Vietnam, Ghana, Taiwan, Tanzania, Mozambique and Bolivia where foreign aid has played a substantial positive role in the development of the economy. There is also a list of several countries which received large amount of aid like Kenya, Papua New Guinea, Haiti, Somalia, Philippine, Congo but failed to use it for their development.

According to recent *Global Competitiveness Report*, institutions of Pakistan are ranked at 115 out of 144 countries. Some indicators of institutions are given in Table 1.

A clear picture of the government performance can be perceived from Table 1. All the above indicators show poor governance in Pakistan according to *Global Competitiveness Report*. The Pakistani business community has identified corruption as the most problematic factor in Pakistan. Inefficient governmental bureaucracy has been ranked as second problematic factor for doing business in the Pakistan.

TABLE 1

Indicators of Institutions

Indicators	Pakistan's Ranking out of 144 countries
Judicial independence	57
Property rights	116
Favouritism in decisions of government officials	129
Irregular payments and bribes	119
Organized crime	136

Source: Schwab (2012), *Global Competitiveness Report*, 2012-2013.

Pakistan has been relying on foreign aid since 1947. Foreign aid is one of the key sources of income in Pakistan but foreign aid has not remained effective to improve the economic circumstances of Pakistan. The question arises that if foreign aid does not contribute to our developmental purpose then where does this foreign aid go? There is one view that foreign aid weakens quality of governance through high level of corruption, weak rule of law, weak institutions and absence of accountability, and leads to bad management; that's why foreign aid does not contribute to the process of growth. Durbarry (1998), Javid and Qayyum (2011), and Burnside and Dollar (2004) point out that foreign aid contributes to economic development in the environment of good policy or good governance otherwise it has no effect or otherwise this effect is negative. That's why this study has been planned to explore the impact of foreign aid on governance in Pakistan. Presently, there exists no such study that explores the connection between foreign aid and governance in case of Pakistan.

OBJECTIVES OF THE STUDY

The present study will analyze the relationship between foreign aid and governance in Pakistan. The objectives of study are:

1. To empirically examine the effect of foreign aid on governance in Pakistan, and

2. To explore the channels through which foreign aid influences governance.

The present study attempts to analyze the relationship between foreign aid and governance in Pakistan. The rest of the study is organized as follows: the next Section provides an overview of the foreign aid in Pakistan, Section III gives a review of theoretical and empirical literature on the subject, and Section IV deals with model specification, description of the variables, data sources, and explains methodology. Section V discusses the results. Then concluding remarks and suggestions are provided in the last section.

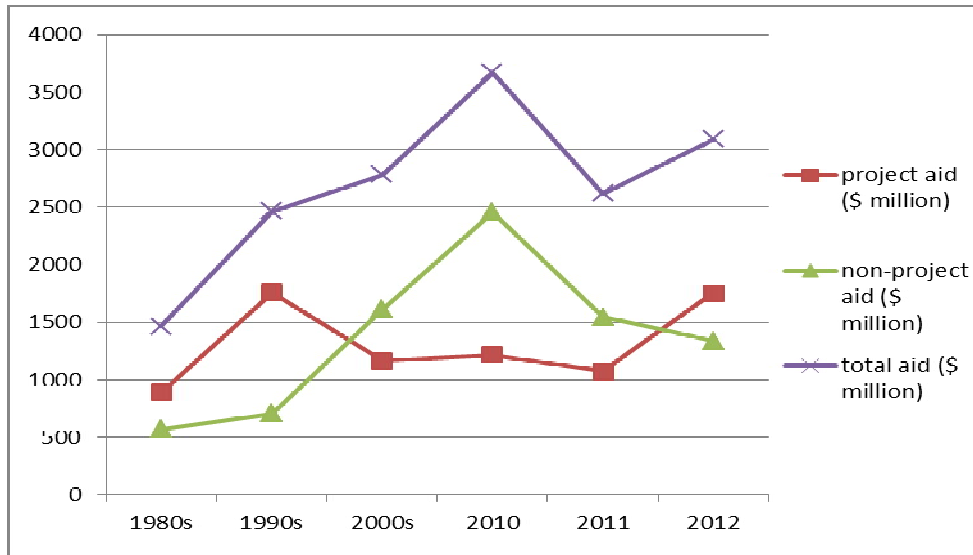## II. AN OVERVIEW OF FOREIGN AID IN PAKISTAN

Pakistan has been the recipient of the foreign aid since 1947 and its volume has been increasing since then, however, with some periods of slow down. In 1960s and 1970s, this aid was available on easy terms and conditions. With the passage of time, Pakistan is facing difficulties in getting more aid.

In 1960s, Pakistan received foreign aid equal to about 6.6 percent of the GNP. In early 1970s, Pakistan got foreign aid near to 4.2 percent of the GNP. The inflow of aid to Pakistan remained US $ 1.00 billion mark and the aid percentage to GNP was 5.5 percent in 1974-1975. The government started public investment programmes such as roads, social services, electric power and projects, like Pakistan Steel Mills and Indus Super Highway with the help these aid inflows. However, by late seventies (1977-78 and 1978-79), gross disbursements of foreign aid decreased as the United States cut down aid because of nuclear policy of Pakistan (Malik *et al.*, 1994).

Pakistan again got a huge amount of foreign aid (4.6 percent of GNP) during 1980s because of its frontline role in the America-Soviet Union clash over Afghanistan. In mid 1980s, the inflows of foreign aid touched US $ 2.0 billion mark per annum which boosted the credit worthiness of Pakistan (Le and Ataullah, 2006). Further, international aid sanctions, in particular by the Government of United States of America, were levied on Pakistan because of Pakistan's nuclear tests in 1998. As a result, other multilateral and bilateral aid also declined significantly during 1998-2001.

Nevertheless, things changed dramatically after 9/11. After joining the 'War against Terrorism', the inflows of aid to Pakistan increased by seven times and touched US $ 776.5 million mark. The United States started one more 5-year economic assistance package amounting to US $ 3 billion for Pakistan in June 2003. Other bilateral and multilateral institutions also approved aid and deferred payment of external debts of Pakistan. This situation shows how foreign aid inflows to Pakistan have always been subject to conditionalities and susceptible to strategic and geopolitical interests of the donors, in particular US.

FIGURE 1

Trend of Foreign Aid in Pakistan

Source: Self-generated using *Pakistan Economic Survey*.

