Absorption Capacity and Disbursement Constraints

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Abstract

Why do donors and recipients act the way they do? In this paper I provide some partial answers by discussing some of the most important incentive constraints facing donors and recipients. Some of these incentive constraints, like multiple objectives, difficulties in measuring output or outcomes, and weak performance incentives, are problems most public agencies face, although they are often more pronounced in donor agencies. More important, there are features that are unique to the foreign aid sector, including multiple agents (donors) and a weak or broken information/accountability feedback loop between beneficiaries (in the recipient country) and voters and politicians (in the donor country). The donor agencies' incentives also influence the recipients' behavior, and their ability to use aid productively. This paper will discuss the incentive problems in disbursing and absorbing aid and how they interact in determining the efficiency of foreign aid. In so doing, it will mostly highlight problems, but to some extent also discuss ways forward.

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1 Introduction

In many respects foreign aid agencies are very similar to other public agencies in that they face incentive problems common in most of the public sector. These incentive constraints include multiple objectives; difficulties in measuring output and performance, and weak performance incentives. However, although common in the public sector, these institutional features are often more pronounced in the foreign aid sector. In addition, there are features in the aid business that make foreign aid particularly subject to adverse incentive effects. They include the presence of multiple principals; i.e., donors, and a broken information (accountability) feedback loop between the providers and the beneficiaries.

Why do donors and recipients act the way they do? This paper tries to partly answer this question by studying the incentive constraints listed above. The key message of the paper is that while many other factors influence how aid is disbursed and used, these incentive constraints are likely to be among the leading candidates for understanding donor (and recipient) behavior. To improve the way foreign aid is disbursed and used, one needs to explicitly address, or relax, these incentive constraints.

The rest of the paper is organized as follows. In section 2, I discuss the implications of the broken information (accountability) feedback loop. I argue that this feature - - which differentiate foreign aid from domestically financed services - - explains both the focus on volume of foreign aid (both by donors and recipients) rather than results and why the interest of domestic suppliers of aid financed goods and services dominate decision making. I discuss ways to mitigate the problems caused by the broken information (accountability) feedback loop and illustrate this discussion with the case of school funding in Uganda. In section 3, I briefly discuss the problems caused by multiple objectives and tasks - - features that are common in most of the public sector - - and discuss why the incentive problems that arise from the multiplicity of tasks and objectives are likely to be more pronounced in the foreign aid sector. I then turn to one specific issue - - the budget pressure problem - - which I argue is partly a function of the incentive issues raised in sections 2 and 3. I provide some evidence of the macroeconomic implications of the budget pressure problem and discuss how the pressure to disburse can be relaxed. Section 4 discusses the multiple principal problem; that is, that foreign aid is handled not by one but multiple agencies. I highlight both the transaction cost implications and collective action problems that arise when multiple donors give aid to a recipient without being fully coordinated. Finally, in section 5, I discuss the difficult trade-off facing donors today - - the conflict between long run objectives to enhance institution-building and the short run objective to minimize capture and corruption.

2 A broken information (accountability) feedback loop

Foreign aid agencies, just like most agencies in the public sector, face various incentive constraints that influence how they behave and how and why they prioritize the things they do. Three important incentive constraints that have been discussed in the agency literature on public administrations are (i) multiple objectives; (ii) difficulties in measuring output and performance; and (iii) weak performance incentives. As discussed in more detail below, although common in the public sector, these institutional features are often more pronounced in donor agencies. However, aid agencies differ from other organizations in the public sector in some important ways. Maybe most importantly, the people for whose benefit aid agencies are supposed to work (i.e. poor people in the recipient countries) are not the same as those from whom their revenues are obtained (tax payers in the donor country). As noted in Martens et al. (2002), this geographical and political separation between taxpayers and beneficiaries blocks the normal performance feedback process.

In a standard model of public accountability, individuals and households have dual roles, as citizens and clients. As clients, individuals hope to benefit from various public programs. As citizens, individuals and households use various mechanisms to influence and control politicians and indirectly the performance of the public administration. When individuals and households are well-informed and have mechanisms to sanction politicians - - for example the right to vote them out of office - - politicians have potentially strong incentives to monitor and pressure public institutions to do what individuals and households, whom they represent, want.[1] Two key assumptions in these type of models are that individuals and households as clients are informed about programs intended for their benefit and that individuals and households as citizens have the ability to sanction politicians. In the case of foreign aid, geographical and political separation between the beneficiaries (clients in the recipient country) and the donors (citizens in the donor country) severely constraints both these mechanisms. Citizens in the donor country have no direct knowledge or experience of the programs financed by the aid agency. Moreover, it is very costly for tax payers in the donor country to obtain reliable information on the outcomes of aid programs that they finance. The intended beneficiaries (the clients), on the other hand, are not voters in the country that pays for the aid and thus have no real political leverage over

[1] See Becker (1983) and Whitman (1995).

domestic politicians who approve these programmes (Martens et al. 2002).

