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Trade aid, institutional quality, and trade

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A R T I C L E I N F O

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A B S T R A C T

This paper uses a new database on trade aid to examine the relationships among trade aid, institutional quality, and trade. Using an instrumental variable approach and a large country sample, I find that trade aid has significantly higher positive effect on trade when it is interacted with the measure of institutional quality. This result is robust to various model specifications, tackling potential endogeneity issues, and excluding outliers. This finding provides key insights on policy recommendations for policymakers and donors.

1. Introduction

Trade aid has rapidly become a popular concept among trade communities and donors particularly after the launching of Aid for Trade initiative in 2005.[1] The main objective of this type of aid is to assist developing countries in reducing behind-the-border restrictions and to help them benefit from trade reform. Trade aid is development assistance aimed at supporting developing countries creating stronger connections with the benefits from international trade. It also targets harmonizing and ameliorating the prevailing structures of trade aid provisions which significantly helps developing countries in solving several problems, and thereby integrating into the international trading system (Ismail, 2007). Moreover, trade aid plays significant roles in harmonizing trade facilitations including creating greater transparency, efficiency and standardized customs procedures, improving international trade infrastructure, and promoting smooth relations among customs authorities and other public institutions such as certifying or authorizing bodies. Accordingly, donors provide huge amount of trade aid. For example, between 2002 and 2008, donors' total trade-specific aid disbursements reached on average to 19.3 billion US$ (constant 2008 prices), which comprises around 33% of sector allocable Official Development Assistance (Organization for Economic Co-operation and Development (OECD, 2010). Up to and during the WTO Ministerial Conference in Hong Kong in 2005, donors vowed to increase trade aid. Further, the European Commission and EU Member States pledged an additional 2 billion Euros a year by 2010, the United States promised to increase trade aid by 100% in the same year, and Japan promised to deliver around 10 billion US$ until 2013 (WTO, 2007). Based on the reports of OECD (2010), donors are successful in delivering their commitments.

Subsequently, very few studies attempt examining the effect of trade aid on trade. For example, Busse, Hoekstra, and Königer (2012) find that trade aid reduces the cost of trading. Cali and Te Velde (2011) suggest that trade aid has positive effect on exports of the recipient countries. Further, Wagner (2003) examine the effect of overall aid on exports and concludes that a 1 percent point increase in aid leads to 133% increase in exports of goods. Brenton and von Uexkull (2015) examine the effect of product specific technical assistance for trade on export performance of the recipient countries and find that aid is effective in promoting export of the product subject to assistance.

However, in the aid literature a recent revitalization took place in which the question has shifted from "Does aid work?" to "Under

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[1] The Aid for Trade initiative has been launched in December 2005 at the Ministerial Conference of the World Trade Organization (WTO) in Hong Kong (see Page, 2007).

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what circumstances can aid be anticipated to be helpful?" In econometric terms this is captured by the inclusion of interaction terms between aid and other factors that may potentially influence the effectiveness of aid in the recipient countries. The most persuasive work along these lines is the one by Burnside and Dollar (2000) which suggests that aid has significantly positive effect on economic growth if the recipient countries have good fiscal, monetary and trade policy environments. This study has inspired many scholars to understand the effect of aid under different conditions in which aid conveys benefits to the recipient countries. For example, Guillaumont and Chauvet (2001) argues that the effectiveness of aid depends on the existence of exogenous environmental shocks. The authors construct an index for environmental vulnerability, which comprises the fluctuations of agricultural production, the trend and instability of the terms of trade, and the population size. They conclude that countries suffering from high environmental vulnerability grow slower but also that aid is more effective in solving this problem. Based on this result, the authors suggest that aid has to be provided to those countries which are severely affected by environmental shocks. A related result is provided by Collier and Dehn (2001), who study periods characterized by a negative terms of trade shock (defined as those located at the bottom 2.5% of the distribution). Their results imply that aid can be mainly important during these periods.

