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## COST-EFFECTIVENESS OF FOREIGN AID PROGRAMS IN THE BALTICS

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## Abstract

After the upheavals in Central and Eastern Europe in the late 1980s and early 1990s, the Western world has given considerable aid to the fledgling democracies. In this paper we draw a summary from Baltic experience in the fields of educational programs, scientific and environmental programs, and commercial projects in banking, taxation and energy. We analyze the motivation and identify different possible effects of foreign aid. We signal possible inefficiencies arising from the lack of coordination of foreign aid, deal with possible waste as being a form of loss in cost-effectiveness, and address the policies followed by aid providing agencies. Finally, we suggest ways that can help to achieve cost-effectiveness by assisting the donor and recipient in maximizing benefits gained and possibly reducing costs. (JEL F35)

## 1. Introduction

After the upheavals in Central and Eastern Europe in the late 1980s and early 1990s, the Western world has given considerable aid to the fledgling democracies. The Organisation for Economic Co-operation and Development [OECD, 1996] survey of aid flows to Central and Eastern European countries 1990-1994 showed total net official and private flows from bilateral sources amounting to \$81 billion and from multilateral institutions \$26 billion. On an annual basis, total receipts rose rapidly from \$10 billion in 1990 to \$31 billion in 1992, but declined over the following two years to \$18 billion in 1994.

For an eastern European country, the aid may even overshadow its own GDP. In the former East Germany following reunification the aid from the western part exceeded the regional GDP of East Germany.<sup>i</sup> The amount of foreign aid is smaller in the Baltic states of Estonia, Latvia and Lithuania, but still represents a significant part of economic activity. For example, 1995 foreign aid was \$82 million in Estonia<sup>ii</sup> although it has only 1.5 million people.

In this paper we do not aim at carrying out a comprehensive empirical evaluation of all programs. We have to point out the large amount of resources required to mount a comprehensive survey of cost-effectiveness across all types of foreign-aid programs. We draw a summary from Baltic experience in the fields of educational programs, scientific and environmental programs, and commercial projects in banking, taxation and energy. We analyze the motivation and evaluate the aid flows, a field in which relatively little work has been done so far.

Our goal is to present a framework for future evaluation studies. First, we identify motives that underlie the aid to the Central and Eastern European countries. Second, we address the effects of the aid flows. As in environmental aid "there has been almost no evaluation of Western bilateral-aid projects in Eastern Europe, e.g. their cost-effectiveness for a specific objective. This is related to the fact that many countries, such as Sweden and Denmark, do not have clear environmental strategies for their East European environmental aid programs, which leads to inefficient use of aid funds" [Löfstedt and Sjöstedt, 1995, p. 368]. In the Netherlands, the AR or General Accounting Office<sup>iii</sup> asked ministries to list policy evaluation studies carried out during

1987-1989. The AR considered only half of the studies listed by the ministries to be policy evaluation studies. In addition, less than a quarter of the reports analyzed by the AR appeared to study policy effects, and thereby, present any measure of cost-effectiveness [Algemene Rekenkamer, 1991, p. 71].

The OECD defines an evaluation as "an assessment, as systematic and objective as possible, of an on-going or completed project, program or policy, its design, implementation and results" [OECD, 1992, p. 132]. Insofar as empirical evaluations have been carried out, these were usually done for internal use. Other evaluations have been more project-specific as at such lower levels of detail, we come up with good concrete data on the actual cost-effectiveness of projects in terms of cash investments and pay-back periods on investments. One such area that evaluates effectiveness is in the use of Swedish funds and manpower in the Baltic Environmentally Adapted Energy Systems (EAES) program of the Swedish agency NUTEK (National Board for Industrial and Technical Development). EAES project-effectiveness evaluation examples are Martinot (1995) and Blumberga (1995).

Though there are difficulties and inadequacies of assessing operational cost-effectiveness objectively, we analyzed our own directly-collected data [Chong, 1995], plus a sample of Baltic cases in various sectors [Secretariat for Analysis of Swedish Development Assistance, 1994; National Board for Industrial and Technical Development, 1995; European Bank for Reconstruction and Development (EBRD), 1994]. We then drew our conclusions from these cases which we believe to be representative for the Baltics in their fields.