The broken information (accountability) feedback loop magnifies problems arising from multiple objectives, difficulties in measuring output and performance, and week performance incentives. It affects both the donor and the recipients.

First, voters in the donor country do not derive any direct benefit from service provision funded by foreign aid nor do they observe outcomes in the recipient country. However, they can observe the share of the government budget allocated to foreign aid. For this reason, the volume of aid given has become one of the key performance measures of aid, and political discussions and debates about aid in many donor countries, center almost exclusively on the question of how much should be given in aid to poor countries. To the extent the majority of voters are in favor of assisting poor countries, this is also a focus that benefits the aid agency. Importantly, volume of aid and outcomes are not necessarily correlated. The political focus on volume rather than impact also influence how aid agencies work (as discussed below).

Second, the broken information (accountability) feedback loop explains why the interest of domestic suppliers of aid financed goods and services dominate decision-making (Martens et al. 2002). Consultancy companies, experts and suppliers of goods are both direct beneficiaries of aid (through contractually agreed rewards) and have direct leverage on political decision-makers in the donor country. As a result, they have a disproportionally large influence on how aid programs are designed and implemented. Cross-country work on the determinants of aid across countries provide indirect evidence of this bias. For example, Alesina and Dollar (2000) and Collier and Dollar (2002) show that almost half of the foreign aid provided by the OECD countries have not be guided by any consideration of poverty alleviation.

The broken information (accountability) feedback loop also influences the recipient behavior. Most importantly, when projects are donor driven or financed, clients in the recipient country rationally anticipate that their influence on the financier is limited at best. As a result, public official in the recipient country assigned to the aid project/program have weak incentives to exert effort. To the extent that the political system induces weak accountability in general between citizens and politicians, these incentives are magnified.

How can the bias in foreign aid policy induced by the broken information (accountability) feedback loop be mitigated? Martens et al. (2002) argues that because of the broken "natural" feedback loop in foreign aid, inserting an explicit evaluation function in foreign aid programmes is necessary to eliminate performance problems. However, this can at best only be a partial solution. First, to the extent that evaluations are handled by the aid agency itself, which is typically the case, it will be subject to attempts of manipulations. For example, lower-quality evaluation studies could be preferred as it would be harder to draw firm conclusions on actual performance then. Moreover, even if the evaluations are well done, to the extent there is no mechanism in place to act on these evaluations, i.e. no mechanism to get the evaluation results out in the public, the aid agency's behavior would likely not be affected. An independent foreign aid evaluation agency could be a way around these problems.[2] Second, even if donors adopt formal evaluation as a key component in aid programs, there would still be difficulties in exercising external influence without undermining local accountability relationships (Word Bank, 2003).

[2] In Sweden an independent agency for the evaluation of foreign aid has been formed. However, domestic regional development concerns determined the location and budget for the new agency, raising concern about the political commitment to credible and independent evaluations of foreign aid.

These problems raise the need for a complementary approach of enhancing client power. For example, when possible, donors can encourage citizens monitoring of projects financed by aid through report cards and public expenditure tracking surveys. The case of Uganda provides an illustrative example.

In all governments, resources earmarked for particular uses flow within legally defined institutional frameworks. Typically, funds pass through several layers of government bureaucracy down to service facilities, which are charged with the responsibility of spending the funds. However, in developing countries, information on actual public spending at the frontline level or by program is seldom available. To remedy this problem, a so-called public expenditure tracking survey (PETS) was developed. A PETS is designed to follow the flow of resources through various strata of government to determine how much of the originally allocated resources reach each level. It is therefore a useful device for locating and quantifying political and bureaucratic capture, leakage of funds, and problems in the deployment of human and in-kind resources. It can also be used to evaluate impediments to the reverse flow of information needed to account for actual expenditures (Dehn, Reinikka, and Svensson 2003).

