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# Aid and institutions in transition economies

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ABSTRACT

We investigate whether aid contributed to institutional development in transition economies. We find that aid flows have a positive effect on democratization, especially on constraints on the executive and political participation. At the same time, total aid has no effect on overall quality of governance, while US aid appears to have a negative impact on some dimensions of governance. Aid's differential impact on democracy and governance is consistent with uneven development of institutions and the democracy consolidation hypothesis. We also find that aid has a non-linear effect on democracy. Openness has a positive effect on both democracy and good governance. Oil resources have an adverse effect on democracy. Adult mortality, civil war and adherence to Islam are all detrimental to good governance.



## 1. Introduction

The aim of this paper is to analyze the impact of aid on institutions, specifically democracy and governance quality, in transition economies. It is widely acknowledged that institutional quality is vital for improved economic performance and improved overall welfare (*e.g.*, Knack and Keefer, 1995; Dollar and Kraay, 2003; Easterly et al., 2004; Golinelli and Rovelli, 2013). For example, Acemoglu et al. (2001) note that countries with 'better' institutions, more secure property rights, and less distortionary policies will invest more in physical and human capital, and will use these factors more efficiently to generate wealth and development.

There is much dispute among scholars and practitioners on the effects of aid on institutional quality and political reforms. Some scholars find that aid has a positive effect on institutions (Goldsmith, 2001; Tavares, 2003; Dunning, 2004). This can occur when aid provides the financial and human capital resources needed to develop democratic institutions, and when aid enhances incentives to undertake political and economic reforms. Others argue that aid undermines institutional quality and political reforms (Bräutigam and Knack, 2004; Djankov et al., 2008; Kalyvitis and Vlachaki, 2012; Young and Sheehan, 2014) and that aid decreases the likelihood of democratization by contributing to the development of 'bad' institutions or by increasing rents to those who control the State, allowing elites to exclude others from power and thereby reducing political representativeness (Wright, 2009:552).

The objective of this paper is to investigate whether aid flows contribute to institutional development in the *transitional* group of recipient countries. The transition path from institutions supporting central planning towards institutions supportive of market-based economies has varied between countries and our aim is to explore to what extent aid drives this variation.

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Transition involves a dual process of transformation of economic and political structures that affects the economic and political interests of competing groups. Many of these countries commenced their transition from a centrally planned economy to a more market-based economic system after the dissolution of Soviet Union; though several like Poland commenced their transition earlier. The path of transition has been challenging and these countries have received extensive technical and financial assistance from western donors.[1] Between 1990 and 2012, aid was nearly 7 per cent of GDP for all 32 transitional economies. A total of 193,607 million (USD $2012) was allocated to European, 133,453 million (USD $2012) to Asian, and 21,367 million (USD $2012) to Central Asian transitional economies. Aid has been a major source of funds for some countries; see Appendix A.

One of the aims of foreign aid was to facilitate the transition from authoritarianism to democracy, promoting economic stabilization and the development of market orientated institutions.[2] While some countries have taken impressive steps towards democratization, others have lagged behind. This heterogeneity in the transition experience makes transition nations an interesting case study of aid effectiveness in reforming institutions. This important group of countries has to date received relatively little attention from scholars of aid effectiveness. The extant studies are listed in Table 1. The first three listed studies explore the impact of aid on economic reform; these studies suggest mixed results from aid. The next three studies come closest to ours (Heckelman, 2010; Schweickert et al., 2011; Freytag and Heckelman, 2012).[3] Ours is the first paper to consider all transition economies and we provide a more comprehensive analysis of the effects of aid on democracy and governance quality. Our results are broadly in line with earlier studies, though we highlight the difference in aid effectiveness in terms of democracy and governance.

The key issue explored in this paper is the effects of aid on democracy and governance. We also explore whether there are differences in the effectiveness of total, multilateral, and bilateral aid flows. In addition to the effects of aggregate measures of democracy and governance, we explore the effects of aid on the various components (dimensions) of democracy and governance. Furthermore, we also investigate the existence of non-linearities in aid effectiveness. The analysis covers a 23-year period, 1990 to 2012, for all 32 transition economies.

Our key finding is that aid has increased democracy in transitional countries. However, aid has simultaneously had either no effect or an adverse effect on the quality of governance. Interestingly, the ineffectiveness of aid in improving governance is found also among transitional countries that are EU members. The findings are robust to alternative model specifications, sub-samples, alternate measures, and alternate estimators.

Section 2 of the paper outlines the main theoretical considerations. Section 3 describes the data while Section 4 outlines the empirical methodology. Sections 5 and 6 present the empirical results for the effects of aid on democracy and aid on governance, respectively. In Section 7 we discuss aid's differential impact on democracy and governance. Section 8 concludes the paper.

## 2. Theoretical perspectives

The promotion of democracy and good governance have become increasingly important components of the foreign policy of many developed nations. Democracy, defined by Przeworski et al. (2000:19) as "… a political system in which key government offices are filled through contested elections", is seen by many as desirable for growth and development (though the evidence is mixed, see Doucouliagos and Ulubasoglu, 2008). Democracy is also seen as desirable from a non-economic perspective; citizens have a preference to live in a country with civil liberties and political rights. Another important set of institutions is 'governance'. Good governance - in the form of institutions that establish predictable, impartial, and consistently enforced set of rules for investors - is crucial for the development of poor countries (Keefer and Knack, 1997; Knack, 2001).

Institutions evolve through a complex process of internal and external pressures for change. External sources of institutional change include trade and economic openness which inject new ideas and provide incentives for structural reform. Development aid, the focus of our paper, is also potentially an important external channel. Institutional reform is a political process, involving conscious decisions to change decision-making processes and dimensions such as the rule of law, accountability and transparency. Aid allocations are also a political process, involving conscious decisions to direct varying amounts of scarce funds to specific recipients. Institutions are dynamic and dimensions such as democracy and governance evolve over time. The role of aid in institutional development in recipient countries is a disputed issue. Theory predicts that aid can have both positive and negative effects on political institutions. Hence, the net effect of aid on institutions such as democracy and governance is an empirical issue (Kersting and Kilby, 2014).

In this paper we advance and test two hypotheses:

**H1.** Institutions are multi-dimensional and aid can affect the different dimensions in varying ways. Aid to transition economies can result in improvement in some dimensions, no change in others, and potentially even a deterioration in some dimensions.

**H2.** The effects of aid on institutions may be non-linear, being conditional on factors such as the level of aid, entrenchment of socialism, openness, natural resource endowments, political stability and civil war.

We develop these two hypotheses below after first considering the channels through which aid can potentially affect institutions.

[1] Svejnar (2002) discusses the economic and political reforms that were implemented as part of the transition process. Fidrmuc (2003) discusses the liberalization and growth experience of transition economies. See Campos and Coricelli (2009) who explore non-linearities between economic and political reforms.

[2] Political imperatives exerted pressure to lend large amounts and to provide assistance (World Bank, 2004).

[3] Askarov and Doucouliagos (2013) conduct a meta-analysis of numerous studies of the effects of aid on democracy and conclude that aid has a positive effect only in transitional economies.