# Foreign Aid and Conflict in Pakistan: An Empirical Analysis

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## ABSTRACT

*This paper examines the relationship between foreign aid and conflict in Pakistan. The country has witnessed many internal and external conflicts from 1961-2013, the period of analysis. By applying Heckman selection procedure, the study finds that aid increases conflict. Given the fungibility of aid, the results show that aid and military expenditure increase the probability of conflict and inflation, but decrease the probability of tax mobilisation. The paper concludes that strategic objectives of donors create rifts and insecurity in the recipient society which in turn increases military expenditure and arms import. It further reduces the capability to govern and reform.*

**Key words:** Conflict, aid, military expenditure, regime instability, fungibility, Pakistan.

## 1. INTRODUCTION

In the development literature, conflict has been discussed as an incompatibility of objectives between various groups. It is defined in this study in terms of incompatibility of objectives that result in violence and armed struggle in society over a long period of time. Pakistan is comprised of various ethnic and religious clusters. In such a society, a certain degree of incompatibility is not only natural, but also understandable. Scholars like Rashid (2000), Nasar (2000) and Murphy & Malik (2009) describe incompatibility of objectives as an outcome of increased religiosity or fundamentalist influence on Pakistan's society. They also highlight that emphasis on a certain explanation of *Shariah* was the root cause of this incompatibility. However, Jalal (2011) explains administrative paralysis and fractured educational system as the main reasons for the ideological remapping of liberal Pakistan as an outpost of 'original' Islamic model of Saudi Arabia. Further, Ali (2016) sees, for example, conflict in Swat as a failure of inefficient

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administration, along with the complex and expensive judicial system and ideological factors. According to these scholars, religion is used as eyewash; and in effect, following United States' (US) policies and a certain interpretation of Islam under Saudi influence, are the reasons of conflict in Pakistan. On the other hand, Tahir (2017) points out that heavy dose of economic assistance, usually given during authoritarian regimes, made it difficult to tailor indigenous policies for accommodating cultural and ethnic diversity which is essential for sustainable and inclusive development in Pakistan.

In this paper, conflict is measured in terms of casualties. This is due to the unavailability of the financial cost of armed conflicts individually. The *Pakistan Economic Survey* measures the direct and indirect cost of the War on Terror (WoT) since 2000. During the last 17 years, the cumulative cost has amounted to approximately USD 126.8 billion (GoP 2018). Pakistan has experienced conflicts of varied intensity and dimensions, but no organised armed struggle against the state. There are certain high intensity ethnic conflicts, a few inter-state wars and numerous religious conflicts, making it difficult to use annual cost of these conflicts as a focus variable. In this study, therefore, conflict is measured in terms of the fatalities. According to the Uppsala Conflict Data Program (UCDP):

> [Conflict is] a contested incompatibility that concerns government and/or territory where the use of arms between two parties, of which at least one is the government of a state, results in at least 25 battle-related deaths (UCDP/PRIO Armed Conflict Dataset 2011, p.1).

Various types of conflict were identified and discriminated as per their nature. There were certain years when there was no armed conflict, while there were years when there was an internal ethnic conflict (e.g. in Balochistan).[1] In other years, internal conflict such as MQM[2] riots and external conflict such as Kashmir occurred simultaneously. Still other years witnessed internal conflict having ethnic and religious dimensions like Tehrik-e-Taliban Pakistan (TTP) and the Baloch insurgency. According to UCDP, Pakistan is among the six countries that qualify to be in the category of 'war' because of one thousand battle-related deaths in one year.

Pakistan has a long history of conflict. The country emerged after the Partition of the subcontinent in the name of Islam, after a long series of conflicts with the British colonial power, and the majority Hindu religion (Jalal 2009). The threat perception from India took Pakistan to the US camp. India was perceived to have opted for the Soviet bloc,

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[1] From 1974-1977 and 2004 onwards, there was ethnic conflict in Balochistan.
[2] MQM is the Muhajir Qaumi Movement, a Karachi-based organisation fighting against the state in 1990, 1995 and 1996.

despite non-alignment. Pakistan became 'the most allied ally' of the US. The country joined the US-sponsored security alliances of Central Treaty Organization (CENTO) and Southeast Asia Treaty Organization (SEATO) in addition to a bilateral agreement with the US. As a political and strategic partner, she received huge inflows of economic and military aid. In the 1960s, Pakistan was one of the top aid recipients. The Point Four Program, launched for Near East and South Asia, was carried out especially for Iran and Pakistan. The country adopted the path of development based on the agenda set by the Harvard Advisory Group (HAG) and the World Bank. As a result of heavy doses of aid, a Gross Domestic Product (GDP) growth rate of around 6.5% per annum was achieved. However, this aid-financed growth was lopsided, resulting in regional, social and political tensions. First, there was the war of 1965 with India. As aid inflows dried up suddenly, war followed mounting social and political tensions. Aid was distributed unequally between East and West Pakistan, which contributed to disaffection between the two sides. In West Pakistan, there was a mass revolt against the concentration of wealth and power in a few hands. By 1971, there was civil war in the country. Indian intervention led to the separation of East Pakistan in December 1971. In the early 1970s, the conflict in Balochistan also started. The Paris Club[3] was the major source of aid. Almost 77% of aid came from bilateral assistance under its aegis. A very small amount was from non-consortium and outside consortium countries.

