

**EU Aid and the Recipient Government:  
Aid Effectiveness and the New Soft Budget Constraint  
in the Former USSR**

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*Abstract:* The European Commission proposes an aid delivery model relying on two types of domestic actors: developmental entrepreneurs and distributive planners. Developmental entrepreneurs substitute rather than complement political entrepreneurs at the civil society level; differentiated forms of non-representative government in Russia, Ukraine, and Kazakhstan do not allow the institutional independence of civil society from state objectives. EU aid fosters a principal-agent relationship between the local bureaucrat and the NGO or a policy research institute; the delegation of authority from the state to NGOs could never have been the case without the presence of significant financial incentives. These collaborative structures between state and society for the purpose of national development with transnational means provide a novel definition for aid bureaucracies, applicable both in a comparative and an international context. These are partnerships of transnational sovereignty. Their survival is contingent on a financial decision taken in Brussels and implemented in the territory of the post-Soviet recipient. EU aid can soften the budget constraint of the recipient government, only when financially viable NGOs and businesses support development strategies at the domestic level. This model constitutes a marginal deviation from the soft budget constraint definition in centralized economies; here, the financing institution may let the recipient go bankrupt, as long as there is another partner to carry on with the completion of the contract.



## I. Introduction

Aid effectiveness may not be defined only in terms of donor strategies, but also recipient responses. In this paper, I argue that the EU aid to Russia, Ukraine and Kazakhstan has had effects similar to those of the soft budget constraint under central planning;<sup>1</sup> the formation of consortia between European and post-Soviet legal entities with the purpose of project implementation has facilitated local and national development goals, adopted by the respective bureaucracies. The idea of reform complementarities is not unknown in the transition economies literature;<sup>2</sup> nevertheless, foreign aid has never been analyzed as an instrument or systemic mechanism of reform incentives. Unlike standard schemes of developmental cooperation, EU aid to the former Soviet Union has been entangled with the domestic development process; instead of concentrating in the provision of grants and loans to federal or regional budgets, EU aid bureaucrats have worked collectively with federal, regional and local bureaucrats in Russia, Ukraine and Kazakhstan to achieve common policy ends.<sup>3</sup> Aid complementarities may, therefore, receive an additional dimension; they are not only evaluated in terms of the *ex ante* foreign policy preferences of the donor, but also in terms of the *ex ante* economic policy preferences of the recipient. In the formal section of this chapter, I focus on the treatment of EU aid as the new soft budget constraint and provide possible insights on aid complementarities as determinants of post-Soviet reform.

It becomes obvious that aid effectiveness from the recipient's perspective is defined in two ways: 1. The degree of complementarity between the recipient's development strategies and aid contracts proposed by the donor and 2. The potential of foreign aid contracts to finance domestic development projects that are likely to fail due to scarcity of public or private financial resources. The direct welfare effects of aid do not form a critical question in this

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<sup>1</sup> Kornai Janos. "The Soft Budget Constraint", *Kyklos* Vol. 39 (1): 3-30, 1986.

<sup>2</sup> Roland Gérard, *Transition and Economics: Politics, Markets and Firms*, MIT Press, 2000, Introduction and Political Constraints and Reform Strategy.

<sup>3</sup> Staff, "Was ist Official Development Assistance (ODA)?" Referat 304, Federal Ministry for Economic Cooperation and Development, 2009.

context; rather than exploring whether the low-income tail of the population distribution becomes better off with the implementation of aid projects, I approach aid as a consolidating factor of domestic state capacity.<sup>4</sup> The aid-trade relationship is not as profitable for the recipient as it is for the donor; while export-oriented trade policies are a sufficient condition for high growth rates, they do not satisfy the recipient-induced aid intentionality.<sup>5</sup> Because it is usually the case that the recipient is rich in raw materials and the donor in services and technologically advanced commodities, aid is inclined to offset the recipient's losses from trade. EU aid - more than any other form of development assistance - advances the commercial interests of the EU member-states by committing to aid contracts, which reduce the recipient's financial dependence in the long-run. This contradictory set of incentives can be explained, if one looks more closely at the literature on aid effectiveness; as Olson points out, rapid economic growth should not be the imminent goal of aid programs.<sup>6</sup> On the contrary, the gradual formation of required political and infrastructural preconditions that will make this growth sustainable in the long-run is a sine qua non component of any sound development policy.<sup>7</sup> EU aid does not generate the regular economic problems that one encounters in the aid literature; fungibility and rent-seeking, overvaluation of currency, less incentives for domestic savings.<sup>8</sup> Given that government-to-government aid does not lie in the core of the EU development process, its effectiveness may not be measurable in aggregate growth terms.<sup>9</sup> Rather than treating the public sector as an inevitable component of aid implementation, EU aid bureaucrats work primarily on aid contracts that facilitate the provision of public goods by

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<sup>4</sup> Akram Tanweer. "The International Foreign Aid Regime: who gets foreign aid and how much?", *Applied Economics* 35:11, 1351-1356.

<sup>5</sup> Krueger Anne O. "Trade policy as an input to development", *American Economic Review*, 70:2, 288-292.

<sup>6</sup> Olson Mancur Jr. "Rapid Growth as a Destabilizing Force" *Journal of Economic History*, Vol. 23, No. 4 (December 1963): 529-552.

<sup>7</sup> Olson Mancur Jr. "Rapid Growth as a Destabilizing Force" *Journal of Economic History*, Vol. 23, No. 4 (December 1963): 529-552.

<sup>8</sup> Krueger Anne O. "Aid in the Development Process", *World Bank Research Observer* 1: 1, January 1986.

