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## Aid Effectiveness in Times of Political Change: Lessons from the Post-Communist Transition

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# Aid Effectiveness in Times of Political Change: Lessons from the Post-Communist Transition

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## Abstract

We argue that the tilt towards donor interests over recipient needs in aid allocation and practices may be particularly strong in new partnerships. Using the natural experiment of Eastern transition we find that commercial and strategic concerns influenced both aid flows and entry in the first half of the 1990s, but much less so later on. We also find that fractionalization increased and that early aid to the region was particularly volatile, unpredictable and tied. Our results may explain why aid to Iraq and Afghanistan has had little development impact and serve as warning for Burma and Arab Spring regimes.

## 1 Introduction

The global development architecture has changed substantially during the last 10 years. Donor countries outside of the OECD have grown more important, non-state actors such as global NGOs and philanthropists have proliferated, and many aid recipients have also become donors in their own right (Kharas, 2011). At the same time, there has been political turnover in many recipient

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countries, most dramatically recently in the Middle East and North Africa (MENA) region. New regimes have come to power, political elites have changed and competition for economic rents has become more open. Altogether this means that many new partnerships between donors and recipients have been established, and often in a setting in which the political and economic future of recipient countries is uncertain. In this paper we argue that the salience of general foreign policy interests in times of political transition can diminish the role of aid as an instrument to foster development. In particular, commercial and strategic interests may dominate early on in a relationship, and aid may largely be allocated based on the desire to establish commercial connections and fostering ideological and military allies. Beyond allocation this may also influence aid practices in a way that goes against what is currently deemed best practices. Ambitions to stop aid fragmentation, to respect ownership and reduce aid volatility and unpredictability - as expressed in the Paris Declaration and Accra Agenda for Action - may be frustrated in the rush to establish new political connections and influence the future direction of recipient countries.

A current case in point are the events unfolding in the MENA region. The Arab Spring has naturally attracted enormous attention, with Western countries offering foreign aid for governments pursuing democratic reforms and liberalizing their economies.<sup>1</sup> At the same time, policy towards this region is also guided by other priorities, such as commercial ties (in particular with resource rich countries such as Libya), security concerns and fear of mass-migration. There is also a battle for influence in the region, with oil-rich Gulf states supporting a more religiously conservative, authoritarian and inward looking model. The question is to what extent the broader foreign policy interests will completely determine aid policy or if there will remain room for a development focus, and whether the commitment to effective aid practices agreed upon in the Paris Declaration and the subsequent High-Level meetings will be upheld.

How these different objectives will shape western aid policy in the MENA region is too early to judge. Instead we focus in this paper on the historical case of Central and Eastern Europe (CEEC) and the Commonwealth of Independent States (CIS) in the early years of their transition towards market economies. Also then western donors stood ready to offer foreign aid in support of economic and political development, but strategic and commercial interests were in the mix as well.

The future path of Russia was uncertain, pushing Western Europe to quickly embrace the Eastern and Central European countries in order to secure their loyalty. Russia, Ukraine, Belarus and Kazakhstan had nuclear arms, and countries such as Russia, Poland, Czechoslovakia and Ukraine were perceived as having great commercial potential. Despite the common denominator of being part of the Eastern Block, these countries varied substantially in terms of strategic importance, commercial potential, and levels of economic development and poverty. The sudden opening up of these countries therefore serves as a natural experiment to investigate the early motivation behind aid partnerships and how it has changed over time. In particular, by looking at the allocation of aid across recipients, how that allocation has changed over time, and the urgency with which donors entered certain markets, we get a sense of the role of strategic and commercial interests relative to that of fostering development and alleviating poverty over time. We can also, though more tentatively due to limited data, look at some aspects of aid practices. For instance, we look at what happened to aid fragmentation in the early 1990s, and whether aid to CEEC and CIS was different from aid to other recipient countries in respects such as volatility, tying and predictability.

The paper is organized as follows. In the next section we offer a discussion of the related literature. In section 3 we look at aid allocation to CIS and CEEC countries in the years 1990 to 1995, and how it compares to the allocation to other recipients at the time. In section 4 we look at trends over a longer time period, showing how aid allocation to the region changed with the maturity of relationships between donors and recipients. Section 5 addresses entry decisions looking at the speed of entry into CIS and CEEC countries. In section 6 we report on the sensitivity analysis of our main results on aid allocation, and in section 7 we look at some measures of aid practices directly related to the objectives laid out in the Paris declaration. Finally, we conclude in section 8.

## 2 Literature Review

In this section we discuss the most relevant parts of the rather extensive literature on aid motivation, allocation and effectiveness. Our paper builds on this literature but also makes a rather specific

contribution by emphasizing that aid motivation, and thereby also most likely its effectiveness at promoting development in the receiving countries, may change over time as partnerships mature. Very little has been written about the evolution of development partnerships over time. Some studies have illustrated how the emergence of sudden strategic concerns can lead to a dramatic increase in aid, or how events like the end of the Cold War can shift donor priorities and leverage more generally (Fleck and Kilby, 2010; Boschini and Olofsgård, 2007). The only paper we know of that explicitly identifies a systematic difference between early and mature partnerships is Frot (2009), who shows how aid quantities depend critically on the length of the partnership. The impact on the predicted level of aid from entering a partnership roughly seven years later is equivalent to the effect of having a GDP per capita level around USD 5 000 higher. Hence, this illustrates a significant difference between early and mature relationships, but it does not discuss how motivation behind aid may vary depending on the maturity of the relationship.<sup>2</sup> To our knowledge, our study is the first to address this in a systematic way. The quantitative analysis allows us to compare the relative importance of different coexisting motivations and especially how this relative importance changed over time.

#### (a) Aid Regimes

The social science literature on foreign aid regimes contrasts two main schools, the international political realist perspective and the liberal idealist perspective (sometimes referred to as a Wilsonian perspective, or as humane internationalism).<sup>3</sup> The first perspective focuses on states as single actors and emphasizes economic power and military strength as the main motivation for all foreign policy, foreign aid included. This perspective leaves little room for development in poor countries as the ultimate objective, instead the need to feign altruistic motives makes aid an inefficient instrument for the ultimate objective to buy political support and commercial advantages (Morgenthau, 1962). In McKinley and Little (1979) the realist perspective is referred to as the donor interest model, contrasted against the recipient need model, a terminology used in much of the literature that followed, and also by us in what follows.

The realist perspective found much support during the days of the cold war and its implications where quite straightforward: give more aid in times of international tension and focus on countries that are ideological and military allies and/or in which there are substantial commercial interests primarily with respect to trade and investments (McKinley and Little, 1979; Schraeder et al., 1998; Lancaster, 2008).

The liberal idealist perspective portrays a more complex model of policy making. Foreign policy is here influenced by different political forces within the donor country, such as special interest groups, political parties and institutions of the state, but also more generally ideas or worldviews influenced by culture, religion and ideology (Lancaster, 2008). The liberal tradition also emphasizes that foreign policy often reflects domestic policy, suggesting a linkage between domestic welfare policies and a more development-focused foreign aid agenda (Lumsdaine, 1993; Therien and Noel, 2000). The idealist perspective is associated with humane internationalism, which stresses the responsibility to assist poor countries, a belief that a more just world is in the interests of all, and that this is not in conflict with donor countries' own economic interests (Stokke, 1989). This thus corresponds to the recipient need model in the terminology of McKinley and Little (1979).