Figure 1 shows the trend of foreign aid in Pakistan from 1980s to 2012. Project and non-project are two components of foreign aid. Project aid directly increases productive capacity of a country whereas non-project aid increases debt burden of aid receiving countries. Project aid shows increasing trend in the eras of 1980s to 1990s and is higher than non-project amount. Then projects aid shows increasing trend from 1990s to 2011 and non-project is higher than project. In 2012, project aid money is higher than non-project aid.

III. LITERATURE REVIEW

The literature on the relationship between aid and governance is inconclusive.

Svensson (2000) investigated the relationship between the prevalent level of corruption and concessional development assistance. The ordinary expectation of aid may be sufficient to escalate the indulgence of rent seeking activities and decrease productive public expenditure. However, this consequence may be overturned if the donor community can go into a binding policy promise. He found no evidence that the donors thoroughly assigned foreign aid to countries having less corruption.

Foreign aid is used to increase salaries for public employees including judges, police and tax collectors and improve training. As salaries rise, more competent civil servants can be hired and bribe solicitation can be reduced (Van Rijckeghem and Weder, 2001). In this way, aid can be used to improve the bureaucratic quality and it can also help in building sound institutions.

Santiso (2001) argues that aid conditionality is not the best-fit methodology to support good governance in developing countries. This methodology faces significant difficulties when applied to restructuring the institutions of governance particularly parliamentary structures and judicial systems. Without considering the fundamental distribution of power, there is chance that parliaments will become submissive and judiciaries will be dominated by the influence of powerful officials. An important lesson learned is that if donors desire to create a real difference then it will be essential for donors to emphasize more clearly and more strictly on issues of power, interest groups and politics than they have done in the past although these things were often chaotic and problematic.

Tavares (2003) explores whether foreign aid recipient becomes corrupt by using cross sectional data of developing countries. He finds that foreign aid significantly reduces corruption. There are several possibilities through which aid reduces corruption. Firstly, foreign aid may be linked with conditions and rules that are helpful to decrease corruption by limiting their own preferences of the recipient country's officials. Secondly, foreign aid relieves the receivers from public revenue shortages and enables them to increase salaries of public employees that may reduce corruption.

Gupta *et al.* (2003) find that grants provided to countries are afflicted by high levels of corruption and grants are fully offset by decrease in the revenue effort. Consequently, grants do not supplement to the aggregate amount of capitals available to the recipients.

On negative side, the aid dependent country realizes that donors mean to design policy, thus, government becomes inactive and policy making capability of aid recipient becomes weak. Individual officials have disincentives to disagree with the donors because this will result in delay of the receiving desirable resources (Bräutigam and Knack, 2004). Aid generates moral hazard in recipient country. Moral hazard is a state in which one party acquires risk because they know that it is secure against the risk and the other party will bear the cost. If aid is clearly a complement to the government own hard work in a programme or project then there would be a less chance of moral hazard and there would be a more chance of establishing a true partnership between aid and supporting programmes maintained by

governments. Though, over a period of time, history of foreign aid shows that the emphasis on self-help becomes weak and problem of moral hazard arises. History of aid shows that there would be more chance that a government will allow corruption in the customs department or there would be a continuation of unsuccessful in-house revenue service. Aid dependent countries may be motivated to underutilize their accessible sources of tax revenues (Bräutigam and Knack, 2004).

Moss *et al.* (2006) discuss that aid flows can have consequence in a decline in governmental accountability. It is because governing leaders are no longer interested to ensure the support of their public and the acceptance of their parliaments when they do not require raising revenues from the homegrown economy. If external donors are providing the large part of public finance of recipient country then governments are mainly accountable to those external agencies. Foreign aid allows politician and governments to ignore structural reforms to resolve issues and to spend aid money on popular purposes rather than on productive purposes.

Rajan and Subramanian (2007) discuss that one of the channels, through which foreign aid might adversely affect governance, is by restraining the growth of the manufacturing sector. They use contract enforcement and rule of law as a proxy for good governance. A possible channel through which they provide evidence in their paper is that aid might be mainly associated with weak governance because aid inflows decrease the requirement of governments to tax. Generally speaking, this paper suggests that even if the shortage of capital is the hurdle in the process of growth; hence, it may lead to the path of prosperity in developing countries. The form in which the capital is received as foreign aid could have negative spillover effects that limit its benefits. Indeed, if foreign aid decreases competitiveness by increasing the exchange rate or if foreign aid reduces the competence of manufacturing investment by badly disturbing governance then aid inflows may decrease the profitability of investment and limit the process of growth in particular in the export sectors.

Foreign aid may have negative effect on rule of law in a way that governments are not accountable to the international loaning agents if they do not reform rule of law.[1] International lenders are the principals instead of

---

[1] It is necessary to have knowledge of multidimensional principal-agent rapport to understand the relationship between rule of law reforms and foreign aid. In the perfect state citizen relationship, the citizens are the principals. They are the holders of the revenues and valuable resources that are shifted to the agent that is the state, through taxation.

the citizens in the case of foreign aid whereas the recipient state is just an agent. Then on this one facet, the recipient country is accountable to the international lenders. The aid agencies themselves are agents of other principals that are the citizens of the donor countries because they pay taxes to the aid agencies. There is an incentive for the aid agencies to carry on producing output (*i.e.* increase loans and grants), irrespective of the fact that recipient government is not interested in reforms. The reason behind that phenomenon is that the principals of the aid agency are the citizens of donor countries and these citizens have nearly no ability to observe the impact of foreign aid in improving rule of law in particular with the objective of reform. As a consequence, the accomplishment of the aid agencies is based on the amount of money given to developing countries. In other words, success of aid agencies does not depend upon real reform or output. Hence, the aid agencies have no incentives to demand real outcomes from recipient side, particularly when real results are hard to accomplish. In this manner, foreign aid negatively affects rule of law reforms although unintendedly (Erbeznik, 2011).

In case of multiple donors, donors' objectives often conflict with aid receiving countries' developmental agendas and donors' objectives also conflict with each other. There is a pressure on donor country to demonstrate tangible outcomes that usually leads donors to pay salary increments to the more brilliant local staff. This type of salary increments distorts motivation of civil servants that leads to change the direction of their attention from their own responsibilities. In this way, multiple donors hinder the functioning of bureaucracy (Knack and Rahman, 2007).

Busse and Gröning (2009) investigated the impact of aid flows on governance. They found that foreign aid had a negative rather than a positive effect on governance. Foreign aid creates rent seeking and moral hazard problems. Foreign aid could block or postpone much needed national reforms to improve governance.