The first PETS was implemented in Uganda in the mid 1990s. The study was motivated by the observation that despite a substantial increase in public spending on education, the official reports showed no increase in primary enrollment. Specifically, the hypothesis was that actual service delivery, proxied by primary enrollment, was worse than budgetary allocations implied because public funds were subject to capture (by local politicians and public officials) and did not reach the intended facilities (schools). To test this hypothesis, a survey was conducted of 250 randomly chosen primary schools. The survey collected five years of data on spending (including in-kind transfers), service outputs, and provider characteristics. This data were then linked to survey data from 18 local governments (districts) and detailed disbursement data from three central government ministries (Reinikka and Svensson 2004).

The program in question - a capitation grant to cover primary schools' nonwage expenditures - is a fairly standard one in developing countries. Like many other spending programs in heavy aid dependent countries, it was funded to a great extent by donor funds. As part of an onging structural adjustment program, the World Bank was also involved in monitoring the program. Based on central government budget data, the program appeared to work well. Funds were disbursed by the Ministry in charge on a regular basis, and a benefit incidence analysis carried out by the World Bank suggested that benefit incidence of public spending was neutral. However, like in many other spending programs in low-income countries, the situation on the ground was completely different from the official statistics (Reinikka and Svensson 2004).

Over the period 1991-1995, on average, only 13 per cent of the total yearly capitation grant from the central government reached the schools. Eighty-seven per cent either disappeared for private gain or was used to finance various political activities at the local level. A majority of schools received nothing. The picture looks slightly better when constraining the sample to the last year of the sample period. Still, only around 20 per cent of the capitation grants from the central government were reaching the schools in 1995 (Reinikka and Svensson 2004a).

The situation in Uganda in the mid-1990s illustrates two facts caused, at least in part, by the broken information (accountability) feedback loop. First, while funding the school grant program, the donor community had no idea (and had done little to find out) about what impact it had; i.e. did school receive the funds and if so did this improve the learning environment? Second, the intended beneficiaries (parents) had typically no information about the school grant program - - most probably did not even know about it - - which of course made it easier for local officials and politicians to capture the funds.

The Uganda case also illustrates the power of impact evaluations in general and quantifying corruption in particular as a spark for reform. Hard evidence of corruption or capture is difficult for governments to simply brush aside and in response to the high degree of local capture of education fund, the central government reacted swiftly. Interestingly, the response was not the typical one - - to improve the financial management system through increased monitoring by central government agencies. Instead, the central government decided to engage the citizenry. Led by the Ministries of Local Government and Finance, it began to publish data in the national newspapers on the monthly transfers of capitation grants to districts. Later on, the Ministry of Education proposed extending the information campaign to all school communities. Primary schools (and district administration headquarters) were required to post notices on actual receipts of funds for all to see. In short, in this two-part campaign, information on entitlements transferred by the central government was made available through newspapers, while information on what each school actually received was posted at schools to inform parents.

In Reinikka and Svensson (2005a) we use a repeat PETS to assess the effects of the newspaper campaign. The raw data suggest a large improvement. In 2001 schools received an average of 80 percent of their annual entitlements and the newspaper campaign can account for a large fraction of this improvement.[3]

The Uganda case also illustrates that interventions aimed at improving accountability in the public sector may be the best way, i.e. more cost efficient way, to improve service delivery outcomes since social service delivery in developing countries is often plagued by inefficiencies and corruption. Specifically, not only did the newspaper campaign dramatically reduce capture but both student enrollment and achievement (test scores) increased substantially in schools that, due to the information campaign, managed to claim a higher share of their entitlements (Reinikka and Svensson, 2005b).

Another implication of the broken information (accountability) feedback loop is that news media's influence on policy is larger for foreign aid than most other domestic programs. Since voters in the donor country have little or no own experience of projects and programs financed by foreign aid, news reports are typically the sole source of information. This introduces a bias in foreign aid policy since news media tend to focus on newsworthy events. There is some empirical evidence of this effect. Eisensee and Stromberg (2005) find that U.S. disaster relief depends to a large extent on the occurrence of other newsworthy events at the time of the disaster, which is obviously unrelated to need. They argue that the only plausible explanation for this is that relief decisions are driven by news coverage of disasters and that this news coverage is crowded out by newsworthy material. Since different types of disasters are more or less newsworthy, this also implies that certain disaster, such as earthquakes, receive a lot of attention, while famines, for example, receive

[3] Specifically, in Reinikka and Svensson (2005a) we show that public access to information can indeed be a powerful deterrent to capture of funds at the local level. We show that head teachers in schools closer to a newspaper outlet are more knowledgeable of the rules governing the grant program and the timing of releases of funds by the central government. These schools also managed to claim a significantly larger part of their entitlement after the newspaper campaign had been initiated.

less. Eisensee and Stromberg (2005) find that to have the same estimated probability of entering network news as an earthquake, a food shortage must have 40,000 times as many casualties.