The end of the Cold War left more room to use foreign aid to promote recipient country development, but also meant that a main motivation for aid disappeared, causing a substantial drop in aid levels (Boschini and Olofsgård, 2007; Hook et al., 1996). Even during the Cold War, both donor interests and recipient needs mattered, but from 1990 the relative weight on recipient needs is generally regarded as increasing (Meernik et al., 1998; Hook et al., 1996), though the "war on terror" meant a partial reversal at least for US policy (Fleck and Kilby, 2010). The picture is somewhat complicated, though, by the introduction of new explicit objectives of foreign aid such as democracy promotion, environmental protection, and fighting corruption. It is not obvious how to position these objectives in the domestic interests and recipient need space. Democracy certainly carries the potential to increase the welfare of recipient country citizens, but it may also be a way to foster recipient countries into the image of western donor countries in the battle for geo-political influence. Environmental protection can similarly increase the welfare of local residents, but ef-

forts to reduce global warming through interventions in developing countries can be perceived as self-serving.

Of particular relevance for our purpose, two main implications of the literature above emerge. First, foreign aid policy may reflect both donor interests and recipient needs. Second, the relative importance of the two can vary over time and across partnerships depending on for instance the geo-political context, shifting values and relative influences in domestic politics, commercial opportunities and level of deprivation. The existing literature has pointed to the the end of the cold war, the start of the war on terror, political change in donor countries and humanitarian crises, but noone has so far in a systematic way studied the difference between new and mature partnerships.

So why should strategic and commercial interests play a more significant role early on in a partnership? What we argue is that realist politics captured by strategic and commercial relationships typically involve competition with other potential donors. In such competition there is a clear ‘first mover advantage’: commercial gains from being the first to establish trade contacts or first to gain exploration rights, or strategic gains from being first to establish political connections with new regimes. There are several historical cases in which global powers have had conflicting interests in the future path of aid recipient countries. Western donors versus the Soviet Union during the Cold War has already been mentioned, but think also about Western donors versus Russia in regards to other members of the Commonwealth of Independent States (CIS) in the 2000s, or Western donors versus the Gulf countries in regards to the current situation in the Middle East and North Africa region. In these cases, the realist perspective holds a lot of sway and foreign aid has been used to gain allies and bolster the power of those with supportive views (Carothers, 2006)<sup>4</sup>. A similar logic applies to commercial relationships. An early foothold into a market with commercial potential can give an investor or an exporter an important advantage relative to its competitors, since it is generally costly to change investors and trade partners once the relationships have been established. To gain an edge in that competition, donor countries sometimes provide aid as an additional sweetener to seal the deal for a domestic company (Schraeder et al., 1998).

Humanitarian concerns, on the other hand, are a public good and largely non-competitive (at least not excludable). As such, there is less urgency to establish relationships with countries



targeted primarily for humanitarian reasons. Rather the opposite: as with all public goods there is a tendency for under-provision of resources since the full cost of the expenditures, but only part of the benefits, are internalized (Stone, 2010). By holding out, donors can also learn from other donors' mistakes operating in the environment of a particular recipient, and thereby increase the effectiveness of their effort. Over time, as strategic and trade relationships become more solid, aid becomes a less essential instrument to achieve commercial benefits and ideological loyalty. Certain strategic concerns, such as nuclear containment in the former Soviet Union and access to military bases in countries neighboring conflict zones, are temporary in nature. Trade relationships become more dependent on actual commercial value as they mature, and alternative ways to maintain the relationship evolve. Aid on the other hand remains an essential and primary tool for promotion of economic development and humanitarian support. We therefore expect that, over time, the liberal idealist perspective fits better with actual policies.

(b) The empirics of aid allocation

There is by now a quite sizeable empirical literature trying to estimate the relative role of donor interests and recipient needs. Most of this literature uses a 'revealed preferences' argument and studies the allocation of aid across recipients with different characteristics to derive an idea of what donors really prioritize. The early literature, such as McKinlay and Little (1977); Maizels and Nissanke (1984), found primarily support for a realist perspective. It is true that aid is often found to decrease with an increase in income, but the economic significance of poverty is typically trumped by strategic and commercial concerns. For instance, Alesina and Dollar (2000) find that measures of historical ties (former colonial status), strategic alliances (as measured by the correlation of voting records in the UN general assembly) and the Israel-Palestine conflict have a much greater explanatory power and larger economic effects on the margin.

Other proxies of strategic importance that have been used in the literature, and found to be significant, include arms imports (Hess, 1989; Maizels and Nissanke, 1984), arms expenditures (Schraeder et al., 1998), and membership in the UN Security Council (Kuziemko and Werker, 2006; Dreher et al., 2009). Studies on the impact of the Cold War (Boschini and Olofsgård, 2007) and

the ‘war on terror’ (Fleck and Kilby, 2010) suggest that strategic motives have been of particular importance in certain time periods.

Commercial interests, in particular captured by trade flows or exports, have also been shown to be important in several studies. Berthélemy and Tichit (2004) find that trade flows became a more important determinant of aid allocation after the end of the Cold War. Neumayer (2003) finds that exports have a significant and positive effect on bilateral aid for most major bilateral donors. Finally, some studies have also investigated the impact of geographical distance between donors and recipients, arguing that certain donors can have a particular interest in supporting a neighboring region for strategic and/or commercial reasons. The US has been shown to favor Latin America, Japan East Asia, Australia and New Zealand the Pacific nations, and Germany, Austria and Switzerland their neighbors to the near East or South (Neumayer, 2003).

#### (c) Aid effectiveness and the Paris Declaration

Keeping the different objectives of aid in mind, it is still the case that the literature on aid effectiveness deals with the effect of aid on economic growth or other aspects of recipient country welfare (Boone, 1996; Burnside and Dollar, 2000; Rajan and Subramanian, 2008). It is beyond the scope of this paper to review this literature at length, but commercial and strategic motivations can affect aid effectiveness as defined both directly and indirectly. They have a direct effect if they imply that aid does not flow to the countries or sectors in which it is most likely to have an impact on development, if they undermine aid conditionality, and if they help incompetent and corrupt regimes stay in power. Stone (2010) finds that the development impact of aid depends on its motivation, and argues that this at least partially has to do with the credibility of aid conditionality. If aid is motivated by commercial interests, conditions on economic and political reforms will not carry much clout, and it is no secret that nations of strategic importance have received large flows of aid despite deplorable human rights records in the ages of the Cold War and the war on terror. This is especially relevant for EU donors in their strategy to offer ‘more for more’ to their southern neighbors. In the end, if aid becomes dominated by commercial interests, stronger conditions on paper will mean nothing. If enforcing conditionality goes against the interests of the donors, it

will not be credible. Collier and Dollar (2002) compare actual aid allocation with a model of *efficient* aid allocation emphasizing the role of proper economic policies and need. They argue that a reallocation based on where aid is most likely to contribute to development could lift 50 million more individuals above the poverty line.

