

## Foreign Aid and Quality of Governance in Latin America

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The paper analyzes the effect of foreign aid on governance on a group of Latin American countries. While there is overwhelming evidence that governance has a significant impact on economic development of a country, the findings of earlier studies on the effect of foreign aid on governance is often contradictory. Using the Stata statistical tool we employed the Random Effects and the Feasible Generalized Least Squares estimation techniques on a panel data of 20 Latin American countries. The findings suggest that foreign aid has a positive influence on quality of governance. The empirical evidence is strong as the findings hold true not only when a composite measure of governance is employed in the model, but also generally when the six individual dimensions of governance are used. The findings of the study are especially important as many of the countries in the sample are significant recipients of foreign aid. Improved governance will not only enhance the effectiveness of development aid in the long run but may also generate other positive spinoffs.

*Key Words:* Foreign aid, quality of governance, Latin America

### Introduction

Aid has been a critical element in the developed world's attempt in the post-WWII period to help poor and developing countries emerge out of poverty. The focus on aid on the part of industrialized countries and multilateral institutions such as the World Bank stemmed from their belief that the structural deficiencies in the recipient countries must be overcome before these countries can attain a desirable growth trajectory. Foreign aid can contribute to economic growth by augmenting the domestic resources of developing economies, enabling transfer of critical technical and management know-how and by helping provide developing countries access to global markets (Chenery, 1965; Papanek, 1972). While industrial countries are encouraged to increase their aid budget to meet Millennium Development goals, robust evidence linking foreign aid with substantive economic growth is lacking (Rajan & Subramanian, 2007). Asongu & Nwachukwu (2014) provide a brief summary of the literature on the conflicting findings of the effect of aid on economic growth. The lack of conclusive evidence linking aid to economic growth has led academics and developmental experts to analyze the role of governance as a factor affecting growth in the recipient countries. Good governance ensures a macro-organizational environment in which markets function (Dunning, 1992) and could serve as a catalyst for economic growth. Conversely, in the absence of


good governance, economic benefits may not be realized.

Various recent studies provide empirical support to the positive impact of governance to economic development (World Bank, 2005). While governance *per se* can be broken down into multiple aspects such as rule of law, regulatory quality, etc., broadly speaking governance refers to efficiency and effectiveness of the government in implementing its policies. Reynolds (1985) notes that the capacity of political and governance institutions of countries largely explains the difference in the growth rate of various developing countries. Collier (2007) identifies the weakness in the governance mechanism as the reason why foreign aid under the Official Development Assistance Program to the African countries did not produce the desired results.

If the criticality of governance to growth is acknowledged, then the question clearly becomes whether foreign aid is conducive to improving governance or has a negative effect.

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The literature on the effect of foreign aid on governance is, however, contradictory. Bräutigam (2000) notes that while aid has been part of the solution in many countries as it has led to an improvement in institutional quality and economic management, this is not universally true. In some countries donor agencies have substituted for governance functions and set their own goals, which have led to an adverse impact on local governance capacity. It has been argued that aid can give rise to moral hazard as it enables the continuation of the status quo leading to an adverse impact on governance. It can also result in enhancing the predatory power of the government and create opportunities for the government to proliferate (Ali & Isse, 2003). Extensive aid packages to developing countries have led to what the World Bank calls “opportunities of malfeasance” (World Bank, 1989, p. 27).

This study adds to the existing literature on the effect of aid on governance. It examines panel data from 1996-2014 from 20 countries of Latin America. This research is similar to the study of Quazi and Alam (2015), which analyzed the effects of aid on quality of governance in 14 countries of South Asia and East Asia. We believe that focusing on specific regions has merit; countries in the same region have similarities in terms of their economic and cultural profile and restricting the study to a region helps control for extraneous factors. We are not aware of any aid-governance study specifically targeted to Latin America. The study, thus, contributes not only to the existing literature on the effect of aid on governance, but also helps focus on an important set of emerging economies.

The next section deals with literature survey and is followed by a section dealing with the model and methodology of the study; this is followed by a discussion of the results and finally conclusion.

## Literature Review

The empirical studies on the relationship of aid with governance are fairly voluminous though hardly conclusive. While a host of studies have found empirical evidence linking aid with improved governance, many researchers have contrary findings.