3 Multiple objectives and tasks

Most donors have multiple objectives. The Swedish foreign aid agency, Sida, for example lists six goals for Swedish development cooperation: (i) economic growth; (ii) economic and social equality; (iii) economic and political independence; (iv) democratic development; (v) environmental care; and (vi) gender equality. Since development is multidimensional, it is not surprising that also the agencies working on development have multiple objectives. The problem with multiple objectives is that they typically imply trade-offs. This is particularly so in the short run. Donor agencies seldom make these trade-offs explicit so individual managers are typically uncertain about what should be prioritized in a given situation. Since it is not uncommon that managers in donor agencies shift positions at regular intervals, policy choices, in a given sector or country, do typically shift over time, and long term commitments become more difficult to stick to. Obviously, the recipient country may act accordingly. Trying to meet short run objectives become more important that reaching long-term goals.

Officials in an aid agency also perform a multiplicity of tasks. While this is something that characterize the job description in many public agencies, the broken information (accountability) feedback loop makes the incentive problem arising from multiplicity of task more pronounced in donor agencies. When faced with multiple tasks that compete for their time, agents will tend to focus on those that are more likely to satisfy their career concerns or require less effort. Since some tasks are more easily monitorable by their supervisors (such as input activities like budget, procurement, hiring of consultants), these tasks will receive a disproportionate attention at the expense of less easily monitorable tasks (for example effort exerted in actual implementation of a project). Thus, the disruption in the performance-feedback loop, combined with the difficulties of measuring performance, results in a disproportionate focus on input activities and the expense of attention given to the quality of outputs, i.e. the actual result of the aid program (Martens et al. 2002).

There is no easy way around this problem. First, with multiple objectives it is more difficult to write, or agree on, output or performance contracts. This is particularly the case if some goals are more difficult to measure or operationalize than others. Second, even if this could be solved, such a contract requires that salaries should be linked to performance of aid projects/programs - a type of payment schedule that are far from the traditional enumeration system of public officials in most donor countries. Interventions that address the broken information (accountability) feedback loop, for example by inserting an explicit evaluation function in foreign aid programmes, could go someway in mitigating the problem.

4 The budget pressure problem

> *Both donor and recipient have incentive systems which reward reaching a high volume of resource transfer, measured in relation to a predefined ceiling....In many administrations, both bilateral and multilateral, the emphasis is on disbursements and country allocations. Non-disbursed amounts will be noted by executive*

> *boards or parliamentary committees and may result in reduced allocations for the next fiscal year....Results are measured against volume figures, with no regards for the quality....Besides, when the time has come to evaluate the actual outcome, most of those responsible for the project on both sides will have been transferred.* [Edgren, 1996, p. 11 (Former chief economist of the Swedish aid agency)]

Even in the case of a single task, there are incentive problems in the donor agency that tilt attention to committing and spending budgets rather than focusing on outcomes. In most donor organizations, it is common to separate allocation and disbursement decisions.[4] Typically, the allocation process is centralized (in many countries general guidelines and country allocations are set by the parliament) while the disbursement decision is decentralized (i.e., country- or project-specific). This set-up also characterizes foreign aid at the project level. The planning and initiation of a project are typically coupled with a commitment of funds to that particular project. Disbursement (of committed funds) is a subsequent decision.

This institutional setup has resulted in a strong bias towards "always" disbursing committed funds to the ex ante designated recipient, or project, irrespective of the recipient government's performance, or project performance, and the conditions in other potential aid recipient countries (projects). Thus, resources are not shifted towards projects or countries where they can be more effectively utilized and ex ante "threats" of not disbursing committed aid if the recipient fails to implement certain polices is not credible. The bias, in turn, arises because the opportunity cost of a given aid budget (or a committed adjustment loan) for the disbursing donor agent is low.

[4] This section draws from Svensson (2003).

