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# Donor Transparency and Aid Allocation

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## Abstract

In recent years, the transparency of foreign aid has received substantial attention among aid practitioners. This analysis shows the impact of political transparency in donor countries on those countries' formal promotion of aid transparency and on their concrete aid allocation patterns. Political transparency as measured by standard corruption indices not only impacts on the engagement of bilateral donors in the International Aid Transparency Initiative. Differences in political transparency in donor countries also explain a large part of their varying aid selectivity patterns. Donors with higher levels of political transparency allocate aid more according to recipients' neediness and institutional performance.



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## Abbreviations

CDI	Commitment to Development Index
CPI	Corruption Perception Index
CPIA	Country Policy and Institutional Assessment (World Bank)
GDP	Gross Domestic Product
IATI	International Aid Transparency Initiative
IMF	International Monetary Fund
NGO	Non-Governmental Organization
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
PCA	Principal Component Analysis
TSCS	Time-Series Cross-Section
UK	United Kingdom
UN	United Nations
US	United States



## 1. Introduction

In the ongoing debate on foreign aid's effects on development, many scholars have argued that aid is more effective in countries with "good" political institutions (Svensson 1999; Burnside / Dollar 2000, 2004; Chong / Gradstein 2008).<sup>1</sup> Aid should thus be allocated primarily to needy countries with a relatively sound institutional environment (Collier / Dollar 2002; Dollar / Levin 2006). Accordingly, limited aid effectiveness in the past can be attributed at least partly to donor organization's aid allocation patterns, which have not been sufficiently geared to development goals. In line with this argument, a huge body of empirical studies has found evidence of specific economic and political interests of donor governments distorting the development orientation of aid allocation in the past.<sup>2</sup>

Given these insights and ongoing commitments to make foreign aid more effective, non-governmental organization (NGOs) have been increasingly demanding more transparent aid processes to make the providers of foreign aid accountable to their actions and to reduce the manoeuvring space for special interest politics in this field of international cooperation. Moreover, several bi- and multilateral donors have founded the International Aid Transparency Initiative (IATI) in 2008, which aims at promoting aid transparency at all steps of the aid-delivery chain.

Against this background, this analysis suggests that political transparency in donor countries strongly impacts on both, donor countries formal engagement in the IATI process and their aid allocation patterns. It is shown that political transparency has not only significantly influenced bilateral donors' engagement in the IATI. Moreover, more politically transparent donor countries are also more likely to allocate aid resources according to recipient's neediness and institutional performance. These empirical findings support the notion that neither increasing aid transparency nor improving aid allocation can be understood as technical aspects of foreign policy-making but are deeply rooted in the domestic institutional context of donor countries. Accordingly, the contribution of this analysis can be related to three fields of enquiry. Firstly, it is related to the study of foreign analysis as a function of domestic politics. Secondly, it is related to research investigating the impact of political transparency on policy outcomes. Thirdly, this study provides additional evidence on the important linkage between aid effectiveness and "good" governance.

Conceptually, the analysis relates to principal-agent theories, which have gained prominence in the study of the complex system of aid delivery.<sup>3</sup> Democratic donor governments are perceived as rational agents that spend public resources and are supposed to be accountable to their citizenry respectively to their parliaments – their principals. However, like areas of domestic social policy, the field of foreign aid is plagued by special interest groups. For instance, aid allocation can be diverted to satisfy bureaucratic interests of large aid administrations wanting to maintain a variety of client countries and projects. Aid allocation can also be used to promote the interests of specific economic sectors or to

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1 For the controversy over the relationship between foreign aid and economic growth see, for example, Burnside / Dollar (2000), Easterly (2003), Roodman (2007), Arndt / Jones / Tarp (2009).

2 Especially Alesina / Dollar (2000) and Alesina / Weder (2002) have initiated the more recent research on the political economy of bilateral and multilateral aid allocation.

3 For the study of principal agent problems in development cooperation see Martens et al. (2002), Gibson et al. (2006), Easterly (2006), and Milner (2006).

gratify politically allied governments in the developing world. If such non-development-oriented motives for foreign aid gain ground, the development-oriented selectivity of aid resources will decrease. Given this framework, it is argued that the responsiveness of donor governments to special interest groups tends to increase with decreasing levels of political transparency. Consequently, the level of political transparency in a donor country should impact on both, the formal engagement to make aid more transparent and the way aid is allocated among developing countries.

The next section provides a brief review of the literature on the link between aid allocation and aid effectiveness (2.1) and the political economy of aid allocation (2.2). The analysis then proceeds by describing the current debate on aid transparency and by deducing the hypothesis regarding the impact of donor's political transparency on their engagement in the IATI and on their aid allocation patterns (2.3). Section 3 provides more systematic support for these hypotheses by comparing 29 Western donor countries with simple econometric means. The last section (4) presents a summary of major findings and their practical implications.

## 2. Conceptual considerations

### 2.1. Why allocate aid selectively?

Foreign aid is meant primarily to promote economic development in poor countries. However, owing to the lack of robust evidence, there is an ongoing debate about the effects of aid on economic growth or poverty reduction.<sup>4</sup> The difficulty of making foreign aid effective has increasingly been modelled by relying on principal agent frameworks. Such a perspective points to two major problems, the first being the main argument for allocating aid selectively according to recipient countries' neediness and institutional performance.

Donor governments provide recipient governments with financial or technical resources, which are to be used wisely to promote economic development. Donors thus act as principals, who pass resources to an agent, who is meant to use them for a jointly defined goal – the country's economic development. Unfortunately, recipient governments may pursue goals other than improving the collective welfare of their society. In this regard, whether the recipient government has a strong interest in aid resources for economic development very much depends on the institutional setting. Recipient governments that are embedded in an institutional environment characterised by democratic inclusiveness and low levels of corruption will have a strong domestic incentive to promote inclusive development.<sup>5</sup>

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4 On this debate see for example, Easterly (2002), Roodman (2007), Rajan / Subramanian (2008), Arndt / Jones / Tarp (2009) and Chong / Gradstein (2008). Partly the heterogeneity of the results is due to different approaches in dealing with such issues as endogeneity, the selection of proper instruments and time lags to capture the potential effect of aid on indicators of economic development.

5 For the impact of political institutions on economic development see Keefer/Knack (1997), Hall / Jones (1999), Acemoglu / Johnson / Robinson (2002). An increasing number of studies also find that higher levels of democracy promote development-related indicators, such as education, health systems, and poverty reduction (Lake / Baum 2001; Blaydes / Kayser s. a.).