Corruption has a significant bearing on governance quality. Theoretically, by easing revenue constraints, foreign aid enables governments to invest in institutions of governance and focus more effectively on tackling corruption, etc. (Busse & Gröning, 2009). Specifically, it can enable payments of higher salaries to government employees to reduce incidence of corruption, provide technical assistance to build legal systems, and allow aid donors to impose specific governance related reforms and provide critical oversight (Quazi & Alam, 2015). Okada & Samreth (2009)

found empirical support linking aid with reduced levels of corruption. Similarly, using panel data from 66 countries, Svensson (2000) found aid and corruption to be negatively related. In a study of aid from 11 OECD countries to non-OECD countries, Tavares (2003) also came to a similar finding. He attributes this to the imposition of conditionalities by the donors on the recipient countries. Further, not only is the utilization of aid better in low-corruption countries, but foreign aid helps in improving institutional and governance quality (Okada & Samreth, 2012). Research also points out to the differential effect of multilateral and bilateral aid. Multilateral aid is more effective in reducing corruption, as it is often accompanied with conditionalities on improving institutional quality and reduction in corruption which is not the case with bilateral aid, which is generally influenced by historical ties and political interests of the donor countries (Okada & Samreth, 2012).

The positive effect of foreign aid on governance is supported by empirical studies (Goldsmith, 2001; Dunning, 2004; Charron, 2011). Goldsmith (2000) was unable to find any negative consequences of aid; he concluded that aid has a positive or neutral relationship with governance. Ear (2007) investigated the aid-governance relationship using Kaufmann et al.’s six dimensions of governance. Only one of the six dimensions, the rule of law, appears to have a negative relationship with aid. Findings suggest that aid can play a positive role when its components such as technical cooperation and average grant amount are considered.

In contrast to the studies cited above, many studies have come to a contrary conclusion with regard to the effect of aid on governance quality or democratic performance. Moyo (2009) has been very critical of foreign aid. In her opinion, aid has led to an increase in corruption and she contends that much of the foreign aid for structural readjustment programs were lent to countries with a poor record in complying with lending conditions (Moyo, 2009, p.55). Foreign aid on a continuous basis may create a culture of dependency and rent seeking and could delay necessary reforms to improve governance (Busse & Gröning, 2009). This is corroborated by Heckelman & Knack (2005) who found that aid dependency led to weakening of market-liberalizing reforms. Along similar lines, Bräutigam (2000) notes that by inducing dependency, foreign aid lessens local ownership and accountability of development efforts and reduces the need for enhancing tax revenues. Additionally, it may lead to unproductive competition among interest groups over access to aid money and may have the unintended consequence of diverting human resources from government and public sector projects to aid-funded projects (Tavares, 2003; Bräutigam & Knack, 2004; Ear, 2007; Asongu, 2013).

Knack (2001) found a significant and negative relationship between aid and quality of governance in recipient countries. Similarly, in a study of 32 sub-Saharan countries, Bräutigam & Knack (2004) found a negative relationship between aid and governance. In another study of 52 African countries, Asongu (2013) found that foreign aid generally had a negative effect on various dimensions of governance or that its effect was insignificant. Specifically, it weakened economic and institutional governance while its effect on political governance was not statistically significant.

### Model, Methodology and Data

The sample for this study consisted of 20 countries from Latin America. These were: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela. Panel data for these countries was collected for the period 1996 through 2014. The model employed for the study is discussed below.

$$\text{Quality of Governance}_{i,t} = \alpha + \beta_1 \text{Foreign Aid}_{i,t} + \beta_2 \text{Urban Population}_{i,t} + \beta_3 \text{Tax Revenues}_{i,t} + \beta_4 \text{Education}_{i,t} + \beta_5 \text{Economic Development}_{i,t} + \varepsilon_{i,t}$$

The dependent variable is the quality of governance and the variable of interest is foreign aid. Urban population, tax revenues, education, and economic development are used as control variables. The independent variables used in the study are consistent with the existing literature on the subject.

To analyze the panel data regression was carried out using the Stata statistical tool. We employed both the Random Effects and the Feasible Generalized Least Squares estimation techniques.

Data on quality of governance was obtained from the *Worldwide Governance Indicators* (WGI, 2015), an established source for such information. WGI collects data from over 200 countries through collaboration with various institutions, such as think tanks and survey institutes. WGI breaks governance along six dimensions of Voice and Accountability, Political Stability, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption. These are defined below.

- i. *Voice and Accountability* - Reflects perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.
- ii. *Political Stability and Absence of Violence/Terrorism* - Reflects perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism.