There can also be indirect effects in the form of deteriorating aid practices. In the Paris Declaration (2005) donors and recipients defined an agenda for aid effectiveness around five core principles (ownership, alignment, harmonization, results and mutual accountability).<sup>5</sup> The stated objective is to lay out a practical, action-oriented roadmap to improve the quality of aid and its impact on development. The agenda says nothing about aid allocation, but the incentives for donors to adhere to the aid practices outlined should depend on the underlying motives. As emphasized by Knack and Eubank (2009, p.7): "[...W]hen bilateral donors use aid to advance diplomatic or commercial objectives, incentives to rely on their own parallel systems for aid delivery will be further aggravated. For example, using their own procurement rules will likely advantage donor-country contractors". Commercial interests may also increase pressure for tying aid, and aid may become more fractionalised and volatile as donors rush into new partnerships, eager to be relevant.

The Paris Declaration has also put together a monitoring system to assess progress towards the targets outlined, using survey responses from donors and recipients. In most cases, the results are quite sobering. For example, a study by the OECD (2011) finds that only one of thirteen targets had been met by 2010. Knack et al. (2010), Easterly and Williamson (2011) and Birdsall and Kharas (2010) also build a number of different indicators following the stated objectives of the agenda, creating a ranking of donors according to their performance along these indicators. Other studies have focused on motivating and supporting policy action. For example, Bigsten and Tengstam (2011) quantify the gains that can be made through the full implementation of the Paris Declaration by the EU members. Frot (2009) studies a simple reform that would drastically reduce fragmentation by eliminating "small" partnerships, although leaving unaffected donors' aid budgets and developing countries receipts. Knack and Eubank (2009) focus on what explains the variation in the use of country systems by donors. All in all, this literature provides criteria and in some cases explicit indicators to evaluate the quality of aid practices, in accordance to what donors themselves

have deemed desirable and agreed upon from a development perspective. We draw on this literature to provide approximative indicators of the quality of aid practices for the period of time and the set of countries we are interested in.

In the next section, we start by identifying which factors seem to have been the most important for donors at the time of establishing new aid partnerships for the case of CIS and CEEC countries.

### **3 Aid to CIS and CEEC from 1990 to 1995**

The end of communism in the former Eastern Bloc suddenly opened up a new set of low and middle income countries for western aid. These countries varied substantially in levels of development, strategic importance and commercial potential. In this sense, the fall of the Berlin Wall constitutes almost a unique natural experiment to test how the relative weight of donor interests versus recipient needs may be different in the beginning of a partnership compared to the later period.

We first estimate a parsimonious aid allocation model for the universe of aid-recipient countries in the years 1990 to 1995, using a CIS-CEEC group interaction.<sup>6</sup> Some parts of aid flows to the region in the early goings were explicitly strategic, such as military aid for nuclear disarmament. We ask, instead, whether aid that officially is disbursed for purposes of development and used at the discretion of the recipients is also correlated with strategic and commercial motives. We therefore use Country Programmable Aid (CPA) as our dependent variable, rather than Official Development Assistance (ODA), to better capture the portions of aid expenditures over which the recipient countries actually do have some authority (Benn et al., 2010). CPA excludes from ODA debt relief, humanitarian aid, in-donor costs and aid from local governments, core funding to international NGOs, aid through secondary agencies, ODA equity investments and aid which is not possible to allocate by country.<sup>7</sup> However, we have also replicated our results using ODA as the dependent variable. Since CPA is the narrowest definition of development aid, we expect a stronger focus on strategic and commercial interests when looking at the ODA flows instead. This is indeed what we find. All results are available in the online appendix.

To capture need we rely primarily on income per capita, measured in purchasing power parity

terms and in logarithms to reduce the impact of outliers, and *disasters* which measures the number of natural, biological or technological disasters that the country experienced during the previous year.<sup>8</sup> One explicit objective of many donors for aid to CEEC and CIS at the time was to support a transition to democracy (Carothers, 2006; Heckelman, 2010). We therefore include the level of democracy using the *Polity* indicator from the Polity IV project. As discussed above, it is not obvious how to classify such motivation along the axes of donor interests versus recipient needs, so we refrain from a strong position on this. Colonial status is included to reflect donor interest in maintaining influence over former colonies, and it is measured as a dummy that takes on the value of 1 for all former western colonies. To capture commercial interests, which we in line with the literature classify as donor interests, we control for trade volumes between each recipient and the aggregate of donors, measured as total export and import flows over GDP.<sup>9</sup> Finally, the log of population size is included as a control variable to capture the well-known fact that more populous countries tend to get more aid in total but less in per capita terms.

The standard in the aid allocation literature is to use the log of total aid as the dependent variable, and a linear estimator such as the OLS, with or without fixed effects. The drawbacks of this approach are that observations receiving no aid are dropped unless some ad hoc alteration is done to the data, and calculations of predicted values are complicated by an additive term. Instead it has been recommended (Ai and Norton, 2000; Santos Silva and Tenreyro, 2006) to use a Poisson model with the absolute level of aid as the dependent variable and robust standard errors.<sup>10</sup>

The main argument we are interested in testing is whether donors identify countries that will be of particular commercial and strategic importance, and then use aid as one of potentially many instruments to further their interests for the future in that set of countries. Commercial potential and strategic importance are generally not changing from year to year, but depend on more slow moving variables such as geography, size, military capacity, stock of human capital and historical circumstances. It follows that to test our arguments we should primarily rely on cross-country variation in the data. We have too few cross-country observations to solely rely on the between variation, though, so we pool our data using both cross-country and time series variation throughout but cluster our error terms by country. In some of our specifications we take averages for a few

years to reduce the impact of measurement errors and more random yearly variation.<sup>11</sup>

Column (1) of Table 1 shows the results from the Poisson regression on aid, with a dummy for CEEC and CIS countries included linearly and interacted with all independent variables. As expected, aid increases with population size. No other factor has a significant impact in the control group, but some have a significantly different impact in the CEEC-CIS. In particular the effect of trade is positive and significant in the CIS and CEEC countries, suggesting a more prominent role of commercial interests. The coefficient on the Polity index turns from negative to positive, indicating that aid may have been used more proactively in the CIS and CEEC group to encourage countries that early on reformed their political institutions. Finally, the regional dummy itself is negative and significant suggesting that aid to these countries on average was lower than to other recipients with similar levels of income, democracy, and so on.

The results in column (1) highlight average differences across the two groups, but there is also substantial individual variation within groups. If we compare expected aid inflows – derived multiplying the estimated coefficients by the average value of the independent variables for each country – to the actual average aid inflows during the same years<sup>12</sup>, we notice in particular two things: i) among CIS countries, Russia, Ukraine and Belarus get much more aid than expected, while the countries in the Caucasus and Central Asia much less; ii) countries closer to the core of Western Europe seem to be getting more aid than countries further away. Given these observations, we first rerun the regression in column (1) but only with the sample of CEEC-CIS countries (presented to simplify comparisons in column (2)), and then in column (3) we include two variables that may explain the patterns from above: a dummy for nations in possession of nuclear arms at the time of the dissolution of the Soviet Union (Russia, Ukraine, Belarus and Kazakhstan) and a measure of the average distance between the capitals of the recipient and its donors. These measures largely reflect donor interests. The strategic importance of containing nuclear arms is straightforward, but the particular focus on neighbouring countries also reflects the strategic interest at the time in guaranteeing a bulwark against an unstable and unpredictable superpower in Russia.

