



The effects of aid agency independence on bilateral aid allocation decisions

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ABSTRACT

We investigate whether differences in the formal independence of donor countries' aid agencies affect bilateral aid allocation decisions. Specifically, we examine whether allocation decisions made by donor countries with merged aid agencies are more heavily influenced by foreign policy and commercial trade concerns, and less influenced by developmental concerns. We exploit variation in the independence of DAC member countries' aid agencies across time and space to identify this effect in a panel empirical model. Our econometric methodology borrows from developments in the empirical trade literature to accommodate a dataset with numerous zero-value observations. Our results indicate that aid agency independence does not have significant effects on the determinants of bilateral aid flows at the extensive or intensive margins. Donor countries with merged aid agencies do not place more emphasis on foreign policy and trade concerns, and donor countries with independent aid agencies do not place more emphasis on recipient-country poverty.

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1. Introduction

The Federal Governments of Australia and Canada merged their aid agencies with their departments of foreign affairs and international trade in 2013. These decisions were met with criticism from observers and aid practitioners who were concerned that allocation decisions made by merged agencies would be less responsive to recipient needs, and more responsive to donor-country foreign policy and commercial trade interests. There is a widely-held belief that aid allocation decisions made by merged agencies could be contaminated, or at least influenced, by competing foreign policy and commercial trade interests within a single department, and that these influences could affect both the extensive margin (*i.e.*, who receives aid) and the intensive margin (*i.e.*, how much aid is granted). Specifically, aid may be channeled towards recipient countries with historical and geo-economic ties to donor countries (*e.g.*, colonial ties, geographic proximity), or towards recipient countries with strong commercial trade ties to donor countries.

The anecdotal evidence to support these concerns is mixed. The aid agencies of major donor countries are characterized by a wide range of governance structures, from very independent (*e.g.*, the

United Kingdom) to closely merged (*e.g.*, Norway). Bilateral aid allocation decisions across these aid agencies do not follow a pattern that aligns with the commonly-held prior belief that merged agencies grant aid in a more egoistic manner than independent aid agencies. In fact, some of the most-closely merged aid agencies perform relatively well on objective measures of aid quality (Faure, Long, & Prizzon, 2015; Gulrajani, 2010).

However, comparisons of allocation decisions across donor countries are fraught with difficulties. Aid decisions are made through complicated interactions within, and between, governments, bureaucracies and interest groups. The formal independence of an aid agency is just one factor that could contribute to decisions on who receives aid, and how much. Other important determinants of aid allocations must be credibly controlled for in order to identify the effects of aid agency independence on bilateral allocation decisions.

This is the primary contribution of our research. We build an empirical model that estimates the relative importance of donor-interest and recipient-need variables in determining the bilateral aid flows of Organisation for Economic Co-operation and Development's (OECD's) Development Assistance Committee (DAC) countries. This model is augmented to estimate how the independence of donor-countries' aid agencies affects the relative importance of these determinants. Specifically, we investigate whether allocation decisions made by donor countries with independent

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aid agencies are more responsive to recipient-country needs, and less responsive to donor-country interests. We analyze the effects of aid agency independence on the extensive and intensive margins of bilateral aid allocations. Our empirical model is applied to a panel data set comprised of OECD's DAC members' bilateral aid commitments from 1995 to 2012.

The second contribution of our research is to bring state-of-the-art econometric techniques to bear on the analysis of bilateral aid flows. A number of previous studies have estimated the determinants of bilateral aid flows using a range of econometric methodologies. We borrow from developments in the empirical trade literature by employing a modelling technique (Zero-Inflated Negative Binomial Pseudo-Maximum Likelihood estimator) that is well-suited to accommodate the high-frequency of zero-value observations common to bilateral trade and aid data sets.

This paper contains seven subsequent sections. Section two surveys the relevant literature on aid allocations. Section three examines aid agency governance structures, and discusses our strategy to identify the effects of aid agency independence on aid allocation decisions. Section four presents the empirical model and the econometric methodology. Section five describes the data and the variables. Sections six and seven discuss the benchmark and supplementary empirical results, respectively. The paper closes with a discussion of the implications of the results, some limitations of our findings, and concluding comments.