Okada and Samreth (2012) conclude that aid money usually decreases corruption and its reduction effect is larger in less corrupt countries. One possible channel is that in less corrupt countries, there is less chance of misuse of resources by public officers and foreign aid may be used more effectively and in this way it improves the quality of institutions. Furthermore, result of foreign aid on corruption is not the same by different donor countries. Multilateral aid, from different institutions for instance the International Monetary Fund, World Bank and regional development banks, has larger reduction impact than that of total foreign aid. The reason behind

this may be that donor institutions usually bind recipients to commit to decrease corruption as a condition of providing financial aid.

Jaouadi and Hermassi (2013) illuminated the real impact of aid on governance in the developing countries including the MENA and Sub-Sahara region over the period 1990-2004 using the threshold theory. The threshold level represents the degree of economic absorption capacity of the recipient countries. After some threshold level, the assistance effect becomes damaging on stimulating the governance of the above mentioned countries. The aid amount above the threshold level is a severe threat to the institutional building of recipient governments because the additional aid will increase an environment of risk.

Qayyum (2013) attempted to discover the effect of foreign aid on governance for Asian developing countries. This study has taken annual data over the period of 1984 to 2010. The results indicated that foreign aid in an environment of conflicts deteriorated institutional quality. The reason is somewhat obvious as in the presence of foreign assistance government is not accountable to the general public and now government is not reliant on the earned revenue. The study has found that foreign aid stimulates corruption which infers that at every time if government officers are in a position to get foreign assistance then they would indulge in corruption and as a result weakening governance. Foreign aid also deteriorates bureaucratic quality and the reason behind is that donors may employ bureaucrats on higher salary packages and hire these bureaucrats on foreign funded projects.

Bonaglia *et al.* (2001) found that more open economies demonstrated lower level of bureaucratic corruption or low level of corruption and as a result there emerges better governance. Corruption increases when there is monopoly of power with discretion. There is no incentive for bribery in a society if the perfect competition prevails in an economy. In perfect competition, there are millions of agents and they can't affect price or the amount of the goods that one buys or sells. In the same way, corruption is decreased when economic rents are not influenced by the discretionary power of some government official.

Collier and Dollar (2004) argue that foreign aid can have an income and substitution. Foreign aid alters the relative price of good against bad governance and makes good governance cheaper and there are more chances that the bad governance will be substituted by the good governance. Compensating this effect, aid money directly supplements public resources and diminishes the need for the government to back its expenditures with taxation. Thus, it reduces internal pressure for accountability and we can

consider this effect as an adverse income effect. Usually, this suggests a change in the demand for accountability since this is related in taxation, which is reduced by resolving aid's fungibility issue. They concluded that the net effect of aid money on corruption and consequently on governance could be favourable or unfavourable. This all is the question which can only be resolved empirically.

Gatti (2004) presents some empirical evidence on the explicit connection between restrictions to trade and corruption. High trade barriers to international transactions openly motivate private agents to bribe public officials and bureaucrats in exchange for discrimination and diminish competition between foreign and local firms so that level of corruption does remain high.

Larrain and Tavares (2004) conclude that there is a positive relationship between FDI and corruption.

Acemoglu and Robinson (2005) highlight that globalization affects institutional quality. Inequality is a channel through which globalization affects institutional quality. They use trade and financial openness as a proxy for globalization. Based on the Heckscher-Ohlin model, they argue that if a labour abundant developing country opens trade or capital inflows then inequality is decreased because wages will rise comparative to the return to capital. With a lower level of inequality, there are more chances for democracy and it becomes less redistributive. Globalization decreases the income gap between factors and thus also decreases the risk of political conflict since voters of lower income groups demand less for highly redistributive policies. Endurance of democracy depends on income distribution and so on factor prices. According to this reasoning, globalization is likely to effect democracy and thus also corruption in developing countries both by financial openness and trade mainly over its effect on inequality. If the developing country is land abundant and it opens up trade then trade raises the income of landowners who usually represent small elite. As a result, inequality increases and there is less chance of the survival of democracy. Thus, they conclude that the effect of globalization on democracy and corruption remains an empirical question.

Larrain and Tavares (2007) conclude that trade policy is a vital source of rents when the government applies duties on the different kinds of products. Duties are subject to political influence and public officers use their extensive discretionary influence. Producers are ready to bribe officials for their private interests. In comparison, there is a little room for policymaker's discretion in case of free trade so it becomes an effective policy instrument in

the combat against corruption. They also find that political rights have negative impact on corruption.

Blouin *et al.* (2012) demonstrate that globalization affects positively governance through increasing a country's vulnerability to unexpected capital flight. This increased risk of capital flight can regulate governments and improve welfare and governance. If the country has solid economic essentials (*e.g.*, because of fundamentally diversified export sector) and is not sensitive to adverse shocks in the global economy then globalization is expected to have a positive effect. The effect of globalization on governance can go either way. Globalization is expected to improve well-being if a country is less susceptible to random shocks either because it is comparatively developed or has a varied export sector. In opposite situation, globalization has a negative effect on welfare, if the country has fragile fundamentals (*e.g.*, specializes primary goods that are volatile or in exporting mining) or faces a volatile and weak global economy. In these situations, globalization depresses welfare by having a negative inducement effect on governance.

Moore (2004) finds a positive connection between tax revenue and good quality of governance in the case of developing countries. The extent to which governments depend on general taxation for their financial resources defines their accountability towards their citizens. Many governments who depend more on non-tax income like gas, oil and minerals exports or on aid money do not make much tax effort and as a result state elites become economically independent of citizen taxpayers. This changes the political incentives that political elite face and the means in which they pursue to achieve, use and maintain their power. The long term consequences for aid dependence rather than tax dependence on governance are hurtful.

McDonald and Jumu (2008) analyze the impact of foreign aid, natural resources and tax system on governance. They also reveal that it should be examined that from where the revenues of a country are coming rather than to just consider where they have been used. They also point out that foreign aid seems like tax revenue so it should be allocated and used in a transparent way. They conclude that aid and natural resources have negative influence on governance but tax revenue has significant positive influence on governance.

Altunbas and Thornton (2011) argue that taxation can improve the quality of governance and also can produce good quality public sector institutions by making governments more accountable and responsive to their citizens. Taxes are also helpful in building capacity and improving

public policy. Using cross sectional data of developing and developed countries, they found that taxation develops the quality of governance and that those taxes that are collected most directly by citizens play the most vital role in improving governance.