In order to assess the cost-effectiveness of programs, we need criteria for measuring costs and benefits. We have come across very subjective and sometimes controversial measurements of costs and benefits. Although we were not always able to exercise the American-style Freedom of Information Act data access, we did manage to meet official bodies and individual contacts from living and working in the Baltics during 1990-1996. This meant that we received direct data and statistics, and we concentrated in areas where costs and benefits were either known (according to pre-defined criteria) or concrete (observed and even measurable). Apart from financial costs we can examine other costs. One view of costs [Martinot, 1995, pp. 2-3] included factors of direct investment, intermediation, risk, avoided costs, financial repayment, and other costs (e.g., externalities or third party harm/injury, such as pollution). We can assume that there are benefits that motivate donors to provide the relatively large sums of funds and resources available.

The remainder of the paper is organized as follows. Section 2 addresses the motives underlying foreign aid, both on the side of the donor and on the recipient's side. Section 3 identifies different possible effects of foreign aid. In section 4 we signal possible inefficiencies arising from the lack of coordination of foreign aid, while section 5 deals with the possibly resulting waste. Section 6 addresses the policies followed by aid providing agencies. Section 7 deals with procedures and presents some recommendations to help achieve cost-effectiveness. Finally, in section 8 we present some concluding remarks.

## 2. Foreign Aid Motives

As a major Baltic "player", the EBRD sets overall goals: "It is important to note that the performance classifications of the evaluated operations are based on four strategic criteria: The EBRD's additionality (other financing for the operation is not available on favourable terms); the operation's transition impact, including environmental considerations; the company/project performance; and the Bank's investment performance" [EBRD, 1996a, p. 34]. As a nation, Sweden in 1993 trebled its aid to SEK 1.12 billion (\$170 million) to the Baltic countries, Poland and the Russian oblasts of St.Petersburg and Kaliningrad. But Estonia, Latvia and Lithuania got most of the aid - even though their populations total about 8 million - making Sweden the largest Western aid-donor in the region [Schori and Karlsson, 1993, p. A4].

There are many reasons for a foreign power to donate aid to the Baltic countries. Reasons cited, for example, "Sweden's aid policy towards the Baltic region is a mix of philanthropy and realism and includes aid for economic, strategic and environmental purposes" [Löfstedt, 1995a, p. 255]. Such assistance has been said to be motivated by the "neighborhood interest" of looking after one's own backyard. This has included Baltic military border security equipment of patrol boats, radar, all-terrain vehicles and technical help for improving the safety of Lithuania's Ignalina nuclear reactor, which is a Chernobyl-type reactor. There are ECU 33 million (\$42 million) available for increased safety measures at Ignalina, which was strongly motivated by the fear of a nuclear disaster coupled with the proximity of the European Union countries to the reactor site [EBRD, 1996a, pp. 39-40].

On the donor's side there are also different actors, including politicians, civil servants, private consultants, and pressure or special interest groups. Basically, they may be moved significantly by the same motives as actors on the recipient's side. This has manifested itself in the large amounts of foreign aid donated by Sweden and Finland to Estonia, even though Estonia only has 1.5 million inhabitants. Historically, these Western benefactors are concerned with the fate of the recipient country. Sweden possessed Estonia and northern Latvia as colonies during the 16th and 17th centuries. Finland is Estonia's strongest ally and relation in the Finno-Ugric linguistic family.

The self-interest of those donors involved does play a large role. For example, the old Swedish aid agency BITS (being the National Committee for International Technical and Economic Collaboration) was required by law to fund only Swedish firms and consultants (BITS became subsumed into the larger aid agency, SIDA, in 1995). Local Western companies can therefore derive profit from deliveries to the Baltic aid-providing agency. The high costs of employing Western staff and using Western equipment drive up the total project costs; thus, it is not possible to instigate low-cost Baltic programs (e.g., see Chong, 1993). On the other hand, it would not be politically easy to win approval for a project that employs mainly lower-cost eastern European labor and equipment. Thus, much of the foreign-aid budget is already "ear-marked" or "tied" for Western firms and staff, with cost-effectiveness and helping the Eastern country bearing secondary importance [Löfstedt, 1995b, p. 43].

