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Introduction

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1. THE SETTING

This book is about the institutions that guide the behaviour of persons involved in the implementation of foreign aid programmes. Following North (1990), it distinguishes between institutions and organisations. Institutions are the formal and informal rules of behaviour that constitute incentives for all agents involved in the aid delivery process; they affect the performance of foreign aid programmes. Organisations are the groups of persons that adhere to a particular set of these rules. In the case of aid, they include taxpayers and donor organisations, politicians, lobby groups, donor agencies and consultants in donor countries, and recipient organisations in beneficiary countries. This book analyses how these institutions affect the outcomes produced by organisations involved in the aid delivery process. It diverges from more traditional approaches to aid performance because it seeks to explain that performance in terms of incentives inside the aid delivery process, rather than recipient country policy performance. The proposed approach also differs from game-theoretic models that attempt to explain aid performance in terms of outcomes of strategic interactions between donors and recipients at macro-institutional level. This book goes down to micro-level decision-making processes and behaviour by agents working in donor agencies, subcontractors hired by these agencies and officials working in beneficiary country organisations. It will show that incentives and constraints for individual agents can diverge significantly from those of the organisation that they work for and thus lead to very different behavioural outcomes from those predicted by macro-institutional approaches. On the other hand, the models and analysis presented in this book are sufficiently general to be applicable not only to conditionality-based institutional and policy reform programmes but also to non-conditional aid and more traditional investment projects.

It is also a book about the use of foreign aid to achieve institutional and policy reform in recipient countries. In our view, the performance of donor-induced reform programmes is correlated with the institutional set-up of donor agencies and aid programmes to deliver these reforms. Donors cannot realistically and successfully tackle institutional reform questions in recipient countries if they do not have an appropriate institutional set-up in place to deliver the required types of aid in a credible manner. For instance, a project-based approach to institutional reforms may be more exposed to moral hazard problems than a conditionality-based approach; project approaches allocate aid to inputs while conditionality approaches pay for results. Alternatively, recipient countries cannot expect to receive appropriate technical and political support for their reform plans from donors that do not have the institutional technology to deliver their contributions in a credible way. This book examines how the switch from traditional investment projects to institutional reform programmes affects performance incentives for individual agents involved in aid implementation as well as the overall performance of a donor agency.

The idea to research the subject of this book originally arose in the foreign aid Evaluation Unit of the European Commission (EC). In the summer of 1997, I was working with a few colleagues and consultants on two global performance reports of EC-financed Phare and Tacis institutional reform programmes in the transition economies of Central and Eastern Europe. We had worked our way through a pile of monitoring and evaluation reports on individual Phare and Tacis projects, interviewed many programme managers and consultants and completed some fieldwork as well. While we were compiling a synthesis report, we were struck by the convergence of views that emerged out of this apparently chaotic pile of information. There were many similarities in project design, implementation and outcomes, in behaviour of project managers and policy decisions, despite a wide diversity of project circumstances, across countries, sectors and types of projects. Evaluation reports on EC programmes in other regions of the world revealed similar patterns. Surely, there had to be common factors and incentives in the EC aid delivery process that generated these similarities in outcomes, out of a diversity of situations.

To illustrate this point, let me just cite a few of these general findings. A Phare evaluation report (European Commission, 1997, pp.55–56) concluded that there is 'a tendency for the Commission to contract out expertise in the transition process and retain in-house expertise in financial and administrative procedures . . . strong emphasis on financial and procedural control rather than substantive design and performance' and contracts were 'based on inputs and activities specifications rather than on outputs and effective results'. An evaluation report on the EC's Mediterranean aid (European Commission, 1998) concluded that multiple objectives came without 'a comprehensive analysis of the linkages and interconnections between different policy objectives' and consequently 'no goal hierarchy, leaving the Commission with unclear guidance for aid management and implementation'. The frequent recurrence of these and similar findings indicated that aid programme performance was not only determined by the particular circumstances of individual project managers and recipient countries but also – and perhaps predominantly – by the incentives embedded in the institutional environment of the aid agency and its aid delivery process. These findings may not sound terribly original to persons who have had any substantial involvement in aid delivery. However, the virtual absence of any studies of incentive structures in aid delivery processes is even more striking. This book is an attempt to fill that gap.