The 1980s witnessed the fallout of the Soviet occupation of Afghanistan and the rise of the Non-State Actors (NSAs) supported by the US and Saudi Arabia, massive influx of Afghan refugees and the associated tensions. There was aid as well as growth, which collapsed as soon as the Soviet Union withdrew from Kabul. In the 1990s, Pakistan came under sanctions due to its nuclear programme. There was very little aid and very low growth. In 1999, the operation in Kargil took place. Tensions related to this conflict had not yet subsided, when India accused NSAs in Pakistan for terrorist attacks after 9/11. The WoT in the 2000s brought aid and growth back, but with the NSAs posing an existential threat to the state itself.

In this period, the composition of aid also changed from bilateral to multilateral. Initially, Pakistan received aid from the US, a bilateral source. Multilateral and non-consortium sources provided a very small amount of total foreign economic assistance. During 1999-2008, Pakistan received some aid from the US for fighting its WoT. Decline in bilateral aid means fewer grants and more loans. The US, Saudi Arabia and the United Kingdom (UK) are amongst the countries which have provided direct and indirect economic assistance to Pakistan. The influence of these countries is visible on Pakistan's society and economic thinking. The US has remained the biggest donor,

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[3] The Paris Club is an informal group of world's major creditors. These countries provide assistance to debtor countries in the form of rescheduling and reduction in debt service obligations.

extending nearly USD 67 billion between 1951 and 2011 (Centre for Global Development).

It is not easy to assess the overall success of aid programmes. There are at least 71 donors, 44 sectors and 1,332,540 aid projects that were financed in developing countries during 1970-2014 (Tierney et al., 2014). Donors contend that 'recipient compliance with the agreement is subject to moral hazard and adverse selection.' This makes the aid agenda unachievable (Isopiand Mattesini 2009; and Martens et al. 2002). They put aid conditionalities like good governance, democracy and transparency, and ownership of the aid agenda for its effectiveness. On the other hand, developing countries call for more aid, specific and clear aid policy and partnership not donorship (OECD n.d.). According to Boyce and Pastor (1998), International Financial Institutions (IFIs) started using reduction in military expenditure and good governance as rhetoric for aid programmes.

Due to the controversies about whether aid promotes development or not, 2002 led to the aid effectiveness movement. Scholars applied *agency theories* to conflict-ridden societies for describing aid as an effective means to achieve policy support and reducing terrorism. Azam and Delacroix (2005), Azam and Thelen (2010), Bapat (2011), Piazza (2008), Sandler (1995 & 2006), Sandler & Enders (2004); Walsh & Piazza (2010), and Young & Findley (2011) found that aid could be used as an effective means to reduce terrorism or to win support for achieving economic, political and strategic objectives of the donor. However, Collier & Hoeffler (2004) suggest that aid works in post-conflict societies and minimises risk of future conflict. Easterly (2006 & 2008) and Pfutze (2008) suggest that donors must adopt piecemeal problem-solving techniques for making aid effective. Why countries fail to reconsider previous performance while signing new contracts is another criticism levelled against aid objectives (Isopi and Mattesini 2009). This change in aid objectives from development to compliance made it even more difficult to assess the rationale of aid in a developing society.

This paper provides empirical evidence on how aid affects a country in conflict. Conflict is the focus variable and aid appears as an independent variable with military expenditure, inflation rate and taxes. There are five sections in the paper. The second section reviews the relevant literature; the third gives a historical perspective on Pakistan. In the fourth section, the analytical framework is explained along with the data sources; and the fifth section presents the analysis, followed by the conclusion.

## 2. LITERATURE REVIEW

Research on conflict and aid relationship has mostly been done in cross-country settings. Not many country studies have been carried out on this topic. The International Terrorism: Attributes of Terrorist Events (ITERATE) dataset enabled researchers to investigate conflict in cross-country settings, with a focus on transnational terrorism. The

Global Terrorism Data (GTD) is another dataset which differentiates between domestic and transnational terrorism. Scholars have used this dataset to conduct cross-country studies. In conflict studies, geography hardly matters. Malkki (2018) reviewed articles on terrorism and political violence in Nordic countries. She found the role of these countries to be marginal. Asongu et al. (2018) estimated the relationship between terrorism and governance in Africa. They found that political and economic governance had negative effects on terrorism dynamics. Using interactive quantile regressions, Asongu et al. (2015) found that foreign aid dampens the effects of terrorism on Foreign Direct Investment (FDI). The empirical evidence was related to 78 developing countries from 1984-2008.

Tahir (2017) and Mehmood (2013) researched a single country, i.e. Pakistan. The latter analysed the impact of terrorism, estimating its cost at around 1% of real GDP per capita growth every year. However, Tahir (2017) found that conflict is strongly related to aid commitment and purpose. Country studies are of recent origin as they enable overcoming heterogeneity biases in cross-country studies. Scholars working on the aid-conflict relationship have diverse views. According to Blattman & Miguel (2010), Fearon (1995), and Fearon & Laitin (2003) inciting conflict is the rational choice of a marginalised group that wants to take over a resource. They found that some studies carried out at the global level, with a global dataset of military expenditure, yielded a positive correlation between aid levels and increased incidence of conflict (Collier & Hoeffler 2004; Balla et al. 2008). Enders & Sandler (2006), Feyzioglu et al. (1998) and Young and Findley (2011) find a substitution effect of aid: expenditure that can be made on the social sector development is made on military. This wrong policy and misallocation of resources result in unending episodes of conflict. Nunn & Qian (2014) find that conflict in developing countries more than doubled since the early 1970s. According to them, food aid has increased the incidence, onset and duration of civil conflicts in recipient countries. It is easy for armed groups to steal food aid en route. Recipients of food aid are typically weak against such groups, so rebel or militia groups 'tax' or misappropriate aid for the conflict. Stealing wheat, for instance, creates conflicts.