Politicians may gain political support, for instance among émigrés from the recipient country. Estonia has a large émigré population living in Sweden and Finland. Civil servants may also

improve their position by administering an aid project. An "institutional" self-interest to reinforce the position or power of the donor country in international politics may be an underlying motive for the aid provided. Thus, Denmark provided up to DKK 160 million (\$28 million) in environmental aid to Eastern Europe, primarily Poland. This is because Poland is its largest Eastern European neighbor, and most of the pollution in that Danish part of the Baltic sea originates from the river Vistula, Poland. Once again, the aid is administered by the Danish Environmental ministry with representations from the trade, labor and engineering associations. Most aid investment goes to Danish manufacturing companies and consultants, with a third of the total budget going to direct environmental investment and equipment in the targeted Baltic countries [Löfstedt and Sjöstedt, 1995, p. 367].

Many actors play an important role on the aid recipient's side, including politicians, civil servants, and private consultants. Each actor or group of actors may be ruled by different motives. First, they may be stirred by the benevolent motive of serving the interest of the recipient country. It is postulated that they want the best results for their country in terms of concrete benefits. Such benefits are, for example, the improvement in water quality and a better sewage system instead of Western analyses. This manifested itself in the complaint of the Latvian ex-Environmental vice-minister that he preferred more Western aid as pipes for the Riga sewage system instead of another pre-feasibility study [Bjerström, 1992].

Second, the financial or career self-interests of the individual involved play a major role, be it of a politician, a civil servant, or a private consultant. A politician may expect to gain political or popular support by acquiring some aid, while he also may expect to gain benefits for his ministry or for himself. A civil servant may improve his position by serving as the donor country's counterpart and being responsible for the absorption of the aid. A private consultant has an interest because the aid program opens up new opportunities for assignments and revenue.

An example of political and business self-interests is in the race to win the contract for the rebuilding of the electricity generators in Narva, Estonia. The capital contract amounts to some \$100 million and carries a large element of prestige for all those who will work on it [Chong, 1995, p. 8]. But there is little expenditure for pollution-control and energy conservation projects which are less politically-beneficial. These energy-conservation measures are more financially cost-effective. The Ministry of Economy's Energy Conservation Center had an annual budget of \$10,000 (i.e., 0.01% of the new generators' cost) but this agency was threatened with axing [Chong, 1995, p. 8]. Estonian power demands fell 6% in 1992 after the fall of the USSR, giving a reduction in SO<sub>2</sub> pollution of 6% at zero additional cost [Löfstedt and Sjöstedt, 1995, p. 369]. But we have to add that this comparison somewhat unfairly juxtaposes a once-off drop in demand with a concomitant fall in energy output/pollution and is not an active pollution-reduction measure. Since 1994, the Estonian economy has grown [The Economist Intelligence Unit, 1996, p. 4] and the increased economic activity necessitates additional costs as pollution-reducing investments. To illustrate the cost-effectiveness of such investments - as opposed to once-off reductions of pollution and production resulting from a fall in economic activity - we refer to the FIM 24 million (\$5 million) costs - paid 3/4 by Finland and 1/4 by Estonia - to install the latest scrubber technology at one of these power plants. This resulted in a 0.5% fall in national SO<sub>2</sub> pollution, i.e. \$10 million per percentage-point SO<sub>2</sub> pollution decrease.

Air quality is definitely poor in the Narva region of Estonia. "Air pollution, particularly from SO<sub>2</sub> and fly ash [comes] from thermal power plants and other industrial activities in North-East Estonia as a result of the burning of oil-shale (with 1.6-2.4% sulphur), and also with NO<sub>x</sub> from traffic (the majority of vehicles use leaded fuel and do not have catalytic converters)" [Mander, 1996, p. 1]. There are limited signs of immediate improvement; certainly, enforced fitting of catalytic converters and reduction in electricity usage would be more cost-effective for pollution reduction, but these measures are unlikely to be politically acceptable. "An enormous decrease in the population's interest in environmental problems has occurred since the re-establishment of independence" [Mander, 1996, p. 1]. Thus, these particular cases suggest that the political and business self-interests may be plausible explanations for driving large Western projects, as they cannot be justified in terms of cost-effectiveness alone.

