



Paper Code : ES9 – 58

Governance Institutions, Official Development Assistance and Economic Growth in Vietnam

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Abstract

Using balanced panel data adapted from Provincial Competitiveness Index (PCI) and data from 63 provinces during the period 2006-2015 adapted from the General Statistics Office (GSO) of Vietnam, this paper examines the role of ODA and local governance institutions on economic growth. The empirical results show better quality of provincial governance institutions is associated with higher economic growth contribution; and effects of ODA on economic growth is stronger for provinces where their quality of governance institutions is better.

Contribution of this paper is to provide empirical results that help understanding the relationship among ODA, governance institutions and economic growth. It would also benefit policymakers in making strategically plan for ODA mobilization and improving quality of governance institutions for higher and sustainable economic growth.

Keywords: *ODA, Governance institutions, Economic growth, and Vietnam*

Introduction

Why are some countries so rich, while others are so poor? This question was posed by Adam Smith in 1776. For the next 200 years, this question was mentioned in the study by Acemoglu & Robinson (2012). Economic growth is always the macro target of national governments. Todaro & Smith (2015) argue that economic growth is a stable process in which the productivity of the economy increases over time to bring about national productivity growth and income growth. It can be seen that economic growth is reflected in the increase of the wealth of the country. Growth theories suggest that this increase can be achieved through the addition of inputs to production such as capital, labor or better inputs using less and less cost to achieve output higher and higher quality. Meanwhile, the new institutional economics, pioneered by Coase (1998), argues that institutions are a driver of economic efficiency. New institutional economics is the answer to the question why in many parts of the world are still poverty. The answer lies in the failure of the person in charge of implementing the innovation to increase output. The institutional governance of a society creates motivations that directly influence economic and political activity and we know the foundation of institutional governance for successful economic growth (North, 2000).

According to economic growth and institutional theories, labor, capital, technology and institutions are main factors of economic growth. As a component of capital, ODA plays a major role in the early stages of development in developing countries, where domestic savings are low compared to investment needs. Infrastructure is important for socio-economic development but requires a large amount of capital in long period; thus



public investment can be satisfied the needs. ODA is an appropriate source of funding, contributing to increased government investment and becoming an external resource that is conducive to the implementation of socio-economic development investments. According to Dollar and Easterly (1999), countries with good policy environment, transparent and effective governance institutions, 1% increase in ODA associates with 0.5% increase in GDP.

In addition, institution is an important pillar for 2035 economic targets to make Vietnam a high middle-income country. Towards that goal, there are many proposed solutions, of which institutional innovation is an important pillar (WB and MPI, 2016). Acemoglu et al. (2001) suggests that institutional quality is an important factor that encompasses both geographic and policy positions in deciding economic performance of a country. Policies that promote efficient resource allocation lead to higher economic growth (Sachs and Warner, 1995; Wacziarg and Welch, 2008). Thus, these hypotheses affirm the importance of institutions to economic activity. Governance institutions in particular plays an important role in the allocation of ODA resources. For example, in non-transparent institutional settings, wasteful use of ODA, and misuse of ODA, it does not only promote of economic growth but also applies burdens on future generations (Stiglitz, 2002). In a country with good governance, ownership of property is guaranteed and fewer distortion policies, it encourages actors in the economy to invest more in human capital, use resources more effectively (Acemoglu và Robinson, 2010). Good governance institutions for the business environment reduces transaction costs and improve business results (North, 1990).

This paper uses provincial data in Vietnam to examine the role of governance institutions and ODA on economic growth. Based on the theory of comparative advantage and Matsuyama's (1992) study, this paper provides a framework for studying the impact of governance institutions and ODA on economic growth. Based on the empirical results, the paper proposes recommendations to exploit the advantages and contributions of the governance institutions and ODA to economic growth in Vietnam.

The contribution of this paper is provides evidence on relationship between governance institutions, ODA and economic growth. It will shed a light in understanding the rolo of governance institutions and ODA on economic growth. It also provides recommendations for improving the effects of governance institutions and ODA on economic growth at provincial level in Vietnam.