- iii. *Government Effectiveness* - Reflects perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.
- iv. *Regulatory Quality* - Reflects perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.
- v. *Rule of Law* - Reflects perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.
- vi. *Control of Corruption* - Reflects perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

Countries are scored on a scale of -2.5 to +2.5 on each of these dimensions of governance. To arrive at a composite value of the quality of governance, a simple average of the scores along the six dimensions was carried out. This is consistent with earlier studies (Knack, 2001; Ear, 2007). For our analyses we employed not only the composite score of governance, but also the six constituent dimensions of governance as the dependent variable. Urban Population was used as a control variable since economies of scale associated with higher urban population can be conducive to establishment of institutions, which in turn aids good governance (Knack, 2001; Bräutigam & Knack, 2004; Ear, 2007). Education is used a proxy measure of human capital which is integral to governance quality (Heckelman & Knack, 2005). Most developing countries suffer from a resource crunch, which comes in the way of setting up effective governance mechanisms. Economic development is used as a control variable since higher level of economic development and consequently higher tax revenues provide greater resources at the disposal of the government which can enhance the quality of governance (Goldsmith, 2001; Knack, 2001; Bräutigam & Knack, 2004; Dunning 2004).

The independent variables are defined below. The source of data was *World Development Indicators* (World Bank, 2015).

Foreign Aid: Share of net Official Development Assistance in Gross National Income (GNI)<sup>1</sup>

Urban Population: Share of urban population in total population.

Education: Share of education expenditure in total government expenditure

Tax Revenues: Share of tax revenues in GDP

Economic Development: Natural log of per capita GNI (current US\$).

for each country in the sample during the period 1996-2014.

Table 1 lists the average composite measures of quality of governance and average foreign aid inflow

Table 1. Quality of governance and foreign aid in sample countries (1996-2014)

Country	Quality of Governance (Composite Indicator)	Foreign Aid (ODA/GNI %)
Argentina	-0.25	0.04
Bolivia	-0.48	6.01
Brazil	0.00	0.03
Chile	1.15	0.09
Colombia	-0.47	0.38
Costa Rica	0.60	0.13
Cuba	-0.62	0.20
Dominican Republic	-0.34	0.36
Ecuador	-0.71	0.46
El Salvador	-0.19	1.25
Guatemala	-0.60	1.08
Haiti	-1.23	16.64
Honduras	-0.59	5.23
Mexico	-0.12	0.03
Nicaragua	-0.52	11.24
Panama	0.10	0.13
Paraguay	-0.76	0.71
Peru	-0.31	0.50
Uruguay	0.72	0.12
Venezuela	-1.06	0.04
<b>Global Average</b>	<b>0.003</b>	<b>0.19</b>

Data Sources: *Worldwide Governance Indicators 2015*, *World Development Indicators 2015*.

## Regression Results

Tables 2-9 report the panel model regression results. Each model is estimated with two estimation techniques - Random Effects and Feasible Generalized Least Squares (FGLS). The Random Effects method was selected over the Fixed Effects method, as the Hausman test statistics revealed strong presence of random effects in the regression equations<sup>2</sup>. The diagnostics statistics also revealed the presence of autocorrelation without heteroscedasticity, which is addressed by using the FGLS method with panel-specific autocorrelation in homoscedastic panels. A total of seven regression models are estimated; in the first one, the

dependent variable is the composite measure of quality of governance, followed by six models where the dependent variables are the six components of governance (e.g. political stability, rule of law, etc.).

Results presented in Table 2 show that the explanatory variables (except tax revenues and education) are generally statistically significant in either random effects model or FGLS model or both models. The effect of foreign aid on the composite measure of quality of governance appears positive and significant in both models. Urban population and per capita income also appear to have positive effects on the quality of governance, which is in line with *a priori* expected signs of the coefficients.

Education turned out to be not significant (indeed has a negative coefficient in the random effects model). This is surprising since human capital is expected to impact governance quality. One plausible explanation is that there is not enough variation in the education

levels in the countries in the sample. Similarly, tax revenues did not turn out to have a significant positive effect. We can conjecture that the effect of tax revenues is likely being captured by per capita income and hence its individual effect is not manifested.

Table 2: Determinants of Quality of Governance (Composite Measure)

	Random Effects Model		Feasible GLS Model	
	Coeff	Z stat	Coeff	Z stat
Foreign Aid	0.02	1.66*	0.02	2.11**
Urban Population	0.01	1.54	0.02	5.74**
Tax Revenues	-0.0004	-0.60	0.001	0.95
Education	-0.004	-0.60	0.0002	0.03
Per Capita Income	0.11	3.03**	0.20	2.86**
Constant	-1.64	-4.60	-3.26	-6.92
Diagnostic Statistics	n = 92		n = 90	
	Wald $\chi^2_5 = 37.19$ (p-value = 0.00)		Wald $\chi^2_5 = 124.56$ (p-value = 0.00)	
	Overall $R^2 = 0.51$		Log likelihood = 77.71	

\*\*Coefficient statistically significant at 5%; \*Coefficient statistically significant at 10%.

