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Abstract

This policy chapter summarises an evolving debate on the effect of foreign aid on corruption and institutions. It entails a series of publications that have been successively motivated by feedbacks from academic and policy making circles. The plethora of papers explores debates sustaining the direct, conditional and indirect effects of foreign aid on institutions. Moreover, another debate on the incidence of foreign aid distortions on corruption is also assessed in light of a recently celebrated literature on development assistance. Overall, the findings show that the effects of foreign aid on corruption and institutions are: directly positive; conditionally positive with a magnitude dependent on initial institutional capacity levels; contingent on fundamental characteristics of development due to heterogeneity and; indirectly positive or negative depending on the transmission mechanism. While the impact of foreign aid uncertainty on corruption is also positive, the sign on governance could change in light of governments' commitment to increase its dependence on local tax revenues.

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1. Introduction

The subject of foreign aid remains widely debated in academic and policy making circles. In essence, there has been a recent stream of studies raising doubts about the mechanisms by which foreign aid is governed (Banuri, 2013; Krause, 2013; Wamboye et al., 2013; Ghosh, 2013; Marglin, 2013; Titumir & Kamal, 2013; Monni & Spaventa, 2013). Some accounts in the narrative present a picture of foreign aid being governed by neo-colonialism (Amin, 2014). This stance is shared: on the one hand by Ndlovu-Gatsheni (2013) on the entrapment of Africa within colonial power webs and; on the other hand by Kindiki (2011) on the need for the continent to strategically reduce its dependence on systems or regimes of international aid. This chorus has been joined by Obeng-Odoom (2013) who has articulated that foreign aid policies have to be holistic processes that clearly defined the needs of poor countries. This articulation converges with the stance of Amin (2014) who has equally emphasised that models of development should not be restricted to what donors wish was good for poor economies[1].

The above new and evolving stream substantially supports recently celebrated literatures on foreign aid, notably: The Bottom Billion (Collier, 2007), Dead Aid (Moyo, 2009) and the Somaliland Eubank (2012) hypothesis. These literatures have a common denominator of suggesting a rethinking of foreign aid policies and mechanisms.

While there is a general consensus on the need for good institutions in African development (Wantchekon, 2003; Vicente & Wantchekon, 2009; Boyce & Ndikumana, 1998,

[1] There is a growing literature on the dynamics of well being and happiness in the economics of foreign aid (Arvin & Lew, 2010ab, 2011, 2012ab).

2001, 2003, 2011; Fosu, 2013ab; Anyanwu & Erhijakpor, 2014), the use of development assistance as a policy instrument in promoting institutions in developing countries has been a subject of much controversy because prior to the fall of the Berlin Wall, foreign aid was essentially used to prevent African governments from associating with the Soviet Union (Gibson et al., 2014). Accordingly, the aid-institutions debate has revolved around three main strands, inter alia: the effect of foreign aid on institutions; if more development assistance is allocated to countries with higher standards of institutions and; how aid can be used to transform institutions (Arvin et al., 2002; Arvin & Barillas, 2002). The policy-oriented chapter is more focused on how aid affects institutions with particular emphasis on corruption.

The debate on the effect of foreign aid on corruption first begins with Asongu (2012a) concluding that the Okada & Samreth (2012) findings on the negative nexus between aid and corruption may not be relevant for Africa. Second, following informal criticisms on differences in methodologies, Asongu (2013a) employs the quantile regression approach of the underpinning paper to confirm his earlier findings. A positioned that is confirmed in a dynamic cultural setting (Asongu, 2015a) as well as with institutional benchmarks of foreign aid effectiveness (Asongu, 2015b). Third, to further reconcile the debate, Asongu & Jellal (2013) have used fiscal behaviour (of taxation and government expenditure) and private investment channels to show that the sign of the effect depends on the mechanism by which aid affects corruption. In essence, aid channelled through government expenditure (private investment) increases (decreases) corruption. Fourth, Asongu (2014a) has provided more subtlety to the analysis by decomposing African countries into fundamental characteristics of its development. The findings reflect significant heterogeneity across the investigated homogenous panels. Fifth, the conjecture of Eubank (2012) has been validated by Asongu

(2014b) and used to elucidate the Kangoye (2013) findings by Asongu (2014c). He has concluded that while the Kangoye findings on a positive nexus between aid uncertainty and corruption are relevant, when the concept of governance is extended beyond corruption, the findings become irrelevant for the African continent.

