

Chapter 2

Aid Effectiveness and the Soft Budget Constraint

Abstract This chapter analyzes EU development aid as the new soft budget constraint in the former Soviet Union. Aid effectiveness is defined as contractual completeness. The collaboration between federal or subnational administrative bodies on the one hand and private businesses or civic organizations on the other produces a novel definition of sovereignty. Transnational sovereignty suggests that development policy is decided by the recipient and financed by the donor. Transnational sovereignty partnerships (TSPs) constitute a novel type of aid recipient and an institutional component of the TACIS program. TSPs consist of distributive planners and developmental entrepreneurs. Distributive planners define domestic economic policy and developmental entrepreneurs implement it based on EU development aid. This is the core of transnational sovereignty in the hybrid institutional context of the European Union. A decision issued by the European Commission in Brussels provides the financial and institutional basis for the implementation of a development project in Russia and Eurasia, where central or local administrations are the initial planners and the final beneficiaries. The TACIS Program bailed out domestic development projects, whose final output would have otherwise been very uncertain.

2.1 Aid Effectiveness and the Recipient Economy

The TACIS Program has had effects similar to those of the soft budget constraint under central planning. The formation of consortia between European and post-Soviet legal entities facilitated the implementation of local and national development goals, already initiated by recipient bureaucracies. The idea of reform complementarities is common in the transition economics literature (Roland 2000). Unlike standard schemes of developmental cooperation, EU development aid to Russia and Eurasia has been entangled with the recipient's institutions. Instead of concentrating on the provision of grants and loans to federal or regional budgets,

This chapter draws largely from my articles "Aid Effectiveness and the Soft Budget Constraint: EU Development Aid to the former Soviet Union", *Economics Letters* 112 (2011): 287–289 and "Aid Effectiveness and Imperfect Monitoring: EU Development Aid as Prisoner's Dilemma", *Rationality & Society*, Vol. 25, No. 4 (November 2013): 489–512.

EU aid bureaucrats have worked collectively with federal, regional, and local bureaucrats in post-Soviet recipient economies to achieve common policy ends. Aid effectiveness is to be assessed not only in terms of the foreign policy preferences of the donor, but also in terms of the economic policy preferences of the recipient. In the formal section of this chapter, I focus on the analysis of EU development aid as the new soft budget constraint to the economies of the former Soviet Union.

I define aid effectiveness as contractual completeness. An aid program is effective when its contractual conditions are met by the recipient. The direct welfare effects of development aid are not a critical question in this chapter; rather than exploring whether the low-income tail of the population distribution becomes better off with the implementation of development aid projects, I analyze development aid as a consolidating factor of domestic state capacity (Akram 2003). 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 (Krueger 1980). Because it is usually the case that the recipient is rich in raw materials and the donor in services and technologically advanced commodities, development aid is inclined to offset the recipient's losses from trade. EU development aid—more than any other form of development assistance—advances the trade interests of EU member states by committing to 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 (Olson 1963). Rather than treating the public sector as a necessary evil of the aid implementation process, EU aid bureaucrats work primarily on aid contracts that facilitate the provision of public goods by the recipient government, and thus advance its administrative capacity and quality of welfare provision (Krueger 1986). Collier and Dollar, in their comprehensive review of aid effectiveness, contend that aid does not induce policy change while the opposite is likely; policy reform can create a favorable environment for the successful implementation of aid contracts (2004).