Badinger and Nindl (2014) present new empirical evidence on the determinants of corruption. They conclude that political rights have negative effect on corruption and globalization has a negative relationship with corruption.

According to some economists, aid is not helpful to accelerate economic development because foreign aid has a negative effect on governance. Aid undermines government accountability to citizens that's why it goes into the pockets of corrupt politicians and expands unproductive government bureaucracies or it is just misused. While some economists say that aid has a positive effect on governance because foreign aid can force recipient to strengthen their policy and establish good and sound national institutions. It enables them to improve bureaucratic quality by paying attractive salaries to civil servants. With these mix results of hope and doubts, this study has empirically examined effect of foreign aid on governance in Pakistan. There exists no such study that explores the connection between foreign aid and governance in case of Pakistan.

IV. MODEL SPECIFICATION, DESCRIPTION OF THE VARIABLES AND DATA SOURCES

Following the earlier literature on the relationship between foreign aid and governance, we have specified the following model in case of Pakistan:

$$Gov_t = \beta_0 + \beta_1 odagdp_t + \beta_2 taxgdp_t + \beta_3 absenceofpolright_t + \beta_4 econglo_t + \eta$$

To measure the governance, International Country Risk Guide (ICRG) dataset has been used in this study. It's an index, ranges from 0 to 16. It is made by summing up the three measures: corruption, bureaucratic quality and rule of law. The higher value indicates good governance while value close to 0 indicates bad governance. The ICRG rankings are issued on monthly basis. We have calculated yearly values by calculating the average of the 12 months values for each year.

A disbursement of foreign economic assistance (loans and grants) is in million US Dollars. We have calculated foreign aid as a percentage of GDP. Source of this variable is *Pakistan Economic Survey* (various issues).

Economic globalization has two dimensions. One dimension is actual economic flows and second dimension is proxies for restrictions to trade and capital. Actual economic flows include data on FDI, trade and portfolio investment. Restrictions on trade and capital are measured as hidden import barriers that comprise taxes on international trade (as a percentage of current revenue), average tariff rates and an index of capital controls. This is KOF index of economic globalization introduced by Dreher (2006).

Taxes include both direct and indirect taxes (consolidated federal and provincial). Then we have calculated tax percentage of GDP. This has been taken from various issues *Pakistan Economic Survey*.

It's an index that ranges from 1 to 7. Higher value means absence of political rights in a country. Lower value means good condition or presence of political rights in a country. Data on political rights has been taken from Freedom House.

To examine the short-run and long-run relationship between foreign aid and governance, we have applied ARDL approach to co-integration, which allows for differences in the order of integration of the variables. This approach estimates short-run and long-run relationship concurrently and delivers efficient and unbiased estimates. Following Pesaran *et al.* (2001) the error correction representation of the ARDL model is as follows:

$$
\begin{aligned}
\Delta (GOV)_t \;=\;\; & \beta_0 + \lambda_1 (GOV)_{t-1} + \lambda_2 (polright)_{t-1} + \lambda_3 (odagdp)_{t-1} \\
& + \lambda_4 (ecoglo)_{t-1} + \lambda_5 (taxgdp)_{t-1} + \sum_{i=0}^{p} \beta_1 \Delta(GOV)_{t-i} \\
& + \sum_{i=0}^{q} \beta_2 \Delta(polright)_{t-i} + \sum_{i=0}^{r} \beta_3 \Delta(odagdp)_{t-i} \\
& + \sum_{i=0}^{s} \beta_4 \Delta(ecoglo)_{t-i} + \sum_{i=0}^{u} \beta_5 \Delta(taxgdp)_{t-i} + \varepsilon_{t1}
\end{aligned}
$$

The parameter β_i, where $i = 1, 2, 3, 4, 5$, is the corresponding long-run multipliers while the parameters λ_1, λ_2, λ_3, λ_4 and λ_5 are the short-run dynamic coefficients of the fundamental ARDL model.

Δ is a symbol for the first difference operator

β_0 is the drift component

ε_{t1} is the typical white noise residuals.

In the ARDL model, the long-run relationship among variables is carried out on the bases of calculating partial F-test on the first differenced portion

of Unrestricted Error Correction Model (UECM) of the above mentioned equation. In this step, the regression equation for Gov_{it} is quantified as:

$$\Delta\,Gov_{it} \quad = \quad a_0 + \sum_{i=1}^{p} b_i \Delta(Govi)_{t-i} + \sum_{i=1}^{p} c_i \Delta(odagdp)_{t-i}$$

$$+ \sum_{i=1}^{p} d_i \Delta(polrighti)_{t-i} + \sum_{i=1}^{p} f_i \Delta(ecogloi)_{t-i}$$

$$+ \sum_{i=1}^{p} g_i \Delta(taxgdpi)_{t-i}$$

To generate error correction mechanism, the one lag of each variable at the level is incorporated to above equation and Microfit 4.0 is used to test this variable addition. It is done by F-test. F-test finds the joint significance of all the new additional lagged level variables.

$$\Delta\,Gov_{it} \quad = \quad a_0 + \sum_{i=1}^{p} b_i \Delta(Govi)_{t-i} + \sum_{i=1}^{p} c_i \Delta(odagdp)_{t-i}$$

$$+ \sum_{i=1}^{p} d_i \Delta(polrighti)_{t-i} + \sum_{i=1}^{p} f_i \Delta(ecogloi)_{t-i}$$

$$+ \sum_{i=1}^{p} g_i \Delta(taxgdpi)_{t-i} + \theta_1 (Gov_i)_{t-1} + \theta_2 (ecoglo_i)_{t-1}$$

$$+ \theta_3 (polright_i)_{t-1} + \theta_4 (odagdp_i)_{t-1} + \varepsilon_i$$

The null hypothesis for no cointegration for the variable *Govi* against alternative hypothesis is given as:

H_0: $\theta_1 = \theta_2 = \theta_3 = \theta_4 = 0$

H_1: $\theta_1 \neq \theta_2 \neq \theta_3 \neq \theta_4 = 0$

This hypothesis is established by partial F-test.