Literature review

Governance Institutions and Economic Growth

Solow (1956) shows the importance of capital, labor and technological progress on determining economic growth. However, the total factor productivity is exogenous in the model Solow has not pointed out any factors that lead to technological progress or increase the efficiency of capital and labor. According to neo-classical theory, Romer (1986, 1990) and Lucas (1988) developed a model of endogenous growth in which a deeper analysis of the factors leading to economic growth is good knowledge, or human capital. In recent times, the new institutional theory of economics has argued that institutions are the root of economic growth and development in many countries (North, 1990, Acemoglu et al., 2005; Acemoglu & Robinson, 2012). The quality of



economic institutions and political is the factor that affects the cumulative factors in the traditional growth model. Thus it affects performance of the economy in the long run. Empirical studies show a strong correlation between institutions and economic growth. Mauro (1995) studied in 67 countries between 1960 and 1985, suggesting that corruption reduces private investment, thus negatively affecting economic growth. Poor countries tend to be corrupt, bureaucratic and politically unstable, and the existence of these problems leads to their low economic growth. Aisen & Veiga (2013) studied in 169 countries during 1960-2004 suggesting that political instability - proxied for governance institutions, has a negative impact on economic growth; Jaunky (2013) studying for 28 sub-Saharan African countries during 1980-2005 shows that in the short term, institutions do not affect economic growth, but in the longer term, institutions and economic growth have a two-way relationship: Institutional improvements impact on economic growth and, on the contrary, high economic growth leads to increased democracies; Azam & Emirullah (2014) assessed the impact of corruption - represented for on the economic growth of the 9 countries in Asia and the Pacific in 1985 -2012, and it shows a negative impact between corruption and economic growth. Poor and underdeveloped countries often have low governance institutions, which in turn impedes economic activity, decreasing the GDP per capita. Venard (2013) argues that high corruption and low governance institutions quality slows down economic development.

There are also many studies that confirm the role of governance institutions on economic growth based on national data. Knack & Keefer (1995), Rodrik et al. (2004) used variables representing institutional quality such as asset ownership, compliance, corruption, and It shows that institutional quality contributes to economic growth. Gani (2011), Venard (2013), Nakabashi & Associates (2013), Alexiou & Partners (2014), Fayissa & Gill (2015) come to the conclusion that a country has political stability, good government performance, social, legal compliance and corruption are controlled, will contribute to stimulating economic growth. Research with 81 countries in the 2002-2006 period, Siddiqui & Shmed (2013) pointed out that, institutions have a positive impact on economic growth; Acermoglu et al. (2014) suggest that good governance institutions quality, with good democratic indicators, has a strong positive impact on economic growth. Fayissa & Gill (2015) used data for 37 Asian and coastal countries during 1996-2013, indicates that the governance institutions has a positive relationship to economic growth. The implication of this research is that institutional reform needs to be comprehensive in order to promote economic growth and poverty reduction.

Official Development Assistance and Economic Growth

The relationship between capital and economic growth is well documented in growth theories. Classic economists such as Adam Smith, Alfred Marshall and David Ricardo emphasize that capital is an important factor and determine growth and development. ODA is a part of capital, and it contributes to national economic growth. Schumpeter (1954) argues that ODA only leads to growth when combined with the transfer of new entrepreneurial spirit and skills, thereby enhancing the absorption capacity of the ODA recipient economy. For ODA recipient country, environment and policy, capacity to attract, use and manage ODA will play a positive role in their economic growth. When aid recipients have poor governance, corruption, the use of

ODA is widespread and ineffective. For example, in countries like Africa and Latin America, ODA can cause debt burdens and impede growth.

Overview of previous studies, the relationship of ODA to economic growth is quite diversified and give different results to countries and regions. Easterly (2003, 2005), Ranis (2010), Rajan and Subramanian (2008) and Lehmann et al. (2012) indicate the failures of inefficient use of ODA. Many studies found positive impact of ODA on economic growth (Crosswell, 1998; Tarp, 2006; Papenek, 1973; Levy, 1988; Addison, Mavrotas and McGillivray, 2005; Hamid Ali, 2013; Jones, 2013). At the same time, some studies suggest that ODA has negatively impacted LDCs, through the actual appreciation of the local currency, resulting in loss of competitiveness, promote corruption and damage to institutional development (Fielding, 2007, Killick and Foster, 2007; Moss et al., 2006; Moyo, 2009).