This chapter has a twofold purpose. First, it proposes a model that treats EU development aid as a soft budget constraint. Second, it introduces the term *transnational sovereignty partnership*. A transnational sovereignty partnership is a recipient institution composed of a post-Soviet bureaucracy and a consortium of developmental NGOs that implement the assigned aid contract. Its financing depends exclusively on the EU development aid. It is assumed that post-Soviet bureaucrats distribute financial resources with the purpose of maintaining a minimum of social subsistence to their poorest group of citizens¹; aid implementation

¹ 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.

becomes feasible with the donor's supervision and the recipient's administrative accountability. This is why post-Soviet aid bureaucrats are defined as distributive planners. Developmental NGOs and businesses are agents rather than counterbalancing institutions of governmental policy; they do not complement the absence of state capacity, but reinforce the government's role as provider of public goods.²

The distinction between weak and strong authoritarianism seems to be also important for aid effectiveness (Islam 2003). Strong authoritarian governments are more likely than weak autocracies to make efficient use of development aid flows. Socioeconomic indicators such as infant mortality and public health services improve because of aid flows under strong authoritarian regimes, whereas weak dictators cannot use aid to promote their human development indicators (Islam 2003). Collier and Dollar, in their comprehensive review of the aid effectiveness, contend that aid does not induce policy change while the opposite is likely; policy reform can create a favorable environment for the successful implementation of aid contracts (Collier and Dollar 2004). EU development aid meets their basic criteria of aid effectiveness (Collier and Dollar 2004). I argue that EU development aid can be used as a soft budget constraint by recipient governments and their NGOs as intermediaries to improve the provision of public goods. The differentiation between federal and centralized political systems is critical in that respect; as evidence from the Bundesländer indicates, subnational administrations of federal governments can contribute with their universities, private enterprises, NGOs, and technical knowledge to the promotion of German development policy (Wiemann 2008). Multiplicity of actors at the subnational level can only constrain the rent-seeking strategies of recipient governments. The expected payoff is lower for all parts and aid-induced policy reform is certainly likely to generate winners among bureaucrats.

This chapter is structured as follows; in Sect. 2.2, I analyze the coordination between developmental entrepreneurs and distributive planners from the perspectives of transnational sovereignty and monitoring institutions of the European Union. In Sect. 2.3, 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 development aid as a new form of a soft budget constraint in transition economies. Section 2.4 proposes a formal definition of aid effectiveness in the light of the soft budget constraint literature. The [final section](#) concludes.

² Contrary to Boschini Anne and Anders Olofsgard. "Foreign Aid: An Instrument for Fighting Communism?", *Journal of Development Studies*, Vol. 43, No. 4 (2007), 622–648.

2.2 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. 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 (Casella and Eichengreen 1996). 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 (Knack and Rahman 2007). 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, central and local bureaucrats do not have any rent-seeking incentives that are usually produced by the competitive supply of multiple aid loans and grants (*ibid.*) (Fig. 2.1).

The European Commission proposes an aid delivery model relying on two types of domestic players that jointly form a transnational sovereignty partnership: developmental entrepreneurs and distributive planners. Developmental entrepreneurs substitute rather than complement political entrepreneurs at the civil society level; differentiated forms of nonrepresentative government in Russia and Eurasia do not allow the institutional independence of civil society from the state and its policy objectives. Given the competition for aid resources available to



Fig. 2.1 Street life in Kiev, Ukraine (BMZ, © Thomas Koehler/photothek, 2014)

developmental NGOs and businesses, only developmental organizations with a successful implementation record are likely to survive for more than one aid delivery period.

Hence, bureaucrats in the former Soviet Union have used aid flows to maintain a minimum level of distribution. Unlike other forms of multilateral or bilateral aid, EU development aid has not relied on the corrosion of the recipient's administrative capacity; aid contracts do not serve as indirect bribes to bureaucrats or elected officials. Post-Soviet bureaucrats maintain the highest degree of information with respect to the needs of the population; this is why the European Commission makes its aid delivery decisions based on information by recipient governments (*ibid.*). Particularly when it comes to the Russian case, Desai, Freinkman, and Goldberg indicate that fiscal autonomy in Russian regions leads to increased economic growth while at the same time creates incentives for rent-seeking both for regional politicians and local large-scale firms (2005). Thus, they propose a combination of fiscal decentralization and political centralization so that both growth rates remain high and rent-seeking incentives at the local level are eliminated.