<sup>9</sup> Krueger Anne O. "Aid in the Development Process", *World Bank Research Observer* 1: 1, January 1986.

the recipient government, and thus advance its administrative capacity and quality of welfare provision.<sup>10</sup>

The distinction between weak and strong authoritarianism seems to be also important for aid effectiveness;<sup>11</sup> while aid has a negative and statistically significant effect on growth, there is considerable variation when regime types are taken into account.<sup>12</sup> Strong authoritarian governments are more likely to make efficient use of foreign aid flows than weak autocracies; socio-economic indicators such as infant mortality and other public health services improve because of aid flows under strong authoritarian regimes, whereas weak dictators cannot use aid to promote their domestic growth rates.<sup>13</sup> In my model, I assume that post-Soviet aid bureaucrats distribute aid resources with the purpose of maintaining a minimum of social subsistence to their poorest group of citizens;<sup>14</sup> project implementation becomes feasible with the donor's supervision and the recipient's administrative accountability. Developmental NGOs are therefore agents rather than counterbalancing institutions of governmental policy. This interesting observation, which stresses the intra-collaborative nature of public sphere in the former Soviet Union, takes place at the expense of transparency and democratic accountability; NGOs do not complement the absence of state capacity, but reinforce the government's role as provider of public and social services.<sup>15</sup> Collier and Dollar, in their comprehensive review of the aid effectiveness, contend that aid does not induce policy change

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<sup>10</sup> Krueger Anne O. "Aid in the Development Process", *World Bank Research Observer* 1: 1, January 1986.

<sup>11</sup> Islam Muhammed N. "Political Regimes and the Effects of Foreign Aid", *Journal of Developing Areas*, 37:1, 35-53, autumn 2003.

<sup>12</sup> Islam Muhammed N. "Political Regimes and the Effects of Foreign Aid", *Journal of Developing Areas*, 37:1, 35-53, autumn 2003; Comment

<sup>13</sup> Islam Muhammed N. "Political Regimes and the Effects of Foreign Aid", *Journal of Developing Areas*, 37:1, 35-53, autumn 2003.

<sup>14</sup> There is relative stability continuity in the maintenance of a social welfare optimum both under socialism and during the transition period; See Way Lucan. "The Dilemmas of Reform in Post-Soviet States", *Politics & Society*, Vol. 30, No. 4 (December 2002): 579-598; Collier Stephen J. and Lucan Way. "Beyond the Deficit Model: Social Welfare in Post-Soviet Georgia", *Post-Soviet Affairs*, 2004, Vol. 20, No. 3: 258-284.

<sup>15</sup> This observation contradicts the primary understanding of aid as a side foreign policy instrument; Boschini Anne and Anders Olofsgard. "Foreign Aid: An Instrument for Fighting Communism? ", *Journal of Development Studies*, 1-33.

while the opposite is likely; policy reform can create a favorable environment for the successful implementation of aid contracts.<sup>16</sup> EU aid meets their basic criteria of aid effectiveness;<sup>17</sup> more specifically, I argue that aid can be used as a soft budget constraint by recipient governments and their NGOs as intermediaries to improve the provision of fundamental social goods. The differentiation between federal and centralized political systems is critical in that respect; as evidence from the German Bundesländer indicates, subnational administrations of federal governments can contribute with their universities, private enterprises, NGOs and technical knowledge to the promotion of Germany's federal development policy.<sup>18</sup> Multiplicity of actors at the subnational level can only constrain the rent-seeking strategies of the recipient government; the expected payoff is lower for all parts and aid-induced policy reform is certainly likely to generate winners among the bureaucrats.

The chapter is structured as follows; in section 1, I analyze the coordination between developmental entrepreneurs and their principals, which I defined as distributive planners. In section 2, I review the literature of the soft budget constraint in planned and transition economies; I draw the analogies between the economics of socialism and post-socialism by defining EU aid as a new form of the soft budget constraint under post-socialism. In that respect, I differentiate between the federal political system of Russia on the one hand, and the centralized political systems of Ukraine and Kazakhstan on the other. In section 3, I propose a two-part formal model; first, I propose a formal analysis of aid model aid in the light of the soft budget constraint literature with extensions on aid complementarities as the main set of incentives for policy reform in the post-Soviet space. In Section 4, I discuss my findings.

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<sup>16</sup> Collier Paul and David Dollar, "Development Effectiveness: What have we learnt?" *World Bank Working Paper*, 1-35, January 2001.

<sup>17</sup> Collier Paul and David Dollar, "Development Effectiveness: What have we learnt?" *World Bank Working Paper*, 1-35, January 2001.

<sup>18</sup> Wiemann Juergen. "Neuausrichtung der Entwicklungspolitik der Bundesländer vor dem Hintergrund der veränderten internationalen Rahmenbedingungen", Discussion Paper 20/2008, German Institute for Development Policy, Bonn 2008.

## II. Developmental Entrepreneurs and Distributive Planners

Casella and Eichengreen (1996) argue that foreign aid can be conducive to stabilization, if it is announced and disbursed early in the inflation process; timing seems to play a significant role in aid effectiveness because it affects the incentive structures of high and low cost players in the recipient economy.<sup>19</sup> The government is enabled to impose less distortionary taxes and still implement a successful stabilization program; in any case, foreign aid reduces the distributional costs of inflation among interest groups and facilitates macroeconomic adjustment.<sup>20</sup> EU aid is announced and disbursed in such a way that macroeconomic adjustment may be influenced only indirectly. Moreover, local aid agents do not come from the federal or regional bureaucracy, but civil society, business, and scholarly networks; thus, the recipient's bureaucratic capacity is not eroded by financial incentives provided by the EU to domestic administrators.<sup>21</sup> The exclusion of the recipient's bureaucracy from the core of aid implementation generates a direct accountability mechanism between the EU and its contractors; thus, responsibility is centralized and local bureaucrats do not have any rent-seeking incentives that are usually produced by the competitive supply of multiple aid loans and grants.<sup>22</sup>

I contend that the European Commission proposes an aid delivery model relying on two types of domestic actors: developmental entrepreneurs and distributive planners. Developmental entrepreneurs substitute rather than complement political entrepreneurs at the civil society level; differentiated forms of non-representative government in Russia, Ukraine, and Kazakhstan do not allow the institutional independence of civil society from state objectives.

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<sup>19</sup> Casella Alexandra and Barry Eichengreen, "Can Foreign Aid Accelerate Stabilization? ", *The Economic Journal*, Vol. 106, No. 436, (May 1996): 605-619.

<sup>20</sup> Casella Alexandra and Barry Eichengreen, "Can Foreign Aid Accelerate Stabilization? ", *The Economic Journal*, Vol. 106, No. 436, (May 1996): 605-619.

<sup>21</sup> Knack Stephen and Aminur Rahman. "Donor fragmentation and bureaucratic quality in aid recipients", *Journal of Development Economics*, 83 (2007): 176-197.