Pearson *et al.* (2001) have presented two arrays of suitable critical values. One array supposes that all variables under consideration are of integrated of order one, *i.e.* I(1) while the other set assumes that all variables are of integrated of order zero, *i.e.* I(0). This gives a group covering all likely arrangements of the variables into I(0) or I(1) or marginally integrated. If the estimated or calculated value of F-statistic is greater than the upper bound of critical values then null hypothesis (no cointegration exists) is rejected. This forms long-run connection among variables of interest. If the calculated F-statistic is less than the critical value of lower bound then the null hypothesis of no cointegration cannot be rejected. It means that there exists no

cointegration. If the calculated or estimated value falls between upper and lower bounds critical values then F-test will be inconclusive. Many factors determine F-value such as sample size, a number of explanatory variables and trend and/or a constant of ARDL. F-test is much affected by the number of lags used on each first differenced variable (Bahmani-Oskooee, 1999).

As per requirement, we have tested all the variables for unit root before applying ARDL approach; and the results have been reported in Table 2.

TABLE 2

Augmented Dickey Fuller Test for Unit Root

Variables	Level		1st Difference	
	Intercept	Trend and Intercept	Intercept	Trend and Intercept
Gov	–1.54	–2.07	–3.27**	–3.19
Abpolright	–1.63	–1.64	–4.32***	–4.24***
odagdp	–1.13	–3.49*	–7.36***	–7.54***
ecoglo	–0.95	–2.53	–6.01***	–6.00***
taxgdp	–0.37	–3.34*	–7.65***	–6.37***

Critical values for level and 1st difference are –3.7, –2.98 and –2.63 at 1%, 5% and 10% respectively with intercept. Critical values for level and 1st difference are –4.35, –3.59 and –3.23 at 1%, 5% and 10% respectively with intercept and trend.

***$p < 0.01$, **$p < 0.05$, *$p < 0.1$

TABLE 3

F-Test

Lag Length	F-statistics	Critical values at 1%		Results
		I(0)	I(1)	
1	6.2	3.29	4.37	Cointegration
2	7.79			Cointegration

K = variables are on the left hand side.

Table 2 shows that no a single variable is of I(2) or higher order. The results of F-test of ARDL approach for the existence of cointegration have been given in Table 3.

Table 3 shows that calculated F-statistics is greater than critical value of upper limit so we can conclude that cointegration exists at 1%. The next step is to determine the lag length for ARDL test, which is presented in Table 4.

TABLE 4

Lag Length Selection

Endogenous variables: ECOGLO GOV ODAGDP ABPOLRIGHT TAXGDP						
Exogenous variables: C						
Sample: 1984 – 2012						
Included observations: 27						
Lag	LogL	LR	FPE	AIC	SC	HQ
0	–214.9912	NA	8.218822	16.29564	16.53561	16.36700
1	–141.0084	115.0843	0.226640	12.66729	14.10711*	13.09542
2	–102.8211	45.25905*	0.105608*	1.69045*	14.33012	2.47536*

* indicates lag order selected by the criterion

The result in Table 4 suggests the use of AIC at lag 2, SC at lag 1. The result of this study is based on AIC at lag 2. Based on the above prerequisites, we estimate the ARDL model, which is given in Table 5.

TABLE 5

ARDL (1, 0, 2, 0, 2) Selected Based on Akaike Information Criterion
Dependent variable is GOV
27 observations used for estimation from 1986 to 2012

Regressor	Coefficient	Standard Error	T-Ratio [Prob]
GOV(–1)	0.62400	0.13048	4.7823 [0.000]
ODAGDP	–0.41674	0.14553	–2.8636 [0.011]
TAXGDP	0.01396	0.12401	0.1125 [0.912]

Regressor	Coefficient	Standard Error	T-Ratio [Prob]
TAXGDP(–1)	0.29406	0.13698	2.1467 [0.047]
TAXGDP(–2)	0.24931	0.14672	1.6992 [0.108]
ECOGLO	0.13092	0.04500	2.9095 [0.010]
ABPOLRIGHT	–0.17989	0.11085	–1.6227 [0.123]
ABPOLRIGHT(–1)	–0.30239	0.15631	–1.9346 [0.070]
ABPOLRIGHT(–2)	0.12583	0.10306	1.2210 [0.239]
C	–5.6315	2.9959	–1.8797 [0.077]
R-Squared	0.86539	R-Bar-Squared	0.79413

The diagnostics are given below:

*Test Statistics * LM Version * F Version *

*A: Serial Correlation*CHSQ(1) = 0.84215 [0.359]*F(1, 16) = .51512 [0.483]*

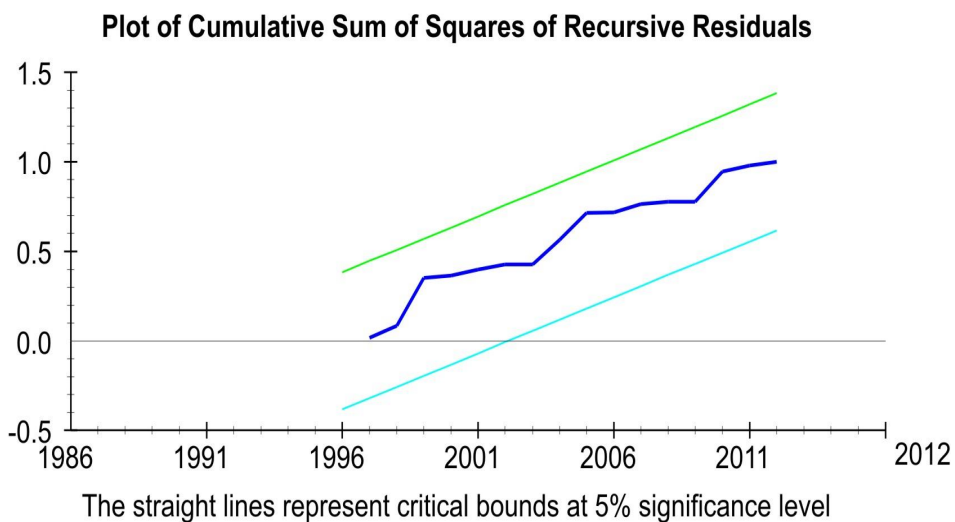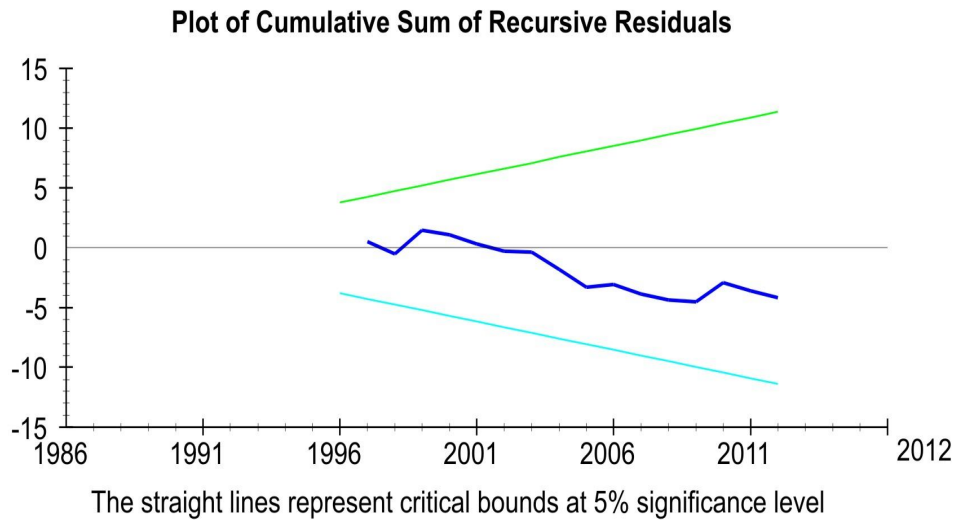*B: Functional Form *CHSQ(1) = 0.12281 [0.726]*F(1, 16) = 0.073112 [0.790]*