Easterly describes foreign aid bureaucracies as a "cartel of good intentions," which does not intend to sign risky contracts, because both the marginal cost of monitoring will be higher and the probability of success will be lower (2002). This logical pattern may explain why EU aid bureaucrats are less likely to approve contracts directed to less stable bureaucratic environments, given that it is still unclear whether increased administrative and fiscal independence from the center leads to higher levels of subnational institutional stability. Nevertheless, in transition economies reduced bureaucratic and fiscal capacity is more likely to be connected with the institutional dominance of the central government over regional ones. Remmer makes the well-founded statement that aid flows increase the size of the public sector in recipient countries; this phenomenon consolidates incentives for the increase of public spending while creating counterincentives for revenue generation through taxation (2004: 86–89). Boone does not test directly the impact of aid on growth, but he focuses on its effect on government consumption; he concludes that aid has a strong impact on government consumption, but a very marginal one on poverty alleviation (1996: 315–317).

Governmental accountability is another factor that matters for aid effectiveness. Holmes contends that it should be the key issue in foreign aid planning toward Russia; without an accountable government, foreign aid results will be consistently imperfect and fragmented (1999: 3–4). He points out that in a country with a tradition of state interventionism governmental accountability should be the policy outcome sought by donors in the first place. This is why he proposes the promotion of solid institutional alliances between the donor, the Russian government, and non-state actors such as NGOs or interest group associations. The increasing federal concentration of EU development aid to Russia can be a useful extension of Holmes's enlightening take. Donors do not want to work with governments that cannot contribute to project success. Putin's federal reforms in 2000 severely weakened Russia's structure as a federal state. The capacity of the Federal Ministry of Justice to prevent regional laws from even coming into force, the institutional

reinforcement of the seven presidential envoys, as well as the frequent exertion of political pressures on regional courts are clear signs that Russia has been transforming itself into a hybrid polity where formal rules are combined with vertical administrative intervention, which is in most cases unconstitutional (Hahn 2001).

It has to be noted here that the existence of development-driven NGOs in the former Soviet Union depends on the funding they receive from the European Commission or other multilateral institutions that work directly with them or through their respective national governments. The more stringent the monitoring imposed by the donor, the more objective the criteria for the continuation of aid financing and favorable tendering decisions. As it has been aforementioned, informational transfers from post-Soviet recipient governments to the European Commission critically define the policy areas of aid contracts decided in Brussels. This is why aid governance in the former Soviet Union has been linked with collaborative activity between distributive planners and developmental entrepreneurs. If post-Soviet planners were not committed to the provision of public goods, then EU development aid would not have been the main pillar of structural adjustment and transition for all post-Soviet economies. Instead, they would have been better off receiving bilateral aid from reciprocal 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 (Bräutigam 1992).

EU development 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 security (Milner 2006). Bräutigam argues that aid intensity over a protracted period leads to aid dependence (2001). Moreover, aid dependence generates a coordination game among three sets of players: politicians and bureaucrats, national and regional interest groups, and aid organizations (Bräutigam 2001). 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, development aid reinforces the role of the EU as the most preferable currency area and commercial partner.³ At the same time, it ensures the continuity of energy supplies from Russia and Kazakhstan through Ukraine to Western

³ As Cassels argues in "Aid instruments and health systems development: An analysis of current practice", *Health Policy and Planning*, Vol. 11, No. 4: 354–368, 1996, budget support alone is not an efficient solution. On the contrary, a combination of developmental instruments and objectives is more preferable.

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.

Commitment to public goods as a strategy can dominate the accumulation of personal rents, only when the reform of legal institutions, public infrastructure, and social services increases the legitimacy of government and facilitates the performance of functions that post-Soviet bureaucracies would have to implement. The presence of a strong public sector is a key component for EU aid effectiveness, because in the post-Soviet space the real institutional choice is not between public and privatized governance, but between a strong state and the absence of it. Hence, while it maintains its indirect conditionality clauses, EU development aid reinforces national development strategies in Russia, Ukraine, and Kazakhstan. The treatment of the EU as a paradigmatic set of institutions toward which post-Soviet economies should converge is a key normative assumption underpinning EU aid effectiveness in the post-Soviet space.