<sup>22</sup> Knack Stephen and Aminur Rahman. "Donor fragmentation and bureaucratic quality in aid recipients", *Journal of Development Economics*, 83 (2007): 176-197.

Decentralization may increase quality in the provision of public goods;<sup>23</sup> nevertheless, the commitment of developmental entrepreneurs to the improvement of social services and public goods is what matters. Given the competition for aid resources available to developmental NGOs by that only developmental organizations with a successful implementation record are likely to survive for more than one aid supply periods. At the same time, the lack of elections does not render aid failures a reason for governmental change. However, nondemocratic planners will be able to maintain their social legitimacy for more than one aid supply periods, if they already implement distributive policies at home.

Hence, economic planners in Russia, Ukraine, and Kazakhstan use aid flows to maintain a minimum level of distribution. The central role of the public sector in planned economies created an economic culture of egalitarianism whose underlying effects have been continuous throughout the transition period.<sup>24</sup> Unlike other forms of multilateral or bilateral aid, EU aid does not rely on the corrosion of the recipient's administrative capacity; aid contracts do not serve as indirect bribes to bureaucrats or elected officials. Distributive planners maintain the highest degree of information with respect to the needs of the population; because of this informational asymmetry, the European Commission decides its aid contracts based on the information received by the recipient post-Soviet governments.<sup>25</sup> State support for developmental entrepreneurship depended on the expectation of foreign aid flows; the stringent monitoring procedures by the European Commission led to a generation of developmental enterprises, whose private ownership structures did not undermine the recipient's ability for policy implementation.<sup>26</sup> At the same time, an entry increase for developmental enterprises in recipient economies has substantially decreased the probability

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<sup>23</sup> Golola Moses. "Decentralization, Local Bureaucracies and Service Delivery in Uganda", *Discussion Paper 2001/115*, WIDER World Institute for Development Economics Research, October 2001.

<sup>24</sup> McMillan John and Barry Naughton. "How to reform a planned economy: Lessons from China". *Oxford Review of Economic Policy*. Vol. 8, No. 1, 130-143.

<sup>25</sup> McMillan John and Barry Naughton. "How to reform a planned economy: Lessons from China". *Oxford Review of Economic Policy*. Vol. 8, No. 1, 130-143.

<sup>26</sup> McMillan John and Christopher Woodruff. "The Central Role of Entrepreneurs in Transition Economies", *Journal of Economic Perspectives*, Vol. 16, No. 3 (Summer 2002), 153-170.

of financial mismanagement and policy deviations by the recipient; the presence of multiple potential contractors constrains aid failures and rationalizes the aid process.

The definition of developmental entrepreneurship is much more restrictive than the general definition implied in the comparative economics literature;<sup>27</sup> the existence of developmental organizations is contingent upon the funding they receive from the European Commission or other multilateral institutions that work directly with them or through their respective national government. Thus, appointed or elected bureaucrats of transnational or national origin decide on their financial survival perspectives. The more stringent the monitoring imposed by the donor, the more objective the criteria for funding continuation and favorable tendering decisions. As it has been aforementioned, informational transfers from the post-Soviet recipient government to the European Commission define critically the policy areas of aid contracts decided in Brussels. Aid governance in the post-Soviet space requires the parallel activity of distributive planners and developmental entrepreneurs.<sup>28</sup> If post-Soviet planners had not been distributive, then EU aid would not have been the main developmental pillar of structural adjustment and transition for all post-Soviet economies; they would have been better off to receive bilateral aid from reciprocal bilateral donors or other multilateral organizations. Aid disbursed by the latter is associated with conditionality ties directed toward the central government without further donor supervision or involvement of developmental entrepreneurs from the donor's side.<sup>29</sup>

EU aid reflects the institutional structure of the organization it comes from; a hybrid governance form between national and international structures. Rather than evaluating the aid budget of the European Union in terms of audience costs faced by the contributing member-states, it is reasonable to argue that their volume of aid participation consolidates the policy areas that have been delegated to EU institutions; primarily trade, monetary policy and energy

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<sup>27</sup> Djankov Simeon et al. "Entrepreneurship in Russia and China Compared", *Journal of the European Economic Association*, April-May 2006, 4(2-3): 352-365.

<sup>28</sup> Braeutigam Deborah. "Governance, Economy and Foreign Aid" *Studies in Comparative International Development*, Fall 1992, Vol. 27, No. 3, 3-25.

<sup>29</sup> Braeutigam Deborah. "Governance, Economy and Foreign Aid" *Studies in Comparative International Development*, Fall 1992, Vol. 27, No. 3, 3-25.

security.<sup>30</sup> Bräutigam argues that aid intensity over a protracted period leads to aid dependence.<sup>31</sup> Moreover, aid dependence generates a coordination game among three sets of players; politicians and bureaucrats, national and regional interest groups, and aid organizations.<sup>32</sup> The difference between standard bilateral aid packages and EU aid contracts is that aid intensity does not make domestic macroeconomic stability directly contingent on the approval of aid flows by the Commission. Rather than capturing the budgetary balance of the recipient, EU aid reinforces the role of the European Union as the most preferable currency area and commercial partner.<sup>33</sup> At the same time, it ensures the continuity of energy supplies from Russia and Kazakhstan through Ukraine to Western European economies. High or low levels of bureaucratic capacity on the side of the recipient define the distributive ability of post-Soviet planners, which is the key quality for aid effectiveness from the recipient's perspective. It becomes clear that distributive autonomy is only feasible when budget support is excluded and project support does not offer rent-seeking incentives to post-Soviet bureaucrats.<sup>34</sup> Distribution can dominate the accumulation of personal rents, only when the reform of legal institutions, public infrastructure and social services increases the social legitimacy of the government and facilitates the performance of functions that post-Soviet planning would have to implement. The presence of a strong public sector is a key component for EU aid success, because in the post-Soviet space the real institutional choice is not between the public and the private sector, but between a strong state and the absence of it. Hence, while it maintains its indirect conditionality clauses, EU aid reinforces national development strategies in Russia,

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<sup>30</sup> Milner Helen V. "Foreign Aid and Domestic Principal-Agent Problems", *Columbia University Unpublished Manuscript*, 2004.

<sup>31</sup> Braeutigam Deborah. "Aid Dependence and Governance" *EGDI Working Paper 2001: 1*.