### **3. Effects**

Effects of aid programs can be direct effects as concrete and immediate results of the program, for instance, Riga city's much-needed overhaul of its sewage system. Latvia's welfare is improved by a gain in technical skills and material assistance. The EBRD and the Latvian government agreed to spend SEK 800 million (\$121 million) to clean the sewage outlet from Riga to the river Daugava, a waterway to the Baltic sea. The EBRD put up a loan of SEK 150 million (\$23 million) and the European Investment Bank (EIB) lent SEK 124 million (\$19 million). Finland, Switzerland and Sweden guaranteed loans on a total of SEK 77 million (\$12 million). A third of Riga's sewage has up to now gone totally untreated into the Daugava river and caused very serious long-term environmental damage in the surrounding area. The sewage cleaning project will greatly decrease the amount of pollution in the Daugava, Riga Bay and Baltic Sea [Tidningarnas Telegrambyrå, 1996]. Another example is that the European Union's PHARE-program is notable in leaving behind all the hardware that was purchased for the project. Thus, after the consultants have left, cars, computers, etc. will stay in the recipient country. Larger hardware gains often come in the form of loans instead of grants or donations, such as in large capital projects.

Indirect effects may occur in the medium/long-run as a by-product of the aid, for example, the improved public transport or sewage may result in an increased productivity of the city's industries and an increased attractiveness to investors. In addition, local people increase their knowledge and experience partly from contact with the aid project. The British Know-How Fund (KHF) does not give direct effects of capital accumulation in any hardware or equipment purchase but solely provides technical assistance in terms of expert skills transfer. It has been involved in banking skills training in Lithuania, which were demonstrably much needed in the wake of Lithuania's 1995 banking crisis. The sums invested in Britain's KHF Lithuanian banking program are small in relation to other larger programs, i.e \$150,000. The small size and the large element of local labor, plus lack of any capital equipment injection, meant that this budget tended to be easier to monitor and control. Essentially, this type of project ensured that the stock of human capital in the host country increases as a result of the aid project.

The indirect effects of aid programs are difficult to measure and to identify. The causal relationship between the indirect effect(s) and the original aid program may be vague or questionable. Evaluations of aid programs are rare and they have been carried out with the (implicit) intention to justify the policy pursued rather than obtain an objective assessment of the results. The US Agency

for International Development (USAID), for example, issued a press release on July 6, 1996 of USAID's Estonian success stories. This presentation may be consistent with the finding of the AR, that in the Netherlands ministries use evaluations partly or solely to support their main policies [Algemene Rekenkamer, 1991, p. 63]. However, USAID has compiled a comprehensive assessment of its more than 60 activities in Estonia over the last five years. Since the full USAID report was not yet available at the time of writing, we cannot judge to what extent it conducts an accounting cost-benefit analysis or otherwise objectively looks at program results rather than supports main US policies.

Riding on the back of its press presentation is the latent need to preserve good public relations, both in the host country and at home. Nevertheless, it may be such that the self-interest motive is perceived by tax-payers/voters to be too uncontrolled, or foreign-aid becomes too cost-ineffective, that remedial action must be taken. An example is the creation of the Secretariat for Analysis of Swedish Development Assistance (SASDA): "The Swedish Government has appointed a committee with the task of analyzing the results and effectiveness of Swedish development aid. SASDA's point of departure is the aim of a better understanding of the mechanisms of development in order to enhance the results and increase the effectiveness of aid in achieving the five goals set by the Swedish parliament: increased resources, economic and social equality, economic and political independence, the democratic development of society, and the long-term management of natural resources and care of the environment" [SASDA, 1994, front cover page].

#### **4. Lack of Coordination**

International aid is uncoordinated to a large extent and is offered by individual countries, groups of countries or supranational bodies (such as the European Union), multilateral institutions (including United Nations agencies, The World Bank, the International Monetary Fund (IMF),<sup>iv</sup> the International Labour Office, etc. In addition, a large contribution comes from both national and international charities. Several surveys of international aid flows are available, such as the OECD survey covering aid to Central and Eastern Europe [OECD, 1996]. However, the surveys available are not complete, do not cover total real spending, and do not contain evaluations of the effects.