Transnational sovereignty partnerships are idiosyncratic institutions composed of a public core and private entities as implementation branches. Contrary to standard public-private partnerships, which have considerably reduced transaction costs in aid delivery, EU development aid has transformed post-Soviet bureaucracies in an unintended but unique way. Transnational sovereignty partnerships are U-form organizations that combine the public mandate of a regional or central bureaucracy and the flexibility of civic or corporate organizations. That way, they constitute the post-Soviet planner's institutional response to the incentive structure proposed by the TACIS program. The primary goal of EU aid bureaucrats is to avoid direct budget support or grants that will finance public contracts already 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 a transnational sovereignty partnership on the territory of the recipient.

Zhuravskaya argues that Russian intergovernmental relations in the 1990s undermined the bureaucratic capacity of local authorities, because they stripped them of the option of accumulating their own tax revenue base, independently from their hierarchically superior regional and federal governments (2000). Hence, EU development aid, although it does not offer an autonomous resource base for the local administrative planners, supports projects that set common policy objectives for both the EU and the beneficiary government, central or regional. In the former Soviet Union bureaucracies preceded and often captured transitions to more representative forms of government. Thus, state capacity may not be inherently linked to the development of electoral institutions.

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 a collective rural industry with state intervention rather than collapse (Oi 1992). 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 accountable to the public officials of their administrative jurisdiction. EU development aid offers a set of incentives that strengthen the institutional position of both administrators and local entrepreneurs, since the latter's market presence depends on two factors: (1) Political approval by the bureaucracy and (2) Formation of consortiums with European NGOs. The inherent contradiction in the Russian civil society becomes obvious here. Civic organizations and business groups must have an *ex ante* alignment of their declared organizational goals and objectives with the guidelines of the central or regional bureaucracy, in order to participate in the aid delivery process.

The comparative study of bureaucratic organization indicates that state interventionism is essential for economic development, particularly in countries that have gone through war or radical regime change (Cheng et al. 1998). Unlike other forms of multilateral aid, EU development 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 (Knack 2001). The incremental rather than holistic character of EU development aid has not intended to weaken domestic bureaucracy and has therefore enhanced its effectiveness potential. At the same time, the recipient government preserves its distributive monopoly by allowing civic and private sector development to the extent it meets its own policy objectives. This degree of coordination between the development aid agency and the bureaucrat—local, regional, or federal—reinforces the jurisdictional centralization of public goods, financed by the European Commission. In that respect, I suggest that EU development aid works as the new soft budget constraint for the post-Soviet planner, not in the sense of bailing out defunct public enterprises, but of preserving state capacity.

2.3 Centralization and EU Development 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 (1995) provide a revised explanation of the original Kornai definition; they define centralization in terms of credit distribution rather than property rights. Project profitability defines the refinancing of a poor project in the second period (Dewatripont and Maskin 1995). Banks become, therefore, the core of economic development and market organization, because their financing decisions define which enterprise



Fig. 2.2 International Finance and Banking School. Moscow, Russia (© European Union, 2014)

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 (Dewatripont and Maskin 1995). Qian and Roland (1998) treat the soft budget constraint as common grounds for the sequential study of both centrally planned and transition economies. They suggest that the bailout of hierarchically lower 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 (1998). 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 (Qian and Roland 1998) (Fig. 2.2).

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 of high-cost projects *ex post* facilitate large-scale innovation that requires sufficient levels of prior information (Qian and Xu 1998). 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 (Qian and Xu 1998). The role of agency is crucial here. An enterprise may request optimal financial support from 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 1 (Maskin 1999). Unlike the Dewatripont and Maskin model, the enterprise itself will initiate projects that it has not pre-screened and will complete some unprofitable projects (Maskin 1999).