<sup>32</sup> Braeutigam Deborah. "Aid Dependence and Governance" *EGDI Working Paper 2001: 1*.

<sup>33</sup> As Cassels argues in Cassels Andrew. "Aid instruments and health systems development: An analysis of current practice", *Health Policy and Planning*, Vol. 11, No. 4: 354-368, 1996., budget support is not an efficient solution; on the contrary, a combination of developmental instruments and objectives is necessary.

<sup>34</sup> Eifert Benn and Alan Gelb. "Improving the Dynamics of Aid; Towards More Predictable Budget Support", *Office of the Vice President, Development Economics, World Bank*, April 2005.

Ukraine and Kazakhstan by proposing the economies of the EU member-states as the realistic institutional, financial and economic model for any transition.

The projection of European Union as the ideal economic and political entity where post-Soviet economies should converge constitutes a crucial normative assumption underpinning EU aid effectiveness from the donor's perspective. Structural features of sub-national bureaucracies and local business-government relations may shape the quality of the consortiums between European legal persons and their counterparts in Russia, Ukraine or Central Asia.<sup>35</sup> The intensity of civil society tends to be representative of bureaucratic openness in a given region, particularly in the post-Soviet context. EU aid fosters a principal-agent relationship between the local bureaucrat and the NGO or a policy research institute; the delegation of authority from the state to non-governmental actors could never have been the case without the presence of significant financial incentives. I argue that distributive planners consent to the by-passing of their formal authority, because they treat the post-Soviet legal persons involved in the aid delivery process as their agents. It is self-evident that no contract implementation is possible, if it contradicts the policy objectives of the planner; this is the reason why the most successful consortiums are established with legal persons that have strong ties with the bureaucratic apparatus of their jurisdiction.

From an organizational standpoint, I observe that the political and economic prerequisites of EU aid delivery generate an interesting phenomenon; the emergence of a multifaceted organizational form composed of a public core and private extensions. Rather than the public-private partnerships, which have been observed in multiple parts of the world and reduced considerably the transaction costs in the development process, EU aid has transformed post-Soviet bureaucracies in an unintended but unique way. The formation of a public organization whose implementation branches are private entities, funded by an external source leads to an interesting consideration; optimal organizations are inclined to minimize the levels of

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<sup>35</sup> Fleischmann Arnold et al. "What's a City to Do? Explain Differences in Local Economic Development Policies", *Political Research Quarterly*, 1992, 45, 677-699.

uncertainty in their decisions and thus output, because they have to generate their own income base.<sup>36</sup> Thus, this U-form organization, which combines the public mandate of the regional or federal bureaucracy and the flexibility of civic or corporate organizations, constitutes the post-Soviet planner's institutional response to EU aid. It has been stated before that the primary goal of European aid bureaucrats is to avoid direct budget support or grants that will finance public contracts that have already been decided by the recipient government. What I suggest is the existence of two overlapping policy sets, whose intersection defines the core of aid contracts funded by the European Commission and implemented by the consortium between a European business or NGO and the U-form binary organization of the recipient.

While distance from the West and colonial experience are not relevant variables in my analysis, population size seems to play the inverse role as a determinant of aid allocation for the European Commission.<sup>37</sup> Rather than focusing on demographically less dense areas, EU aid allocation implies that the size of the public sector and thus bureaucratic capacity are essential components of aid effectiveness, when they are not associated with corruption.<sup>38</sup> Data from the EU food aid program indicates that population size is a positive factor in food deliveries, because it is positively correlated with actual human need.<sup>39</sup> It is profound that while high levels of administrative capacity are observed in aid recipients with large public sectors, high degrees of bureaucratic concentration may also account for potentially high transaction costs in the form of bribes and delays in aid delivery.

This contradictory nature of bureaucratic concentration has been used so far to explain aid failure rather than aid success. Zhuravskaya argues that Russian intergovernmental relations

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<sup>36</sup> Cremer Jacques, "A Partial Theory of the Optimal Organization of the Bureaucracy", *Bell Journal of Economics*, Vol. 11, No. 2, (autumn 1980): 683-693.

<sup>37</sup> Neumayer Eric. "The Determinants of Aid Allocation by Regional Multilateral Development Banks and United Nations Agencies", *International Studies Quarterly*, Vol. 47, No. 1, March 2003, 101-122.

<sup>38</sup> Neumayer Eric. "The Determinants of Aid Allocation by Regional Multilateral Development Banks and United Nations Agencies", *International Studies Quarterly*, Vol. 47, No. 1, March 2003, 101-122.

<sup>39</sup> Neumayer Eric, "Is the Allocation of Food Free from Donor Interest Bias?", *Journal of Development Studies*, Vol. 41, No. 3, 394-411; ethnic and foreign policy convergence matter as determinants of aid allocation in Neumayer Eric. "What Factors Determine the Allocation of Aid by Arab Countries and Multilateral Agencies?" *Journal of Development Studies*, 39:4, 134-147.

have undermined the bureaucratic capacity of local authorities, because they stripped them off the option of accumulating their own tax revenue base, independently from their hierarchically superior regional and federal governments.<sup>40</sup> What may be inferred from her argument is that EU aid, although it does not generate an autonomous resource base for the local administrative planners, yet it supports those projects that set common grounds for the policy objectives of both the Commission and the recipient government at any of its levels. The design of Weberian bureaucracies often requires social forces and political conditions that are just not present in transition economies.<sup>41</sup> Given that in the former Soviet Union bureaucracy pre-ceded transition to more representative forms of government, state capacity is independent from the impact of electoral institutions. Post-Soviet economies have experienced periods of their own state collapse during the 1990s; during this disintegration, private actors, who substituted the state in a wide array of its functions, facilitated the provision of basic public goods.<sup>42</sup>

Oi introduces the definition of local state corporatism as a positive outcome of Chinese fiscal reform; the expansion of revenue base for local bureaucrats incentivized their transformation to local entrepreneurs and thus the creation of collective rural industry with state intervention rather than collapse.<sup>43</sup> In the former Soviet Union, I observe the inverse process. Private organizations fulfill the mandate of public agencies and thus developmental entrepreneurs become *de facto* distributive bureaucrats, accountable to the public officials of their jurisdiction. Instead of maintaining formal hierarchies, EU aid suggests a set of financial incentives that strengthen the institutional position of both formal administrators and local entrepreneurs, since the latter's survival is contingent on two factors: 1. Political approval by the former and 2.