*C: Normality *CHSQ(2) = 0.28202 [0.868]* Not applicable *

*D: Heteroscedasticity*CHSQ(1) = 0.084353 [0.771]*F(1, 25) = 0.078349 [0.782]*

A: Lagrange multiplier test of residual serial correlation; B: Ramsey's RESET test using the square of the fitted values; C: Based on a test of skewness and kurtosis of residuals; D: Based on the regression of squared residuals on squared fitted values

Diagnostic test checking shows that there exists no serial correlation because p-value is greater than 0.05. Normality condition is also satisfied. It shows that variance is constant so model is normally distributed. Functional form shows that there is no specification error in the model proved by Ramsey's Reset Test showing value higher than 5%. There is no heteroskedasticity issue.

For testing stability, the technique of cumulative sum of recursive (CUSUM) and cumulative sum of square (CUSUMSQ) is introduced by Brown *et al.* (1975) and suggested by Pesaran *et al.* (2001). This technique is used to check the parameter constancy or stability of the model. Testing of stability is compulsory because the existence of cointegration does not necessarily mean that those estimated coefficients must be stable. Unstable coefficient produces unreliable information.

Plot of Cumulative Sum of Recursive Residuals

The straight lines represent critical bounds at 5% significance level

Plot of Cumulative Sum of Squares of Recursive Residuals

The straight lines represent critical bounds at 5% significance level

The null hypothesis in the case of CUSUM and CUSUMSQ is that all the coefficients are stable. It can be seen that CUSUM and CUSUMSQ are plotted against the break points. The null hypothesis cannot be rejected if the plots remain within the critical bounds which are created at 5% level significance. The above plots show the stability among the variables throughout the period under consideration. This confirms that the model is stable.

As Table 6 shows, economic globalization and oda have significant impact on governance in the short-run. Political rights and tax percentage of GDP have insignificant impact on governance in the short-run. If oda percentage of GDP increases by 1% then governance index decreases by 0.42 point. If economic globalization index increases by 1% then governance index increases by 0.13 point.

TABLE 6

Error Correction Representation for the Selected ARDL Model
ARDL (1, 0, 2, 0, 2) Selected Based on Akaike Information Criterion
Dependent variable is dGOV
27 observations used for estimation from 1986 to 2012

Regressor	Coefficient	Standard Error	T-Ratio [Prob]
dODAGDP	–0.41674	0.14553	–2.8636 [0.010]
dTAXGDP	0.01396	0.12401	0.1125 [0.912]
dTAXGDP1	–0.24931	0.14672	–1.6992 [0.106]
dECOGLO	0.13092	0.04500	2.9095 [0.009]
dABPOLRIGHT	–0.17989	0.11085	–1.6227 [0.121]
dABPOLRIGHT1	–0.12583	0.10306	–1.2210 [0.237]
dC	–5.6315	2.9959	–1.8797 [0.076]
ECM(–1)	–0.37600	0.13048	–2.8816 [0.010]
R-Squared	0.54420	R-Bar-Squared	0.30289

R-Squared and R-Bar-Squared measures refer to the dependent variable; dGOV and in cases where the error correction model is highly restricted, these measures could become negative.

The coefficient of ECM shows the speed at which the variables converge to the equilibrium. Coefficient of ECM shows the speed of adjustment whereas the negative sign show that it is converging to the equilibrium rather than diverging. This means that 38% of disequilibria from the short-run shocks converge back in the long-run. 54% variation in dependent variable is explained by independent variable.

TABLE 7

Estimated Long-Run Coefficients using the ARDL Approach
ARDL (1, 0, 2, 0, 2) Selected Based on Akaike Information Criterion
Dependent variable is GOV
27 observations used for estimation from 1986 to 2012

Regressor	Coefficient	Standard Error	T-Ratio [Prob]
ODAGDP	–1.1084	0.41694	–2.6583 [0.017]
TAXGDP	1.4823	0.55616	2.6652 [0.016]
ECOGLO	0.34818	0.12448	2.7971 [0.012]
ABPOLRIGHT	–0.94802	0.34338	–2.7609 [0.013]
C	–14.9775	9.0226	–1.6600 [0.115]

As Table 7 shows, all independent variable have significant impact on governance in the long-run. If ODAGDP increases by 1% then governance index decreases by 1.1 point. If index of absence of political rights increases by 1% then governance index decreases by 0.95 point. If tax percentage of GDP increases by 1% then governance index increases by 1.5 point. If index of globalization increases by 1% then governance index increases by 0.34 point.