In her empirical research on US food aid and non-concessional food availability in PL 480 recipient countries, Stewart (1998) found that eight out of ten conflicts emerged in developing countries. Collier (2007) and Young & Findley (2011) see aid as a reward for indulging in conflict. It is an unintended consequence of aid or a consequence of aid withdrawal (Bruckner & Ciccone 2010; Nielsen et al. 2011). It leaves no power with the government to deal with rebels. Balla et al. (2008) and Besley & Persson (2008 & 2011) ask whether conflict is a consideration in giving aid. Giving aid to one group or government can create a war-like situation and shift the balance of power. Sudden change in aid allocation can inflame conflict in a society (Fearon 1995; Feyzioglu et al. 1998). Collier (2007) finds that increased military spending is a depiction of external and

internal risks. But these two risks could be completely uncorrelated because there was a low possibility of their occurrence together. According to him, if aid increases by one percentage point of GDP, military expenditure increases by 3.3%. Collier & Hoeffler (2004) show that aid works better in a post-conflict environment. Alesina and Darzen (1991) found inflation as a war of attrition between rivals. With prior knowledge of restrictive policies of the state, the elite shift the burden to the weaker sections. Persistence of inflation is the outcome of foreign aid that temporarily assuages tensions that can lead to violent outbursts (Muscat 2002). In short, a high and persistent inflation rate largely enriches the prosperous business class.

Donors impose conditionalities on aid programmes for introducing specific economic reforms. The agenda for reforms is usually annexed to the growth objective because increased purchasing power enables developing countries to import from developed countries (Webersik 2006). However, as Easterly (2008) maintains, aid may or may not produce growth, but it certainly creates and strengthens elites and predatory governments. Further, transfer of income for a specific agenda creates inequalities and distributional conflicts (Casella & Eichengreen 1996). Besley & Persson (2011) and Blattman & Miguel (2010) find that there is a positive relationship between conflict and state wealth. Conflict increases when state wealth can easily be appropriated. Increased aid inflows can cause conflict in a weak institutional framework. Developing countries have been criticised for bad economic governance and dictatorial regimes, although aid money is usually given to these very corrupt governments, unbalancing society with power politics and rent seeking. However, there is no systematic relationship between less corruption and more aid (Svensson 2000).

Another group of authors carried out cross-country studies to conclude that without aid, the situation may be worse (Hansen & Tarp 2001). Aid can be used as an effective policy tool to win support from host countries for protecting strategic and economic interests. It is effective as compared to military intervention for protecting strategic interests. Using transnational terrorism data from 1970-2000, Enders & Sandler (2002), Enders et al. (2011), and Walsh & Piazza (2010) find that respect for physical integrity is consistently associated with fewer terrorist attacks. For Young & Findley (2011), aid is effective in reducing transnational terrorism. These studies find that increased aid allocation can considerably reduce conflict. They also find that fungibility of aid and predatory states are the reason for increased conflict. Further, changing the definition of terrorism, different types of terrorism, or changing the unit of analysis affects key predictors of terror events cross-nationally. Khan (1997) finds an ambiguous impact of foreign aid on the development process: aid agencies and donor countries assume a pre-eminent position in the policy configuration; and leave the host government with little room to formulate its own policy framework.

## 3. HISTORICAL PERSPECTIVE

In Pakistan 3,848 armed conflicts against civilians were recorded, with at least three deaths in each case from 1990–2015. Around 28 incidents of attack against the government for territory by separatists, with more than 25 deaths, were reported in 1971-2015; and 23 incidents against the state with more than ten deaths occurred during 1990-2015. Pakistan has seen not only interstate violence against the government for territory, but also against the state for not implementing a specific ideology. Pakistan has fought three wars with India. There is a view that conflict at the border results in conflict in society (Themnér & Wallensteen 2013).

Table 1 shows the relationship between conflict, aid, growth, investment and military expenditure for all regimes. The first military ruler was Field Marshal Ayub Khan, whose regime in the 1960s witnessed one low intensity conflict over Kashmir in 1964; and one major conflict, the 1965 war with India. In this period, Pakistan's growth rate was the envy of the developing world. She was considered the fastest growing economy and about to take off. The war disrupted the growth momentum, recorded at an average of 6.43% annually and 4.52% in per capita terms. Aid contributed 46% of the investment. The share of economic aid in GDP was as high as 8.49%. Military expenditure was high, with its share in GDP at 3.13%, but not very high due to large inflows of military assistance.