Geographic distance turns out highly significant and negative suggesting that donors favoured countries in proximity to Western Europe. Note also that the negative effect of income now be-

Table 1: Aid allocation in 1990-95

	(1) All recipients	(2) CEECCIS	(3) CEECCIS	(4) 3-yrs av.
pcGDP	-.11 (.12)	-.15 (.33)	-.61* (.32)	-.98*** (.31)
pcGDP*CCC	-.046 (.35)			
Population	.43*** (.10)	.86*** (.13)	.79*** (.13)	.78*** (.081)
Population*CCC	.43*** (.16)			
Trade	.0012 (.0045)	.026*** (.0096)	.034*** (.012)	.022*** (.0065)
Trade*CCC	.025** (.010)			
Polity	-.015 (.020)	.067** (.027)	-.064 (.039)	-.058 (.042)
Polity*CCC	.082** (.033)			
Disasters	.012 (.021)	-.027 (.018)	-.054** (.028)	.055** (.023)
Disasters*CCC	-.040 (.027)			
Colony	.33 (.23)			
CISCEECC	-7.46* (4.27)			
Distance			-.0013*** (.00030)	-.0020*** (.00028)
Nuclear			.28 (.22)	.12 (.18)
Chi2_ <i>p-value</i>	2.6e-270	7.9e-69	0	2.2e-256
Countries	117	24	24	21
<i>N</i>	627	98	98	42

Note: Dependent variable is aid flows. GDP and population are logged. Yearly observations for the period 1990-1995, 3-year averages in column (4). Standard errors clustered at the country level in parentheses. \*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

comes much larger and the coefficient on *Polity* switches sign to become negative, suggesting that the previous results were driven by the fact that geographically close countries also tended to be economically wealthier and more politically open. The nuclear dummy turns out positive as expected, but insignificant.

Another possible reason for the differences across the sets of countries in column (1) may be that different donors carry different weights in the two groups of recipients. To reduce this bias we eliminate in sequence the donors (Germany, Japan, Austria) whose aid have a strongly disproportionate relative size in one or the other recipient group. Both Germany and Japan have been found to be motivated by commercial interests in other papers, e.g. Stone (2010). Results are very similar. We also dropped Russia from the sample in order to see how sensitive our results are to the exclusion of the by far largest market. Very little changes, though, and the coefficient on trade actually increases somewhat in size.<sup>13</sup>

Finally, in column (4) we show the results using averages for the three-year periods 1990-92 and 1993-95. Since yearly disbursements fluctuate substantially, our results might be driven by a few extreme observations. By looking at this short panel with three-year averages, we take one step towards reducing potential bias from high yearly volatility. The trade-off is that we are now down to only 42 observations. The results largely confirm the previous findings, except for the effect of disasters that now turns positive and significant. This suggests that CPA may still be affected by disasters but this effect kicks in only with a lag, i.e. after the actual disaster, and as part of reconstruction.

Overall the picture that emerges from the analysis above is that development aid in the early stages may have been partly driven by ambitions to alleviate poverty: countries with lower per capita income did get more aid, in particular when we control for geographical proximity and nuclear warheads. However, commercial and strategic interests did clearly loom large.

A one standard deviation increase in trade volume, taking the conservative estimate from column (3), yields an increase in aid corresponding to 12% of a standard deviation of the log of aid in the sample. Doing the same for distance to capital yields a reduction by 64% of the standard deviation, while the effect of the nuclear dummy corresponds to a 15% increase. The corresponding number



for the log of income is a 23% reduction. In other words, the trade volume matters about half as much as income, and only slightly less than having nuclear armaments. However, distance has by far the strongest influence on aid allocations to this group of countries in this period.

## 4 Trends over time in aid to CIS and CEEC

In Table 2 below we focus exclusively on CIS and CEEC recipients, and examine trends over time between 1990 and 2007.<sup>14</sup> In column (1) we show the results from a naïve regression in which we constrain the marginal effects to be identical across different time periods. Not surprisingly, the estimates are quite different from Table 1.

In columns (2) to (4) we test our argument that the motivation for aid is different in the early going by introducing two dummies for the time periods 1990 to 1995 and 1996 to 2001 respectively. These dummies are introduced separately and interacted with all independent variables. Columns (2) and (3) pool the yearly data, the only difference being that we exclude Russia in column (3). In column (4) we use three-year averages of the data to diminish the effect of random yearly variation. The results show that the effects of trade, geographic location, democracy, income and disasters have changed substantially over time. Details vary across specifications, but generally the effect of trade was positive in the first part of the 1990s, much more limited in the latter part of the 1990s and either zero or negative between 2002 and 2007. Geographic distance shows a similar pattern, with countries close to the donors (i.e. close to Western Europe) getting more aid in the early 1990s, and less aid after that, although not significantly less. More democratic countries receive less aid in the early period and more aid in the subsequent periods. This suggests that aid over time has been used more to reward countries opening up politically, but it may also be that aid has helped countries open up politically (Heckelman 2010). Income has a negative correlation with aid in the early period, turning insignificant after that. Finally, disasters are positively correlated with aid since 2002, but negatively before that. The time dummy for 1995 itself is positive suggesting that initially the countries got more aid than expected given the specification of the model. Overall the results suggest that the motivation for development aid to the CEEC and CIS countries changed

Table 2: Table 2: Aid to CIS and CEEC over time

	(1) Pooled	(2) Pooled	(3) No Russia	(4) 3-yrs av.
pcGDP_90-95		-.62* (.33)	-1.05*** (.29)	-1.26*** (.35)
pcGDP_96-01		.091 (.15)	-.065 (.20)	-.27 (.27)
pcGDP	.079 (.18)	-.044 (.19)	.23 (.23)	.29 (.29)
Population_90-95		1.02*** (.30)	1.15*** (.27)	.23 (.23)
Population_96-01		.089 (.14)	.073 (.16)	.026 (.18)
Population	.73*** (.15)	.40*** (.15)	.68*** (.16)	.54** (.22)
Trade_90-95		.040*** (.013)	.057** (.022)	.044*** (.014)
Trade_96-01		.0094 (.0062)	.020* (.012)	.026* (.013)
Trade	-.0032 (.0052)	-.0051 (.0056)	-.033*** (.010)	-.022 (.013)
Polity_90-95		-.13*** (.047)	-.15*** (.045)	-.13*** (.046)
Polity_96-01		-.017 (.024)	-.027 (.023)	-.012 (.024)
Polity	.037 (.026)	.069** (.029)	.089*** (.025)	.072*** (.026)
Disasters_90-95		-.15*** (.035)	-.040 (.11)	-.15** (.075)
Disasters_96-01		-.10*** (.032)	-.072 (.045)	-.19*** (.074)
Disasters	.025 (.020)	.11*** (.034)	.012 (.052)	.21*** (.074)
Distance_90-95		-.0016*** (.00037)	-.0019*** (.00039)	-.0023*** (.00032)
Distance_96-01		-.000096 (.00017)	-.00016 (.00019)	-.000089 (.00018)
Distance	-.0000049 (.00021)	.00027 (.00020)	.00034 (.00022)	.00030 (.00018)
Nuclear_90-95		-.13 (.39)	.092 (.44)	.17 (.46)
Nuclear_96-01		.055 (.25)	.26 (.32)	.43 (.38)
Nuclear	.055 (.24)	.32 (.29)	-.18 (.32)	-.047 (.45)
90-95		5.83 (5.15)	14.8*** (4.58)	16.1*** (5.93)
96-01		-3.48 (2.79)	.75 (3.80)	1.76 (4.67)
Chi2_ <i>p-value</i>	9.2e-165	0	2.6e-117	0
Countries	25	25	24	25
N	332	324	311	126

Note: Dependent variable is aid flows. GDP and population are logged. Standard errors clustered at the country level in parentheses. \*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

over time, and in particular that strategic and commercial interests were of greater relevance early on in the partnership.