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Donor agencies have been aware of this challenge and have attempted to reduce the principal agent problem by imposing conditionality and stepping up their monitoring efforts. However, such measures are said to be of limited success because of the fungibility of aid, the remaining information asymmetries between donors and recipient governments and the collective action problems donors have in making their conditionality credible. Since the late 1990s the effectiveness of foreign aid has therefore been increasingly perceived as conditional on the recipient country's institutional environment (Svensson 1999; Burnside / Dollar 2000, 2004).<sup>6</sup> Where recipient governments are faced with political institutions that set incentives for development, the principal agent problem referred to above becomes less intense, since developmental interests of donors and recipients will converge.

Inherent in targeting aid solely by reference to the institutional performance of potential recipients is, however, the problem of structurally disadvantaging the neediest countries. If it focuses primarily on institutional or policy performance, aid allocation will be biased in favour of middle-income countries. Foreign aid should therefore go to poor countries with relatively good institutional performance. Bueno de Mesquita and Smith (2007, 281) claim, for instance, that “*aid to poor democracies around the world would likewise generate effective development*” because the political institutions in such countries would drive politicians towards the provision of public goods instead of providing rents for powerful interest groups. Since the publication of the 1998 World Bank report entitled “*Assessing Aid*”, this basic allocation rule has gained broad acceptance by policy-makers. If it is to increase aid effectiveness, selective allocation must take two major components into account: the neediness and the institutional performance of potential recipients (World Bank 1998; Collier / Dollar 2002; Dollar / Levin 2006; Faust / Messner 2007, 22–23). As Knack / Rogers / Eubank (2010, 6) put it:

*“Aid is widely believed to have greater development impact where it is needed most – that is, where there are large numbers of poor people – and where the policy and institutional environment is favorable to growth and development.”*

Interestingly, this consensus in the aid-related research community fits nicely with the preference structure of the public in rich countries. Although there are no strictly comparative polls of the citizens of many donor countries on this question, existing surveys suggest that citizens prefer aid allocation to be development-oriented. In general, the public in rich countries wants aid to go to needy countries whose governments use it well (Lumsdaine 1993, 43). For instance, almost three quarters of respondents in the European Union stated in a 2004 survey that aid targeted at poverty reduction should be related to recipient countries' efforts to deepen democracy (Eurobarometer 2005, 44). A 2001 poll on United States (US) citizens' attitudes to foreign aid identified serious concern among respondents that corrupt governments in recipient countries could undermine the developmental efforts associated with aid flows (PIPA 2001, 13). From the same study it is evident that respondents are far more supportive where aid is targeted at poverty reduction and the promotion of economic development rather than the donor country's strategic security or trade goals (PIPA 2001). Overall, while there is strong support among Organisation for Economic Co-

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6 Although the robustness of these results has been challenged (Roodman 2007), there is nevertheless a broad consensus that an improved institutional environment is at least necessary – but probably not sufficient on its own – if aid is to be allocated more effectively.

operation and Development (OECD) citizens for aid to poor countries, public opinion is also very sensitive to the wasteful use of aid and related corruption. Consequently, the existing consensus among aid experts and citizens of donor countries gives technical and political legitimacy to the allocation of aid according to recipient countries' neediness and institutional performance.

## 2.2. How has aid been allocated?

How have donor countries performed in terms of the selectivity argument presented here? Many empirical studies on individual donor countries or multilateral institutions have shown that aid allocations were at least not exclusively determined by the neediness and institutional performance of recipient countries. One influential study (Alesina / Dollar 2000) revealed that from 1970 to the mid-1990s more democratic countries received more aid, while poorer developing countries were disadvantaged by overall aid allocations. Moreover, donor governments' political and strategic considerations outweighed the effect of recipient countries' policies or political institutions (Alesina / Dollar 2000, 40). Another influential study, covering a similar period showed that countries with comparatively low levels of corruption were not systematically favoured over others (Alesina / Weder 2002).

Similar sobering results were found when individual bilateral donors or multilateral agencies were considered. Not very surprisingly, colonial powers have often favoured their former colonies when allocating aid resources (Alesina / Dollar 2000; Zanger 2000). Allies of the US have been systematically profited from the allocation of this country's humanitarian aid (Drury / Olson / Van Belle 2005), and there were positive link between US arms exports to a country and the likelihood of its benefiting from debt relief (Neumayer 2002). The International Monetary Fund (IMF) was influenced by US foreign policy interests during the heyday of structural adjustment lending in the 1980s and early 1990s.<sup>7</sup> Empirical evidence also shows that the number of conditions attached to IMF loans has been lower for closer allies of the US and other G-7 countries, especially before elections (Dreher / Jensen 2007). Studies of World Bank lending reach similar conclusions (Andersen / Hansen / Markussen 2006; Fleck / Kilby 2006).

While these analyses detect divergence from the allocation principles discussed in the previous section and recognise the impact of political interests on aid allocation, a more recent study has identified a trend towards greater selectivity, especially in multilateral assistance (Dollar / Levin 2006).<sup>8</sup> Bilateral donors have also attached greater importance to development-oriented aid allocation in the last 15 years (Claessens / Cassimon / Van Campenhout 2009), a development that can be associated with the end of the Cold War and growing pressure to increase the effectiveness of foreign aid.

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7 In particular, it was found that voting in the United Nations (UN) in tune with US interests could increase a country's chances of receiving a loan from the IMF (Thacker 1999, 67).

8 Today the World Bank and regional development banks often use formulas which define the leeway for resource allocation across countries. These allocation formulas attach considerable importance to indicators of institutional performance and neediness. Allocation could nonetheless be improved if greater emphasis was placed on different aid instruments, such as project or programme aid, according to the political context in recipient countries (Winters 2010a).

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Yet donor countries behave far from uniformly and do not respond to changing context variables in the same way. The literature has constantly revealed significant variations in donors' allocation patterns (Zanger 2000; Alesina / Weder 2002; Claessens / Cassimon / Van Campenhout 2009). Scandinavian countries, for instance, have traditionally attached more importance to democracy and respect for human rights in recipient countries than other bilateral donors (cf. Gates / Hoeffler 2004). Measures of aid selectivity thus detect substantial variance of allocation patterns among aid agencies? (Roodman 2009; Dollar / Levin 2006; Knack / Rogers / Eubank 2010).