Why is the opportunity cost low? Studies of bilateral donor organizations have emphasized that, in practice, "spending the budget" has become a key goal in itself (Paldam, 1997; Edgren, 1996), in large part due to the problem of multiple objectives and a broken information (accountability) feedback loop. Moreover, large unused resources is typically viewed as a sign that the country department, or the specific project, has a problem, why else can it not disburse its funds? Since the allocation of the overall aid budget across country departments is partly determined by the disbursement history, a country department failing to disburse the committed funds will most likely receive a smaller allocation the following year. The size of the budget, in turn, not only constrains the overall spending program of the country department, but also determines the status of the job (for general references to the theory of bureaucratic interests, see Wintrope, 1997; Moe, 1997; and Niskanen, 1994). The same argument applies to project or sector specific aid.

Evaluations of the lending process within the World Bank have pointed towards similar incentives. Mosley et al. (1995) argue that the World Bank's country loan officers are under intense pressure to meet country disbursement targets notwithstanding how unpromising that government's subsequent implementation performance is. Apart from the "maximization of the budget" argument, they stress a coordination/free-rider problem; bearing in mind what other countries have got away with, Bank staff know that it will not be financially productive to make an example of one particular recipient who defaults on conditions by refusing to disburse the committed funds. Moreover, the enforcement of conditionality might be in conflict with other goals of the Bank, such as providing quick-disbursing finance so as to hinder a potential default on outstanding loans. [5]

[5] As discussed in Svensson (2003), there exists a number of screening devices within the World Bank to counteract any pressure towards "irresponsible" lending. However, many

Again donor incentives also influence how recipients behave. When assistance is given as conditional aid it typically implies that the donors pay the recipient to do something it would otherwise not do. For this to be a credible contract, the donor agent must ex ante have incentives to halt disbursements if the conditions have not been met. However, if the true objective of the donor agent is to disburse the budget, not the actual performance of the aid project/program, such as aid contract will no be credible. That is, aid will be disbursed irrespective of what actions the recipient takes. This in turn adversely influence the recipient incentives to take actions according to the specified contract ex ante.

The low opportunity cost of committed funds hypothesis has a stark empirical implication, the disbursement decision should be independent of reform implementation. That is, committed funds should be disbursed irrespective of the recipients' actions. Svensson (2003) provides some preliminary evidence consistent with this hypothesis. Drawing on information from a study on the determinants of around 200 structural adjustment programs (Dollar and Svensson 2000), Svensson (2003) use as a proxy variable of reform effort a binary variable reflecting the failure or success of World Bank supported reform programs, as determined (ex post) by the Operations Evaluation Department (OED) of the World Bank. Using this variable has advantages and disadvantages. The advantage is that it provides a consistent measure of whether reform programs succeeded or failed. The disadvantage is that the measure of success is subjective.[6]

To assess whether the disbursement decisions depend on perceived reform outcome, Svensson (2003) uses a two-stage procedure. First, the probability

conditions attached to Bank loans are phrased in terms permitting a subjective assessment ('substantial progress', 'satisfactory performance') which, in turn, facilitates the tranche release of committed funds.

[6] See Svensson (2003) for details.

of reform is estimated by means of a probit model (following Dollar and Svensson, 2000). Second, the estimated probability is used as proxy for the perceived success of reform in explaining the difference between committed and disbursed funds. Formally, the two step procedure can be stated as,

$$\pi_i = \text{probit}\left(r_i = \boldsymbol{\beta}_x' \mathbf{x}_i + \nu_i\right) \tag{1}$$

$$sf_i = \gamma \hat{\pi}_i + \boldsymbol{\beta}_z' \mathbf{z}_i + \varepsilon_i, \tag{2}$$

where r_i is the binary reform proxy discussed above (*reform*); x_i is a vector of political determinants of reform (as identified in Dollar and Svensson 2000); sf_i is the share of committed funds disbursed during the reform period; $\hat{\pi}_i$ is the estimated probability of reform success; z_i is a vector of other controls influencing the disbursement decision, and ν_i and ε_i are iid error terms.

Dollar and Svensson (2000) show that a small number of political economy variables can successfully predict the outcome of an adjustment program 75% of the time. Their results suggest that successful reform is associated with democratic government (*demo*) and political stability (*stability*). High degrees of ethnic fractionalization (*ethnic*) are bad for policy reform and long-term incumbents (*tenure*) are not likely candidates for reform. The basic finding in Dollar and Svensson (2000) is replicated in Table 1. To estimate the second-stage equation, Svensson (2003) assembles data on committed and disbursed funds. As additional controls in equation (2), Svensson (2003) include the logarithm of initial GDP per capita (*logGDPc*) and the logarithm of initial population (*logpop*). Both variables have been shown to be highly correlated with aid flows (see, for instance ,World Bank, 1998). Mosley et al. (1995) argue that an implicit goal of policy-based lending is to provide quick-disbursing finance so as to hinder potential default on outstanding loans. To control for this possibility, Svensson (2003) also add the initial debt to GDP ratio (*debt*).