At this point it might be argued that the end of the Cold War not only meant the emergence of a new set of recipients, but also a more general shift in aid motivation and allocation. It is therefore possible that the pattern that we see above for CEEC and CIS countries also holds true for other recipients, which would invalidate our argument that motivations depend on the maturity of the relationship. To rule out this possibility we rerun the regressions from columns (1) and (2) on all other recipients: no such pattern can be identified in the other group of aid recipients.<sup>15</sup>

## 5 Entry decision

As an additional test of our argument, we apply an alternative approach to gage the relative importance of donor interests and recipient needs in the early stages: which countries are donors in the most hurry to enter? If aid is primarily motivated by recipient needs then donor countries should be in the most hurry to enter the poorest countries (maybe conditional on political institutions and economic policies). On the other hand, if donors were predominantly motivated by commercial interests, then they should be in the most hurry to enter relatively better off countries (bigger markets), and in particular those with which they trade. We construct a measure of the number of years since 1989 it took before a donor entered into an aid relationship with a recipient country, and use a Poisson model with robust standard errors (results are shown in the online appendix). The results largely confirm those for aid allocation. Donors have entered earlier into countries with greater commercial potential as captured by higher income and trade flows. On the other hand, donors also entered quicker into countries with more democratic institutions. Together with the negative sign on *Polity* in Table 2, this suggests that donors entered earlier into more democratic countries, although not primarily offering more aid but by quickly offering political support for the democratic transition.

## 6 Sensitivity analysis

To check further for the robustness of our results, we perform some additional tests.<sup>16</sup> We are in particular focusing on the robustness of the commercial interests, as reflected by the correlation between trade and aid.

The positive correlation between trade and aid is typically interpreted in the literature as an indication that aid is used to push donor country's exports or secure imports of vital interest (energy or rare earth metals for instance). We argue that this commercial motive may be particularly important in the early stage of the partnership, not only to promote current trade, but also to gain a competitive advantage that can help promote trade in the future. If this is correct, then we should expect also *future* trade flows to be correlated with aid in the first years of the partnership. To the extent that trade in those early years only reflects part of the potential for trade in the future, the estimated effect of future trade may be even stronger. Introducing both current trade and trade five years later in the model of column (3) from Table 1 makes current trade insignificant, while trade five years later retains statistical significance. The little variation there is between the two measures (the correlation between current trade and future trade is very high) indicates thus that trade potential may be more important than current trade.

Another indication of the role of trade in the early period comes from looking at bilateral rather than aggregated data. If the trade potential with different recipients differs across donors, then one would expect the aggregated data to show a smaller effect than the dyadic data. When we use dyadic data from 1990 to 1995 and replicate column (3) from Table 1, the size of the coefficient on trade becomes eight to ten times as large as in Table 1. This suggests that donors are primarily concerned with their own trading partners, not just countries that trade much in general. In principle, donors can support a viable business and investment environment for development purposes, and this may be more effective in a setting in which the geographical potential for trade and FDI is higher to start with. However, then they would have no reason to focus particularly on their own trading partners, as these results suggest. Aid for the purpose of making sure that trade ties are established with donor A instead of donor B do not serve the purpose of developing the recipient country's private

sector. In the worst case, aid money could tilt the deal in favor of inferior commercial contracts if recipient country governments impose undue pressure on private companies.

We have been arguing that trade potential motivates aid flows because aid can function as a sweetener for trade deals. However, the causal link between aid and trade may well be bidirectional: more generous aid disbursements can generate foreign connections, provide technological and management know-how, and help support a business environment more conducive to export-oriented industries in general. Furthermore, bilateral aid and trade flows may also be jointly caused by some third unobservable variable perhaps related to historical connections between economic and political elites or cultural affinity. To deal with potential endogeneity bias we follow Frankel and Romer (1999) and specify a gravity model for bilateral trade using both countries' land area, donor country population, a dummy for shared borders, and the latter's interaction with the others as external instruments. In Table 3 we report the results from the 2SLS regressions (the first stage is reported in the appendix). As can be seen by comparing Column 1 (OLS) with Column 2 (2SLS), the coefficient for trade becomes larger with instrumentation.

Trade may not be the only channel through which shared borders affect aid flows: a shared border makes it more likely that two countries have been part of the same country historically, and migration flows are larger for neighboring countries. We hence include *Migrants\_90* and *Same\_country* as a test of the exclusion restrictions on some of the instruments. None of these variables are significant in the instrumented model and their inclusion actually inflates the estimated effect of trade. The table also reports two statistics that inform about instrument strength. The first is the *p-value* of the Angrist and Pischke (2009) test of excluded instruments. The second is the Kleibergen and Paap (2006) Wald statistic. Both are tests of instrument weakness. The null hypothesis of the Angrist and Pischke test is rejected at 5% level, and the Kleibergen and Paap Wald statistic is very high. It is lower though in column (3), suggesting that the instrumentation is somewhat weakened by the inclusion of *Migrants\_90* and *Same\_country*.

Table 3: Table 3: Sensitivity analysis - IV for trade

	(1) OLS	(2) OLS IV	(3) OLS IV
pcGDP	.21 (.23)	.19 (.25)	.081 (.27)
Population	.56*** (.18)	.53** (.23)	.54** (.23)
Trade	.46*** (.086)	.65** (.28)	1.15** (.54)
Polity	.026 (.025)	.026 (.025)	.030 (.028)
Disasters	-.039 (.040)	-.049 (.040)	-.13 (.095)
Distance	-.00011*** (.000020)	-.00011*** (.000024)	-.000094*** (.000024)
Nuclear	-.65* (.34)	-.64* (.38)	-.69* (.39)
Same_Country			.0076 (1.13)
Migrants_90			-.0029 (.0027)
R2	.20	.21	.12
AP test ( $p$ -val)		0	0
KP $F$ stat		35850.8	5152.1
Countries	24	23	23
$N$	1087	1008	1008

Note: Dependent variable is aid flows at the partnership level. AP: Angrist-Pischke. KP: Kleibergen-Paap. Standard errors clustered at the recipient level in parentheses.  
\*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

## 7 Aid Practices

The evidence so far suggests that a realist perspective emphasizing commercial and strategic donor interests best fits aid motivation when new countries emerged as potential aid partners after the end of the Cold War. As argued above, this has implications for the ability of aid to promote development as it may skew the allocation of limited budgets away from where aid is most likely to have a favorable impact. This may not be the only way, though, through which aid effectiveness suffers. Aid practices such as those that donors committed to in the Paris Declaration (and in the following High Level meetings in Accra and Busan) may also suffer. The measures now used to evaluate progress with the Paris Declaration (e.g. Knack et al., 2010 and OECD, forth. b) are generally not available for the 1990s, so we are quite restricted in our evaluation. But below follows some indicative evidence, comparing aid practices in the CEEC and CIS countries in the 1990s to practices in other recipients during the same time period.