### 2.3. Donor transparency and the heterogeneity of allocation patterns?

How can this variance among donors be explained? Assuming that all donor governments have at least some special economic or political interests that they try to safeguard by focusing aid on allies and other important recipients, why are allocation patterns still different? The hypotheses proposed here are that different degrees of political transparency in donor countries affect aid allocation patterns as well as those governments' formal engagement in increasing aid transparency.

These hypotheses are closely related to the second principal agent problem in the aid delivery channel. Here ministries and donor agencies responsible for distributing aid are not only perceived as principals vis-à-vis aid-receiving governments but also as agents, who promise their own citizens and the recipients that they will mainly pursue development-oriented goals with their aid instruments.

Unfortunately, the executive bodies responsible for delivering foreign aid also pursue special interests. In his critical essay, William Easterly (2002) has described the international aid system as a "cartel of good intentions", where aid agencies are at best held partly accountable for their behaviour and have considerable room for manoeuvre to pursue their own interests. Similarly, more detailed analysis of donor agencies or systems of aid delivery produced evidence of the impact of special interests on foreign aid (e.g. Gibson et al. 2006). In an earlier study, James Putzel (1998) criticised the lack of transparency of the European Commission's foreign assistance, which reduced accountability to European citizens in favour of an inefficient network of bureaucracy, aid agencies and consultancy firms.

These criticism indicate, implicitly at least, the importance of donor transparency in the aid effectiveness debate. If transparency is poor, the impact of special interests easily leads to the diversion of aid from developmental objectives. Aid agencies often prefer to diversify widely rather than focus on a limited number of partner countries. When it comes to partner countries, ministers and top aid managers often have their own personal preferences, which may be shaped by their personal experience or the influence of important lobby groups. Moreover, most of the literature on aid allocation shows how the impact of foreign policy interests unconnected with developmental priorities has diverted aid, despite official promises and citizens' preferences for aid to be allocated primarily according to the neediness and institutional performance of potential recipients.

Partly as a result of such enquiries, the question of how to make aid agencies and related actors more accountable to their own constituencies as well as to recipient countries or their civil societies is among the most prominent issues on the current agenda for the re-

form of the international aid system.<sup>9</sup> Increasingly, NGOs have been pointing to the lack of transparency in the delivery of foreign aid, calling for greater transparency in development assistance and attempting to improve the availability of data on aid projects. *Access-Info*, a major NGO that emphasises the need for the general transparency of government information, has, for example, made “aid transparency” a special focus of its work. Calling for greater transparency in foreign aid to ensure its domestic legitimacy, a recent report (*AccessInfo* 2009) compared five bilateral donor countries and – differences notwithstanding – pointed to an overall lack of transparency.<sup>10</sup> An even more systematic attempt was provided by *Publish What You Fund*. This NGO published its first Aid Transparency Assessment in 2010, which attempts to build different indicators for measuring the transparency of bi- and multilateral donors.

Other NGOs have drawn attention to particular deficiencies regarding the transparency of foreign aid. A 2010 EuroDad report on the governance structures of several bilateral donor countries frequently mentions transparency and accountability problems. As regards the USA, the report notes the active involvement of Congress in foreign aid, but criticises institutional fragmentation and unclear strategic objectives as sources of poor transparency of information intended for the public. A 2010 report by Oxfam America explicitly welcomes the passages in recent US legislative initiatives that promise to improve transparency for recipients and the US public (Oxfam 2010, 11). In the case of Germany, the EuroDad report urges the Ministry for Economic Cooperation and Development to improve transparency for both domestic and international actors. In contrast, the same report applauds Dutch policy-makers and parliamentarians for their awareness and attempts to ensure the proper communication of the risks and potentials inherent in foreign aid to the public (EuroDad / Reality of Aid 2010, 14–15).

Beyond this increasing engagement of non-state actors, several donor governments and multilateral agencies have also engaged in promoting aid transparency. The most important of those attempts is the IATI founded in 2008, which aims at improving transparency of aid activities so that aid agencies may become more accountable to their own constituencies and to recipient of foreign aid. Membership of donor countries in IATI as well as the funding of the initiative and the participation in its different technical working groups is voluntary.<sup>11</sup>

However, these calls for making foreign aid procedures more transparent do not empirically sustain the argument that aid allocation patterns are affected by the level of political transparency in the respective donor country. Analysis of public opinion has at produced initial evidence that could indicate such linkages. For instance, in the case of France and the US, econometric evidence has shown that the differences in newspaper coverage of

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9 In this regard, “mutual accountability” has become one of the five core principles of the 2005 “Paris Declaration on Aid Effectiveness”, the first declaration by donor and recipient governments to mention existing problems in the aid delivery channel.

10 The report examined the bilateral aid systems of Canada, France, Norway, Spain and the United Kingdom (UK), focusing on the availability of information in several areas, namely organizational structure, overall strategy, aid budget, narrative and financial reporting on the previous year. In addition, the organization developed a manual that shows the public how to proceed if they want government information on foreign assistance.

11 Information on donor’s participation in initiative is provided by IATI’s secretariat ([www.aidtransparency.org](http://www.aidtransparency.org)).



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developing countries had an effect on aid allocation (Van Belle / Hook 2000; Rioux / Van Belle (2005)).<sup>12</sup> Transparent information on aid flows may therefore lead decision-makers to back development-oriented aid allocation, assuming that they fear a critical response from watchdog NGOs, the press or parliament to evidence of aid allocations to dictatorships, corrupt regimes or less needy developing countries. Instead, an intransparent environment would enable foreign aid bureaucracies to renege on their promise to allocate aid primarily in a development-friendly way.

Beyond this research on public opinion, the assumption that “*foreign aid in the context of accountable institutions is better aid*” (Winters 2010b, 39) has gained some empirical support with regard to the overall quality and quantity of external development promotion. Accordingly, higher levels of democratic accountability and lower levels of bureaucratic inefficiency and corruption lead to improved overall development promotion, higher levels of foreign aid and increased cooperation with less corrupt recipient countries (Chong / Gradstein 2008; Faust 2008; Schudel 2008). This evidence suggests that the institutional performance of donor countries has an impact on foreign aid. Yet, no systematic evidence has been provided on the potential linkages between political transparency on the one hand and the formal engagement in aid transparency initiatives and multidimensional aid allocation patterns on the other hand.