Next we analyze the effect of foreign aid on the six individual dimensions of governance. Detailed results are presented in Tables 4-9, which are summarized in Table 3. The results are generally similar with what was observed when a composite measure of governance was used as the dependent variable. The effects of foreign aid, urban population and per capita income

on the different dimensions of governance generally appear to be positive (either in the random effects model or FGLS model), but the effects of tax revenues and education appear to be insignificant. The overall diagnostic statistics (measured by Wald  $\chi^2$ , overall  $R^2$  and log likelihood statistics) came out generally satisfactory for all estimated models.

Table 3: Summary of Detailed Results from Tables 4-9

	Voice and Accountability		Political Stability		Government Effectiveness		Regulatory Quality		Rule of Law		Control of Corruption		
	RE	FGLS	RE	FGLS	RE	FGLS	RE	FGLS	RE	FGLS	RE	FGLS	
Foreign Aid	+	+	NS	+	NS	NS	NS	+	+	+	+	NS	+
Urban Population	+	+	NS	+	+	+	NS	+	NS	+	+	+	+
Tax Revenues	NS	NS	NS	NS	-*	NS	NS	+	NS	NS	NS	NS	NS
Education	NS	NS	NS	NS	NS	NS	NS	+	NS	NS	NS	NS	NS
Per Capita Income	+	+	NS	NS	NS	NS	+	+	+	+	NS	+	+

Notes: +\* denotes statistically significant coefficient with positive sign  
 -\* denotes statistically significant coefficient with negative sign  
 NS denotes statistically insignificant coefficient

Table 4: Determinants of Voice and Accountability

	Random Effects Model		Feasible GLS Model	
	Coeff	Z stat	Coeff	Z stat
Foreign Aid	0.06	3.58**	0.02	2.15**
Urban Population	0.02	2.23**	0.01	2.69**
Tax Revenues	-0.0002	-0.14	-0.0003	-0.21
Education	-0.004	-0.44	-0.01	-1.20
Per Capita Income	0.14	2.56**	0.25	2.98**
Constant	-2.24	-4.69	-2.62	-4.89
Diagnostic Statistics	n = 92		n = 90	
	Wald $\chi^2_5 = 41.31$ (p-value = 0.00)		Wald $\chi^2_5 = 60.13$ (p-value = 0.00)	
	Overall R <sup>2</sup> = 0.41		Log likelihood = 58.16	

\*\*Coefficient statistically significant at 5%; \*Coefficient statistically significant at 10%.

Table 5: Determinants of Political Stability

	Random Effects Model		Feasible GLS Model	
	Coeff	Z stat	Coeff	Z stat
Foreign Aid	-0.008	-0.28	0.03	1.72*
Urban Population	0.01	0.74	0.02	2.23**
Tax Revenues	0.003	1.23	0.003	0.96
Education	0.001	0.08	-0.01	-0.54
Per Capita Income	0.07	0.69	0.11	0.74
Constant	-1.55	-1.91	-2.28	-2.54
Diagnostic Statistics	n = 92		n = 90	
	Wald $\chi^2_5 = 4.69$ (p-value = 0.45)		Wald $\chi^2_5 = 28.61$ (p-value = 0.00)	
	Overall R <sup>2</sup> = 0.15		Log likelihood = 4.36	

\*\*Coefficient statistically significant at 5%; \*Coefficient statistically significant at 10%.

Table 6: Determinants of Government Effectiveness

	Random Effects Model		Feasible GLS Model	
	Coeff	Z stat	Coeff	Z stat
Foreign Aid	0.01	0.47	0.01	0.51
Urban Population	0.02	2.90**	0.03	6.26**
Tax Revenues	-0.003	-2.36**	-0.0001	-0.04
Education	-0.01	-0.89	0.01	1.38
Per Capita Income	0.04	0.78	0.10	1.12
Constant	-1.77	-4.00	-3.20	-5.66
Diagnostic Statistics	n = 92		n = 90	
	Wald $\chi^2_5 = 28.66$ (p-value = 0.00)		Wald $\chi^2_5 = 107.18$ (p-value = 0.00)	
	Overall R <sup>2</sup> = 0.50		Log likelihood = 52.33	

\*\*Coefficient statistically significant at 5%; \*Coefficient statistically significant at 10%.