V. DISCUSSION

This study finds a negative and significant effect of foreign aid on governance. The results support the findings of Bräutigam and Knack (2004), Rajan and Subramanian (2007), Knack and Rahman (2007), Busse and Gröning (2009), Qayyum (2013), Jaouadi and Hermassi (2013) who found that aid dependence could undermine the quality of public sector institutions and governance in many ways. It weakens accountability, enhances corruption and relieving pressures to modify ineffective policies, alleviate burden to restructure institutions. Foreign aid can deteriorate the bureaucratic quality of recipient governments. This deterioration happens directly by drain off scares or limited talent from the civil service. Aid donor countries mostly appoint the most skillful public bureaucrats at salaries packages that are much greater than the recipient government salaries packages. Each donor is concerned with development agenda in aid receiving country but its first priority is its national interest and goals. In case of multiple donors, donor objectives conflict with aid receiving country's

developmental agendas and donors' objectives also conflict with each other. There is a pressure on donor country to demonstrate tangible outcomes that usually leads donors to pay salary increments to the more brilliant local staff. This type of salary increments distorts motivation of civil servants. Foreign aid decreases the motivations of governments and political leaders to adopt a determination to reform. As a consequence, there will be very less chance of the success of the rule of law reforms (Erbeznik, 2011). Ordinary expectation of aid may be sufficient to escalate the indulgence in corruption and decrease productive public expenditure (Svensson, 2000).

The present study finds a negative and significant relationship between globalization and governance that is in line with the studies of Bonaglia *et al.* (2001), Gatti (2004), Larrain and Tavares (2004), Acemoglu and Robinson (2005), and Blouin *et al.* (2012) who found a positive relationship between globalization (trade openness) and governance. According to these studies, more open economies demonstrated lower level of bureaucratic corruption or low level of corruption and as a result better governance. Corruption increases when there is monopoly power with discretion and low level of accountability. There is no incentive or motivation for bribery in a society if the perfect competition prevails in an economy. Larrain and Tavares (2004) explored that foreign direct investment may reduce corruption because of the reason that the high levels of international capital mobility make foreign investors more expected to leave the market if corruption is not checked.

The present study finds a positive and significant effect of tax on governance that is consistent with the result of the Moore (2004), McDonald and Jumu (2008), and Altunbas and Thornton (2011) who found positive effect of tax on governance. According to these studies, citizens focus on information regarding spending of tax money, this increase accountability in state institutions and there will be less corruption. Donor will not think that aid is the only the solution for revenue problem. Instead donors will deliver aid to recipient countries with policies and reforms that help in improving governance.

This study finds a positive and significant effect of absence of political right on governance which is in line with the result of Larrain and Tavares (2007) and Badinger and Nindl (2014) who found that presence of political rights have negative impact on corruption. According to these studies, the level of political rights that are assured by a political system can also be connected with corruption. Some of the features of democratic political systems such as free press, open and regular electoral competitions can upturn the possibility of revealing corrupt activities.

VI. CONCLUSION AND SUGGESTIONS

Pakistan has been the beneficiary of foreign aid inflows since its independence. The present study investigates the effect of foreign aid on governance in Pakistan. The results of present study show that foreign aid has negative influence on governance in Pakistan. There can be a number of explanations and causes for this result. For example, foreign aid is stimulating corruption which infers that at every time if government officers are in a position to get foreign assistance then they would indulge in corruption that results in weak governance. Foreign aid also deteriorates bureaucratic quality and the reason behind is that donors may employ bureaucrats on higher salary packages from other countries and hire these bureaucrats on foreign funded projects. In this way the native bureaucrats become inefficient. Governments are not accountable to the international loaning agents if they do not reform rule of law. A weak mechanism of accountability is another major reason for poor governance resulting from foreign aid inflows in Pakistan.

Moreover, to receive foreign aid over a protracted span of time is deteriorating the quality of governance in Pakistan. That is the reason aid is not contributing to economic development and Pakistan is still dependent on foreign aid. Both the international aid donor community and Pakistan are locked into a situation that they are impotent to yield development predictably or consistently.

Suggestions must be formulated very cautiously, pending supplementary research. Further investigation can be done by disaggregates foreign aid by source (*e.g.*, multilateral vs. bilateral). This disaggregate analysis may create more insight into the accurate mechanisms by which aid money seems to undermine the quality of governance. Findings of this study recommend some possible suggestions.

1. Foreign aid programmes should be clearly understood as a temporary and short-term development tool. The notion of having an aid "exit strategy" is not a new thing. The successful Marshall Plan, evidently, was a temporary programme with in-built exit and motivation for self-help.

2. Donors should formulate such type of policies that there should be a margin for recipient governments to plan and formulate their own projects and policies.

3. A larger portion of aid money could be dedicated or tied for the enhancement in the quality of governance. For example, foreign aid will be tight to some kinds of programmes like to form meritocratic

bureaucracies and to form strong, corruption free and independent court systems.

4. Our results show that economic globalization has positive effect on governance. Pakistan should depend on much stable and sustainable external financing resource that has positive effect on governance instead of depending on unstable, volatile and insecure resources. Given the common features of FDI and trade, we can believe that both are more sustainable and stable external resources as compared to foreign aid. FDI and trade have not only positive impact on governance but also cause spillover effects.

5. In order to make aid productive and meaningful for growth and development, policy makers should focus on governance issues and ensure proper utilization of foreign resources with strict accountability.

REFERENCES

Acemoglu, D. and J. A. Robinson (2005), *Economic Origins of Dictatorship and Democracy*. Cambridge University Press.

Alonso, J. A. and C. Garcimartín (2013), The determinants of institutional quality. More on the debate. *Journal of International Development*, Volume 25(2), pp. 206-226. http://dx.doi.org/10.1002/jid.1710

Altunbas, Y. and J. Thornton (2011), Does paying taxes improve the quality of governance? Cross-country evidence. *Poverty and Public Policy*, Volume 3(3), pp. 1-17. http://dx.doi.org/10.2202/1944-2858.1155

Badinger, H. and E. Nindl (2014), Globalization and corruption, Revisited. *The World Economy*, Volume 37(10), pp. 1424-1440. http://dx.doi.org/10.1111/twec.12156

Bahmani-Oskooee, M. (1999), Do federal budget deficits crowd out or crowd in private investment? *Journal of Policy Modeling*, Volume 21(5), pp. 633-640. http://dx.doi.org/10.1016/S0161-8938(98)00005-2

Blouin, A., S. Ghosal and S. Mukand (2012), Globalization and the (mis)governance of nations. CESifo Working Paper Series # 3715.