Anecdotic evidence derived from the analysis of individual donor systems points to the existence of a link between political transparency and aid allocation patterns. Parliamentarians in Germany, for example, have complained about having access to too little information on country-level experience that might inform their debates on aid allocation (EuroDad 2010, 13). Country-specific evidence of the possible link between transparency and aid allocation can also be gleaned from the peer review reports on donor systems prepared by the OECD’s Development Cooperation Directorate (DCD-DAC). These official country-specific reports, which assess the quality of specific bilateral aid systems every three to four years, also contain information on aid transparency.

Interestingly, in OECD donor countries known for having lower degrees of overall political transparency specific aid transparency issues are frequently mentioned as crucial challenges if the overall quality of their aid systems is to be improved. In the case of the Italian aid system, for instance, a number of reports have pointed to transparency problems: some have criticised the lack of standardised statistical documentation, the failure to communicate aid policies properly to the public, the lack of transparency of the aid allocation process, budget procedures and links between Italian foreign direct investment and development cooperation (OECD 2004, 2009a). Similar transparency problems are underlined in the 2006 assessment of the Greek foreign aid system (OECD 2006). The 2002 report had already highlighted the need for the Greek parliament, NGOs and the wider public to be better informed about the procedures and impact of Greek foreign aid allocation (OECD 2002). The 1999 peer review of Japan’s aid efforts criticised the failure to make Official development assistance-(ODA) related information, such as country analysis studies and project and evaluation reports, available to the public (OECD 1999). While the subsequent 2003 report acknowledged the Japanese government’s efforts to put transparency issues on its reform agenda, it nevertheless pointed to continuing weaknesses, such as the public’s

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12 Even the proportion of multilateral aid given by donor countries is said to be at least partly influenced by public opinion (Milner 2006).

growing aid fatigue, due partly to a lack of transparency and deficiencies in the publicising of contract information owing to business confidentiality rules (OECD 2003, 19, 23).

In contrast, reports on OECD members, which are generally considered as having high levels of political transparency, generally arrive at far more positive assessments of aid transparency. Either transparency issues are not referred to as major challenges to their aid systems, or they are mentioned with a positive undertone. The 2009 report on Sweden, for instance, mentions that the country has been a front-runner in promoting a strategy of transparent communication of its development assistance activities to the public (OECD 2009b). The 2008 report mentions Norway's active role in international corruption prevention fora and its engagement in making international aid more transparent and accountable (OECD 2008). The different degrees of transparency-related challenges frequently encountered in OECD peer review reports thus seem to be linked to the varying overall levels of political transparency in donor countries. This link is plausible, given that aid agencies are deeply embedded in a donor country's political system. In the 2007 OECD report on Finland this assumption is made explicit, complex procedures aimed at guaranteeing transparency and accountability in Finnish aid allocation being linked to the generally high level of political transparency in the country.

Altogether, this initial evidence supports the hypotheses presented. Lower levels of political transparency in donor countries should not only make those countries' governments less receptive for engaging in international initiatives supporting aid transparency. It also is plausible to assume that the degree of political transparency of donor countries impacts on their aid allocation patterns. Thus, the extent to which the aid allocation of a given donor country responds to the neediness and institutional performance of potential recipients should be at least partly the result of the donor country's degree of political transparency.

### **3. Evidence from cross-country comparisons**

#### **3.1. Political transparency and donor governments' engagement in the IATI**

Since the IATI is the most prominent official initiative for aid transparency, the varying degree of donor governments' engagement should be driven by their respective levels of political transparency. For measuring the variance of the dependent variable we use a proxy indicator from the 2010 aid transparency assessment of Publish What You Fund. Based on the information provided by IATI's secretariat, the assessment presents an index, ranging from 0 to 1, higher values indicating stronger engagement in IATI. The index is built on three types of information, namely whether a donor country is a signatory of the Initiative, whether it has provided financial resources to the organization and whether it has been actively participating in the initiative's working groups. The index reveals huge differences between bilateral donor governments. For instance, while some donor countries such as Portugal, Japan or Belgium have not participated in the Initiative at all (value of 0), others such as the Netherlands or the UK have shown strong engagement in all the dimensions of the index (value of 1).

To measure the *political transparency* of a donor country, two alternative proxy variables are used; namely the average of the 2008, 2009 and 2010 values of Transparency International's Corruption Perception Index (CPI-transparency). As an alternative measure, the

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corresponding values of the Control of Corruption Indicator derived from the World Bank Governance Indicators are used, where countries are ranked on a scale from -2.5 to 2.5.<sup>13</sup> These measures of corruption provide good proxies for political transparency, because all parties involved in a “corrupt transaction” have a strong interest in keeping it secret. Thus, even if these variables do not measure political transparency in a direct and purely objective manner, they are still good proxy variables for the purpose of this analysis and reveal major differences among donor countries.<sup>14</sup> For instance, on a scale of 1 to 10, the average CPI-TRANSP value for Greece or Italy are relatively low (4.0, respectively 4.33) while countries such as Denmark or Sweden receive substantially higher values (9.3 respectively 9.23).<sup>15</sup>

Table 1 provides the results of simple regression analysis, where the IATI engagement is the dependent variable and the sample consists of 29 bilateral donor countries, mostly OECD member states.<sup>16</sup> Consistent with the hypothesis, when using the transparency index as the only independent variable, it is highly significant and positively related to the IATI engagement (Model 1).

In model 2, three additional independent variables are added to control the robustness of this result. The first control variable is the per capita income of the respective donor countries to capture differences in economic development. As can be seen, this variable has a negative sign but is far from being statistically significant. The second control variable measures the amount of bilateral ODA given by the respective donor. The reason for including this variable is that one can plausibly assume that larger donors get more attention by critical NGOs and by recipient governments and might feel more obliged to demonstrate engagement in an initiative promoting aid transparency. The positive and highly significant coefficient of this variable supports this argument. Finally, model 2 also includes

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13 Both variables attempt to measure the level of public-sector corruption. They are based on a large number of primary sources and cover a large number of countries. For their methodological composition see Kaufman / Kraay / Vreeland (2009) and Transparency International (2009).

14 Still, both indices are sometimes criticized for producing point estimates based on different sources, with the associated standard errors (Landmann / Häusermann 2003, 30). However, this potential shortcoming is of minor importance in a sample of advanced industrial countries. Then, not only are the indices based on broader and more reliable information, but the average standard errors are also substantially smaller than in a sample of developing countries.