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<sup>40</sup> Zhuravskaya Ekaterina V. "Incentives to provide local public goods: fiscal federalism, Russian style", *Journal of Public Economics*, 76 (2000): 337-368.

<sup>41</sup> Goldsmith Arthur, "Africa's Overgrown State Reconsidered: Bureaucracy and Economic Growth", *World Politics*, Vol. 51, No. 4, (June 1999): 520-546.

<sup>42</sup> Roland Gérard, *Transition and Economics: Politics, Markets and Firms*, MIT Press, 2000, Government Collapse and Economic Performance; African experience of state collapse is not pertinent here as described in Addison Tony. "Reconstruction from War in Africa: Communities, Entrepreneurs and States" *CSAE Conference 2001*, WIDER Helsinki.

<sup>43</sup> Oi Jean C., "Fiscal Reform and the Economic Foundations of Local State Corporatism in China", *World Politics*, Vol. 45, No. 1, (October 1992): 99-126.

The conclusion of aid consortiums with European businesses and NGOs. The inherent contradiction in terms of the Russian civil society becomes obvious here; civic organizations and local business groups can exist only if their declared organizational goals and objectives are in line with the guidelines of the local or regional bureaucracy. At the same time, only then Russian civic organizations can defend their cause with European aid funding and therefore marginally affect the policy set of the Russian executive.

The comparative study of bureaucratic politics indicates that state interventionism is essential for economic development, particularly in countries that have gone through war or radical regime change.<sup>44</sup> Unlike other forms of multilateral aid, EU aid does not shift talented personnel away from the public sector of the recipient country; the quality of governance in the post-Soviet space is preserved in the form of excess supply of administrative services.<sup>45</sup> The existence of overlapping policy sets by the donor and the recipient create the critical mass of development in Russia, Ukraine, Kazakhstan, and the other economies of the former USSR that have received aid from the European Union. Its incremental rather than holistic character does not intend to weaken domestic bureaucracy and therefore enhances its effectiveness potential. At the same time, the recipient government maintains its distributive monopoly by allowing civic and private sector development to the extent it meets its own policy objectives. This ex novo coordination between the aid agency and the bureaucrat – local, regional or federal – reinforces the jurisdictional centralization of public goods and social services, funded by the European Commission. In that respect, it may be plausible to suggest that EU aid works as the new soft budget constraint for the post-Soviet planner, not in the sense of bailing out defunct public enterprises, but preserving bureaucratic quality and state capacity.

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<sup>44</sup> Cheng Tun-Jen et al. "Institutions and Growth in Korea and Taiwan; The Bureaucracy", *Journal of Development Studies*, Vol. 34, No. 6: 87-111.

<sup>45</sup> Knack Stephen. "Aid Dependence and the Quality of Governance: Cross-Country Empirical Tests". *Southern Economic Journal*, Vol. 68, No. 2, October 2001, 310-329.

### III. Centralized Systems and EU Aid: The New Soft Budget Constraint

The soft budget constraint has been one of the critical elements in the organization and survival of centrally planned economies. Dewatripont and Maskin provide a revised explanation of the original Kornai definition; they define centralization in terms of credit distribution rather than property rights.<sup>46</sup> Project profitability defines the refinancing of a poor project in the second period.<sup>47</sup> Banks become, therefore, the core of economic development and market organization, because their financing decisions define which enterprise survives and which does not; this will depend on whether the bank is better off by refinancing a poor project or declaring the respective enterprise bankrupt.<sup>48</sup> Qian and Roland treat the soft budget constraint as common grounds for the sequential study of both centrally planned and transition economies;<sup>49</sup> they suggest that the bailout of hierarchically inferior governments and enterprises – both public and private – becomes less likely, when fiscal decentralization takes place; on the contrary, the budget constraint softens under conditions of fiscal centralization and higher inflation.<sup>50</sup> Monetary centralization may either harden or soften the budget constraint; the critical condition is the delineation of fiscal competencies between the central and local governments.<sup>51</sup>

Thus, the set of incentives for the softening of budget constraints is different in socialist and transition economies. Under central planning, bureaucratic screening *ex ante* and refinancing

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<sup>46</sup> Dewatripont E. and E. Maskin. "Credit and Efficiency in Centralized and Decentralized Economies", *Review of Economic Studies*, Vol. 62, No. 4, 541-555, October 1995.

<sup>47</sup> Dewatripont E. and E. Maskin. "Credit and Efficiency in Centralized and Decentralized Economies", *Review of Economic Studies*, Vol. 62, No. 4, 541-555, October 1995.

<sup>48</sup> Dewatripont E. and E. Maskin. "Credit and Efficiency in Centralized and Decentralized Economies", *Review of Economic Studies*, Vol. 62, No. 4, 541-555, October 1995.

<sup>49</sup> Qian Y. and G. Roland. "Federalism and the Soft Budget Constraint" *American Economic Review*, 88:5, 1143-1162, December 1998.

<sup>50</sup> Qian Y. and G. Roland. "Federalism and the Soft Budget Constraint" *American Economic Review*, 88:5, 1143-1162, December 1998.

<sup>51</sup> Qian Y. and G. Roland. "Federalism and the Soft Budget Constraint" *American Economic Review*, 88:5, 1143-1162, December 1998.

of high-cost projects ex post facilitate large-scale innovation that requires sufficient levels of prior information.<sup>52</sup> During transition, fiscal and institutional decentralization requires the creation of competitive local governments, able to generate their own revenue base and respond to the hardening of budget constraints by the central government. Nevertheless, post-Soviet economies preserve a crucial institutional legacy from the Soviet period; the U-form organization, whose system of incentives depends on decisions taken at ministerial/industrial rather than regional levels.<sup>53</sup> The role of agency is crucial here. An enterprise may request optimal financial support by the central government; the optimal fee level is defined by the number of projects initiated, total net profits, and number of projects terminated after period I.<sup>54</sup> Unlike the Dewatripont and Maskin model, the enterprise itself will initiate projects that it has not pre-screened as well as complete some unprofitable projects.<sup>55</sup>

Very few scholars have defined aid in terms of the soft budget constraint.<sup>56</sup> Bräutigam argues that foreign aid constitutes a moral hazard problem for the donor when aid flows are expected to continue, even when the recipient government is not successful in implementing its proclaimed reform agenda.<sup>57</sup> Thus, this system of incentives may make the recipient to violate the expected level of macroeconomic discipline believing that the donor will bail her out. This rational scheme is pertinent only for aid disbursed directly to the central or regional government budget in the form of a loan or a grant. As I have stated in the previous section of this paper, EU aid generates a completely different system of incentives in post-Soviet

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<sup>52</sup> Qian Y. and C. Xu. "Innovation and Bureaucracy under Soft and Hard Budget Constraints", *Review of Economic Studies*, Vol. 65, No. 1: 151-164, January 1998.