The impact of ODA on economic growth can be explained through the two-gap model, developed by Chenery and Strout (1966), in which ODA will be supplemented by low savings in the country and improving the foreign exchange balance of the country. Bacha (1990) extended the "Two-gap model" to the "Three-Gap-Model", in which it further emphasizes the role of ODA in improving the balance of the state budget and implementation of the fiscal policy. In the context of Vietnam, some studies on the impact of ODA on economic growth have been undertaken (Le Quang Canh et al., 2017). Research confirms causality exists two-way relationship between ODA and provincial economic growth in 63 provinces/cities in Vietnam during 1993-2015.

Methods

The model

Solow (1956) adapted the Harrod-Domar model, with the replacement of capital and labor in productive function (according to the Harrod-Domar model, the assumed capital and labor ratio is constant over time). According to Solow, important determinants of economic growth beyond capital, labor, and technological advancements. Thus, the general production function is of the form:

$$Y = A.F(K, L) \quad (1.1)$$

Where Y is output, A is technological progress, K is capital, and L is labor. North & Thomas (1973) consider governance as the primary cause of other cumulative factors such as capital and labor. Therefore, when studying the impact of the governance regime, ODA on economic growth, from the equation (1.1), the regression model between the independent variables with economic growth according to the Cobb-Douglas production function specified in this study is as follow:

$$Y_{it} = \beta_0 + \beta_1 X_{it} + \beta_2 CONTROL_{it} + u_{it} \quad (1.2)$$

Of which, i is the provinces/cities, 63 provinces and cities of Vietnam; t is the period 1993-2015, Y_{it} is the economic growth represented by GDP; X_{it} is the independent variable vector (ODA_{it} and $ODA(-1)_{it}$ with a lag of 1 period, investment capital other than ODA (minus ODA), L_{it} is labor); $INST_{it}$ is the measurement of provincial governance, including the following aspects: Transparency; Time costs; informal charges; Proactivity of Provincial Leadership; Legal institutions. The variables used in the model are described in Appendix 1.

Methodology

To obtain the research objectives, this paper is conducted by applying the following procedures.

Step 1: Testing for homogeneity of data. Because the data are panel, the homogeneity is tested regarding to three perspectives.

(i) For provinces with its geographical changes, both GDP, ODA and data used in the model have been adjusted according to the current situation of 2015.

(ii) Concerning price, ODA, GDP and data of variables in the model are calculated at 2010 constant prices.

(iii) Perform data validity tests. Use Chi-squared tests to verify consistency in the data, and the results show consistency in the data used.

Step 2: Measuring the impact of governance, ODA to economic growth. Constructed regression models for panel data and estimate by fixed effects model and random effects model. The paper then examines whether the fixed effects model or random effects model is more consistent to reflect impacts of ODA on economic growth. The Hausman test was performed and its result confirms that the fixed-effects model (FE) are more consistent.

Estimate results

Data

Data are adapted from the General Statistics Office of Vietnam for 63 provinces during 2006-2015. Provincial governance data was extracted from the Provincial Competitiveness Index which is conducted by the Chamber of Commerce and Industry of Vietnam for the same period.

Institutional governance: Governance institution includes several aspects of market supporting institutions. Although provinces do not promulgate major laws and policies, it directly interprets and implements those policies. The difference in interpretation and implementation among provinces allows using indicator as a measure of governance institution at the provincial level (Le Quang Canh, 2017). Based on the indices mentioned above the quality of local governance. Indicators used include: (i) Transparency; (ii) Time costs; (iii) informal charges; (iv) Proactivity of Provincial Leadership ; (v) Legal Institutions.

This study uses the methodology developed by Lasagni et al. (2015) to calculate the quality of governance. In particular, the study uses five components in the PCI to measure governance institution weighted by their normalized weights used in PCI.

Procedure on calculating governance institution index is as follows:

Step 1: Gathering the weight of the five indices, including the elements indexed a_{ij} (with i and $j = 1, 2, \dots, 5$). These five indicators represent the quality of local governance institutions. The weights of these indices is from their weights used in PCI (VCCI and USAID, 2015) as suggested by Nifo and Vecchione (2014).