Collier and Hoeffler (2002) argue that aid might be more effective in the years following an armed conflict. The authors show that aid has significantly positive effect on growth particularly between 4 and 7 years after the end of a conflict. They also suggest that the largest proportion of aid should not hit the streets immediately after the conflict, when the country does not have the ability to allocate it properly, but a few years afterwards. Dalgaard, Hansen, and Tarp (2004) show that the effectiveness of aid depends on climatic conditions of the recipient countries. The authors include the interaction of the fraction of land in the tropics and aid in the growth regressions and find a negative coefficient for the interaction term.

Moreover, Fielding, 2011; Knack, 2001 show that the effect of aid depends on the quality of governance in the recipient countries. Collier and Dollar (2003) argue that aid significantly reduces the level of poverty if the recipient countries have good police environments.[2]

Despite the importance of examining the effectiveness of aid conditional on different circumstances in the recipient countries, the evidence on the effectiveness of trade aid in the presence of different conditions is still (surprisingly) scant. This study contributes to the aid literature by concentrating on the effect of trade aid when it is interacted with the measure of institutional quality in the recipient countries. The notion of institutional quality has received a great deal of attention in recent literature. It refers to a wide range of structures that markedly influence economic outcomes, such as contract enforcement, property rights, investor protection, the political system, and others. A growing body of literature including Acemoglu, Johnson, and Robinson (2005), Engerman and Sokoloff (1997), Hall and Jones (1999), Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) suggest that the quality of institutions plays paramount role in spurring economic growth. The authors also suggest that institutional quality is one of the important factors which create differences among developing and developed countries where the later have much better institutional quality.

Moreover, recent studies imply that higher institutional quality leads countries to full benefit from openness strategies. Anderson (2008) thus suggests that the risk of predation and imperfect enforcement of contracts weakens foreign trade because it upsurges both the costs and the risks of trading abroad. Méon and Sekkat (2008) find that exports of manufactured goods are positively affected by the quality of institutions. Anderson and Marcouiller (2002) show that bad opaque public policies and an ineffective legal system reduce the volume of trade. Dollar and Kraay (2003) find a positive correlation between openness and the rule of law, although they claim that these variables may have endogenous relationship. Similarly, Giavazzi and Tabellini (2005) report that political liberalizations have a strong connection with trade liberalization. The authors state that political liberalizations cause trade liberalizations. Knack and Keefer (1995) argue that weak institutions lead to slower economic growth. Olson, Sarna, and Swamy (2000) show that ailing institutions are associated with slower growth of total factor productivity.

Given the emerging consensus on the importance of institutional quality, it is pragmatic to think that the effect of trade aid on trade may enormously depend on the quality of institutions in the recipient countries. Trade aid flows cannot be converted into the goods and services it has been allocated for without the presence of good institutions in the recipient countries. Thus, institutional quality crucially determines how much of the trade aid is diverted and how much reaches its final goal. Further, trade aid may enhance trade activities, but this impact can be further improved if the recipient countries have higher institutional quality. Poor countries with strong economic, social and political institutions benefit directly from the institutions, and in this situation trade aid augments trade sector. In highly distorted institutions, however, trade aid is dissipated in unproductive government expenditure.

However, the extant aid literature is silent about how trade aid affects trade when it is interacted with institutional quality. This paper fills the gap in the literature by examining the role of institutional quality for trade aid effectiveness using International Country Risk Guide Index as a measure of institutional quality in the recipient countries.[3] This paper provides strong empirical evidence supporting the argument that institutional quality augments the effect of trade aid on trade of the recipient countries. The results hold over a large battery of robustness checks including a variety of model specifications, different measure of institutional quality, different measures of trade aid, tackling endogeneity issues, and the inclusion of many of the control variables previously proposed in the literature.

Before turning to the data and the empirical methodology employed in this paper, it is helpful to provide a concrete example where the central ideas of this study, foreign aid (particularly trade aid) might be misused in the presence of ailing institutions, can be glaringly observed.

Africa is a continent that is justifiably renowned for the vast wealth hijacked and expropriated by its elites and for the sacrifices

[2] Hansen and Tarp (2001), Lensink and White (2001) also examine the effect of aid by conditioning on various circumstances.
[3] Further information about the definition of this variable is provided in the subsequent section.