Very few scholars have defined aid in terms of the soft budget constraint (Svensson 2000; Bräutigam 2001). EU development aid generates a completely different system of incentives in post-Soviet 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. 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 (Dewatripont and Roland 2000). 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 (Dewatripont and Roland 2000). 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 twofold incentives scheme, both for the donor and the combination of players involved on the recipient's side. On the one hand, the donor will further support badly implemented projects, because investment costs are usually irreversible (Dewatripont and Roland 2000). 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 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.

This collective and transnational nature of EU development aid to the former Soviet Union may justify why the European Commission has been the relatively most successful donor in the region since 1992. 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.⁴ 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.

These collaborative structures between state and society for the purpose of domestic 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.

2.4 The Model: The New Soft Budget Constraint

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

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

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

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

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

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.

⁴ Contrary to Djankov S. et al. "Who are Russia's Entrepreneurs?" *Journal of the European Economic Association*, 3 (2-3): 587-597, April-May 2005.

To prove proposition 1, I solve the European Commission's optimization problem. The first-order conditions are the following:

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

By the Implicit Function Theorem:

$$\begin{aligned} D_{q_j} U_{EC}(q_j; \theta_i) &= \begin{bmatrix} -\frac{\alpha}{q_1^2} - \frac{\partial^2 C(q_j, \theta_i)}{\partial q_1^2} & -\frac{\partial C(q_j, \theta_i)}{\partial q_1 \partial q_2} \\ -\frac{\partial^2 C(q_j, \theta_i)}{\partial q_2 \partial q_1} & -\frac{\beta}{q_2^2} - \frac{\partial^2 C(q_j, \theta_i)}{\partial q_2^2} \end{bmatrix} \\ D_{\theta_i} U_{EC}(q_j; \theta_i) &= \begin{bmatrix} -\frac{\partial^2 C(q_j, \theta_i)}{\partial q_1 \partial \theta_i} \\ -\frac{\partial^2 C(q_j, \theta_i)}{\partial q_2 \partial \theta_i} \end{bmatrix} \Rightarrow D_{\theta_i} q_j^*(\theta_i) = -D_{q_j}^{-1} U_{EC}(q_j; \theta_i) * D_{\theta_i} U_{EC}(q_j; \theta_i) \Rightarrow \\ D_{\theta_i} q_j^*(\theta_i) &= - \begin{bmatrix} \frac{\alpha}{q_1^2} - \frac{\partial^2 C(q_j, \theta_i)}{\partial q_1^2} & -\frac{\partial^2 C(q_j, \theta_i)}{\partial q_1 \partial q_2} \\ -\frac{\partial^2 C(q_j, \theta_i)}{\partial q_2 \partial q_1} & -\frac{\beta}{q_2^2} - \frac{\partial^2 C(q_j, \theta_i)}{\partial q_2^2} \end{bmatrix}^{-1} * \begin{bmatrix} -\frac{\partial^2 C(q_j, \theta_i)}{\partial q_1 \partial \theta_i} \\ -\frac{\partial^2 C(q_j, \theta_i)}{\partial q_2 \partial \theta_i} \end{bmatrix} \Rightarrow \\ D_{\theta_i} q_j^*(\theta_i) &\geq 0. \end{aligned}$$

This means that the objective function $\Pi_{EC}(q_1, q_2; \theta_i)$ has increasing differences in (q_j, θ_i) . It is clear that there is a single institution for EU development aid, the European Commission, an m number of firms and civic organizations in the recipient economy, and an k number of post-Soviet planning agencies, which are eligible aid beneficiaries. It is the case that $m > n$. The payoff of the European Commission is denoted as $\Pi_{EC}(q_1, q_2; \theta_i)$. Following the models presented by Dewatripont and Maskin (1995) as well as by Qian and Roland (1998), I set up the problem as a two-period game. In period n , the European Commission decides to finance an aid contract, which is to be implemented by a transnational sovereignty partnership, composed of a public planner and a private entrepreneur. It will choose TSP_{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 μ_{ij} or change the structure of the implementing organization and choose TSP_{ij+1} with probability μ_{ij+1} . The number of potential implementing organizations forms a sequence $\{TSP_{11}, \dots, TSP_{mn}\}$, where $i \in [1, m]$ and $j \in [1, n]$.