**Table 1: Conflict, Aid, Growth, Investment and Military Expenditure (Annual Averages)**

| Regimes | Incidence of Conflict (Number) | Aid as % of GDP | GDP Growth Rate | GDP per Capita Growth | Aid as % of Total Investment | Military Expenditure as % of GDP |
|---|---|---|---|---|---|---|
| Field Marshal Ayub Khan 1961-69 | 2(L, H,T) | 8.49 (0.22) | 6.43 (0.3) | 4.52 (0.5) | 46 (0.2) | 3.13 (0.23) |
| Gen. Yahya Khan 1970-72 | 2(H,T) | 4.60 (0.33) | 4.21 (1.47) | 1.29 (4.35) | 30 (0.3) | 3.93 (0.12) |
| Zulfikar Ali Bhutto 1973-77 | 3(L, T) | 6.17 (0.30) | 4.05 (0.5) | 2.17 (0.8) | 37 (0.3) | 6.24 (0.10) |
| Gen. Zia-ul-Haq 1978-88 | 3(L,T) | 6.96 (0.15) | 5.91 (0.3) | 2.04 (0.9) | 28 (0.2) | 5.94 (0.11) |
| Benazir Bhutto & Nawaz Sharif 1989-99 | 7(L,T) | 4.25 (0.26) | 4.54 (0.5) | 1.34 (1.3) | 25 (0.2) | 5.55 (0.13) |
| Gen. Pervez Musharraf 2000-07 | 15(L, H, G) | 2.53 (0.29) | 5.35 (0.4) | 2.91 (0.8) | 14 (0.4) | 3.66 (0.07) |
| Asif Ali Zardari 2008-11 | 4(H,G) | 3 (0.45) | 2.89 (0.6) | 2.14 (0.2) | 17 (0.4) | 3.16 (0.09) |

*Source:* Author's estimation.
Key: () coefficient of variation; L= low intensity; H = high intensity; T= territory;
G= government.

In 1969, the decade long regime of Field Marshal Ayub Khan was followed by another military regime led by General Yahya Khan. In 1970-72, there were two major conflicts - East Pakistan's separation and the Kashmir war. These conflicts were of high intensity and for territory. The annual average growth rate fell 4.21% and GDP per capita increased by only 1.29%. Investment relied on aid to the extent of 30%. Expenditure on the military increased from 3.13 to 3.93% of the GDP. Resources had to be diverted to the military to save territory. Aid dependence declined, but continued to be high at 4.60% of GDP (GoP 2011 & 2016).

The democratic regime of Zulfikar Ali Bhutto (1973-77) was marked with three low intensity conflicts in Balochistan for territory, starting with the dissolution of the provincial government. Bhutto ordered a military operation. The economy grew at a moderate rate of 4.05%. There was a sharp increase in military expenditure as it grew to 6.24% of the GDP. Dependence on aid increased to 6.17% of GDP and contributed 37% of the investment. A new element was the emergence of Islamic countries as donors, contributing 1.42% of GDP. Non-consortium countries, especially China, also became significant contributors (GoP 2011 & 2016).

General Zia's regime (1978-88) was unique as it was a time when Pakistan was a country neighbouring a conflict. The Afghan war imposed a huge burden of refugees. Pakistan received aid to facilitate them and as an ally in the war. All other donors followed the US line. A sum of USD 1509 million was received during this period as relief assistance for the Afghan refugees alone. A high GDP growth rate of 5.91% was achieved. Investment depended on aid to the extent of 28%; and expenditure on military remained high at 5.94% of GDP (GoP 2011 & 2016). The US and Islamic counties were the major donors. While Pakistan was engaged with the US in the Afghan war, India established its control over the Siachen Glacier in the so-called *Operation Meghdoot*. Pakistan had to retreat. Conflict returned again in 1987 when India bypassed the resolution of the United Nations General Assembly (UNGA) and conducted 'elections' in Kashmir.

After the Zia regime, the nature, magnitude and occurrence of conflict changed in Pakistan. The consequences of Afghan war were the spread of *Kalashnikov* culture, drugs and religiosity in Pakistan. Zia's death in a plane crash in 1988 started an era of politically unstable but democratically elected governments (1989-99). Benazir Bhutto and Nawaz Sharif alternated at the realm of power in four short spells, each time dismissed on the allegations of corruption and ineptitude. During this time, Kashmir was the main flashpoint of conflict. The battle-hardened Afghan *mujahedeen* were blamed by India for involvement in Kashmir after the end of the Soviet Afghan war. When India carried out its nuclear tests in 1998 and Pakistan followed suit, nuclear competition added to the conventional arms race between the two countries. The occupation of a vacant peak in Kargil range blocked the Indian highway between Kashmir and Laddakh. It was feared

that this conflict might develop into a nuclear conflict in the region. The US intervened for a ceasefire. Kargil, however, proved to be the culminating point of democratically elected political governments. Changing governments, low intensity conflicts with India and ethnic conflict in Karachi resulted in a lower GDP growth of 4.54%. Investment depended on aid at 25% and military expenditure was, for the first the time, higher than the aid received i.e., 5.55 and 4.25% of GDP, respectively (GoP 2011 & 2016).

General Pervez Musharraf's regime (2000-07) witnessed a multiplicity of conflicts. The conflict in Kashmir took a new dimension with the attack on Indian-held Kashmir assembly in Srinagar in 2001. An attack on the Indian Parliament in New Delhi in the same year resulted in diplomatic break-up and closure of transport links. India threatened to retaliate. There was a threat of nuclear war in 2003. This was the time when Baloch insurgents gathered strength again to demand more control of the province's resources. The conflict became severe after the killing of tribal chief Nawab Akbar Khan Bugti. Balochistan is ethnically complex because it has not only Baloch inhabiting it, but also Pakhtuns and various other groups.