This shift of attention from recipient country performance to incentive mechanisms in the aid delivery process is not entirely new. To some extent, a number of macro-level aid performance studies published during the 1990s already paved the way. These studies aimed to find a correspondence between changes in aid volumes and changes in macro-economic variables in the beneficiary countries (White, 1992; Boone, 1994; Tsikata, 1998). Generally, they conclude that foreign aid has no tangible impact on economic growth in the recipient countries. Burnside and Dollar's (1996, 2000) landmark study came to similar conclusions. However, the authors qualified this finding with the remark that aid does indeed have a positive impact on growth when the policy environment in the recipient country is conducive to growth. It also raised the question of the direction of causality: does aid cause good policies, or do good policies induce aid flows? In other words, does aid have an active or a passive role to play in policy and institutional reforms in beneficiary countries?

Dollar and Svensson (1998) are cautious about the direction of causality. An analysis of a sample of World Bank policy-based loans revealed that donor efforts have no significant impact on recipient country policy performance. Policy outcomes are basically generated by domestic political environments, not by donor influence. This suggests a more passive role for donor agencies: selecting genuine reformers and using aid programmes as a commitment device to ensure that the reformers are not derailed from their mission. It puts responsibility for the success (or failure) of aid programmes more squarely on the shoulders of the recipients.

However, Dollar and Svensson (1998) also note that about one-third of all World Bank structural adjustment loans fail to meet their policy targets but are nevertheless paid out in most cases. This happens because the Bank does not only care altruistically about economic development but also more egoistically about a country's ability to service previous Bank loans. Furthermore, other donors and creditors may pressure the Bank to provide financial resources that enable a country to continue servicing its debt. If this happens regularly, borrowers will not fail to notice the creditor's lack of commitment to his own commitment devices. Clearly, moral hazard can occur on the donor side too. This demonstrates that the donor's policy stance and own internal incentives do indeed matter for the outcome of aid programmes and would lead to a more balanced conclusion whereby donors and recipients share responsibility for the success or failure of aid programmes.

Over the years, the debate on the respective roles and responsibilities of donor agencies and recipient governments has moved away from desired policy and institutional reform outcomes to the processes of reform, including how incentives and constraints influence outcomes. When an optimal outcome is not achieved, it is usually not because of lack of knowledge about this outcome among decision-makers but rather because optimising agents face incentives and constraints that deviate their behaviour from this target (Ranis and Mahmood, 1992). More than a decade after the start of the great economic transition wave in former communist countries, donor agencies have apparently not digested this message. They continue to blame poor reform performance on obnoxious recipients, rather than examine the weaknesses in incentives inside donor and recipient institutions.

There is a substantial volume of political science and political economy literature that discusses political processes and the factors that affect policy and institutional reform outcomes in developing countries, with or without the intervention of foreign aid agencies (Haggard and Webb, 1994; Devarajan *et al.*, 1999). There is also a substantial volume of game-theoretic research on the interplay between aid donors and beneficiaries and devices to reduce the probabilities of moral hazard in this relationship (Collier *et al.*, 1997; Mosley, 1997; Svensson, 1997). That is the nearest that the literature gets to examining the impact of incentives inside the aid delivery process itself on aid outcomes.

This book intends to dig deeper inside the organisations involved in aid delivery and the institutional incentives that are at work in these organisations. It looks at the role of development organisations in the effectiveness of foreign aid and concentrates on intermediary processes, in between the macro-level at which the first allocation decisions are made and the local scene where outcomes become visible.

The aid literature on these subjects is very scarce. A study by Quarles *et al.* (1988) is an exceptional early forerunner in this approach. It is one of the first to take a critical look at institutional incentives and organisational arrangements inside aid delivery processes. Their explanation for the rationale of their research fits very well into the purposes of the present book and deserves a full citation:

> [Aid] agencies are not just rational, neutral tools of policy makers and as such external to the problems of development . . . Special attention is given to the linkages or relationships between development agencies at different levels of organization. Each one is part of increasingly long and complex chains of interdependent organizations. The other units constitute a vital

part of its environment. These linkages, therefore, are a major concern in the contributions. In a sense, all development organizations are intermediate bodies, part of a wider network through which the money flows. (Quarles *et al.*, 1988, p.12)

The quality of aid is directly related to the ways in which it is organized. To what extent are the agencies capable of producing the results they aim at? What are their capabilities and constraints? (Quarles *et al.*, 1988, p.11)

Carr *et al.* (1998, p.44) offer a similar perspective on aid delivery. Their analysis of the effectiveness of aid is based on the idea that:

. . . at each link in the [aid delivery] chain, there exists an agenda which may or may not be consistent with the agendas both below and above it. These inconsistent and often conflicting agendas in the aid chain create difficulties in the determination of expected outcomes for any particular project.