In addition, there is no single institution that serves as coordinator of international aid programs. The United Nations (UN) under an ideal environment seems the most obvious institution for such a coordinating role, since by definition the UN cannot seek national or regional interests in providing aid. Although to some extent it attempts to do so, and the UN Development Program (UNDP) does play a key role, it does not have an official coordinating task as to international aid programs. Its authority does not give it access to or control of the programs of other donor agencies, nor would such control be appreciated by many agencies.

The lack of coordination of international aid gives rise to situations that leave room for inefficiencies. Since there are many aid providers, it is possible that two different providers offer the same aid without knowing each other's proposals.<sup>v</sup> This is a case of an imperfect market where agencies "compete" against each other as part of the bid tender process. Competition between agencies and their different proposals is good for the recipient, but this must be contrasted against possible duplication of donors' effort and waste. Competition is in the interests of the recipient



nation as it may lower the project costs.<sup>vi</sup> It can select the best tender at the best available terms offered as Western countries offer different offset deals and "sweeteners", together with soft bank loans or grants in order to clinch the contract in the Baltics. We have seen this particularly in large capital projects such as the bids for the overhaul of the electricity power generators in the Narva region, Estonia [Chong, 1995, p. 5].

Generally, aid-receiving countries may seem rather passive as to from whom they receive aid. There have been cases where agencies took aid from those that made it available rather than from those who were recognized experts in their field. For example, a former Soviet republic, planned to introduce Value-Added Tax (VAT) and sought advice on how to implement it. An aid program was requested from a country that has no experience with VAT. Indeed, in this particular case the aid providing agency did not honor the recipient country's request precisely on the ground that experts from countries applying a VAT seem more obvious advisors.<sup>vii</sup>

This phenomenon is even more likely when there are different groups in the same recipient aid agency who have large amounts of local autonomy and are in contact with different donor groups or consultants. Instead of working together on the same project, they come up with different and competing solutions, e.g., how to generate electrical energy. The donors would consider this inefficient, if they consider the duplicated effort in feasibility studies and contract tenders. However, the recipient country may consider it efficient in that it can choose the advice that fits its specifications best and provides the best terms for the mix of skills, equipment and loan/grant offered [Chong, 1995, p. 6]. The recipient may also be said to receive the added prestige of twice the amount of attention paid it by two (or more) agencies to fix one problem.

## **5. Foreign Aid Waste**

We can look at waste as being a form of loss in cost-effectiveness. Measuring the extent of inefficiency and waste is not easy per se as this can be largely influenced by our choice of bench-marks. Thus, a project with lax or generous budgets and limits would tend to have met their limits with ease. Those projects that run over-budget could have had their limits set unrealistically. Therefore, we choose to point out differences across projects from recommended guidelines which can indicate inefficiency and a breakdown in accountability, for example, because staff were not able to exercise enough control over the project to avoid cost and time over-runs. Earlier problems with administering aid to the Baltics and Eastern Europe led Sweden to come up with guidelines for aid programs. This outlines the drive towards reducing wasted spending in Swedish-funded pollution-control projects abroad. "Joint implementation is a mechanism aimed at achieving increased cost-efficiency. This means that for each Swedish crown the greatest possible reduction-increasing or emission-reducing effect should be obtained" [Swedish State Studies, 1994, p. 3].

One source of waste comes from the use of bilateral aid using tied donor country products and services, against multi-lateral aid where purchase of required goods and services is more open to international tender.<sup>viii</sup> Finland, one of the largest regional aid donors in environmental work, has a large involvement in the Baltic area. The Polish Environment Ministry has suggested that Finnish bilateral aid that stipulates purchase of goods from Finland results in more expensive goods, even

with a 30% government subsidy, than would be in an international tender [Zylicz, 1993].