The TTP and other militant groups pose another type of threat to the state.[4] These groups do not necessarily want territory, but they do want control of the government to impose their version of Islam. They operate in rural as well as urban areas. General Musharraf supported the US-led WoT in return for aid and arms. Ordinary people were confused when the *mujahedeen* reared by the US as allies were suddenly declared terrorists after 11 September 2001; and subjected to drone attacks in Pakistan's tribal areas. During this period, GDP grew at 5.35% and the dependence of investment on aid was 14%. There was relatively less foreign aid, less expenditure on the military, but more (15) incidents of conflict (GoP 2011 & 2016; UCDP/PRIO 2015).

In terms of strategic policy and incidence of conflict, Zardari's democratic regime was a continuation of the Musharraf era. It witnessed four incidents of conflict in which TTP was involved as a reaction against US policy in Afghanistan; and drone attacks during the period studied here (2008-11). However, GDP growth was the lowest ever, with higher dependence of investment and the economy on aid. Military expenditure was lower at 3.66% of the GDP which was 5.5% of the GDP during the decades of democracy (Ibid.). Despite higher inflows of aid, lower defence expenditure and lower incidence of conflict, growth slowed down.

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[4] In 2014, Pakistan Army started *Operation Zarb-e-Azb* in North Waziristan against al-Qaeda, the Islamic Movement of Uzbekistan (IMU), the Chechen Islamic Jihad Union (IJU) and Emirate-e-Kaukav, as well as the East Turkestan Islamic Movement (ETIM) and other various factions of the TTP like Jamaat ul-Ahrar. Harkat ul-Jihad-e-Islami (HuJI), Harkat ul-Mujahideen (HuM), Lashkar-e-Jhangvi (LeJ), Jaysh-e-Muhammad (JeM) and Lashkar-e-Taiba (LeT). This operation was successful in restoring peace to Pakistani cities (Zahid 2015).

In sum, conflict and aid have had a negative impact on the process of reforms. Aid led to growth but with high volatility. Values of the coefficient of variation in all democratic regimes were higher than their predecessor military regimes, suggesting inconsistency in allocation of aid. The country secured highest aid inflows during the regime of Field Marshal Ayub Khan. There was high growth, but not without creating a divide between the rich and poor. A clear objective and an approach to long-term development on a sustained basis were missing. It resulted in inequalities and an elite class. This laid the foundations of reliance and dependence of policymakers on a foreign-guided agenda; and elite capture of the state which was never popular with the poor masses.

**Figure 1: Relationship between Foreign Economic Assistance and Conflict**
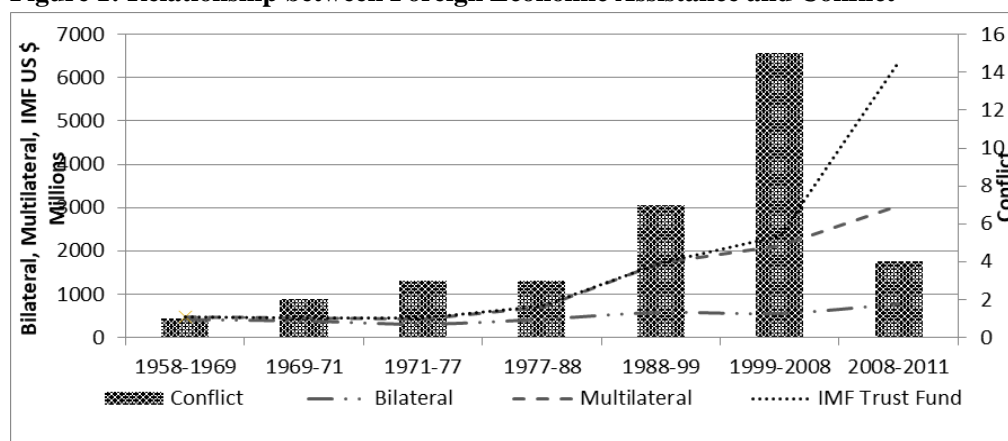


*Source:* Economic Survey of Pakistan, various issues

Figure 1 shows the relationship between conflict and aid in Pakistan. With every episode of conflict, the country received more aid, either as a reward for being in conflict or for the delegated task of protecting donors' strategic interests.

### 3.1. Macroeconomic Indicators

Pakistan is a clear case of a society where the state finances its fiscal deficit by inflation. When there is greater availability of foreign aid, there is low inflation. The state implicitly taxes its people and encourages rent seeking. Table 2 shows various indicators of macro economy in Pakistan. There is a continuous increase in inflation rate, decrease in tax-to-GDP ratio and depreciation of currency. Conflict and aid have had a negative impact on reforms. Pakistan has one of the lowest taxes to GDP ratio in the world which shows that the state prefers to tax its people implicitly, and values today's consumption more than future consumption. During 1989-2000, tax-to-GDP ratio was 13%, but it has since declined to 9% during 2008-11 (GoP 2011 & 2016; UCDP/PRIO 2015). The government prefers to increase prices which are an implicit tax rather than increase the tax ratio. Since they control the state, the elite easily shift the burden to the poor and vulnerable in the form of indirect taxes and inflation.