15 These indices aside, several recent attempts have tried to measure (fiscal) transparency in a more direct or objective manner. However, most are ill-suited to the purpose of this analysis. In some cases, more objective proxy variables of transparency (e.g. Hollyer / Rosendorff / Vreeland 2010) do not properly capture the differences among industrialized donor countries. Other recent attempts to measure corruption or political transparency, such as the global integrity index and the open budget initiative, do not cover enough donor countries for a multivariate statistical analysis. One of the most recent and sophisticated attempts to measure fiscal transparency, which is based on information from IMF reports (Andreula / Chong / Guillén 2009), reveals a close correlation between fiscal transparency and corruption indices, indicating that the corruption indices described above are indeed a useful proxy for measuring transparency. Although it covers over 80 countries, this fiscal transparency index is available for only one point in time and covers only 17 of the 29 donor countries for which data on aid allocation are available.

16 The analysis is based on Tobit estimations because the dependent variable is censored at a minimum (0) and at a maximum (1) and more the half of the observations reach either minimum or maximum values.

<b>Table 1: Bilateral donor engagement in the IATI</b>			
Tobit estimations	Model (1)	Model (2)	Model (3)
CPI-transparency	0.352*** (4.15)	0.412*** (2.86)	
WGI Control of Corruption			1.044*** (3.05)
GDP per capita (log)		-0.467 (-1.08)	-0.50 (-1.26)
Bilateral ODA (log)		.282*** (2.87)	.316*** (3.10)
Trade with developing world		-4.06 (1.12)	-3.73 (-1.14)
Constant	-2.504*** (-3.52)	-4.075*** (-3.13)	-3.837*** (-2.79)
Observations	29	29	29
<i>Pseudo R</i> <sup>2</sup>	0.28***	0.47***	0.50***
<i>Coefficients with t statistics in parentheses; *p &lt; 0.10, **p &lt; 0.05, *** p &lt; 0.01; based on Tobit estimations with robust standard errors.</i>			
Sample: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea (South), Luxembourg, Netherlands, New Zealand, Norway, Poland, Portugal, Slovakia, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.			

a variable of a donor country's economic linkages with the developing world, here measured as the share of foreign trade, which is realized with developing countries. Here one could expect that an increasing share corresponds to an increase of economic interests in the developing world, which in turn might reduce a donor government's interest in making its aid relations more transparent. While the coefficient of this variable has the expected negative sign, it does not reach conventional levels of statistical significance. Most importantly, however, the proxy variable for political transparency remains influential in size and statistical significance despite of the above-mentioned controls. The results also remain unchanged in model 3, where the variable from Transparency International is substituted by the World Bank indicator on Corruption Control. Thus, one can conclude that the level of political transparency in a donor countries has had a substantial impact on its government's formal engagement in the IATI.

### 3.2. Political transparency and aid selectivity patterns

For testing the second hypothesis about political transparency's impact on a donor country's aid allocation pattern, two common indicators are used for measuring aid allocation according to recipients' neediness and institutional performance.

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One prominent selectivity measure (CDI-SELECT) is a subcomponent of the Commitment to Development Index (CDI), which ranks bilateral donor countries according to their overall engagement in external development promotion (Roodman 2009). The CDI selectivity measure weights the ODA of each donor by multiplying each donor-recipient pair by two selectivity weights. These weights “reflect the recipient’s appropriateness for aid, the idea being that the poorer and better-governed it is, the more appropriate it is for aid” (Roodman 2009, 8). Gross Domestic Product (GDP) per capita (log) is used as a weight for a country’s overall neediness, while the weight for the recipient’s overall institutional performance is the composite value of the World Bank governance indicators.<sup>17</sup> Both neediness and institutional performance are weighted equally. The selectivity index is scaled between zero and one, higher values meaning a stronger orientation towards neediness and institutional performance. For conceptual reasons, two types of aid are (partly) excluded from the weighting. First, emergency aid is not weighted regardless of whether a country is rich or poor. Second, aid intended to promote sound and participatory political institutions is weighted by only 50 per cent because donors are not to be penalised by the index for attempting to promote “good” governance in countries with weak institutions (Roodman 2009).

A second selectivity measure (DL-SELECT) was introduced by Dollar / Levin (2006) and employs a regression-based approach to measuring a donor’s allocation pattern. Here, ODA disbursements by individual donors to recipients – again excluding humanitarian aid – are regressed with three independent variables: the recipient’s institutional performance as measured by the World Bank’s Country Policy and Institutional Assessment (CPIA), GDP per capita and population (log).<sup>18</sup> The selectivity regression is run separately for each donor. In the regressions institutional selectivity is measured by the partial regression coefficient of the CPIA, while poverty selectivity is measured by the partial coefficient of GDP per capita. The latter variable is multiplied by -1 so that allocation to poorer countries is rewarded. After the coefficients have been z-transformed, the overall selectivity index is the simple average of both (Knack / Rogers / Eubank 2010, 7).

These two original selectivity measures are aggregated to the main dependent variable via principal component analysis. As has been shown, both selectivity indices are based on the same conceptual ground. They reward aid allocation patterns that are oriented towards a country’s neediness and institutional performance. However, the two measures use some different indicators and aggregation methods. Consequently, they do not fully overlap, but are still strongly correlated. The correlation coefficient of the average of both measures for 29 bilateral donors in the period 1998-2008 is 0.66. Given this overlap, the main dependent variable (PCA-SELECT) is constructed via principal component analysis, which cor-

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17 These indicators are: democratic voice and accountability, political instability and violence, rule of law, bureaucratic regulation, government effectiveness and corruption (Kaufmann / Kraay / Mastruzzi 2009).

18 The CPIA consists of 16 indicators and is a comprehensive World Bank account of recipient countries’ institutions and economic policies. Population is included in the regression to account for the small-country bias in aid allocation. When the DL-SELECT variable is computed, the equation for each donor takes the following form:

$\text{Log}(\text{aid}_{ij}) = b_0 + b_1 \text{Log}(\text{population}_j) + b_2 \text{Log}(\text{per capita GDP}_j) + b_3 \text{Log}(\text{CPIA})$ , where  $i$  indexes donors and  $j$  indexes aid recipient countries.

rects for measurement errors and captures the empirical evidence behind the theoretical idea of both original selectivity measures.<sup>19</sup>

As the analysis employs OLS cross-section analysis as estimation technique, averages of the dependent and independent variables were constructed. In the case of the independent variables, averages for the period 1997-2008 were taken for CDI-SELECT, since the average of the dependent variable is from the period 1998-2008, a one-year time lag thus being allowed. In the case of DL-SELECT, data were available for the period 1999–2007, and averages of the independent variables were constructed accordingly. The period under consideration is appropriate for testing the proposed hypothesis, because most data on the dependent and independent variables in this period are available for a large number (29) of donor countries, thus increasing the variance between countries. Donors also include countries that have only recently become providers of development assistance, such as South Korea, Poland and even Turkey.<sup>20</sup> Moreover, this period is a plausible time span for testing the hypothesis, because aid selectivity has attracted a particularly high level of interest among policy-makers since the second half of the 1990s.