The rest of the chapter is organised in the following manner. Section 2 discusses the effect of foreign aid on corruption. The effectiveness of foreign aid in institutional quality is engaged in Section 3. Section 4 covers the channels of foreign aid to corruption. The dynamic effects of foreign aid on corruption are discussed in Section 5. Section 6 is focused on the nexus between foreign aid uncertainty and corruption. We conclude with Section 7.

2. The effect of foreign aid on corruption

The debate begins with Asongu (2012a) stressing on methodology and policy issues from the Okada & Samreth (2012) paper. The former presented the methodological underpinnings of their paper as the following: *"previous research has primarily been based on Ordinary Least Squares (OLS), instrumental variables and panel estimation. These approaches have disadvantages, as they only estimate the parameters of interest at the mean evaluation by a conditional distribution of the dependent variable (Billger & Goel, 2009)"* (p.240). In order to confirm the empirical motivation, he has assessed Billger & Goel (2009) and found the following: "many *previous studies of the determinants of corruption employ OLS estimation, therefore reporting parameters estimates at the conditional mean of corruption. While mean effects are certainly important, we expand upon such findings using quantile regression. In addition, an underlying assumption for OLS regression is that the error term and the dependent variables are normally distributed.....OLS estimation can yield unreliable estimates, but quantile regression does not require a normally distributed error term*" (pp. 300-301).

According to the narrative, three points are derived after the cross-examination. First, the panel instrumental variable techniques of estimation are not invalidated by Billger & Goel (2009). Second, when classical conditions for OLS validity are satisfied conditional on the exogenous variables (i.e. the presence of an independently and identically distributed error term), quantile regression become redundant, implying all conditional quantiles of the endogenous variable march lockstep in relation to the conditional mean. Third, whereas the criticism from Okada & Samreth holds ground in relation to OLS, it is lacking in substance if extended to some panel dynamic and instrumental variable estimation strategies.

The study has assessed a panel of 52 African nations with data from World Bank Development indicators for the period 1996-2010. In essence, Okada & Samreth have employed data from 120 developing countries for the period 1995-2009. The dependent variables are the corruption-perception and corruption-control indexes. The exogenous variable is Net Official Development Assistance (NODA) to which NODA from the Development Assistance Committee (DAC) nations and multilateral donors are included for robustness purposes.

Using panel system Generalised Methods of Moments (GMM) and Two-Stage-Least Squares instrumental variable techniques, the findings run counter to those of Okada & Samreth. Compared to the quantile regression technique employed by Okada and Samreth, the GMM and 2SLS techniques control for endogeneity. It is concluded that development assistance mitigates (fuels) corruption-control (corruption). As a policy implication, Asongu (2012a) has concluded that the findings of Okada & Samreth for developing countries may not be relevant for Africa. This has led to informal criticisms in academic circles as some have argued that the Asongu (2012a) and Okada & Samreth findings are not directly comparable because they are based on two different methodologies. This has led to the second strand of the debate because; Asongu has not exclusively limited his response to corruption.

3. The impact of foreign aid on institutional quality

This second strand has been informally initiated by some scholars who have criticised Asongu (2012a) for failing to account for the conditional element in the Okada & Samreth finding ("…*reduces corruption especially and its reduction effect is greater in less corrupt countries*" p.1). As a direct response, the debate has been extended by Asongu (2013a) in a twofold manner. First, he has enlarged the scope of the inquiry from corruption to eight governance variables. These include measurements of: political governance (political stability and voice & accountability), economic governance (government effectiveness and regulation quality) and institutional governance (rule of law and corruption-control). Second, he has used the same empirical underpinnings (or quantile regression) as in Okada & Samreth. Central to this extension is the hypothesis that the institutional downside of development assistance as suggested by Okada & Samreth may be questionable in the presence of higher initial levels of institutional development at the domestic level. The quantile regression approach used by both authors does not account for endogeneity. The technique consists of investigating the effects of the independent variables throughout the conditional distributions of the dependent variable.

With this hypothetical basis factored-in, Asongu (2013a) has confirmed the Asongu (2012a) finding on the negative character of foreign aid on the quality of institutions in Africa. The empirical evidence has been based on 53 African countries with data from African Development Indicators (ADI) of the World Bank for the period 1996-2010. The Asongu (2013a) finding has been further confirmed using varying specifications and positioning, inter alia: in the presence of dynamic cultural settings (Asongu, 2015a) as well as when assessing institutional benchmarks for foreign aid effectiveness (Asongu, 2015b). Asongu (2015ab) are also based on quantile regressions that do not account for endogeneity.