For other evidence of waste, we have come across faculties in the Baltic state universities where large amounts of money were spent in short trips by Western lecturers to deliver isolated single lectures with little follow-up or impact on the final university education service. Other assistance has included books, computers and telecommunications equipment sent to the people who were not qualified to use them or unable to provide much-needed training to students. We recommend a longer-term strategic partnership for universities whereby key staff can be transferred between West and East for terms of about six months to transfer knowledge and skills [Van der Hoek and Chong, 1995, p. 13]. These are cost-effective means of building teaching and research skills on both sides, East and West.

We have pointed out several concrete examples of where waste or lack of cost-effectiveness can be said to exist in programs. These are just a cross-section, but we need to go deeper with specific cases of uses of program aid across all industrial sectors in the Baltics. It does emphasize that foreign aid needs to be planned for the medium to long-term and coordinated with the recipients and other donor agencies. Others have already proposed that there should be assessments to cut down waste or sub-optimum performance in the programs, e.g., NUTEK, Sweden conducts evaluation exercises for all its projects in the Baltics as routine procedure [Vares, 1995; Blumberga, 1995; Pedisius, 1995]. Furthermore, these evaluations must be followed up "[F]or evaluations to be useful, they must be applied. Feedback to both policy-makers and operational staff is essential" [OECD, 1992, p. 132]. As obvious as this may seem, the AR found for Dutch ministries that over half of the evaluation reports analyzed had not been demonstrably used [Algemene Rekenkamer, 1991, p. 65]. The principles for evaluation of Development Assistance as set out by the OECD [1992, pp. 131-138] have mainly been drafted for use by aid agencies for evaluating their own activities. These guidelines are useful only as far as involved parties follow this advice at all.

## **6. Donor Agency Policies**

Foreign aid policies differ between donor countries and aid agencies. USAID has a much larger budget with a large number of projects and operates a different policy from, say, the British Know-How Fund (KHF) active in the Baltic states as part of operations handled by the Foreign and Commonwealth Office (FCO). KHF also stipulates rules for projects such as the submission of the project plan by the host countries' ministries, not Western consultancies. Higher-cost projects need to be submitted to a competitive tender process, with a contribution from the host country and the contractor ("matched funding") required. This is a directive that Britain is unwilling to pay for a project until it sees a commitment from interested parties [Overseas Development Agency, 1996, p. 28]. These pre-requisites may be waived for smaller projects or exceptional circumstances.

British overseas project proposals are evaluated by a central body, the Overseas Development Agency (ODA) which compares projects submitted in order to select those that meet its criteria for project desirability. These criteria depend upon the FCO view of regional political relations and the needs of the foreign country, plus whether Britain wants to raise or lower its political and trade status in the particular target country. This may seem an unwarranted intrusion by the FCO, but it

helps Britain to maintain a smaller and more cost-effective aid operation that suits Britain's needs in maintaining foreign relations with developing Eastern countries. It is a case of foreign aid meeting the foreign relations strategy controlled by a centralized body.

This is contrasted against the former Swedish example which was to have projects evaluated by economists and officials in an agency such as BITS. Such staff did not have specific required skills as in engineering, project-cost management accounting, environmental science etc., and therefore BITS had to employ consultants from outside firms. This had the effect of driving up project costs, or more accurately, the operational costs of BITS and the emphasis of spending a greater proportion of the budget on pre-feasibility studies. Another unwanted result was that a technically-skilled pool of in-house staff was not built up at BITS. This created poor results, among other sectors, in the environmental engineering field. "From a Western point of view, being involved in Eastern European aid, especially bilateral, can be very lucrative. As there are not many consultant firms working in Eastern Europe, there is a high chance that a given firm will have its proposals funded (no international tenders), and there is a large amount of money in circulation. Reports indicate that many consultants do not speak the language where they are working, they are insensitive to the country's customs, spend too little time on site, lack environmental expertise, and sometimes conduct studies that have already been carried out" [Löfstedt and Sjöstedt, 1995, p. 368]. For these high-profile shortcomings BITS became taken over by the other Swedish aid agency SIDA in 1995.