<sup>53</sup> Maskin E. et al. "Incentives, Information and Organizational Form". *Review of Economic Studies*, Vol. 67, No. 2, April 2000, 359-378.

<sup>54</sup> Maskin E. "Recent Theoretical Work on the Soft Budget Constraint", *American Economic Review*, Vol. 89, No. 2, Papers and Proceedings of the One Hundred Eleventh Annual Meeting of the American Economic Association (May 1999): 421-425.

<sup>55</sup> Maskin E. "Recent Theoretical Work on the Soft Budget Constraint", *American Economic Review*, Vol. 89, No. 2, Papers and Proceedings of the One Hundred Eleventh Annual Meeting of the American Economic Association (May 1999): 421-425.

<sup>56</sup> Svensson Jakob. "When is foreign aid policy credible? Aid dependence and conditionality", *Policy Research Working Paper 1740*, March 1997; Braeutigam Deborah. "Aid Dependence and Governance" *EGDI Working Paper 2001: 1*.

<sup>57</sup> Braeutigam Deborah. "Aid Dependence and Governance" *EGDI Working Paper 2001: 1*.

economies. Instead of creating disincentives for macroeconomic stability, the alignment of EU aid with domestic development objectives is *ex post* rather than *ex ante*. The reason for that is that the European Commission will only fund projects that make the post-Soviet economies better trading partners and assist them in approximate the principles of representative governance and basic individual and social rights.<sup>58</sup> The resolve of the recipient government to adopt the economic and political principles of the Union is increasing with the expected profit of regional economic cooperation between the European Union and the largest economies of the former Soviet Union. Hence, post-Soviet reform has been possible, to the extent that it has relied on expected gains from EU aid flows.

Roland and Dewatripont argue that the soft budget constraint is the outcome of a defunct commitment device proposed by the government or the relevant financial institution.<sup>59</sup> Their adaptation of the Dewatripont-Maskin model suggests that the government will have to commit *ex ante* that it will not refinance bad projects in the  $n+1$  funding period, so that managers of bad projects are deterred from submitting those for funding in the first place.<sup>60</sup> The conclusion of aid contracts between the European Commission and any U-form organization, composed of a distributive public planner and a development private entrepreneur, creates a two-fold incentives scheme, both for the donor and the combination of actors involved on the recipient's side. On the one hand, the donor will further support badly implemented projects, because investment costs are usually irreversible.<sup>61</sup> Nevertheless, he can require that the implementing branch of the U-form organization change so that he refinances the project in the  $n+1$  period. The recipient government knows that the European Commission has committed to have the project completed according to its standards. The level of effort

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<sup>58</sup> This argument is further elaborated in the chapter where I analyze aid effectiveness from the donor's perspective.

<sup>59</sup> Dewatripont M. and G. Roland, "Soft budget constraints, transition and financial systems", *Unpublished Manuscript*, September 1999.

<sup>60</sup> Dewatripont M. and G. Roland, "Soft budget constraints, transition and financial systems", *Unpublished Manuscript*, September 1999.

<sup>61</sup> Dewatripont M. and G. Roland, "Soft budget constraints, transition and financial systems", *Unpublished Manuscript*, September 1999.

furnished by the local NGO or private business that runs the project domestically is critical here. Because the current level of effort is not observable, it is possible to look at its record of past international public contracts, prior financial dependence on central or regional bureaucracies, and previous involvement in human and social rights projects, both domestic and international.

Economic development in the former Soviet Union becomes a set of centrally decided policies introduced by two types of planners; the central or regional bureaucracy of the recipient and the supranational donor. The domestic bureaucracy provides the political legitimacy and the supranational donor the financial support required for the completion of any developmental project. Unlike in socialist economies, the allocation of aid does not rely on a single unitary actor but on a dyad of actors; the donor will not finance projects approved by the domestic planner, if they do not increase her utility in terms of trade profits or value-infused policies. Thus, the recipient government has the incentive to propose contracts that will have mutually beneficial outcomes. The rejection of a bad project in the  $n+1$  period does not only entail a major financial loss for the donor, but it also signifies a major opportunity cost for the local planner. Elections may not matter directly or indirectly in the post-Soviet space. Nevertheless, performance-based policy effectiveness can be used as an evaluation mechanism by hierarchically superior bureaucracies, which want to increase their foreign aid revenues. As Bolton and Farrell argue, speed and reliability of coordination in a centralized system may outperform the drive to find the lowest-cost entrant.<sup>62</sup> In my argument, the financing authority is external to any post-Soviet political system. This phenomenon stresses that the planner's distributive autonomy is constrained by the donor's allocative preferences; the donor cannot impose his policy preferences on the recipient *ex ante*, and the recipient cannot block a signed and ongoing aid contract *ex post*.

This collective and transnational nature of EU aid to the former Soviet Union may justify why the European Commission has been the relatively most successful donor in the region since

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<sup>62</sup> Bolton P. and J. Farrell, "Decentralization, Duplication and Delay", *Journal of Political Economy*, Vol. 98, No. 4 (August 1980): 803-826.

1991. Although EU aid contracts have been less ambitious in terms of budget constraints and policy objectives, compared to their respective projects run by the World Bank, or mature bilateral donors, they have been able to approximate largely their initial targets. Rather than intending to reform the critical mass of the recipient's political system, the European Commission has made efficient use of the region's strong bureaucratic tradition to secure aid effectiveness. The growth of post-Soviet entrepreneurship is positive not when it substitutes, but when it complements the bureaucracy's economic mandate.<sup>63</sup> The principal-agent relationship between the planner and the entrepreneur leads to the integration of the latter into the political and economic structures of the former; moreover, the new soft budget constraint is not set by the institutional successor of the Soviet planner, the post-Soviet bureaucrats, but the European Commission.