Given the rise of time-series cross-section analysis (TSCS) and the intense debate on its potential benefits and pitfalls in the last few decades, the choice of simple OLS cross-section analysis merits some further clarification.

The main reason for using OLS cross-section analysis is the “stickiness” of most variables. Most importantly, the measures of transparency are almost time-invariant, the correlation coefficient for the 1998 and 2007 values being higher than 0.9. Time invariance of such governance variables as corruption and democracy can be observed especially in samples that include a large percentage of highly developed OECD countries, where major political transformations were not as common as in most of the developing countries. Nor is PCA-SELECT, the dependent variable highly time-variant, the correlation coefficient for the earliest and latest values being 0.65. Similarly, some control variables, such as aid as a percentage of GDP also demonstrate low variance over time, and others – such as former colonial power status – do not change at all. Because many important variables are either sticky or do not change at all, the use of TSCS controlling for potential omitted variable bias becomes problematic because the use of country-fixed effects absorbs most of the variance in the time series.<sup>21</sup> The application of “simple” OLS cross-section analysis can thus be regarded as following the rule of using the simplest statistical method consistent with the characteristics of the data and the underlying theory (Schrodt 2010, 10).<sup>22</sup>

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19 In principal component analysis (PCA) a set of variables (here CDI-SELECT and DL-SELECT) is reduced to one or more underlying dimensions to enable the pattern of inter-correlations among variables to be identified. Here, PCA-SELECT is the residual of a principal component analysis among CDI-SELECT and DL-SELECT. As expected, the variable is highly correlated with the other two selectivity measures ( $r = 0.91$ ),

20 The CDI-SELECT variable taken from Roodman (2009) was available for the period 1998–2008, while the data for the DL-SELECT taken from Knack et al. 2010 were available only for the period 1999–2007. As a consequence, averages of the control variables were adopted accordingly.

21 For potential problems associated with unit fixed effects see Beck (2001); Plümper / Tröger / Manow (2005).

22 The controversy over OLS cross-sectional regressions and the use (and abuse) of TSCS often concerns structural differences between countries, which make it difficult to assume parameter homogeneity when highly volatile variables are used. The standard solution to the problem of potential omitted variable bias is to use pooled datasets, where fixed country effects control for unobserved country characte-

## Donor transparency and aid allocation

While the above-mentioned argument legitimises the use of cross-section analysis, another potential problem consists in the relatively small number of observations (cases), which limits the degrees of freedom to include many potential control variables that may also have impacted on the selectivity measures. However, the usual inclusion of many – often highly/closely correlated – control variables has also provoked criticism of current cross-country analysis, leading some scholars to propose the inclusion of only a very limited number of control variables (Achen 2002).

To cope with these challenges, this analysis proceeds in a traditional manner. It begins with a bivariate regression, then tests for alternative explanations, including only one additional – theoretically plausible – control variable. Hereafter, a reasonably augmented model is identified, which captures most of the dependent's variable variance. Accordingly, Figures 1 to 3 show the scatter plots for a bivariate regression, using different selectivity variables and the CPI-transparency variable.

The figures 1 to 3 in table 2 support the hypothesis. The measure for transparency explains more than 50 per cent of the variance among donors with regard to the two original selectivity variables. The composite variable CPA-SELECT has even greater explanatory power. As the concept of selectivity based on neediness and institutional performance is best captured by CPA-SELECT, the latter finding even lends further support to the formulated hypothesis. An inspection of the scatter plots also suggests that the results are not driven by influential cases or outliers.

Do these results hold up when measures for other potential explanatory factors are included in the equation? Table 1 presents a number of models, one control variable having been added and the CPA-SELECT being the dependent variable. These control variables can be clustered in different categories.

The first category refers to potential domestic economic and political explanations. One additional control variable here is GDP/capita (log). It captures the level of a donor country's economic development and also broadly distinguishes between traditional donors and countries which have become ODA providers only in the last decade. Countries with lower levels of GDP may be less inclined to allocate aid according to development goals or may not yet have established a critical amount of bureaucratic expertise in this field. Accordingly, a positive effect of GDP per capita on CPA-SELECT may be expected. A second variable tests whether the number of veto-players (Tsebelis 2002) in a polity

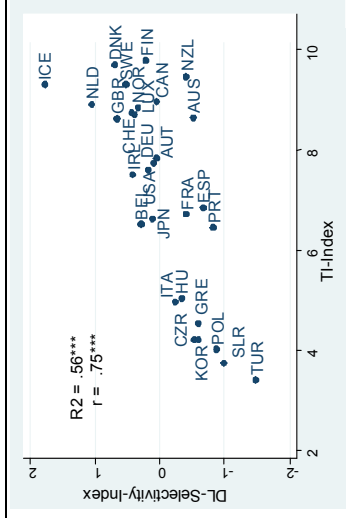
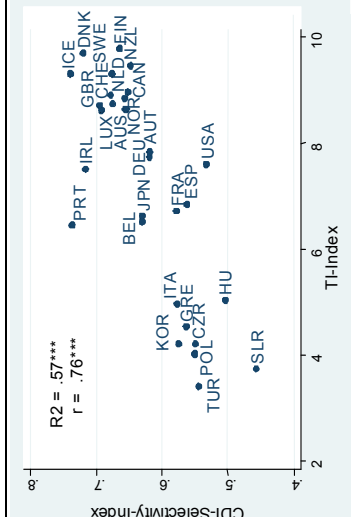
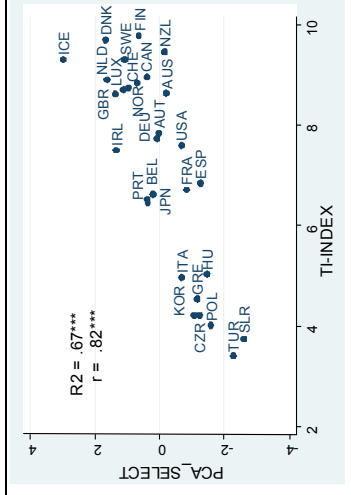
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ristics. However, this potential problem of parameter heterogeneity in cross-section analysis is at least partly reduced through the use of relatively constant control variables that reflect constant or at least slowly changing structural characteristics of countries. In such a scenario, a pure OLS cross-section is an appropriate solution, when these variables capture a large amount of the variance between the units of analysis (countries) and the analysis is not threatened by serious endogeneity problems.