**Table 2: Impact of Aid on Macroeconomy (Annual Averages)**

| Regimes | Taxes (% of GDP) | Inflation (% increase in CPI) | Exchange Rate (Rs/USD) | Aid (% of GDP) |
|---|---|---|---|---|
| Field Marshal Ayub 1961-69 | 8.900 (0.154) | 3.508 (0.784) | 4.760 (0.000) | 8.49 (0.22) |
| Gen. Yahya Khan 1970-72 | 11.000 (0.000) | 4.957 (0.065) | 4.760 (0.000) | 4.60 (0.33) |
| Zulfikar Ali Bhutto 1973-77 | 12.000 (0.053) | 15.678 (0.568) | 9.480 (0.111) | 6.17 (0.30) |
| Gen. Zia-ul-Haq 1978-88 | 10.707 (0.047) | 8.616 (0.317) | 9.317 (0.378) | 6.96 (0.15) |
| Benazir Bhutto & Nawaz Sharif 1989-99 | 13.182 (0.066) | 9.230 (0.327) | 33.635 (0.305) | 4.25 (0.26) |
| Gen. Pervez Musharraf 2000-07 | 10.500 (0.051) | 7.708 (0.733) | 59.790 (0.028) | 2.53 (0.29) |
| Asif Ali Zardari 2008-11 | 9.140 (0.056) | 13.764 (0.078) | 81.150 (0.046) | 3 (0.45) |

*Source:* Author's estimation.
Key: () coefficient of variation.

## 4. ANALYTICAL FRAMEWORK

This study explains how aid affects conflict in Pakistan. It attempts to model the relationship between conflict and aid, by using military spending, taxes and inflation rate as control variables. The hypothesis is that conflict in Pakistan is a function of aid, military expenditure and weak government capacity. Tax-to-GDP ratio and inflation rate were used to serve as proxy for government capacity.

The cost of conflict is weak economic development; and reliance on aid creates inefficient governments that delay reforms in the hope of getting more aid. Fungibility allows government to divert aid to purposes other than development or priorities different from the donors. Donor objectives and fungibility in aid allocation harbour negative externalities in a developing society like Pakistan, which is lacking in capacity to internalise these negative effects. Conflict results in regime instability and lower economic growth. To determine the direction of relationship between aid and conflict, the Granger Causality Test (GCT) was carried out. For establishing the relationship between conflict, aid, military expenditure, taxes, and inflation rate, the study applied the Ordered Probit Model (OPM) and Heckman selection procedure (McKelvey and Zavoina 1975).

## 4.1. Methodology

Conflict ($y_i$) is the dependent variable measured in terms of fatalities. To discriminate between various type of conflict in any given time multinomial scale in discrete intervals was used (0-4), where zero means no conflict, 1 means external conflict, 2 means internal

ethnic conflict (Balochistan), 3 means internal and external conflict (war with India and MQM riots, and 4 means internal conflict (ethnic and religious). GCT (1969) was used to determine the causation between 'conflict' and 'aid' or vice versa, 'conflict' is said to be Granger caused by 'aid' if it helps in the prediction of 'conflict'. Conflict and aid is denoted by $y$ and $x$, respectively. The author applied GCT on aid, conflict, GDP growth rate, regime instability and taxes in Pakistan. After establishing the causation OPM was used to capture differences between various conflict severities:

$$y_i = x_i â + \varepsilon_i , \quad \varepsilon_{i \sim N(0,1), \forall\, i=0....m}$$

where $y_i$ is the conflict coded from 0-4, â's are the probabilities associated with the observed outcomes, $x_i$ is the vector of aid, military expenditure, taxes and inflation rate, and $\varepsilon_i$ is the normally distributed error term with zero mean and constant variance (McKelvey and Zavoina 1975). First with the canonical formulation, based on the GCT, an OPM was estimated for finding the relationship between conflict and aid. To correct the bias at the second stage, a transformation of these predicted individual probabilities was incorporated as an additional explanatory variable. In this model, first the equation predicting conflict and selection equation predicting aid were set as the reason of conflict.

The generalisation that aid causes conflict can give biased results because there are years when there is aid, but no violent conflict. There is a selection problem that inference cannot be extended to the unobserved group, which in this case is the impact of aid when there is no conflict. What would be the amount of aid given to Pakistan when there is no violent conflict or what is the amount of aid given to Pakistan when there is a conflict? The solution of this problem was to use the Heckman selection model (Heckman 1979). The study aimed to estimate the consequences of aid, but had access only to data on GDP growth, policy reforms, poverty and military expenditure. This data ignores conflict. Once the conflict data was acquired, it was seen that there are certain years without any conflict. The selection equation measures the impact of those years when there was conflict as compared to the years when there was no conflict.

## 4.2. Data Sources

The focus variable of this study is conflict in Pakistan, as coded in the UCDP Armed Conflict dataset, version 4- 2011 (Themnér and Wallensteen 2011). Data on aid includes all grants and loans given to Pakistan during 1961-2011. It was taken from the *Statistical Appendix to Pakistan Economic Survey 2010-11* and relevant previous issues. Military expenditure series is from various Stockholm International Peace Research Institute (SIPRI) yearbooks, while arms imports data was taken from the *World Development Indicators,* September 2011.The source of data on GDP growth rate, GDP at market prices and exchange rate was the Pakistan Bureau of Statistics (PBS). Information about

the Consumer Price Index (CPI) was taken from *International Financial Statistics*, September 2011.

## 5. EMPIRICAL RESULTS

The GCT suggests that conflict causes foreign economic assistance without feedback. Also, GDP growth rate has a unidirectional causality with conflict. These two outcomes suggest that foreign aid and GDP growth cause conflict. But the causality test of aid and GDP growth rate indicates that aid causes GDP growth without feedback. When combined, it can be concluded that aid is a cause of growth and conflict in Pakistan. There was no feedback found between regime instability and aid. Table 3 shows the results.