The symbiosis between business and government is not a novelty in the class of transition economies. Che argues that township-village enterprises in China (TVEs) are organizational extensions of the local government; nevertheless, the presence of private banks hardens the budget constraints of TVEs, as opposed to SOEs.<sup>64</sup> China's imperfect institutional environment is radically different from its post-Soviet equivalent; provincial governance was never significant in the Soviet Union and thus "community corporations" could not have escaped the soft budget constraint problem, faced by SOEs.<sup>65</sup> In the former Soviet Union, the partnerships between bureaucrats and entrepreneurs have a finite time horizon; and contrary to the standard model of public-private partnerships, which focuses on the supply of aid, the U-form aid partnerships include elements of both aid demand (distributive planner) and aid supply

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<sup>63</sup> Contrary to Djankov S. et al. "Who are Russia's Entrepreneurs?" *Journal of the European Economic Association*, April-May 2005, 3 (2-3): 587-597.

<sup>64</sup> Che J. and Y. Qian, "Institutional Environment, Community Government, and Corporate Governance: Understanding China's Township-Village-Enterprises", *Journal of Law, Economics, and Organization*, 1-23, 1998.

<sup>65</sup> Che J. and Y. Qian, "Institutional Environment, Community Government, and Corporate Governance: Understanding China's Township-Village-Enterprises", *Journal of Law, Economics, and Organization*, 1-23, 1998.

(developmental entrepreneur). Moreover, in the aid implementation consortium, the participation of a European NGO or business is required.

These collaborative structures between state and society for the purpose of national development with transnational means provide a novel definition for aid bureaucracies, applicable both in a comparative and an international context. These are *partnerships of transnational sovereignty*. Their survival is contingent on a financial decision taken in Brussels and implemented in the territory of the post-Soviet recipient, which defines the degree and horizon of the soft-budget constraint they face. However, their very existence depends on their approval by the aid beneficiary, the post-Soviet planner.

#### IV. Formal Analysis: EU aid and the New Soft Budget Constraint

I assume that the European Commission has the following objective function:

$$\Pi_{EC}(q_1, q_2; \theta) = \alpha B_T(q_j) + \beta B_I(q_j) - C(q_j, \theta_i)$$

$B_T(q) = \ln q_1$  which denotes the European Commission's benefits from the aid volume  $q_1$  spent in trade and investment projects, and  $B_I(q_j) = \ln q_2$ , which denotes its benefits from the aid volume  $q_2$  spent in social and institutional reform projects. It is clear that  $\alpha, \gamma$  are some parameters, while  $\theta_i$  is a proxy for the density of potential TSPs in any recipient economy.  $C(q, \theta_i)$  is a concave cost function, decreasing in  $\theta_i$ . Thus, the first order conditions are:

$$D_q \Pi_{EC}(q_1, q_2; \theta) = \begin{bmatrix} \frac{\alpha}{q_1} - \frac{\partial C(q_j, \theta_i)}{\partial q_1} \\ \frac{\beta}{q_2} - \frac{\partial C(q_j, \theta_i)}{\partial q_2} \end{bmatrix} = \begin{bmatrix} 0 \\ 0 \end{bmatrix} = U_{EC}(q_1, q_2; \theta)$$

By the Implicit Function Theorem:

$$D_q U_{EC}(q_j; \theta_i) = \begin{bmatrix} -\frac{\alpha}{q_1^2} \frac{\partial^2 C(q_j, \theta_i)}{\partial q_1^2} & -\frac{\partial C(q_j, \theta_i)}{\partial q_1 \partial q_2} \\ -\frac{\partial^2 C(q_j, \theta_i)}{\partial q_2 \partial q_1} & -\frac{\beta}{q_2^2} \frac{\partial^2 C(q_j, \theta_i)}{\partial q_2^2} \end{bmatrix}$$

$$\text{And } D_\theta U_{EC}(q_1, q_2; \theta) = \begin{bmatrix} -\frac{\partial^2 C(q_j, \theta_i)}{\partial q_1 \partial \theta_i} \\ -\frac{\partial^2 C(q_j, \theta_i)}{\partial q_2 \partial \theta_i} \end{bmatrix}.$$

Thus,  $D_\theta q_j^*(\theta) = D_q^{-1} U_{EC}(q_1, q_2; \theta) * D_\theta U_{EC}(q_1, q_2; \theta)$ , which is equivalent to:

$$D_\theta q_j^*(\theta) = - \begin{bmatrix} -\frac{\alpha}{q_1^2} \frac{\partial^2 C(q_j, \theta_i)}{\partial q_1^2} & -\frac{\partial^2 C(q_j, \theta_i)}{\partial q_1 \partial q_2} \\ -\frac{\partial^2 C(q_j, \theta_i)}{\partial q_2 \partial q_1} & -\frac{\beta}{q_2^2} \frac{\partial^2 C(q_j, \theta_i)}{\partial q_2^2} \end{bmatrix}^{-1} * \begin{bmatrix} -\frac{\partial^2 C(q_j, \theta_i)}{\partial q_1 \partial \theta_i} \\ -\frac{\partial^2 C(q_j, \theta_i)}{\partial q_2 \partial \theta_i} \end{bmatrix}.$$

I observe that  $D_\theta q_j^*(\theta_i) \geq 0$ , which means that the objective function  $\Pi_{EC}(q_1, q_2; \theta_i)$  has increasing differences in  $(q_j, \theta_i)$ .