We can contrast this modus operandi of high-state expenditure and short-term approach of BITS against the more private-enterprise funded approach of the British KHF and The World Bank. The World Bank has promoted the Lithuanian bank-twinning project. This involved a project cost of approximately \$1 million over 18 months and linked the Lithuanian Ukio Bank in Kaunas with the Dutch ING Bank and the Danish Unibank and the Lithuanian Vilnius Bank with the Dutch ABN-AMRO Bank. No hardware is provided and project costs are shared by funds from The World Bank, the Netherlands and Denmark. Skills transfer is concentrated in management and control systems strategy, marketing, budget and accounting, treasury/securities. The cost-effectiveness of this project is predicated upon a long-term commitment to business relations: "In a twinning project the partners work very closely together, and we learn a lot about each other. That means we will also have less difficulties in doing business together in the future" [The Baltic Independent, 1996].

Similarly, the EBRD has invested ECU 2.3 million (\$2.9 million) in the Estonian Savings bank and ECU 2.5 million (\$3.2 million) for Lithuanian Hermis Bank on an equity basis [EBRD, 1996a, pp. 78-79]. The EBRD would only have done so when it is satisfied that the proposed projects are suitable for their financial viability and regional economic goals after they have been evaluated through the EBRD Bank Procedures [EBRD, 1996b, pp. 10-12]. The relatively high-profile input enables the EBRD to exert a large element of influence on the Board of Directors and to implement constant monitoring for a more appropriate business strategy. Furthermore, this equity move is explicitly taken as a clear business-minded decision: "When the EBRD takes an equity stake it expects an appropriate return on its investment. It will have a clear exit strategy and will only take a minority position" [EBRD, 1996b, p. 4]. Estonian Union and Savings Bank, Latvian LZB, Unibanka and D-L Banks, Lithuanian Hermis and Vilnius Banks have received ECU 63 million (\$80 million) as credit lines to finance SME (small and medium sized enterprises) as part of the EBRD strategy of regional economic development [EBRD, 1996a, pp. 76-82]. This move clearly

aims to stimulate economic growth and employment through generating several locally-inspired small projects instead of a few large capital projects. For its smaller sponsored projects when contract values are relatively low or local resource prices are lower than on the international market, the EBRD favors Local Competitive Tendering, whereas for larger projects the EBRD stipulates Open Tendering: "It provides the greatest opportunity for competition and satisfies the needs for economy and efficiency" [EBRD, 1996c, pp. 6-7].

## **7. Procedures**

The cases mentioned in section 6 are almost classic cases of the "trade not aid" dictum, and would seem a more suitable platform for Baltic enterprises to build on, especially when they come to compete effectively against Western enterprises. One financial institution that operates on this basis is the EIB which lends up to ECU 3 billion (\$3.8 billion) in 1994-1996 to Central and Eastern Europe including the Baltic states. Its foreign aid is built on the provision of loans, not grants, which meet its criteria. "All projects must be economically justified, technically viable and environmentally sound; in addition, productive sector investment must offer an adequate financial return" [EIB, 1996, p. 7].

We have examined some of the motives and effects of operating foreign-aid programs in the Baltic region. There is a need to strike the "right" balance to satisfy interests of those involved. "It may be argued that donor interests should predominate because tax-payers in the donor country have the right to a fair return on their tax money. Furthermore, the donor often has more advanced knowledge about [environmental] problems and technologies and therefore 'knows best'. On the other hand, it may be argued that the recipient has the right to the last word with regard to domestic problems and policy choices. Familiarity with local conditions may give recipient authorities privileged knowledge; they may also 'know best'" [Löfstedt and Sjöstedt, 1995, p. 370].

We can suggest a common project set of procedures that assist the donor and recipient in maximizing benefits gained and possibly reducing costs. These would raise the cost-effectiveness, and thereby, the quality of the project. It is important to pre-screen or evaluate all projects before starting so as to assess likely viability or performance. "The quality of the operations at entry was identified as one of the important ingredients for a project's success. Once disbursements are under way on a fatally flawed operation little can be done to improve the success prospects" [EBRD, 1996a, p. 34].