Recently, a study launched by the Swedish International Development Agency (SIDA) has also examined incentive issues in the interactions between the agents and organisations involved in the delivery of foreign aid, based on more empirical observation of aid delivery processes (Ostrom *et al.*, 2001).

2. INSTITUTIONAL ECONOMICS AND AGENCY THEORY

This book applies a particular type of institutional analysis, usually labelled as 'agency theory', to analyse the incentive problems that may occur in foreign aid delivery. This section explains why we have chosen to follow that path, situates it in modern institutional economics, and shows how it applies to the institutions of foreign aid.

As this book is about institutions, it naturally applies the techniques and insights of institutional economics. Modern institutional economics is a tree with many branches and twigs. The terminology 'institutional economics' covers a wide range of schools of thought and methods. It includes several varieties of transaction costs economics, from Coase (1937, 1960) to Williamson (1985) and North (1990), as well as various branches of organisation theory, including property rights (Grossman and Hart, 1986), incomplete contracts theory (Tirole, 1999), and its analysis of organisational design (Holmstrom and Milgrom, 1991; Aghion and Tirole, 1997). This is not the place to explain the details of each of these schools. Interested readers are referred to more general handbooks of institutional and organisational economics (Laffont and Tirole, 1993; Furubotn and Richter, 1998; Masten and Williamson, 1999).

All these schools of institutional economic thought have a common characteristic: they examine how informational problems affect organisational performance, though from different angles. That is precisely what distinguishes neo-classical from neo-institutional economics. While the former generally assumes that (near-)perfect information is available in transactions at (near-)zero costs, the latter assumes positive information costs. Transaction cost economics looks at the cost of obtaining information required to conclude a contract or exchange (North, 1990) and the potential costs of post-contractual uncertainty or absence of information (Williamson, 1985). Incomplete contracts theory is based on quite similar principles but focuses on the incentives embedded in a contract and the likely behavioural outcomes that they produce under imperfect information (Tirole, 1999). Property rights theory examines how different allocations of this residual contractual uncertainty create different incentive structures. Modern organisation theory combines these different techniques to study incentives and delegation of tasks in large organisations or hierarchies. Institutions – rules of behaviour – exist precisely because they are means to partially overcome these informational problems and the resulting uncertainties. Bilateral contracts, general laws and informal agreements ensure that some of these are kept within acceptable limits. However, they cannot create a risk-free world and we have to live with these residual uncertainties in our daily activities, including in the delivery of foreign aid.

This book applies these insights to informational problems that may occur in the various steps of the delivery process of foreign aid from the donor to the final beneficiary. It examines how these informational problems induce biases in the behaviour of agents involved in this process and how this affects the ultimate performance of aid programmes. Fortunately, it also attempts to explain how some of these problems can be tackled through clever institutional design.

The four studies in this book use a common methodological approach and apply the techniques of only one branch of modern neo-institutional economics, namely principal–agent or agency theory. Principal–agent theory starts from the simple observation that modern organisations are usually hierarchically structured, with principals giving instructions to agents. Principals in a company, a club or a public administration, cannot take all decisions and carry out all tasks themselves. They need to delegate at least part of the work to agents. While the principal appropriates the benefits (and costs) of the task, the agent receives a reward – a wage, a stock option, a promotion, etc. – in return for carrying out the specified tasks. Delegation implies that the principal does not have full information about the activities of the agent. If principals want to have full information and to monitor every aspect of agents' activities, then they might as well carry out the delegated tasks themselves; there would be no gain from delegation. Delegation may result in two types of problems. Firstly, agents may deviate from the instructions given by the principal and carry out delegated tasks in such a way that they advance their own interests, rather than those of the principal. This is called moral hazard. Secondly, at the time of reaching agreement with the principal, the agent may have access to information inaccessible to the principal, and may manipulate this information in ways that run against the principal's interests (as when sellers of second-hand cars are more likely to offer low-quality cars for sale, or when counterfeit money drives out good, as classically described in Gresham's Law). This is called adverse selection. Both problems lower the return from the task for the principal, compared to the return under perfect information.