Step 2: New standardized weights b_{ij} with i and $j = 1, 2, \dots, 5$ - Five components of PCI, are calculated by the formula:

$$b_{ij} = \frac{a_{ij}}{\sum a_{ij}} \quad (4.1)$$

such that $\sum b_{ij} = 1$ i and $j = 1, 2, \dots, 5$

Step 3: Compute the quality of local governance institutions by years. The data used in the study are balance panel data with 63 provinces during 10 years 2006-2015. The descriptive statistics of the data are summarized in Table 2

Table 2. Statistical description of variables

Variable	Mean	Std. Dev	Min	Max
Y_{it}	9.49	1.00	7.00	13.24
L_{it}	6.33	0.61	4.58	8.35
ODA_{it}	5.93	1.14	2.30	10.10
Capital excluding ODA_{it}	7.97	1.20	5.22	11.96
EB_{it}	5.91	1.14	2.30	10.10
$INST_{it}$	7.19	1.84	-1.20	11.43

Source: Author calculates on data obtained from GSO, PCI for the period 2006-2015

2.1. Correlation between independent variables

Pearson correlations test among independent variables was used to examine the multicollinearity in the data. Tested results show that there is no high correlation in the independent variables used.

Table 3 Matrix correlation between variables

Variables	LnL	LnODA	LnODA-1	LnCapitalexcludingODA	LnEB	LnINST
LnL	1					
LnODA	.19*	1				
LnODA-1	.17*	.82*	1			
Ln CapitalexcludingODA	.10*	.67*	.64*	1		
LnEB	.58*	.06*	.05*	.03*	1	
LnINST	.19*	.21*	.2*	.23*	.18*	1

Source: Author calculates on data obtained from GSO for the period 1993-2015

2.2. Estimation and discussion results

The Hausman test was performed to select between the fixed-effects model (FE) and the random-effects model (RE). Test results show that the fixed effects model is more efficient. The regression results are presented in Table 4.

Table 4. Results of ODA impact on provincial economic growth in Viet Nam period 2006-2015

Variables	LnGDP			
	Model FE	Model FE	Model FE	Model FE
	1	2	(3)	(4)
LnL	0.442*** (0.000)	0.434*** (0.000)	0.445*** (0.000)	(0.418)*** 0.000
LnODA	0.014* (0.105)	0.006 (0.558)	0.019** (0.042)	0.011 0.173
LnODA(-1)	0.022***	0.022***	0.021***	0.021***

	(0.001)	(0.001)	(0.002)	0.002
LnCapital excluding ODA	0.425***	0.421***	0.421***	0.419***
	(0.000)	(0.000)	(0.000)	0.000
LnEB	0.077***	0.079***	0.083***	0.081***
	(0.000)	(0.000)	(0.000)	0.000
Ln INST	-0.010	-0.014	-0.019	-0.009
	(0.806)	(0.725)	(0.641)	0.814
LnODA_INST		0.000		
		(0.269)		
LnODA_EB			0.000*	
			(0.082)	
ODA_{it}^2				0.000***
				0.000
Intercept	2.388***	2.501***	2.346***	(2.571)***
	(0.000)	(0.000)	(0.000)	0.000
Observation	500	500	500	500
Adjusted R ²	0.877	0.878	0.878	0.418

–Note: *, **, *** the regression coefficient is significant at 10%, 5%, and 1%. The value in parentheses is p -value

Source: Author calculates and aggregates from GSO data.

Model 1 (benchmark model) includes all independent variables specified in Section 3; Model 2 adds interaction of ODA and quality in the benchmark model; model 3 includes adds interaction of OAD and budget spending, which proxies for the size of local government; and model 4 examines the non-linear impact of ODA on economic growth. All the four models provide similar results, which confirm consistency and reliability of estimated models.

Estimated results show that ODA has a positive influence on local economic growth at the provincial level with a significant level of 10%, while 1-lag ODA has a statically significant and positive impact on economic growth. These results confirm the importance of ODA in economic growth at local level. The estimated results also imply that better institution and transparency, ODA has a negative impact on GDP although the results are not statistically significant.

When adding interaction of ODA and quality of governance institution, impacts of ODA on GDP is not significantly different among provinces with different quality of governance institution. This result is not surprising in the context of Vietnam where ODA

are allocated by the Government. During the period from 1993 to 2015, statistical data depicted that the ODA disbursement was large but 88% allocated for programs and projects managed by central ministries and agencies. Meanwhile, ODA managed by localities accounted for 12.1%, hence, the provinces do not play an important role in attracting ODA during this period.