Foreign aid projects can be supported and coordinated under independent administrators to avoid unnecessary duplication of effort and waste of resources between projects. This paper demonstrates the need for foreign aid programs to be evaluated in tandem by both foreign aid donors and their host country recipients; that evaluations are done to reduce potential waste and that we learn from this process. Thus, we endorse the EBRD's statement about its project evaluations: "There are two basic objectives in project evaluation: to ascertain the results of the EBRD's portfolio of projects and programmes, both intended and otherwise; and to determine whether there are significant lessons to be learned from experience in order to ensure more successful operations" [EBRD, 1996a, p.34].

Ways that can help to achieve cost-effectiveness are:

1. Ask for competing proposals or tenders.
2. Involve independent external skilled judges with technical understanding of the project for a more balanced assessment of the "best" and most suitable solution.
3. Demonstrate that standard recommended operational guidelines have been followed, i.e., feasibility, tender bids competition, operational monitoring and milestones, post-project evaluation. Example procedural steps are: Project proposal, Collateral submission, Project appraisal, Financing, Tendering, Project monitoring, Project evaluation [EIB, 1996, pp. 7-9].

## **8. Concluding remarks**

It is necessary to point out the difficulty of gaining data in a dynamic environment, where some of the data could have politically-damaging results. We came across many cases where projects did operate on a cost-effective basis, and where programs incorporated effectiveness evaluation procedures. Nevertheless, there is proof of some inefficiency from our evidence of sample projects in the Baltics. Standard operational procedures and audits serve to provide a structure for promoting efficiency and monitoring of foreign-aid programs to gain cost-effectiveness.

We recommend the implementation of standard Project Operational Guidelines to reduce room for such waste and inefficiency. We stress that both prospective donors and recipients should obtain a better view of what is available in terms of solutions on the "market" by a tender process where possible. We do recognize the need for political realism, and that it would be prudent for a recipient country to accept an offer of international aid with strings attached (ear-marked aid), where donor country staff and products are used as a return for tax payers' money, rather than to receive no assistance at all. However, a more business-minded approach should be adopted with involvement of local enterprises in order to lower total budget costs and to know more about the local requirements and conditions. We stress that both aid donor and recipient countries are likely to gain from such procedures.

## Notes

i. Total public expenditure as percentage of GNP of the area involved:

	1991	1992	1993
Former Western Germany	48	49	48
Former Eastern Germany	123	124	113

Source: Central Planning Bureau, 1992, p. 43. (The original sources are: Deutsches Institut für Wirtschaftsforschung, *Wochenbericht* 26-27/92, and HWWA, *Konjunktur von Morgen* 867).

ii. Since we have ample experience in Estonia, we gathered some data pertaining to this country (with a population of 1.5 million). In 1995, Estonia received a total of at least EEK 1 billion (\$83 million) grant aid from individual countries (Canada, Denmark, Finland, France, Germany, Netherlands, Norway, Sweden, Switzerland, United Kingdom, and USA), the European Union, the Council of Europe, and the UN Development Program (source: Estonian Ministry of Finance). Obviously, even in the case of small countries like Estonia the aid is scattered over a number of individual donor countries, international bodies, and international institutions.

iii. To avoid confusion with the American General Accounting Office (GAO) we refer to the Dutch General Accounting Office by using the Dutch acronym: AR (Algemene Rekenkamer).

iv. Some take the view that the IMF is not an aid provider. Rather, it maintains close relations with all of its members. Nonetheless, technical assistance and certain loans provided by the IMF may be considered aid.

v. We gained data in the financial consultancy services sector of foreign aid projects that we are not at liberty to divulge. These are from individuals or agencies who gave information on the proviso that we did not make their data public. We respect their wishes. From personal experience in Estonia we know, indeed, that foreign consultants from different donor countries have been working on similar problems without knowing of each others activities or certainly, not cooperating with each other [Van der Hoek and Chong, 1995, p. 13; Chong, 1995, p. 5].

vi. Obviously, this depends on the kind of aid. For example, nobody would rehabilitate the same power plant twice, but technical assistance is, at times, accepted from two sources for the same need.

vii. Based on information kindly provided by Robert J. Maushammer, USAID, Estonia.

viii. The term bilateral aid should be interpreted broadly, since it may not only pertain to aid provided by a single nation, but also by supranational body such as the European Union, which allows only European sourcing.

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