Moral hazard and adverse selection are unavoidable consequences of delegation of tasks in organisations. Large-scale organisations, like aid agencies, usually consist of multiple layers of delegation. Consequently, a wide variety of incentive problems can occur at different levels of delegation and should be addressed through appropriate institutional design. The art of good design consists of mitigating these problems by setting up incentive structures that motivate agents to reveal relevant information to the principal and reduce biases in their behaviour.

Agency theory has found a wide range of applications to virtually every aspect of organisation and contracts (Laffont and Tirole, 1993). It is therefore somewhat surprising to see that there are, as yet, very few traces of applications in the development economics and foreign aid literature to the organisations involved in the implementation of foreign aid.

A major exception to this statement is the use of principal–agent models in the study of conditionality contracts between donors and recipients of aid (Pietrobelli and Scarpa, 1990; Trombetta, 1992; Killick, 1995). Murshed and Sen (1995) use a principal–agent model to capture the stylised facts of multilateral aid negotiations on non-economic conditionality such as military expenditure reduction. Collier *et al.* (1997) discuss conditionality problems in aid but their analysis is only implicitly based on an agency approach. Rodrik (1997) examines the advantages of multilateral donor agencies in imposing effective conditionality. In fact, the entire conditionality debate is about principal–agent relations: a donor requests a recipient to do something, in return for receiving aid. Recipient compliance with the agreement is subject to moral hazard and adverse selection. Streeten (1988) reformulated the principal–agent problem in aid conditionality very pointedly: 'Why would a donor pay a recipient to do something that is anyway in his own interest? And if it is not in his interest, why would the recipient do it anyway?' As explained above, applications of agency models to conditionality are generally situated at a macro-institutional level, exploring the outcomes of direct negotiations between a donor agency and a recipient government. They do not examine differences in incentive structures and agents' behaviour within the donor or recipient organisation as a result of delegation of tasks – which is precisely the subject of the present book. In a way, the conditionality issue could be considered as a special case of a more general agency problem, namely when both the donor and the recipient organisation acts as a single homogenous agent.

Frey *et al.* (1985) are more explicit about the difference between the macro-and micro-institutional approach and suggest that there are two ways to model the behaviour of (international) organisations. Either the organisation is treated as an aggregate unit possessing well-defined preferences or the different interests of individual members of the organisation are considered and the behaviour of the organisation as a whole is taken to be the outcome of the individuals' actions. Frey *et al.* chose the first option for their model of World Bank lending behaviour, partly because the availability of organisation-level data sets allowed them to test the organisation's behavioural assumptions. This book has chosen the second option, because our analysis of foreign aid organisations has led to the conclusion that there is indeed strong divergence of interests between the various agents involved in aid delivery, even though they may contractually be committed to the same organisation and aid programme objectives.

The main disadvantage of our methodological option is the lack of empirical data sets to test the models. Aid agencies, non-governmental organisations (NGOs), aid services suppliers or other organisations involved in foreign aid do not normally collect intra-organisational data on the behaviour of individual employees, their motivation, incentives and effort spent on different tasks, or their objectives and strategic behaviour in negotiations with agents of other organisations. Collecting such data would require surveys, personal interviews, detailed analysis of resource allocations and procedural complexity in aid organisations, etc. It is not the purpose of this book to empirically test the models and assumptions presented. Some of these are illustrated with *ad hoc* examples only. This book is meant to lay the more theoretical foundations for empirical approaches to the institutional economics of foreign aid. As such, it provides a basis for an empirical research agenda that will require considerable data collection efforts.

This research project was not just an attempt to find new applications of agency theory. It is used as an analytical tool to generate novel findings about the performance of aid organisations, institutions and implementation processes that go beyond existing development aid research, including research on aid conditionality. Before we look at the findings of the individual studies in this book