Table 7: Determinants of Regulatory Quality

	Random Effects Model		Feasible GLS Model	
	Coeff	Z stat	Coeff	Z stat
Foreign Aid	-0.01	-0.59	0.02	1.63
Urban Population	0.01	1.07	0.02	5.15**
Tax Revenues	0.002	1.29	0.003	2.13**
Education	-0.02	-1.45	0.02	2.22**
Per Capita Income	0.17	2.83**	0.23	3.38**
Constant	-1.51	-3.32	-3.36	-7.25
Diagnostic Statistics	n = 92		n = 90	
	Wald $\chi^2_5 = 23.96$ (p-value = 0.00)		Wald $\chi^2_5 = 138.02$ (p-value = 0.00)	
	Overall R <sup>2</sup> = 0.37		Log likelihood = 54.39	

\*\*Coefficient statistically significant at 5%; \*Coefficient statistically significant at 10%.

Table 8: Determinants of Rule of Law

	Random Effects Model		Feasible GLS Model	
	Coeff	Z stat	Coeff	Z stat
Foreign Aid	0.03	1.84*	0.03	3.51**
Urban Population	0.01	0.72	0.03	7.12**
Tax Revenues	-0.001	-0.51	-0.001	-0.57
Education	-0.002	-0.21	0.003	0.31
Per Capita Income	0.18	3.26**	0.23	2.64**
Constant	-2.27	-4.50	-4.57	-7.78
Diagnostic Statistics	n = 92		n = 90	
	Wald $\chi^2_5 = 32.04$ (p-value = 0.00)		Wald $\chi^2_5 = 168.25$ (p-value = 0.00)	
	Overall R <sup>2</sup> = 0.54		Log likelihood = 57.19	

\*\*Coefficient statistically significant at 5%; \*Coefficient statistically significant at 10%.

Table 9: Determinants of Control of Corruption

	Random Effects Model		Feasible GLS Model	
	Coeff	Z stat	Coeff	Z stat
Foreign Aid	0.02	0.73	0.02	1.91*
Urban Population	0.03	3.45**	0.04	4.46**
Tax Revenues	-0.002	-1.37	0.002	0.87
Education	0.01	0.93	0.02	1.27
Per Capita Income	-0.04	-0.56	0.26	1.95*
Constant	-2.27	-4.07	-5.05	-5.93
Diagnostic Statistics	n = 92		n = 90	
	Wald $\chi^2_5 = 23.15$ (p-value = 0.00)		Wald $\chi^2_5 = 73.05$ (p-value = 0.00)	
	Overall R <sup>2</sup> = 0.57		Log likelihood = 21.86	

\*\*Coefficient statistically significant at 5%; \*Coefficient statistically significant at 10%.

## Conclusions and Future Research

The objective of the study was to study the effect of foreign aid on governance on a group of Latin American countries. The importance of this issue stems from the fact that while billions in foreign aid have been disbursed to poor and developing countries in the post-WWII period, many recipient countries have not been able to achieve the projected economic growth rate. Studies have suggested that this has been due to an absence of good governance in the recipient countries. The influence of good quality public institutions and governance may exceed the impact of good economic policies in explaining economic performance (Knack & Keefer, 1995). Further, many academics and development professionals have hypothesized that foreign aid by adversely affecting governance have the unintended consequence of compounding the problem. This study was an effort to analyze the issue.

The findings support the view that foreign aid in fact has a positive influence on quality of governance. The implication of the findings for donor and recipient countries alike is clear. By positively impacting governance, foreign aid lays the foundation of improving the effectiveness of development aid in the long run; improved governance may also result in positive spinoffs beyond the economic realm.

The empirical evidence is strong as the findings hold true not only when a composite measure of governance is employed in the model, but also generally when individual dimensions of governance are used. This testifies to the robustness of the findings. The results add to the existing literature on the topic and are especially important since the findings of earlier studies are contradictory. Further, this study is line with an earlier study of South Asian and East Asian countries (Quazi & Alam, 2015) where similar results were obtained. These results are important since these two regions, Latin America and South Asian and East Asian countries, account for a significant number of developing countries and a significant proportion of the global flow of development aid.

Future researchers may add to the existing literature by studying other regions where there is a significant flow of international development funds. Also, the research model can be expanded by adding to the number of explanatory variables especially those dealing with social/cultural aspects, such as those dealing with ethnic heterogeneity and colonial history.

## Notes

1. The model was estimated with another proxy variable for foreign aid (share of net ODA in central government expense). The estimated results were very similar to the results presented in this paper.
2. Hausman test details are available from the authors.

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