**Table 2: Donor transparency & aid allocation**

	PCA-SELECT		PCA-SELECT		PCA-SELECT		PCA-SELECT		PCA-SELECT		PCA-SELECT	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(8)	(8)	(8)	
CPI-transparency	0.417*** (3.87)	0.526*** (7.34)	0.511*** (8.01)	0.459*** (6.55)	0.417*** (6.96)	0.541*** (6.04)	0.454*** (3.43)	0.519*** (8.00)				
GDP per capita (log)	0.710 (1.49)											
Checks & Balances		-0.0768 (-0.37)										
Arms exports (log)			-0.0853* (-1.91)									
Military Expenditure				-0.301 (-1.52)								
Trade w. Dev. World												
Bilateral ODA (log)												
Bilateral ODA % GDP												
Colonial Power Y/N												
Constant	-10.22** (-2.42)	-3.435*** (-4.78)	-3.160*** (-7.86)	-2.764*** (-3.78)	-2.103*** (-3.32)	-3.373*** (-5.71)	-3.480*** (-5.70)	-3.684*** (-9.01)	-0.107 (-0.25)			
Observations	29	29	29	29	29	29	29	29	29			
R <sup>2</sup>	0.700	0.683	0.726	0.710	0.745	0.689	0.692	0.681				
WB-CORRUPTION	1.127*** (3.74)	1.404*** (7.47)	1.375*** (8.07)	1.243*** (6.35)	1.120*** (6.89)	1.438*** (6.22)	1.198*** (3.58)	1.390*** (8.03)				

*t* statistics in parentheses; \*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ , all regressions with robust standard errors.





has an effect on aid allocation patterns. The variable CHECKS is taken from the dataset on political institutions (Beck et al. 2001) and captures the number of veto-players.

A second category captures the size of a donor country's bilateral ODA. Two variables fall into this category: first, the overall amount of bilateral ODA (log) a donor country has disbursed in the period, and second, bilateral ODA disbursements as a percentage of the country's GDP. Including a variable of the size of bilateral ODA can be based on different arguments. It might be argued that, with increasing amounts of ODA, bureaucratic expertise and public awareness of foreign aid issues grow, which should in turn have a positive effect on development-oriented aid allocation. It might also be argued, however, that rising amounts of bilateral aid will also increase the incentives to actors in government and the private sector to use those resources for their special interests. Larger amounts of bilateral ODA will therefore have a negative impact on the selectivity measures.

A third category of control variables deals with the outward orientation of donor countries. To capture economic interests that may be inconsistent with development-oriented aid allocation, we use trade with developing countries as a percentage of the donor country's total trade as a proxy variable. To capture potential security and military interests, the analysis tests for the level of arms exports (log). Alternatively, military expenditure as a percentage of GDP is used. Finally, the analysis also tests for the impact of a colonial-power dummy, which takes the value of 1 if a donor country once belonged to the group of major colonial powers.

Table 1 displays the results, when these variables are added together, with PCA-SELECT used as the dependent variable. Most importantly, the proxy variable for transparency remains highly significant in all models. As is shown in the bottom row of Table 1, this result holds when WB-Corrupt is used instead of CPI-transparency. In addition, Models 3 and 5 suggest that economic and security interests also have a significant, though negative, impact on the selective allocation of foreign aid, which is consistent with theoretical expectations.

Table 2 increases the of independent variables to four, namely measures for transparency, trade with developing countries as a percentage of total trade, arms exports (log) and the amount of bilateral ODA (log). In the OLS regressions, both measures for political transparency remain highly significant with the expected positive sign. Moreover, the greater the importance of the developing world for a donor country's external trade, the less aid is distributed according to neediness and institutional performance. In the model with only three variables, higher levels of arms exports are not significantly related to aid selectivity. But the variable becomes highly significant with a negative coefficient, when a variable that measures the amount of aid given by a country is added.<sup>23</sup>

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23 As an alternative to models 8 to 10, other combinations of independent variables were also tested, including the rest of the variables from Table 1. The results did not, however, achieve the explanatory power of those presented in models 8 to 10. Nevertheless, the measure for transparency remained statistically significant in such alternative equations.

Another robustness test reported in Table 2 is an instrumental variable analysis. Although it is not very plausible to assume reverse causality between transparency and aid allocation patterns, two-stage least square analysis (2SLS) was employed to reduce potential problems due to measurement error or omitted variable bias. Among the potential instruments used for political transparency and corruption, the percentage of Protestants in a donor country was chosen as the most suitable for the country sample under consideration.<sup>24</sup> It explains roughly 50 per cent of the variance of CPI-transparency and is uncorrelated with the error term of equations 8 to 10. The results are very similar to those of OLS regressions. The measures for transparency remain highly significant, as do the two outward-oriented variables. However, when the original selectivity measures are used – as shown in the appendix – the results change partially with the control variables, but not with regard to the transparency variables that remain highly significant.

<b>Table 3: Donor transparency &amp; aid selectivity</b>			
	OLS (9)	OLS (10)	2SLS (11)
	PCA-SELECT	PCA-SELECT	PCA-SELECT
CPI-transparency	0.423*** (6.34)	0.385*** (3.97)	0.471*** (4.03)
Trade with developing world	-1.656** (-2.32)	-1.808** (-2.67)	-1.377* (-1.79)
lnarmsexports9807	-0.070 (-1.56)	-0.0947*** (-3.39)	-0.0828** (-2.54)
lnODAgross9807		0.0896 (0.77)	0.0409 (0.33)
Constant	-1.853*** (-3.38)	-1.973*** (-3.86)	-2.521*** (-4.52)
Observations	29	29	29
$R^2$	0.77***	0.78***	0.773***
WB-CORRUPTION	1.146*** (6.27)	1.033*** (4.04)	1.331*** (4.16)
<i>t</i> statistics in parentheses; * $p < 0.10$ , ** $p < 0.05$ , *** $p < 0.01$ all regressions with robust standard errors.			

Finally, an examination of residuals also excludes the possibility of the impact of transparency on aid allocation being driven by outliers or influential cases. As the sample comprises all donor countries that have made their aid allocations transparent to the OECD, the results should not be affected by sample bias. It can therefore be concluded that the varying degree of political transparency in a donor country does have an influential impact on the country's aid allocation pattern.