2. Determinants of aid flows

The decision by a government to allocate Official Development Assistance (ODA) can be understood to be a function of two factors: recipient needs and donor interests. The first factor, recipient needs, is driven by donors' efforts to address a host of "needs" in recipient countries; e.g., reduce poverty, encourage long-term development, or ameliorate short-term humanitarian crises. Donor interests can comprise a number of elements, including foreign policy, national defense, and commercial objectives. Donor interests are vaguely defined and can change over time (Neumayer, 2003a). For example, national security objectives were important drivers of aid flows during the Cold War, often with little regard for developmental effects (Radelet, 2006). Historical, cultural, and colonial ties between countries can also influence aid flows (Berthélemy, 2006).

Commercial interests in donor countries can affect aid allocation decisions through two channels. First, donor-country governments may be more inclined to provide aid to recipient countries with whom they share commercial trading or investment relationships. Such aid can be viewed as a reward for previous trading activity or as an incentive for future activity. Second, many aid programmes include requirements that tie the expenditure of donated funds to commercial interests in the donor country. For example, food aid that was funded by the Canadian government was tied to procurement from the Canadian Wheat Board until 2008. Likewise, a large share of food aid from the United States (US) is tied to US procurement and processing. The values of tied aid donations are typically small relative to commercial trade and foreign direct investment flows between donors and recipients, but the existence of tying requirements illustrates the influence that interest groups in donor countries have on the setting of foreign-aid policy. Ruttan (1993) goes as far as to describe the donation of food aid that is tied to domestic procurement as a "*public relations device to paper over the reality of surplus disposal [of publicly-held agricultural stocks]*."

Bilateral aid allocation decisions have been shown to be affected by both recipient-need and donor-interest considerations

(e.g. Alesina & Dollar, 2000; Berthélemy, 2006; Neumayer, 2003a). As such, one cannot typically identify an observed allocation decision as being motivated by either recipient needs or donor interests. The literature on foreign aid includes several studies that estimate the relative weights that donor countries place on measures of recipient needs and on measures of donor interests in determining aid flows. Two threads of this literature can be identified. The first thread estimates the influence of a range of factors on donors' aid efforts. Dudley and Montmarquette (1976) and Trumbull and Wall (1994) develop theoretical aid supply functions and estimate these models using indicators of recipient needs and donor interests. More recently, Fuchs, Dreher, and Nunnenkamp (2014) estimate panel models that weigh a range of recipient-need and donor-interest factors in determining aid effort.

The second thread consists of studies that investigate donors' selection of recipients in bilateral allocation decisions. Alesina and Dollar (2000) is the seminal paper in this thread, which estimates the relative weights that donors place on political determinants versus needs-based determinants of aid flows – the paper is aptly titled "Who Gives Foreign Aid to Whom and Why?" This study lays the foundation for the empirical approaches that permeate much of the bilateral aid allocation literature. A number of studies address more specific questions within this framework, including Berthélemy (2006) (identifying relative altruism among donor countries in aid allocation), Kuziemko and Werker (2006) (effect of a seat in the United Nations Security Council on aid allocations), Boschini and Olofsgård (2007) (effect of the Cold War on political determinants of allocation decisions), and Nunn and Qian (2010) (determinants of food aid allocations).

Our research builds on the second thread by developing an empirical model that explains donors' bilateral aid allocation decisions as a function of recipient needs and donor interests. We contribute to the literature by modeling how independence of donor countries' aid agencies affects the determinants of bilateral allocation decisions. Specifically, we allow the weights on recipient-interest and donor-interest variables in an empirical model to be affected by aid agency independence. The results provide insights into our primary research question: does aid agency independence affect how donor countries weigh recipient needs and donor interests in bilateral aid allocation decisions?

3. Aid agency independence

Official aid allocation decisions are managed differently across donor countries, and depend on a range of donor-country characteristics. For example, donor-country government political ideology (Brech & Potrafke, 2014; Fuchs et al., 2014) and government fiscal balances (Faini, 2006) have been shown to affect aid allocations. Another important difference across donor countries that could affect aid allocation decisions is the degree of formal linkage between a donor's aid agency and their Ministry of Foreign Affairs and International Trade (MFAIT¹). The degree of formal influence that a MFAIT has in aid allocation decisions varies widely among major donors, from Norway where development policy is under the mandate of the Ministry of Foreign Affairs, to the United Kingdom (UK) where the Department for International Development is led by its own cabinet-level Secretary who reports to Parliament. The Organisation for Economic Co-operation and Development (2009) classifies each member country of the DAC into one of four categories based on the

¹ The generic acronym MFAIT is used to refer to the governmental ministry/department responsible for foreign affairs and international trade policies in donor countries.

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