The conditional estimation debate has been extended by Asongu (2015a) in a twofold manner. First, he has disaggregated the dataset into fundamental characteristics of legal origins and religious domination, to assess how cultural dynamics affect the aid-corruption nexus. Second, contrary to past studies that have been based on a limited number of variables (Treisman, 2000), the author has considered recent corruption studies to incorporate additional control variables that could affect the signs of the estimations. For instance, the economic, political, trade and press freedom channels employed have been recommended by Saha et al. (2009)[2] and Peyton & Belasen (2012)[3].

The study has investigated a panel of 46 African countries using an updated dataset for the period 2002-2010 from ADI of the World Bank, Grwarney et al. (2011) and Freedom House. While the negative aid-'corruption-control' is broadly confirmed, the findings add subtlety to the debate by presenting some interesting heterogeneous results.

From a legal origin perspective, four key findings are noticeable. First, whereas political freedom fuels corruption-control (CC) in the low quantiles of English common law nations, evidence of such is not present in French civil law countries. Second, CC is consistently improved by the quality of government across all quantiles in countries of English common law. This is not the case in middle quantiles of their French civil law counterparts. Third, economic freedom improves CC only in bottom quantiles of Common

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[2] "*This paper examines the effects of economic freedom, democracy and its interaction term on controlling corruption. The results indicate that interaction between economic freedom and democracy has a significant impact on combating corruption. Partial effect analysis shows that economic freedom reduces corruption in any political environment, and the effect is substantially greater with a higher-level of democracy. In contrast democracy increases corruption when the level of economic liberalization is low, however, once past the threshold level corruption is substantially lower with full economic freedom*" (Saha et al., 2009, p.1).

[3] "*Corruption has affected systems of governance for thousands of years. Existing evidence suggests that it is especially common in "emerging and developing economies," yet cross-country analysis in this context is rare. We examine the impact of political, economic and media freedom on corruption in a large sample of countries across multiple time periods to investigate the marginal differences within each. The results show that increased economic and press freedoms are associated with lower levels of corruption in developing countries. We find that although increased political freedom through democratization is statistically significant, it reduces corruption only in developed countries and may increase levels of corruption in developing countries*" (Peyton & Belasen, 2012, p. 1).

law countries. Fourth, no significantly positive 'press freedom'-CC relation is found. Moreover, Low income French civil law (English common law) nations are predisposed to higher (lower) levels of CC.

With respect to the religious dimension of the results, the following findings were established. First, trade and political freedoms mitigate CC in Christian-dominated nations whereas press freedom exerts a mitigation impact in both cultures of religion. However, the mitigating tendency is more consistent across the distribution of nations that are Christian-oriented. Second, the quality of government is more positively correlated with CC in Christian-oriented countries than it is in Muslim-dominated nations. Third, whereas the relationship between economic freedom and CC is scantily negative in Christian-dominated nations, the impact is positive in their Muslim-oriented counterparts. Fourth, a low-income status in nations with traditions of Christianity and Common law improves CC.

The debate has been further extended from the investigation of institutional benchmarks of foreign aid effectiveness using data from 22 African countries for the period 2002-2009. Asongu (2015b) has factored-in two main streams in the aid-institutions relationship. Accordingly, he has assessed if thresholds or institutional benchmarks matter for the effectiveness of development assistance in institutional capacity building. Seven institutional quality variables have been employed, notably: regulation quality, rule of law, political stability, corruption-control, government effectiveness, democracy and voice & accountability.

Three hypotheses are tested and the findings that are consistent across conditional distributions of institutional quality and specifications have three main implications. First, the institutional rewards of development assistance are contingent on initial levels of institutions in Africa. Second, but for a slight exception, development assistance is instrumental in institutional capacity building in nations with low initial levels in institutional quality. Third, the institutional rewards of foreign aid are questionable in nations with high initial levels of institutional capacity. As a main policy implication, Asongu (2015b) has recommended that blanket policies from aid-institutions assessments may not be appropriate. Hence, policy measures should be based on initial levels of institutional capacity and tailored varyingly across worst and best nations in institutional capacity.

Jellal Mohamed has criticised Asongu informally for not factoring-in indirect channels into the debate. According to the former, mechanisms by which foreign aid affects corruption could substantially affect the nexus.