Bonaglia, F., J. B. De Macedo and M. Bussolo (2001), How globalization improves governance. *OECD Working Paper* 181. http://dx.doi.org/10.1787/774554632487

Boone, P. (1996), Politics and the effectiveness of foreign aid. *European Economic Review*, Volume 40(2), pp. 289-329. http://dx.doi.org/10.1016/0014-2921(95)00127-1

Bräutigam, D. A. and S. Knack (2004), Foreign aid, institutions, and governance in Sub-Saharan Africa. *Economic Development and Cultural Change*, Volume 52(2), pp. 255-285. http://dx.doi.org/10.1086/380592

Brown, R. L., J. Durbin and J. M. Evans (1975), Techniques for testing the constancy of regression relations over time. *Journal of the Royal Statistical Society*, Series B, Volume 37(2), pp. 149-163. http://www.jstor.org/stable/2984889

Burnside, C. and D. Dollar (2004), Aid, policies, and growth: Revisiting the evidence. World Bank Policy Research Paper 3251. Washington, DC: The World Bank.

Busse, M. and S. Gröning (2009), Does foreign aid improve governance? *Economics Letters*, Volume 104(2), pp. 76-78. http://dx.doi.org/10.1016/j.econlet.2009.04.002

Collier, P. and D. Dollar (2004), Development effectiveness: What have we learnt? *The Economic Journal*, Volume 114(496), pp. F244-F271. http://dx.doi.org/10.1111/j.1468-0297.2004.00221.x

Dollar, David and Lant Pritchett (1998), Assessing aid – what works, what doesn't, and why. *World Bank Policy Research Report*. Washington, D.C.: The World Bank.

Dreher, A. (2006), Does globalization affect growth? Evidence from a new index of globalization. *Applied Economics*, Volume 38(10), pp. 1091-1110. http://dx.doi.org/10.1080/00036840500392078

Durbarry, R., N. Gemmell and D. Greenaway (1998), *New evidence on the impact of foreign aid on economic growth*. Centre for Research in Economic Development and International Trade, University of Nottingham.

Erbeznik, K. (2011), Money can't buy you law: The effects of foreign aid on the rule of law in developing countries. *Indiana Journal of Global Legal Studies*, Volume 18(2), pp. 873-900. http://dx.doi.org/10.2979/indjglolegstu.18.2.873

Gatti, R. (2004), Explaining corruption: Are open countries less corrupt? *Journal of International Development*, Volume 16(6), pp. 851-861. http://dx.doi.org/10.1002/jid.1115

Gupta, S., B. J. Clements, A. Pivovarsky and E. Tiongson (2003), Foreign aid and revenue response: Does the composition of aid matter? *IMF Working Paper* 03/176.

Jaouadi, S. and H. Hermassi (2013), Official development assistance and its impact on governance in short term: The threshold theory. *International Journal of Business and Social Research*, Volume 3(3), pp. 185-193.

Javid, M. and A. Qayyum (2011), Foreign aid and growth nexus in Pakistan: Role of macroeconomic policies. *PIDE Working Paper* # 72.

Kimura, H., Y. Mori and Y. Sawada (2012), Aid proliferation and economic growth: A cross-country analysis. *World Development*, Volume 40(1), pp. 1-10. http://dx.doi.org/10.1016/j.worlddev.2011.05.010

Knack, S. (2001), Aid dependence and the quality of governance: Cross-country empirical tests. *Southern Economic Journal*, Volume 68(2), pp. 310-329. http://dx.doi.org/10.2307/1061596

Knack, S. and A. Rahman (2007), Donor fragmentation and bureaucratic quality in aid recipients. *Journal of Development Economics*, Volume 83(1), pp. 176-197. http://dx.doi.org/10.1016/j.jdeveco.2006.02.002

Larraín B., F. and J. Tavares (2004), Does foreign direct investment decrease corruption? *Cuadernos de economía–Latin American Journal of Economics*, Volume 41(123), pp. 217-230.

Larrain B., F. and J. Tavares (2007), Can openness deter corruption? The role of foreign direct investment. *CEPR Discussion Paper* # 6488.

Le, M. H. and A. Ataullah (2006), Foreign capital and economic performance of Pakistan. *The Lahore Journal of Economics*, Volume 7(1), pp. 1-32.

Malik, S. J., S. Aftab and N. Sultana (1994), *Pakistan's Economic Performance, 1947 to 1993*: *A Descriptive Analysis*. Sure Publishers.

McDonald, O. and K. Jumu (2008), Can tax challenge bad governance? *Christian Aid Occasional Paper* # 1, pp. 1-18.

Moore, M. (2004), Revenues, state formation, and the quality of governance in developing countries. *International Political Science Review*, Volume 25(3), pp. 297-319.
http://dx.doi.org/10.1177/0192512104043018

Moss, T., G. Pettersson and N. Van de Walle (2006), An aid-institutions paradox? A review essay on aid dependency and state building in sub-Saharan Africa. *Working Paper* # 74, Centre for Global Development.

Okada, K. and S. Samreth (2012), The effect of foreign aid on corruption: A quantile regression approach. *Economics Letters*, Volume 115(2), pp. 240-243.
http://dx.doi.org/10.1016/j.econlet.2011.12.051

Pesaran, M. Hashem, Yongcheol Shin and Richard J. Smith (2001), Bounds testing approaches to the analysis of level relationships. *Journal of Applied Econometrics*, Volume 16(3), pp. 289-326.
http://dx.doi.org/10.1002/jae.616

Qayyum, U. (2013), Institutional quality, conflict and aid dependency. *Working Paper* # 94. Pakistan Institute of Development Economics.

Rajan, R. and A. Subramanian (2007), Does aid affect governance? *The American Economic Review*, Volume 97(2), pp. 322-327.
http://www.jstor.org/stable/30034469

Santiso, C. (2001), Good governance and aid effectiveness: The World Bank and conditionality. *The Georgetown Public Policy Review*, Volume 7(1), pp. 1-137.

Schwab, Klaus (2012), *The Global Competitiveness Report 2012–2013*. World Economic Forum.

Svensson, J. (2000), Foreign aid and rent-seeking. *Journal of International Economics*, Volume 51(2), pp. 437-461.
http://dx.doi.org/10.1016/S0022-1996(99)00014-8

Tavares, J. (2003), Does foreign aid corrupt? *Economics Letters*, Volume 79(1), pp. 99-106. http://dx.doi.org/10.1016/S0165-1765(02)00293-8

Van Rijckeghem, C. and B. Weder (2001), Bureaucratic corruption and the rate of temptation: Do wages in the civil service affect corruption, and by how much? *Journal of Development Economics*, Volume 65(2), pp. 307-331. http://dx.doi.org/10.1016/S0304-3878(01)00139-0

World Bank (1989), From Crisis to Sustainable Growth – Sub Saharan Africa: A Long-Term Perspective Study. World Bank Group.