As part of the commitment to harmonization, donors have pledged to increase aid co-ordination and reduce aid fragmentation. This involves common arrangements for planning, funding, monitoring and reporting on aid activities, but also a focus on countries and sectors in which donors have a comparative advantage based on capacity or historical relationships. We do not have access to detailed data on the donor coordination of arrangements in the CEEC and CIS in the 1990s so we focus on aid fragmentation and, in accordance with the literature, on measures of the number of donors involved in a recipient country or, reversely, the number of recipient countries a donor is engaged in, as well as an indicator of the presence of (financially) small donors in the recipient countries (Knack and Rahman 2007, Frot and Santiso 2011). We show below a graph of how the number of recipient countries for the average DAC member has changed over time. As can be seen, fragmentation increased slowly from 1976 to 1985, stayed constant until 1990, and then steadily increased up until 1995. The end of the Cold War is thus associated with a substantial increase in donors aid portfolios as new recipients emerged in the CEEC and CIS while very few established relationships were terminated.

Fragmentation can also be measured from the point of view of the recipient countries. Figure

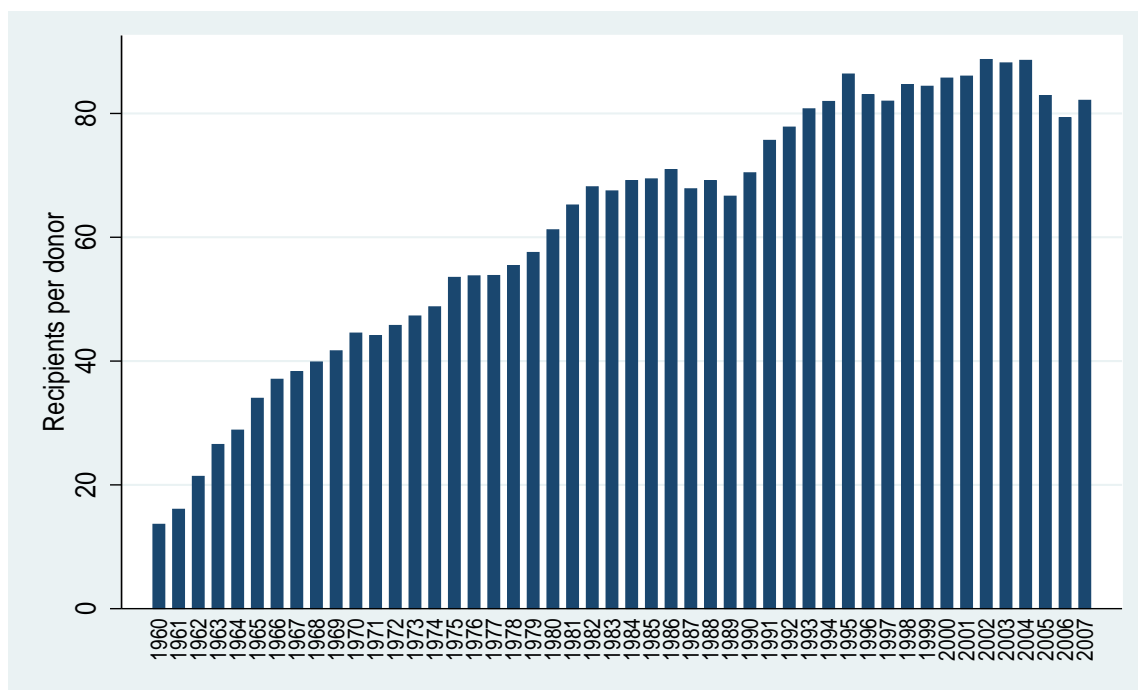


Figure 1: Average number of recipients per DAC donor over time

2 shows how the number of donors that each of the new countries established partnerships with increased rapidly to catch up to the standards of previous aid recipients within only a few years. By 1999 all of the major donors had entered the 27 new countries. The number of donors in each sector also follows a similar pattern (see the appendix).

Another indicator of fragmentation is what the OECD (OECD, 2009) refers to as *non-significant* relationships. The characterization of a partnership as non-significant is based on two criteria: i) how *concentrated* the donor is in this recipient, i.e. how big a share of its aid goes to this recipient in relation to the donor's contribution to total global aid; and ii) how *important* the donor is for the recipient, in particular whether it belongs to the set of largest donors jointly contributing 90% of the country's aid receipt. Partnerships that fail both of these criteria are labeled *non-significant*. Figure 3 shows that this was far more common in this region than in the rest of the world between 1990 and 1995. This is likely due to strong incentives for donors to quickly be part of the action when new regimes came to power, perhaps before considering the possibility and opportunity of a



more substantial long-run commitment.<sup>17</sup>

Another priority in the Paris Declaration is to make aid less volatile and more predictable. Among other things, high volatility complicates public financing, shifts resources from investment to consumption and exacerbates business cycles (Desai et al., 2010), and has therefore been a major concern for many years (see Bulíř and Hamann, 2008). To calculate volatility we ran an AR(1) process, collected the error terms and then calculated the mean squared errors for each country. This approach de-trends the data, contrary to some alternative measures that may suggest high volatility in countries seeing a steady increase or decrease in aid inflows (which does not really imply volatility, and in particular not unpredictability). This is especially important in this case, since new recipients may be more likely to see an increasing trend than more established recipients. Aid indeed seems to be more volatile in CEEC and CIS countries compared with other recipients over the period 1990-1995. Furthermore, volatility within CEEC and CIS is higher in this first period compared with the following 5 years.<sup>18</sup>