24 In the literature, ethnolinguistic fractionalisation, distance from the equator or proportion of Protestants are often used as instruments for corruption (e.g. La Porta et al. 1999; Gupta et al. 2002; Treisman 2000). For instance, Treisman (2000) and Paldam (2001) argue that the proportion of Protestants is a good indication of corruption because Protestantism is relatively less hierarchical.

#### 4. Conclusions

Governance matters. Most scholars and practitioners in the field of development studies and development cooperation would agree that the quality of political institutions has a strong impact on how policies in developing countries are crafted and implemented. During the last two decades, scholars from economics and political science have provided empirical evidence that political transparency, the security of property rights and democratic accountability are crucial factors for explaining the existing variance in economic development across countries. Not surprisingly, these insights have been extended to the research on aid effectiveness, where the success of aid in promoting economic development is also said to be conditioned by the quality of political institutions in the recipient country.

This study has added another element to the latter story on aid effectiveness. Not only does the quality of political institutions is important at the end of the aid delivery channel, namely in recipient countries. The quality of political institutions also matter at the beginning of the aid-delivery chain; at least when one looks at the impact of political transparency in donor countries on their attempts to promote aid transparency and on their concrete aid allocation patterns. For aid to be effective, it thus is not only important to have “good” governance on the recipient side: as the empirical evidence in this paper has shown, the quality of political institutions deeply entrenched in donor countries can also impact on the quality of development assistance. All in all, what is good for the goose seems to be good for the gander, too.

This linkage between political transparency and aid policies is also in line with the broad consensus among scholars that higher levels of political transparency – the ease with which the public can monitor the government – are conducive to limiting the impact of special interests on policy-making. In this regard, the results of this study endorse the argument that - like other social policies - development assistance is not a simple altruistic undertaking but a policy area in which there are many vested interests, which often have become institutionalised in the past. Where political transparency is poor, special interests will have a stronger impact on aid policies, which adversely affect the development-oriented distribution of scarce aid resources.

Finally, from a policy perspective, the presented evidence is a confirmation for those who want donor governments and agencies engaged in international development assistance to be more accountable (Winters 2010a). As the experiences within developing countries show, however, levels of political transparency or corruption do only change slowly over time. Thus, there might be no quick solution for the challenge for development-friendly aid allocation and more transparent aid. Yet, the International Aid Transparency Initiative still can be considered as an important undertaking. Not only does the initiative provide a mechanism for the international diffusion of good practices regarding aid transparency. The initiative and the accompanying NGO activities can provide peer group pressure for yet relatively unaccountable donors to improve their levels of aid transparency.



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# Appendix



## Donor transparency and aid allocation

### 1) Descriptive Statistics

	Source	Obs.	Mean	Std. Dev.	Min	Max
CPI Transparency 1998–2008	Transparency International	29	7.13	2.05	3.41	9.77
CPI Transparency 2008–2010	Transparency International	29	7.17	1.76	4.0	9.33
WB Corruption Control 1998–2008	World Bank Governance Indicators	29	1.46	.77	-.13	2.42
WB Corruption Control 2008–2010	World Bank Governance Indicators	29	1.40	.77	.09	2.42
PCA-SELECT	Own	29	.00	1.3	-2.59	2.98
CDI-SELECT	Roodman 2009	29	.63	.07	.46	.75
DL-SELECT	OECD, DAC Statistics, Knack et al. 2010	29	-.035	.682	-1.48	1.78
GDP per capita (log)	World Bank, World Devel- opment Indicators	29	10.21	.39	9.21	11.07
Checks & balances	Dataset on Political Institu- tions (Beck et al. 2001)	29	4.08	.86	2.5	5.8
Arms exports (log)	SIPRI, World Development Indicators	29	5.68	3.24	0	11.27
Military Expenditure	World Bank, World Devel- opment Indicators	29	1.69	.84	0	3.74
Export % GDP	World Bank, World Devel- opment Indicators	29	45.05	28.50	10.66	150.255
Export to Developing World as % of Exports	IMF, Trade Directorate Sta- tistics	29	.46	.21	.16	.89
Bilateral ODA (log)	OECD, DAC Statistics	29	6.73	1.76	3.00	9.69
Bilateral ODA % GDP	OECD, DAC Statistics	29	.232	.19	.01	.64

## 2) Robustness check with original selectivity measures:

Table 4 shows the replication results of the models covered by Table 3, but using the original selectivity measures CDI-SELECT and DL-SELECT. Most importantly, the results relating to the impact of transparency on aid allocation patterns remain the same. Again, Transparency International's Corruption Perception Index and the Control of Corruption variable derived from the World Bank governance indicators remain highly significant and have a positive effect on the dependent variables. As regards the control variables, however, Table 4 shows some different results. When CDI-SELECT is used, the three additional control variables are highly significant. The percentage of trade with developing countries and the scale of arms exports are highly significant and have the expected negative sign. The overall amount of aid is also positive and significantly correlated with the dependent variable, but only in the OLS regression, not in the 2SLS regression. The statistical significance of these variables disappears, however, when the DL-SELECT measure is used, which casts some doubt on the robustness of the impact of these variables on allocation patterns. When DL-SELECT is used, only the different measures of transparency remain significant.

	OLS CDI-SELECT	OLS DL-SELECT	2SLS CDI-SELECT	2SLS DL-SELECT
CPI-Transparency	0.0168*** (4.45)	0.217** (2.70)	0.0207*** (4.78)	0.262*** (2.84)
Trade w. Developing World	-0.122*** (-2.91)	-0.620 (-1.11)	-0.103** (-2.40)	-0.394 (-0.64)
lnarmsexports9807	-0.0104*** (-4.18)	0.00330 (0.09)	-0.00983*** (-3.76)	0.00953 (0.25)
lnODAgross9807	0.0102** (2.11)	-0.00764 (-0.08)	0.00799 (1.63)	-0.0331 (-0.32)
Constant	0.552*** (13.57)	-1.262** (-2.34)	0.527*** (12.45)	-1.549*** (-2.97)
Observations	29	29	29	29
$R^2$	0.80***	0.58***	0.794***	0.572***
WB-CORRUPTION	0.0431*** (4.20)	0.601*** (2.85)	0.0586*** (4.55)	0.740*** (2.95)

*t* statistics in parentheses; \*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ , all regressions with robust standard errors.

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