4. Channels of foreign aid to corruption

This dimension of the debate has been motivated by the lack of a unifying framework. According to Asongu & Jellal (2013), the Okada & Samreth (2012) and Asongu debate has been based on modelling the direct effects of foreign aid on corruption. The authors are in accordance with Knack & Keefer (1995)[4] in arguing that when institutional quality is modelled as a direct consequence of development assistance, misleading policy implications could result because the model does not factor-in channels via which foreign aid affects institutional quality.

The authors use fiscal behaviour and investment mechanisms to improve the debate on how foreign aid affects corruption. The theoretical underpinnings for their work are deeply rooted in the Harrod-Domar and Solow growth models. Accordingly, these models are based on the imperative of aid-financed augmentations in investment, in order to bridge apparent gaps in ‘poverty and development’ (Easterly, 2005). In this light, the authors postulate that taxation and government expenditure which represent fiscal behaviour are substantially affected by development assistance.

[4] Knack & Keefer (1995, p. 223) have arrived at the conclusion that more variables are needed in order to properly assess institutional quality.

Therefore, employing panel instrumental variable estimations, the Asongu & Jellal (2013) have extended the debate using a panel of 53 African countries for the period 1996-2010. An endogeneity-robust instrumental variable estimation technique is employed in which foreign aid and grants are employed as instruments. Two principal results have been established. On the one hand, development assistance that uses government expenditure as a transmission mechanism has the tendency of increase corruption. On the other hand, foreign aid that is channelled through tax effort and private investment could potentially mitigate corruption. Hence, the authors recommend that development assistance which aims to fight corruption should use tax effort and private investment mechanisms, instead of government expenditure. In summary, by integrating an indirect component, the authors reconcile the debate by establishing that the sign of the effect depends on the transmission mechanism. Hence, the effects are dynamic.

5. On the dynamic effects of foreign aid to corruption

This strand of the debate on the dynamic effects of foreign aid has arisen from a recent stream of studies that has consistently sustained that in the modelling of corruption, fundamental characteristics of development are key to controlling for potential heterogeneity among countries (Ndikumana & Boyce, 2011; Jellal & Bouzahzah, 2012; Hollyer & Wantchekon, 2012; Kodila-Tedika, 2012, 2013; Musila, 2013; Asongu, 2015a). Hence, Asongu (2014a) has put together more pieces of the puzzle by providing dynamic investigations that account for legal origins, the wealth of nations, regional proximity, religious domination, politico-economic stability, natural resources and openness to sea. According to the narrative, the weight of the fundamental characteristics of development is essential for targeted and less blanket policy implications. The empirical evidence is based on an endogeneity-robust dynamic panel system GMM estimation with data from 53 African nations for the period 1996-2010. The results show that the positive effect of development assistance on corruption is most apparent in: French civil law, Middle-income, Christian-dominated, non-oil exporting and landlocked nations. Moreover, there is also some scanty evidence of foreign aid increasing corruption-control in Lower Middle income and 'not landlocked' countries. A discussion of some reasons behind these differences is worthwhile.

With regard to how colonial legacy plays out, French civil law nations are more predisposed to being corrupt than their counterparts of English common law. This finding is consistent with theoretical and empirical literature. Accordingly, the theory on law and property rights sustains that, for legal systems in which less emphasis is placed on private property rights vis-à-vis State power, corruption tends to be less (La Porta et al., 1998; La Porta et al., 1999). Therefore, it is very likely to find situations where a substantial part of development assistance is misappropriated because the institutional web of informal norms, formal rule and enforcement features are weak. As sustained by Asongu (2012c), the discussed advantage of English legal origins over their French civil law counterparts has been extended to other areas of management, inter alia: better institutions with governments that are less corrupt (La Porta et al., 1999); more efficient courts (Djankov et al., 2003) and; better informative standards of accounting (La Porta et al., 1998). This literature has been confirmed in Africa recently, among others: the weight of legal origins in the quality of government (Asongu, 2012b, 2014d) and institutions of property rights (Asongu, 2014e).

The higher positive aid-corruption relationship in nations that are dominated with Christianity, relative to those that are Islam-oriented could essentially be elucidated by the weight of development assistance in the fundamental features. Accordingly, based on the summary statistics, the latter are less reliant on foreign aid than the former: 9.79 versus 11.36 as a percentage of GDP. Another possible explanation may be that, the punishment on culprits of corruption may be more severe in the latter than in the former set of nations. In a nutshell, the findings reflect to a great extent why nations that are dominated by Christians may be more predisposed to devoting more efforts in fighting corruption (Asongu, 2012b, p. 191).