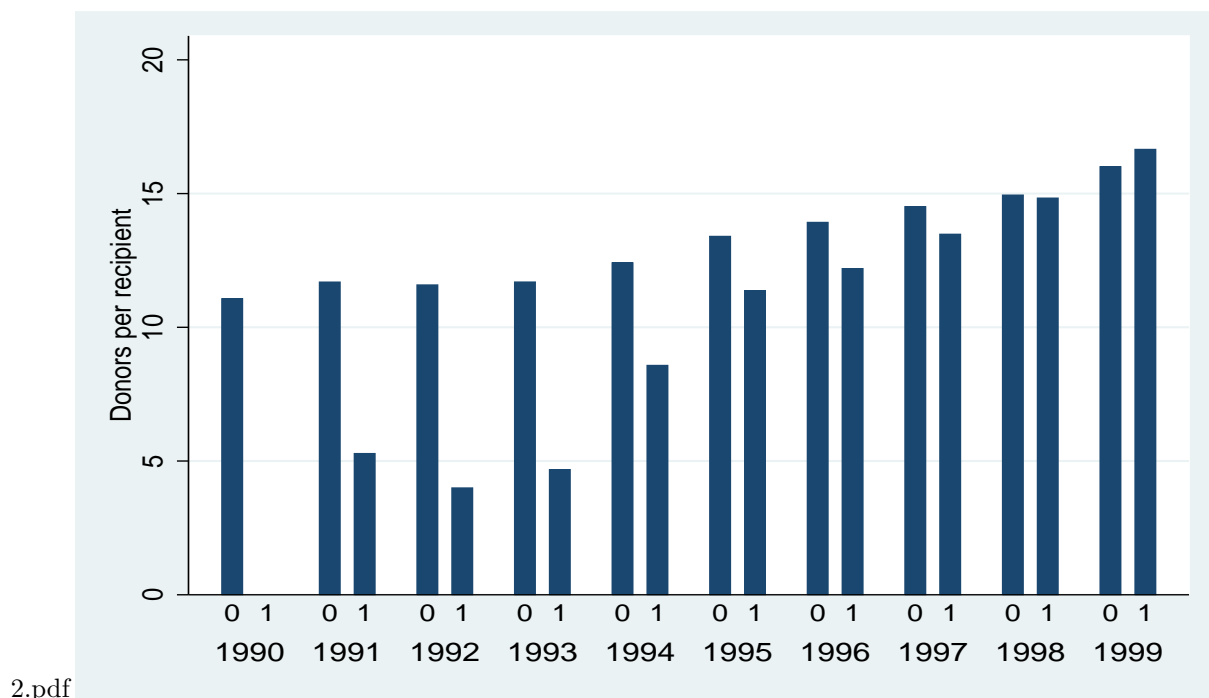
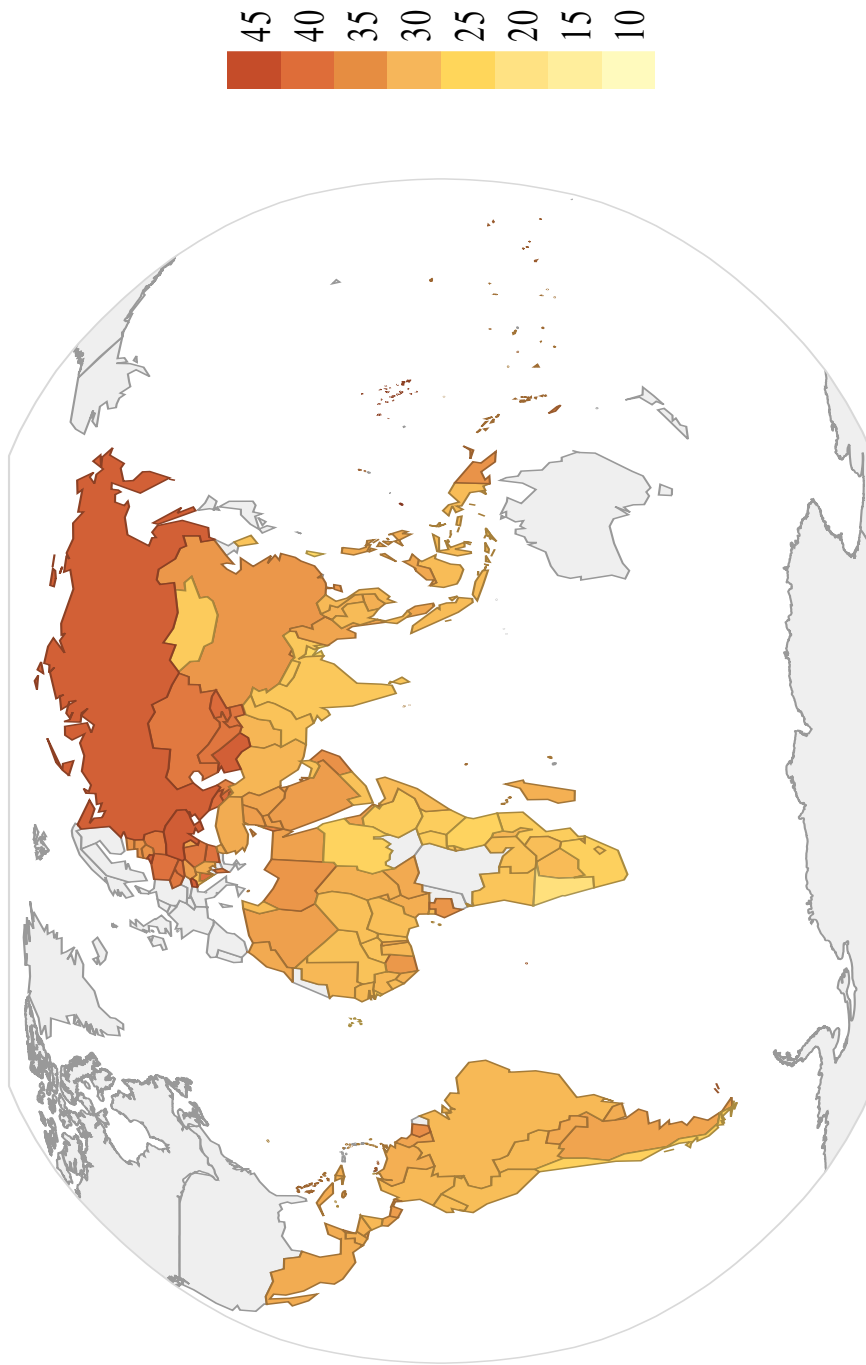


Figure 2: Average number of donors per recipient in CEEC-CIS countries and other recipients



Computed by Wolfram|Alpha

Figure 3: Non-significant aid partnerships, 1990-1995

3.pdf

Table 4: Table 4: Measures of aid quality, differences in means

	(1) Fraction disbursed	(2) Fraction tied	(3) Mean project	(4) Program-based
CEEC-CIS	-.18*** (.020)	.052*** (.0088)	-.47 (.38)	.054 (.033)
Constant	.49*** (.013)	.62*** (.0057)	3.31*** (.21)	.19*** (.0077)
Donors	26	26	26	17
Recipients	176	176	177	165
Observations	15751	16076	17132	4597

Note: Yearly observations for the period 1990-1999. All regressions include donor fixed effects. Standard errors clustered at the recipient level in parentheses. \*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

In Table 4 we look at some other measures of aid effectiveness related to the objectives of the Paris Declaration. By running simple correlations with a CEEC-CIS dummy we capture average differences between this group and other recipients. Column (1) offers another indication of the urgency to establish some kind of relationship before a fully-fledged engagement could be considered: the fraction of aid disbursed relative to that committed is significantly lower in the CEEC-CIS countries. Such a lack of long-term planning may be a factor contributing to the unpredictability of aid. In column (2) we look at the proportion of aid that is tied, something we may expect to go up as commercial interests become more important for aid decisions. The fraction of aid that was tied was also significantly higher in CEEC-CIS compared to other recipients at the time. The average size of projects, around 3.3 million USD as shown in column (3), is slightly smaller in CEEC-CIS, but not-significantly so (smaller projects imply more fragmented aid). Finally column (4) compares the share disbursed through *program-based approaches*. Program aid refers to the disbursement of funds broadly earmarked to a sector and managed by the recipient country, as opposed to the direct implementation of specific projects managed by the donor. Program aid and budget support contribute more directly to the recipient government's budget, and are therefore in line with the focus on ownership. It is also argued that this approach can contribute to reduce aid fragmentation. According to the available data - a rather small sub-sample of donors - around 20% of aid during this period was disbursed with these modalities, and the share is not significantly

different in CEEC and CIS recipients.<sup>19</sup> It is important to stress that these regressions all include donor fixed effects, and hence the results speak to within-donor differences in practices. In other words, the same donors did behave differently in the region compared to towards their previous recipients in these respects.

