THE INSTITUTIONAL ECONOMICS OF FOREIGN AID

This book is about the institutions, incentives and constraints, that guide the behaviour of people and organisations involved in the implementation of foreign aid programmes. While traditional performance studies tend to focus almost exclusively on policies and institutions in recipient countries, the book looks at incentives in the entire chain of organisations involved in the delivery of foreign aid, from donor governments and agencies to consultants, experts and other intermediaries. Four aspects of foreign aid delivery are examined in detail: incentives inside donor agencies, the interaction of subcontractors with recipient organisations, incentives inside recipient country institutions, and biases in aid performance monitoring systems.

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Foreword

The authors of this excellent book address the question of why international foreign assistance programmes have so rarely achieved the goals set out for them by the donor community. Following the Second World War, despite massive transfers of funds from developed countries to developing countries, many developing countries have seen little improvement in economic growth. The opportunities offered to their populations are still quite limited, even though the record in regard to health statistics has improved more than economic and social conditions in many developing countries. The authors do not attribute the cause to a plot fomented by immoral individuals trying to use public funds for private gain – even though such individuals can be found to operate in this terrain. Rather, the cause is less dramatic, but more plausible. The cause is the set of incentives facing the diverse actors involved in the chain of aid delivery.

All public agencies have been created to achieve multiple goals, but they cannot all be achieved simultaneously. Diverse actors within and outside public agencies are usually more interested in seeing one set of goals accomplished over others. Thus, the public sector is often best characterised as having multiple and sometimes conflicting goals, as well as multiple principals who tend to push for the achievement of different goals.

The four authors of this book – Bertin Martens, Uwe Mummert, Peter Murrell and Paul Seabright – have demonstrated the relevance of the principal–agent model used by contemporary political economists by consistently using it to analyse a diverse set of fascinating questions of central importance to understanding international aid processes. The fundamental problem of all principal–agent situations is that agents have private information about their own goals and the effort they invest to achieve a principal's objectives. Consequently, principals have a challenging task to write a contract to increase the alignment of the interests of agents with their own interests. In a public agency, the principal is broadly conceptualised as the general public itself. As the public cannot be watching its agents on a daily basis, the public must elect representatives who, in turn, choose implementing agents to carry out desired public activities. In most public agencies, considerable slippage occurs along the chain of command from voter to elected officials to appointed officials to contractor to beneficiaries. Voters, however, eventually receive most aspects of domestic public services and can thus broadly assess whether these goods and services are roughly worth the tax dollars spent on them. This is always a tough process in a modern democracy where many goods and services are provided by public agencies, and determining whether tax dollars have been used efficiently is difficult. The voter, however, has some chance of directly learning how a government jurisdiction is doing in regard to improving air quality, providing social security, and policing major highways.

In regard to international assistance, however, the authors point out that even this weak feedback loop is broken. As Martens states in his introduction:

> a unique and most striking characteristic of foreign aid is that the people for whose benefit aid agencies work are not the same as those from whom their revenues are obtained: they actually live in different countries and different political constituencies. This geographical and political separation between beneficiaries and taxpayers blocks the normal performance feedback process: beneficiaries may be able to observe performance but cannot modulate payments (rewards to the agents) in function of performance. (Chapter 1, p. 14)

Many of the problems addressed in the volume are linked closely to this broken feedback loop.

Several variants of principal–agent models are developed in the volume. In Chapter 2, 'Conflicts of Objectives and Task Allocation in Aid Agencies', Paul Seabright develops a multi-task, principal–agent model that encompasses the idea that agents also have multiple talents. Among the implications from this model are that a strong decision-making bias exists in this field toward measuring inputs that are easy to monitor rather than outputs that are always more difficult to measure. A second bias is one of ensuring that budgets are spent, rather than that budgets are spent well.

Peter Murrell in Chapter 3, 'The Interaction of Donors, Contractors and Recipients', develops a model of the relations between a donor and a contractor hired to carry the major burden of crafting reforms for a recipient country. As all national reforms are non-excludable and non-subtractive – and thus are public goods – measuring final output is extremely difficult. Some intermediate observable, such as the passage of legislation, is likely to be substituted by the donor as evidence of successful reform. Given that the way a reform operates in practice is affected by how well it fits with a particular socio-economic environment, reform legislation that is based on another country's productive legislation can even be counterproductive when introduced into an entirely different environment. Murrell demonstrates that multiple equilibria are possible, ranging from effective to ineffective reforms depending on how contractual arrangements are negotiated as well as on the configuration of interests.

Continuing with the theme of embedding externally induced institutional reforms in a recipient country, Uwe Mummert models the implementation game after an externally financed *de jure* reform has been accepted by a recipient country. He examines the potential conflict that social norms can create, if induced reforms do not build upon the social structures that have evolved in a recipient country over a long period of time. His good news is that unless extreme social fragmentation exists, rule-violating behaviour is unlikely to become dominant. On the other hand, Mummert stresses that market reforms can never completely lay out all of the do's and don'ts necessary to create a viable, open and competitive market. The problem of direct and indirect conflict between *de jure* and *de facto* institutions is substantially enhanced in fragmented societies where insider–outsider differentiation is deeply rooted.

In his chapter on 'The Role of Evaluations in Foreign Aid Programmes', Bertin Martens points out the major impact of evaluations in a 'democratic' process with a broken feedback loop. Unfortunately, the evaluation process is itself subject to manipulation both by the donor country's development assistance agency as well as by those responsible for aid delivery itself. All too often, underfunded evaluations come so late in the process of aid delivery that the lessons are only relevant for the design of new projects. Aid officials, however, rotate fast enough so that what is learned from one project can rarely be applied by the same official to other projects in the same embedded setting.

Most of the examples in the volume come from multilateral aid processes as major segments of the book were initially formulated in the Evaluation Unit of the European Commission. The lessons, however, are generally relevant for all scholars and long-term aid practitioners interested in improving the performance of international aid processes. I am sure that others will find as many insightful passages as I did in reading through this useful book.

Elinor Ostrom