**Table 3: GCT Results Granger Causality Test**

| Cause and Effect | F-Statistic | Probability | Decision |
|---|---|---|---|
| **Aid does not Granger Cause Conflict** | **6.72491** | **0.0027** | **Reject** |
| Conflict does not Granger Cause Aid | 1.42690 | 0.2505 | Accept |
| **GDP does not Granger Cause Conflict** | **4.15999** | **0.0218** | **Reject** |
| Conflict does not Granger Cause GDP | 2.34931 | 0.1068 | Accept |
| Regime does not Granger Cause Conflict | 0.98007 | 0.3830 | Accept |
| Conflict does not Granger Cause Regime | 0.17220 | 0.8424 | Accept |
| **Aid does not Granger Cause GDPR** | **3.11641** | **0.0538** | **Reject** |
| GDP does not Granger Cause Aid | 1.44696 | 0.2458 | Accept |
| Regime does not Granger Cause Aid | 0.32717 | 0.7226 | Reject |
| Aid does not Granger Cause Regime | 1.68524 | 0.1966 | Reject |

*Source:* Author's estimate.

There are certain years when there was no violent conflict, but there was aid which affects the whole economy. Those observations were censored, when there was aid but no violent conflict. The Heckman probit model was used to estimate the real effect of aid on conflict. This methodology allowed estimating a selection equation and an outcome equation:

Outcome Equation: Conflict = f (aid, military expenditure)

Selection Equation: War = f (aid, military expenditure, inflation, taxes)

The first equation (outcome equation) estimated the effect of aid and military expenditure on conflict (Table 5). At the 4th iteration, the model converged on the log likelihood ratio of –58.512442. The likelihood ratio chi-square of 26.30 with a probability value of 0.0000 suggests that the model is statistically significant:

**Table 5: Ordered Probit Regression**

Number of obs = 51                     LR chi2 (2) = 26.30
Log likelihood   = -58.512442            Prob> chi2 = 0.0000
                                        Pseudo R2 = 0.1835

| Conflict | Coefficient | Standard Error | Z | P>|z| |
|----------|-------------|----------------|------|--------|
| Oda | 0.2958959 | 0.1201611 | 2.46 | 0.014*** |
| Mexp | 0.001158 | 0.0002605 | 4.45 | 0.000*** |
| /cut1 | 3.120312 | 0.9331128 | | |
| /cut2 | 4.05566 | 0.9713684 | | |
| /cut3 | 4.700242 | 0.9942034 | | |
| /cut4 | 5.115743 | 1.027254 | | |

*Source:* Author's estimate.
Note: *** p<0.01, ** p<0.05, * p<0.1

Aid and military expenditure have a positive and significant effect on conflict. The value of aid coefficient is 0.29 which was the same as in the OPM and at the first stage of the Heckman equation. One unit of increase in aid and military expenditure increases the probability of conflict in Pakistan, and both variables are significant as well. A positive sign of variables shows increased probability of aid, and military expenditure increases the probability of conflict. However, aid has stronger effect than military expenditure in Pakistan.

## Table 6: Overall Heckman Selection Model

| Conflict | Coefficient | Standard Error | z | P>|z| |
|---|---|---|---|---|
| Oda | 0.266567 | 0.13568** | 1.96 | 0.049 |
| Mexp | 0.001107 | 0.000288*** | 3.84 | 0.000 |
| Cons | -2.07561 | 1.085052 | -1.91 | 0.056 |
| War | | | | |
| Cpi | -0.03561 | 0.004461*** | -7.98 | 0.000 |
| Taxes | 0.07081 | 0.00887*** | 7.98 | 0.000 |
| Oda | 0.342729 | 0.122779*** | 2.79 | 0.005 |
| Mexp | 0.001299 | 0.000276*** | 4.7 | 0.000 |
| Cons | -4.33876 | 1.01605 | -4.27 | 0.000 |
| /athrho | 16.35542 | 262.0043 | 0.06 | 0.950 |
| /lnsigma | 0.128338 | 0.125269 | 1.02 | 0.306 |
| Rho | 1 | 6.46E-12 | | |
| Sigma | 1.136937 | 0.142422 | | |
| Lambda | 1.136937 | 0.142422 | | |

*Source:* Author's estimates.
Note: *** p<0.01, ** p<0.05, * p<0.1
Wald chi2 (2)          =       19.52
Log likelihood = -55.98282
Prob> chi2          =       0.0001

At the selection stage, all observations without violent conflict were censored in order to find the effect of aid on conflict. It was hypothesised that violent conflict in society is a reflection of weak government that fails to collect taxes, relies on aid and imposes indirect taxes in the form of inflation. At the second stage the effects of independent variables on the outcome were examined. As the value of $\rho$ (rho) is significantly different from zero, we reject the null hypothesis of correlation between the two error terms of two equations, i.e., choice and select equation. This shows that the chosen procedure is valid and relevant. Lambda ($\lambda$) provides the insight about the coefficient of inverse mill ratio. Inverse mill ratio is the ratio of the probability density function over the cumulative distribution function of a distribution. Both $\rho$ and $\lambda$ are significantly different from zero, indicating that the two equations are related and sample selection is present.

The adjusted standard error for the war equation regression is given by sigma ($\sigma$) =1.13, and the correlation coefficient between the unobservable that determines selection into war equation is given by rho ($\rho$) =1. The estimated selection coefficient lambda = sigma×rho = 1.13. It is significantly different from zero.   The average truncation effect is computed as lambda× [average mills value] = 1.13×0 .879 = 0.993.   This shows by how much the selection equation of wars, are shifted up or down due to the truncation effect.