## 8 Conclusions

In this paper we make the argument that foreign aid motivation may vary depending on the maturity of the relationship between the donor and the recipient. More specifically, an international realist perspective emphasizing donor interests may hold more sway early on, as strategic influence and commercial contracts are typically won in competition with others, and as there is often a first mover advantage in establishing such relationships with a new regime or government. On the other hand, a liberal idealist perspective emphasizing recipient needs suffers from the usual problems of under-provision and free-riding as promoting development in poor countries is a public good. Over time, though, as strategic and commercial ties become more solid and depend less on the additional help through foreign aid, development concerns can come more in the relative forefront for foreign aid policy.

We test our argument using the case of Eastern transition. The sudden collapse of communism created almost a natural experiment with a new set of countries, differing widely in levels of poverty, strategic importance and commercial potential, emerging as potential beneficiaries of western aid. We find that aid flows were highly influenced by trade flows and geographic proximity to Western donors in the first part of the 1990s, but that these results substantially weaken over time. We also find that skewed priorities and time pressure influenced aid practices negatively. The rush to establish new partnerships lead to a surge in aid fractionalisation, both from the donor's and the recipient's perspective, and high levels of aid volatility and unpredictability. A larger fraction of aid was also tied to procurement from the donor country, as compared to other recipient countries at the time.

The case of foreign aid during the Eastern transition is important in itself, but we also think it provides some crucial lessons for donor countries looking ahead. The current events in the MENA region are sometimes pitched as the potential for a new economic and political transition (Meyersson et al., 2011). A new political leadership has emerged in countries such as Tunisia, Libya, Egypt and Yemen, and more may come. With the new political leadership also comes a gradual change in economic ownership and control, and the region is opening up for more foreign investments and trade

as the social contract in the region becomes less dependent on the state, and more on the private sector. Strategic concerns related to terrorism, migration and access to oil and gas also guarantee that governments in western countries will have a stake in the transformation taking place. Based on the experience of Eastern transition, it is likely that strategic and commercial interests will dominate the allocation of aid early on, which may have negative consequences on the ability of aid to promote development and alleviate poverty. As the examples of Iraq and Afghanistan suggest, in particular military strategic motives can substantially dictate aid flows if deemed significant enough. If our results have anything to say, the practices for aid effectiveness agreed upon in the Paris Declaration are also likely to suffer, causing aid to the region to be fractionalised, volatile and unpredictable. Respect for ownership and alignment to recipient country objectives may also come under question, in particular if new governments move in an ideological direction alien to western donors. Hopefully in a few years time, a follow up study on the MENA region can be used to test the generality of our current findings. In the meanwhile, however, being aware of these tendencies might help donor countries to actively resist them, to the extent that they produce undesirable outcomes.

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## Notes

<sup>1</sup>Another current case that has attracted substantial attention from foreign governments and donors is the opening up of Burma. Canada, EU and Denmark, among others, have announced increased aid and easing of sanctions during the last year, Parks (2012).

<sup>2</sup>Based on this finding, Frot and Perrotta (2010) use time of entry as an instrument to re-evaluate the impact of aid on economic growth. They find a more robust positive effect than is usually found using alternative instruments.

<sup>3</sup>These perspectives do of course not just cover foreign aid policy, but foreign policy generally (Waltz, 2000).

<sup>4</sup>Egypt turned down a 3 USD billion credit from the IMF in 2011 in anticipation of equally generous loans but with less strings attached from Saudi Arabia and the Emirates.

<sup>5</sup>The agenda has also been expanded on in the subsequent high-level meetings in Accra and Busan.

<sup>6</sup>A full list of countries in respective groups is provided in the online appendix.

<sup>7</sup>In this paper we do not analyze differences in behavior across different donors but instead focus on aggregate aid flows. Exploring such differences would be an interesting avenue for future research. It should be emphasized, though, that aid policy of individual donors depends to a large extent on what other donors do. Frot and Santiso (2011) find support for herding behavior among donors even when carefully controlling for external sources of aid correlation, such as natural disasters, debt relief programs etc. On the other hand, recent policies to mitigate aid fractionalisation, such as the EC 2007 Code of Conduct, should cause aid flows across donors to be negatively correlated. Analyzing individual donors' behavior must thus still take the actions of other donors into consideration, suggesting that aid cannot so easily be analyzed donor by donor.

<sup>8</sup>Data from EM-DAT: The OFDA/CRED International Disaster Database, [www.emdat.be](http://www.emdat.be), Université Catholique de Louvain, Brussels, Belgium.

<sup>9</sup>Just looking at exports over GDP, as is done in some papers, leads to similar results. Ideally we would have liked to include also investments from the donors, but such data is very spotty in the early period.

<sup>10</sup>A section including the formal comparison of the two estimators together with a replication of Table 1 using the log of aid and the OLS estimator is available in the online appendix. The results are very similar. If anything, our key results come out slightly stronger in the linear model.

<sup>11</sup>We cannot rule out that country-specific and time-invariant factors influence aid flows, so our specification reflects the common trade off between precision and consistency. Given that there is substantially more variation between than within countries, and that our theoretical arguments focus on variation across countries, we refrain from using a recipient country fixed effects specification. However we cluster the standard errors at the recipient level whenever applicable in order to take into account the correlation between observations of the same recipient over time.

<sup>12</sup>See the on-line appendix.

<sup>13</sup>Results are not shown here. The complete table is reported in the online appendix.

<sup>14</sup>Data on aid to the following CEEC/NIS countries in transition, first collected for 1990 flows, were recorded only until and including 2004: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Slovak Republic, Slovenia. Our results do not change excluding the years 2005-2007. Results are available upon request.

<sup>15</sup>Results available in the online appendix.

<sup>16</sup>All the results summarized in this section are available in the online appendix

<sup>17</sup>Donors' aid budgets, and aid volumes from a typical donor to a typical recipient, are fairly persistent. Hence it might be difficult to meet the *importance* criterion on a short time horizon. However, the data reveal that total aid received by these new recipients in the initial time period are not dramatically lower compared to the disbursements towards other recipients at the same time - the mean levels are respectively 131.04 versus 176.23 USD millions. This implies more numerous smaller donors, for a similar level of total aid receipt, which is precisely where all the problems with fragmentation arise.

<sup>18</sup>Results available in the online appendix.

<sup>19</sup>20% is actually quite a big share, even compared with current levels of program aid. However, since these data

are based on (voluntary) reports from donor administrations, the smaller the sample, the stronger the concern about selection. It might well be that only the "best" donors take the trouble to report, and they are the ones that also have better quality of aid in other respects.