Table 2.1 Payoffs under EU development aid to the former Soviet Union

Degree of Aid Effectiveness → Player ↓	Contract completed	Incomplete contract with TSP_{ij}	Incomplete contract with TSP_{-ij}
European commission	$\Pi_{EC}(q_j; \theta_i)$	$\Pi_{EC}(q_j; \theta_i) - C(q_{j+1}; \theta_i)$	$\Pi_{EC}(q_j; \theta_i) - C(\bar{q}_{j+1}; \theta_i)$
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}	$-K$	$-\delta K$	$(1 - \mu_{ij})C(q_{j+1}; \theta_i) - \delta K$

Proposition 2 The European Commission will opt for TSP_{ij} 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 TSP_{-ij} in period $n + 1$, if and only if $C(\bar{q}_{j+1}, \theta_i) < C(q_{j+1}, \theta_i)$.

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 ε is so high that $\bar{q}_{j+1} < \min\{q_{j+1} - \varepsilon\}$, then the donor will choose TSP_{-ij} to complete the contract.

Treating EU development aid as a mechanism, which softens the budget constraint of post-Soviet planners, leads to the following matrix of payoffs for the European Commission and any TSP (Table 2.1):

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. 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. 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 δ is the discounting factor 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, $C(q_j; \theta_i) \geq C(q_{j+1}; \theta_i)$. 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 ε is the deficit that TSP runs for being unable to complete the project in the previous period.

2.5 Conclusions

In this chapter, I analyze EU development aid as the new soft budget constraint to the economies of the former Soviet Union. The collaboration between federal or subnational administrative bodies on the one hand and private businesses or civic organizations on the other proposes a novel definition of sovereignty. The emergence of transnational sovereignty partnerships suggests that national administrative

boundaries are fading away when it comes to development policy. This is what defines the core of transnational sovereignty within the hybrid institutional structure of the EU. A decision issued by the European Commission in Brussels predicts whether a development project will be implemented in Russia and Eurasia with the local administration both as the initial planner and the final beneficiary. This is why EU development aid as the new soft budget constraint in the former USSR. It bails out development policies of the recipient and therefore induces future convergence between projects undertaken by the recipient and financed by the donor.

Therefore, the effectiveness of EU development aid is conditioned by the institutional complexities of post-Soviet economic systems. The European Commission adjusted its long-term financing strategy in the former Soviet Union to the development priorities of its Russian, Ukrainian, and Central Asian partners, in order to maximize the probability of aid implementation. Central or local bureaucrats did not have access to TACIS financial resources; they were only able to monitor the implementation process of TACIS contracts and that way to make sure that it conforms to the initially agreed policy objectives. In the 1990s and for most of 2000s the developmental bargain between the EU and its post-Soviet recipients on the other led to the following strategic compromise. On the one hand, the European Commission treated its development aid as a bail-out mechanism for weak projects of post-Soviet bureaucracies at local and central levels. On the other hand, post-Soviet bureaucrats participated actively in the formation of transnational sovereignty partnerships (TSPs) without having the real possibility of rent extraction or usurpation of their monitoring mandate.

Under conditions of high NGO intensity and consistent collaboration between state institutions and private organizations, the European Commission is always inclined to provide more aid, because its expected payoff from it is going to be higher. The inequality $C(\bar{q}_{j+1}, \theta_i) \geq C(q_{j+1}, \theta_i)$ implies that the higher θ_i the lower the cost for continuing with another TSP_{-ij} in the $n + 1$ financing period. Development aid is effective when the policy objectives of the recipient are met and this is only the case when each assigned aid contract is complete.

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