The density  $\theta_i$  of transnational sovereignty partnerships (TSPs) is higher in Russia compared to Ukraine or Kazakhstan, so that the following ordering holds:  $\theta_{RU} > \theta_{UA} > \theta_{KZ}$ . Thus, it becomes clear why aid effectiveness is more likely in Russia than in Ukraine or Kazakhstan.<sup>66</sup>

**Proposition 1:** *The aid-driven payoff of the European Commission is higher, when aid volumes for economic and institutional reform increase symmetrically with the density of transnational sovereignty partnerships (TSPs).*

**Corollary 1a:** *EU aid can soften the budget constraint of the recipient government, only when financially viable NGOs and businesses support development strategies at the domestic level.*

<sup>66</sup> For a very interesting argument on the positive role of bureaucracy on post-privatization firm productivity, see Brown David J., John S. Earle and Scott Gehlbach, "Helping Hand or Grabbing Hand? State Bureaucracy and Privatization Effectiveness", *American Political Science Review*, Vol. 103, No. 2, May 2009.

**Corollary 1b:** *Aid contracts, which increase the size of the private sector at the expense of the public sector, increase the rent-seeking incentives of local and central bureaucrats.*

It is clear that there a single institution for EU aid, the European Commission, an  $m$  number of firms and civic organization in the recipient country, and an  $n$  number of post-Soviet planning agencies, which are eligible aid beneficiaries. It is the case that  $m > n$ . The aid payoff of the European Commission is denoted as  $\Pi_{EC}$ . Following the models presented by Dewatripont and Maskin as well as by Roland and Qian, I set up the problem as a two-period game.<sup>67</sup> In period  $n$ , the European Commission decides to finance an aid contract, which is to be implemented by a partnership of transnational sovereignty between a public planner and a private entrepreneur. It will choose  $THP_{ij}$  with probability  $p_{ij}$  and  $TSP_{-ij}$  with probability  $p_{-ij}$ . In period  $n+1$ , if the project does not yield the expected payoff for the donor and the recipient, then the European Commission can either provide a lower amount of aid to  $TSP_{ij}$  with probability  $\mu_{ij}$  or change the structure of the implementing organization and choose  $TSP_{ij+1}$  with probability  $\mu_{ij+1}$ . It is self-evident that the number of potential implementing organizations forms a sequence  $\{TSP_{11}, \dots, TSP_{mn}\}$ , where  $i$  is in  $[1, m]$  and  $j$  is in  $[1, n]$ .

Treating EU aid as a mechanism, which softens the budget constraints of post-Soviet planners, leads to the following matrix of payoffs for the European Commission and any TSP:

*Matrix 1*

Aid Effectiveness →	Contract Completed	Incomplete Contract with the same TSP	Incomplete Contract with a different TSP
Actor ↓			
European Commission	$\Pi_{EC}(q_j; \theta_i)$	$\Pi_{EC}(q_j; \theta_i) - C(q_{j+1}; \theta_i)$	$\Pi_{EC}(q_j; \theta_i) - C(\bar{q}_{j+1}; \theta_i)$

<sup>67</sup> Qian Y. and G. Roland. "Federalism and the Soft Budget Constraint" *American Economic Review*, 88:5, 1143-1162, December 1998; Dewatripont E. and E. Maskin. "Credit and Efficiency in Centralized and Decentralized Economies", *Review of Economic Studies*, Vol. 62, No. 4, 541-555, October 1995.

$TSP_{ij}$	$p_{ij} C(q_j; \theta_i) - K$	$\mu_{ij} C(q_{j+1}; \theta_i) - \delta K$	$-\delta(K + \varepsilon)$
$TSP_{-ij}$	$-K$	$-\delta K$	$(1 - \mu_{ij})C(\bar{q}_{j+1}; \theta_i) - \delta K$

There are multiple conclusions to be drawn from this matrix. It becomes profound that any  $TSP_{ij}$  is incentivized to complete the assigned contract in period n, because:

$p_{ij} C(q_j; \theta_i) - K \geq \mu_{ij} C(q_{j+1}; \theta_i) - \delta K$ , where K is a constant for operational transaction costs and  $\delta$  is a discount effect between 0 and 1. Moreover,  $p_{ij} \geq \mu_{ij}$ , which means that  $TSP_{ij}$  is less likely to win the contract in period n+1 than in period n. Assuming that the European Commission is a risk-averse donor:

$$C(q_{j+1}; \theta_i) \leq C(q_j; \theta_i).$$

I also argue that any TSP is worse off if it does not receive the aid contract in period n+1 rather than when it does not receive the aid contract in period n. This means that  $\varepsilon \geq \frac{1-\delta}{\delta} K$ , where  $\varepsilon$  is the deficit that TSP runs for being unable to complete the project in the previous period.

**Proposition 2:** *The European Commission will opt for the same TSP in period n+1, if and only if  $C(\bar{q}_{j+1}; \theta_i) \geq C(q_{j+1}; \theta_i)$ . It will contract with a different TSP in period n+1, if and only if  $C(\bar{q}_{j+1}; \theta_i) \leq C(q_{j+1}; \theta_i)$ .*

**Corollary 2a:** *The difference between  $q_{j+1}$  and  $\bar{q}_{j+1}$  will define the European Commission's decision in the period n+1. If deficit  $\varepsilon$  is so high that  $\bar{q}_{j+1} < \min \{q_{j+1} - \varepsilon\}$ , then the donor will choose another TSP to complete the contract.*

Both proofs are derived vacuously. If the bailout of the initial TSP is more costly than the renegotiation of the contract with another similar organization, then the European Commission will opt for another partner. Hence, this model constitutes a marginal deviation from the soft budget constraint definition in centralized economies; here, the financing institution may let the recipient go bankrupt, as long as there is another partner to carry on with the completion of the contract.

## V. Discussion

The political economy of EU aid to Russia, Ukraine and Kazakhstan is crucial for explaining the incremental economic and institutional progress observed in the post-Soviet space since 1991. In this paper, I treat aid effectiveness as contingent upon the organizational responses and policies of the recipient government. In another paper, I complement the argument presented here by analyzing aid effectiveness as a donor's problem. The trilateral distinction among reciprocal (UK), ideological (Germany) and just donors (EU) provides alternative definitions of aid effectiveness, based on the hierarchy of material incentives and normative principles in the donor's political system. I treat the European Union as an intermediate aggregation of the British and German political economies, when it comes to aid allocation. Data on all EU aid contracts delivered to Russia, Ukraine and Kazakhstan is also available in my broader study. Given the extremely marginal - if not non-existent - impact of aid on growth, I intend to construct a Domestic Capacity Index, where collaborative structures between multiple layers of government on the one hand and private organizations on the other determine new modes of EU-infused governance in the former USSR.

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