This study also examines whether the impact of ODA on growth depends upon the local government size. The empirical results show that local government size (represented by the local state budget expenditure) make impacts of ODA on GDP different among local government size. Specifically, the greater government size, the greater the impact of ODA on economic growth. This result is consistent with empirical results found in the literature (Pham The Anh, 2008, Su Dinh Thanh (2011), Su Dinh Thanh et al. (2013), Su Dinh Thanh and Nguyen Minh Tien, 2014), from which size of local government positively associates with local economic growth. The empirical results in model 4 show that ODA does not simply linear affect GDP, but it is nonlinear. However, the marginal impact of ODA on GDP is relatively small and it depends on amount of ODA allocated to the localities. The positive effect of ODA on economic growth at the provincial level is consistent with the expanded Cobb-Douglas theoretical model, as well as coinciding with prediction of exogenous economic growth model which highlighted the positive impact of ODA flows on economic growth.

This empirical results contribute vitally to the essence of ODA inflows for economic growth in Vietnam. Moreover, these results also suggest that policies and institutions should be improved to promote effects of ODA inflows on economic growth at provincial level.

Conclusion

Using panel data at provincial level, this study examines impacts of ODA and governance institution on economic growth. The paper has calculated the quality of governance institution index which is proxied for provincial governance institutions. Estimated results from the fixed effect models indicate that ODA is positively associated with GDP, while quality of local governance institutions does not show its importance to economic growth. When adding interaction of ODA and size of local government, however, bigger size of government makes impacts of ODA on economic growth stronger. Meanwhile, the quality of governance institutions does not make impacts of ODA on economic growth different. The estimated results also show non-linear impacts of ODA on economic growth; however, its effect is too small.

The empirical results imply that ODA is a good predictor of provincial economic growth; thus increasing ODA inflows will translate into higher GDP. Vietnam should improve its institutional environment and make use of ODA. ODA projects should be allocated towards enhancing its spillover which improves socio-economic development.

When Vietnam becomes a middle-income country, ODA will sufficiently decrease. This implies that Vietnam needs to change its strategy for attracting and using ODA. Priority should be given to using ODA, especially ODA allocated to potential programs and projects. Moreover, the local governments should pay attention on improving their governance institution such that quality of governance institution turn out to promote economic growth.



Appendix 1. Variable symbol, measurement and expected signs

No.	Variable symbol	Measurement (Based on research by Elphas.V.O, 2013)	Describe variable	Expected signs and bases
1	Y_{it}	Real growth of Vietnam. This variable is taken into account when entering the model	Real growth of Vietnam's provinces	
2	L_{it}	Manpower of province i in year t of this variable is taken by log when put into the model	The size of human resources in Vietnam's provinces	+ (Solow, 2005)
3	ODA_{it}	Foreign aid - (ODA) disbursed in province i in year t. At 2010 comparable prices. This variable is taken by log when entering the model	Foreign aid in Vietnam's provinces	+/- (Solow, 2005; Griffin and Enos, 1970; Dowling and Hiemenz, 1983)
3	$non - ODA_{it}$	Investment capital for the whole society except for ODA of province i in year t. At 2010 comparable prices. This variable is taken by log when entering the model	Invest in people, law and order, research and development, and social and economic infrastructure. It requires payment for land, buildings and other non-financial assets used in the production process	+ (Solow, 2005; Lopez <i>et al.</i> , 2010; Durham, 2004; Blankenau và Simpson, 2004)
4	EB_{it}	Public Sector Scale: Budget of province i during time t. At constant 2010 prices.	The composition of state budget expenditures varies widely: administrative expenditures, maintenance of operations, and recurrent expenditures also represent expenditures on education, science, technology and economy.	+/- (Bose, 2007)



No.	Variable symbol	Measurement (Based on research by Elphas.V.O, 2013)	Describe variable	Expected signs and bases
5	$INST_{it}$	Institutional governance index of province <i>i</i> in year <i>t</i>	Evaluate the development of local governance.	+ (North, 1990; Acemugle, 2005, 2012)
6	$INST * ODA_{it}$	Regulatory interaction with ODA	Regulatory interaction with ODA	+
7	$INST * EB_{it}$	Interaction of Governance with Government spending Scale	Assessment of Interaction of Governance with Government spending Scale	+
8	ODA_{it}^2	ODA squared	Assessment of "threshold", "critical value" ODA	+ (Selaya và Sunesen, 2012)

Source: Graduate student gather



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