**Table 7: Final Stage of Heckman Procedure**

| Conflict | Coefficient | Standard Error | z | P>|z| |
|---|---|---|---|---|
| Oda | 0.342932 | 0.17928 | 1.91 | 0.056* |
| Mexp | 0.000889 | 0.000486 | 1.83 | 0.067* |
| CPI | 0.026745 | 0.044372 | 0.6 | 0.547 |
| Taxes | 0.058914 | 0.162933 | 0.36 | 0.718 |
| Invmills | 0.878677 | 0.640023 | 1.37 | 0.170 |
| _cons | -6.5148 | 2.837588 | -2.3 | 0.022 |

*Source:* Author's estimates.
Note: *** p<0.01, ** p<0.05, * p<0.1
Truncation effect = [exp (0.99327)-1]*100= 169 %

There is a positive truncation effect of aid on war years. This means that when only war years were, the effect of aid on conflict increased by 169%. It is significant because chi square value is also significant. The final stage of Heckman procedure by including inverse mill ratios is given in Table 7. It can be seen that probability of conflict increased from 0.29 to 0.34 and it is significant as well.

## 5.1. Marginal Effects of Probit Model

**Table 8: Probit Regression Reporting Marginal Effects**

Number of obs = 51          Wald chi2 (4) = 15.94          Prob> chi2 = 0.0031
Log pseudo likelihood = -21.953899          Pseudo R2 = 0.3646

| Conflict | dB/dx | Standard Error | Z | P>|z| | x-bar |
|---|---|---|---|---|---|
| Oda | 0.156682 | 0.05655 | 2.79** | 0.005 | 3.53772 |
| Mexp | 0.000545 | 0.000135 | 3.93*** | 0 | 2035.88 |
| CPI | 0.019161 | 0.013958 | 1.35 | 0.176 | 8.28659 |
| Taxes | 0.00222 | 0.039066 | 0.06 | 0.955 | 11.549 |
| obs. | P | 0.588235 | | | |
| pred. | P | 0.642814 | (at | x-bar) | |

*Source:* Author's estimates.
Note: *** p<0.01, ** p<0.05, * p<0.1

Partial effects of response probabilities on conflict were estimated. These marginal effects measure the change in the probability of conflict for an infinitesimal change in each independent variable. Table 8 explains that at mean value of conflict, aid increases probability of conflict by 16%, military expenditure by 0.05%, CPI by 1.9% and taxes by 0.2% in Pakistan. These results are computed on robust standard errors.

## 6. CONCLUSION

The aim of this paper was to explain how aid causes conflict in Pakistan. The main finding that aid is the cause of conflict in Pakistan is similar to Collier (2007), Balla et al. (2008), and Nielsen et al. (2011). Collier concluded that conflict is an unintended consequence of aid that leads to increased military expenditure. He and his colleagues found the sudden withdrawal of aid to be a causative factor of conflict in developing countries. According to them, declining aid creates a gap in military expenditure which developing country governments are unable to bridge. The study identifies aid inflows within the framework of strategic alliances as a reason for aggravated external conflict that divides society by changing expectations of individuals. It increases the intensity and probability of the occurrence of conflict. There is a causal link between internal and external conflict, which is aggravated by aid to predatory governments. The policy of strategic partnership with the US during the Cold War resulted in a divided society and affected shared norms and institutions. The policy isolated Pakistan in the region and also created internal conflict. The Afghan conflict in the 1980s and the ongoing WoT have had similar effects. All types of aid inflows to Pakistan are conditioned on conflict because of unclear agendas, and rather general objectives of the donors. Beginning as technical assistance, aid now aims to reform institutions and ensure good governance, objectives whose success obviously cannot happen during the terms of aid agreements.

Pakistan's defence spending has been declining as a percentage of GDP and government expenditure since 1990, but internal conflict has increased expenditure on internal security and justice system. Internal armed conflicts have badly affected economic conditions, resulting in lost growth and unsustainable budget deficits. In pursuit of austerity, neglect of the social sector has continued. The result that declining military expenditure has not led to a compensating increase in social sector spending due to deteriorating economic conditions, concurs with the conclusion of Deger & Somnath (1991) and Murshed & Sen (1995). Furthermore, this study does not find any evidence that donors have imposed conditionality on Pakistan to reduce its military expenditure. The strategic policy of external conflict is the source of increased military expenditure, and is responsible for social sector neglect that appears as intense internal conflict. Aid is highly collinear with military expenditure that results in increased arms imports, and is a cause of conflict in society because far less is spent on the social sector. In the beginning, Pakistan had greater reliance on bilateral aid, but now multilateral donors dominate the scene. Falling grants and greater reliance on loans has imposed a heavy debt burden.

Aid increased the occurrence, nature and dimensions of conflict in Pakistan, and led to irresponsible and unstable political governments who wait for donors to prescribe policies rather than take the initiative to reform. They prefer today's consumption to future consumption by shying away from explicitly taxing the elite. The governments prefer to

tax people implicitly in the form of inflation and indirect taxes that create distortions and shift the burden to the poor and the vulnerable. The decline in social sector spending and taxes reflects the eroded power of the state to govern. Aid is a source of growth that cannot be sustained because of the increased scale of conflict. Conflicts eroded the state's ability to ensure public welfare and establish peace, rule of law and protect life and property. Conflict-driven aid received to protect territory and writ of the state became a threat to the state itself.

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