There is a simple answer to the concern of why countries that are non-oil exporting could be more corrupt contingent on development assistance. Accordingly, nations exporting petroleum received considerably less development assistance (3.29% of GDP) as compared to non-exporting oil nations (12.59% of GDP).

The point that development assistance could potentially induce more corruption in countries that are closed to the sea in relation to their counterparts which are more open was quite expected. There is a twofold motivation for this expectation. On the one hand, countries that are landlocked on average tend to get more aid: 12.55% compared to 10.06% of GDP. On the other hand, there is an institutional cost of being landlocked (Arvis et al., 2007).

6. Foreign aid uncertainty and corruption

The Eubank (2012) conjecture/hypothesis has been validated by Asongu (2014b). The conjecture has been further employed by Asongu (2014c) to elucidate the findings of Kangoye (2013). The author has concluded that while the Kangoye findings on a positive nexus between aid uncertainty and corruption are relevant, when the concept of governance is extended beyond corruption, the findings become irrelevant for the African continent.

In essence, the Kangoye (2013) results on the negative effect of development assistance unpredictability and governance is as follows: "*This paper examines the effects of aid on governance from a different perspective by asserting that aid unpredictability can potentially increase corruption in recipient countries by providing incentives to risk-averse and corrupt political leaders to engage in rent-seeking activities. Analyses of data from 80 developing countries over the period 1984–2004 offer evidence that higher aid unpredictability is associated with more corruption as measured by a synthetic index. We also find further evidence that this latter impact is more severe in countries with weak initial* *institutional conditions. These findings are a supplementary advocacy for the need for better management and better predictability of aid flow in developing countries*". (p. 121).

The findings have been extended by Asongu (2014c) because of a recently celebrated conjecture from Eubank (2012). Accordingly, limiting the concept of governance to its institutional dimension could be quite misleading. In essence, whereas corruption has been used as the principal endogenous variable, governance is employed in the title. Asongu (2014c) has been consistent with Kaufmann et al. (2010) and recent literature (Andrés & Asongu, 2013; Andrés et al., 2014; Amavilah et al., 2014) in broadening the concept of governance, notably: political (voice & accountability & political stability/no violence), institutional (rule of law and corruption-control) and economic (regulation quality and governance effectiveness).

Therefore based on the above, two principal axes that converge and clearly standout are: (1) Somaliland on which the hypothesis is founded is ineligible for official development assistance but enjoys relatively better standards of governance and; (2) the findings of Kangoye (2013) are parallel to the Eubank (2012) intuition. The empirical evidence has been founded on 53 African nations with data from ADI of the World Bank for the period 1996-2010. Distortions are measured as standard deviations and standard errors. The estimation technique employed is an endogeneity robust system GMM.

In the findings, Asongu (2014c) first confirm the Kangoye (2013) results when the concept of governance is limited to corruption. However, when a broader definition of governance is employed to entail, institutional, economic, political and general dimensions, the new findings run counter to those of Kangoye. Therefore, it is could be confirmed that in the presence of foreign aid uncertainty, governments are constrained to improve their standards in anticipation for more dependence on local tax income. There have been two principal policy implications from the findings. First, the results of Kangoye for developing nations are seemingly relevant for Africa. Second, when the definition of governance is not limited to corruption, the Kangoye results are no longer relevant for the continent.

7. Conclusion

This policy chapter has summarised an evolving debate on the effect of foreign aid on corruption and institutions. It entails a series of publications that have been successively motivated by feedbacks from academic and policy making circles. The plethora of papers explores debates sustaining the direct, conditional and indirect effects of foreign aid on institutions. Moreover, another debate on the incidence of foreign aid distortions on corruption is also assessed in light of a recently celebrated literature on development assistance. Overall, the findings show that the effects of foreign aid on corruption and institutions are: directly positive; conditionally positive with a magnitude dependent on initial institutional capacity levels; contingent on fundamental characteristics of development due to heterogeneity and; indirectly positive or negative depending on the transmission mechanism. While the impact of foreign aid uncertainty on corruption is also positive, the sign on governance could change in light of governments' commitment to increase its dependence on local tax revenues.

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