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The Role of Governance in Determining Foreign Aid Flow Composition

MATTHEW S. WINTERS and GINA MARTINEZ*
University of Illinois at Urbana-Champaign, USA

Summary. — We hypothesize that selective donors will use types of aid over which they have more control when providing assistance to poorly governed countries. We use an original classification of project purpose codes in the AidData dataset to categorize aid flows from the period 2004 to 2010. Results from fixed effect and compositional data models provide evidence of selectivity in terms of overall aid flows, a tradeoff between technical assistance and programmatic lending, and a tradeoff between social sector and infrastructure projects.

Key words — foreign aid allocation, development aid modalities, governance, compositional data analysis

1. INTRODUCTION

Over the course of the 1990s, a narrative emerged among major international development institutions about "good governance" being a necessary condition for economic growth. [1] At the beginning of the decade, the idea was prominently stated in the World Bank study *Sub-Saharan Africa: From Crisis to Sustainable Growth* (1989), and by the end of the decade, the World Bank's *Assessing Aid* volume offered the logically persuasive – although soon empirically challenged – conclusion that aid works well in countries that have good policies or institutions in place (World Bank, 1998; see also Burnside & Dollar, 2000, 2004). The corollary conclusion was that foreign aid donors should take recipient country governance into consideration when making decisions about aid giving.

Over the course of the 1990s, nearly all bilateral and multilateral international development agencies incorporated language about allocating aid selectively with regard to recipient-country governance into their mission statements. [2] For some donors, such as the World Bank, governance is directly built into the allocation formulas used for divvying up their budgets. The United States, in the mid-2000s, created a new aid agency, the Millennium Challenge Corporation, explicitly charged with disbursing aid to a group of countries that were deemed to have governance of sufficient quality. The Netherlands, in trying to identify a set of partner countries in which to concentrate its aid giving, made governance quality a determinative criterion. [3] Replacing the *ex post* conditionality of structural adjustment programs from the 1980s and early 1990s in which aid flows could be suspended if countries did not implement certain policies, the good governance era that has followed has ostensibly been defined by *ex ante* conditionality (i.e., selectivity) in which countries with poor policies and institutions are either not given aid in the first place or else are given smaller amounts of aid. [4]

Much of the ensuing academic literature has confirmed that donors do respond to recipient-country governance when making aid allocation decisions (Bermeo, 2010; Claessens, Cassimon, & Van Campenhout 2009; de la Croix & Delavallade, 2013; Dietrich, 2013; Freytag & Pehnelt, 2009; Neumayer, 2003b; Schudel, 2008, ND), although some authors have raised questions about whether donors are responsive to corruption (Alesina & Weder, 2002; Easterly & Pfutze, 2008; Easterly & Williamson, 2011; Neumayer, 2003a, 2003b; Svensson, 2000). The most recent literature looks beyond aggregate aid flows, examining instead how donors may find ways of structuring aid projects such that they avoid working directly with corrupt or incompetent governments (Dietrich, 2013) or use certain types of "governance-robust" development assistance in more poorly governed states (Bermeo, 2010; Clist, Isopi, & Morrissey, 2012; Nordveit, 2014).

We extend this recent literature on the relationship between governance and aid allocation by examining how governance predicts the distribution of aid across three modalities and four broad project sectors. We make use of the AidData dataset (Tierney *et al.*, 2011) to create an original categorization of aid flows based on project-level purpose codes. For each of the modalities and sectors that we study, we discuss the way in which governance problems are likely to affect that type of aid. If donors are being selective, they should prefer to use governance-robust development assistance in poorly governed countries. We analyze the patterns in aid commitments over 2004–10 using statistical models appropriate for the analysis of compositional data. Looking at overall aid flows, we find that donors provide higher levels of aid to better governed countries and do so using a larger number of modalities and across a larger number of sectors. [5] Looking at aid modalities, we find evidence that bilateral donors substitute programmatic aid for technical assistance and project aid in well-governed countries. We also find evidence that bilateral donors

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Table 1. *Previous studies of governance and aid allocation. ICRG refers to the corruption component of the ICRG political risk index*

Study	Scope and outcome variable	Operationalization of governance	Findings
Nordveit (2014)	Probability of receiving general budget support from 23 bilateral donors over 1995–2009	WGI's Government Effectiveness index	Better governed countries are more likely to get general budget support and to get larger amounts, but better governed countries do not get more of other types of programmatic aid
de la Croix and Delavallade (2013)	Seemingly unrelated regressions model of corruption in and total aid to 159 recipients from 1996 to 2005	The political stability measure from the Governance Research Indicator Country Snapshot (GRICS)	Aid is significantly and positively correlated with corruption because donors give aid to countries where productivity is lower (which are also corrupt countries)
Dietrich (2013)	Proportion of bilateral aid from 22 donors delivered through non-state actors, 2005–09	Aggregate score on either all six or four of the six Worldwide Governance Indicators	Donors are more likely to bypass the state and use non-state actors to deliver aid in more poorly governed countries
Akramov (2012)	Overall aid flows and sector-specific aid flows from 1973 to 2002 for OECD-DAC donors	Freedom House Score and Category	Donors reward changes in Freedom House category (e.g., from "not free" to "partly free") but not smaller changes in Freedom House score within those categories. These effects can be seen across multiple sectors of aid
Easterly and Williamson (2011)	Proportion of bilateral and multilateral aid going to corrupt countries in 2008 and from 1984 to 2008	ICRG	Corrupt countries receive more aid in the period 1998–2008 than they did in the period 1984–97 Donors have continued to give the same amount of aid to the same countries over time, but some of these recipient countries have become more corrupt
Clist *et al.* (2012)	Existence of budget support and amount of budget support from EC and World Bank, 1997–2009	WGI Government Effectiveness	Government effectiveness predicts receiving general budget support but does not predict the amount
Clist (2011)	Any aid and total aid from seven major donors, 1982–2006	Freedom House combined index; Political Terror Scale	The Freedom House index positively predicts the existence of aid flows from all seven donors and significantly influences the amount of aid for three of them The Political Terror Scale significantly predicts eligibility for three of the donors
Bermeo (2010)	Proportion of bilateral aid delivered through different channels to 106 recipients, 2002–07; also total aid by sector	Average score on five of six Worldwide Governance Indicators	Donors channel aid through NGOs and multilateral organizations in poorly-governed countries Donors provide more technical assistance in poorly governed countries Governance positively predicts larger overall aid flows Governance predicts more aid in the forms of budget support, economic infrastructure aid and aid for productive sectors
Claessens *et al.* (2009)	Total bilateral aid per capita from 22 donors to 147 recipients, 1970–2004	World Bank's Country Policy and Institutional Assessment Score	Better-governed countries receive more aid in the 1999–2004 period but not in earlier periods
Freytag and Pehnelt (2009)	Debt relief to 109 recipients, 1990–2004	Component variables from Worldwide Governance Indicators	In the 1995–99 period, good governance did not predict debt relief, but in the 2000–04 period, countries with effective governments and a good rule of law received more debt relief Corruption levels do not predict the amount of debt relief in any period
Easterly and Pfutze (2008)	Proportion of bilateral and multilateral aid from 39 donors going to corrupt countries in 2004 and from 1984 to 2004	ICRG	Countries perceived as corrupt began receiving *more* aid in the late 1990s and early 2000s as compared to the mid-1980s and early 1990s Donors have continued to give the same amounts to the same countries over time, but some of these countries have become more corrupt

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