What happens with the committed funds when the recipient is perceived as failing to reform? The answer, depicted in Table 2, is "very little". As is evident, there is no significant relationship between the share of committed funds disbursed and the estimated reform effort.[7] In fact, the estimated reform measure enters with the "wrong" sign, although close to zero. There is some evidence that smaller countries (measured by size of population) are more likely to receive committed funds and defensive lending; that is, countries with larger initial debt are less likely to experience cancellations of commitments, irrespective of the reform outcome. Column (2b) shows that the results are similar when only considering World Bank IDA lending.[8]

A possible objection to the results reported above is that the dependent variable *sft* combines concessional and non-concessional sources of financing. Column (2c) depicts the results with the share of committed concessional funds disbursed as the dependent variable (i.e., bilateral ODA and concessional World Bank (IDA) lending), *sfc*. The results are very similar to those reported in column (2a).

How can the donor agencies relax this pressure to disburse independent of the outcome of a project or program? One possible solution is to find ways to internalize the opportunity cost of aid at the disbursement stage. One way to achieve this is to pool projects and programs, i.e., to partly centralize the disbursement decision. Thus, instead of committing a fixed amount of aid t to each recipient (or project) n ex ante, and making aid conditional on reform or outcome, the donor links the allocation and disbursement decision by committing a larger amount (t^*n) to a group of recipients/projects, but where the actual amount disbursed to each individual country (or project)

[7] sft_i is the share of the total funds committed that was actually disbursed during the reform period.

[8] $sfwb_i$ is the share of World Bank commitments disbursed during the reform period.

depends on its relative performance ex post. Linking the allocation and the disbursement decision has two important advantages as compared to present practices. First, it raises the opportunity cost of disbursing aid ex post, thereby giving the donor stronger incentives to use aid where it is most effective. Second, competition among recipients or project (in a sense an aid tournament) allows the donor to make inferences about common shocks, which would otherwise conceal the recipients' choice of action. This enables the donor to give aid more efficiently. Both effects also raise the incentives for the recipient to exert effort (or implement reforms).

Two objections against such a institutional reform are worth stressing. First, it could be argued that competition between recipients introduces uncertainty about financial flows, which renders planning more difficult and makes fiscal spending too volatile. This may be true if making comparisons with how the aid system presently seems to work - commitments are always disbursed. However, this is not true if we compare it with the conditionality outcome as it is supposed to work. In fact, if the shocks facing the recipients are (highly) correlated, the uncertainties will be reduced by having the recipients compete in an aid tournament.

Second, it could be argued that the degree of reform implementation, or effort exerted by the recipient, depends on domestic political economy forces, rather than on conditional aid. In fact, recent evidence suggests this to be the case (Burnside and Dollar, 2000; Dollar and Svensson, 2000). However, these studies analyze the impact of conditional aid (as it seems to work), not as it was meant to work. Therefore, one should not expect any significant correlation between aid flows and policy reform. More important, the institutional reform briefly discussed above deals with the incentive structure within the donor organization. Even if the degree of policy reform is solely determined by domestic political economy forces; i.e., is independent of foreign assistance, linking the allocation and disbursement decisions will still be useful since this provides incentives for the donor to allocate/disburse aid to where it can be effective.

A question partly left unanswered is, why is it that if the linking of the allocation/disbursement decisions improves outcome, the donor community does not explicitly link these decisions? One answer is of course that the potential cost of tournament type aid schemes is perceived as being very high (for example the cost related to the political risk of creating competition between countries or projects). However, the extent of competition between countries, and thus the potential cost, can be controlled by varying the share of aid disbursed through a tournament-type aid scheme. This also seems like a less important concern for project aid. A more plausible explanation is related to the change in the existing power structure within the donor agency/donor community implied by such a regime shift. In essence, the reform would reduce the discretionary power of many managers mainly in charge of the disbursement decisions. Moreover, by making the opportunity cost explicit in the decision process, the management would be required to make "tougher" choices. Recipient-specific interest groups (e.g., domestic firms, NGOs), and potentially the recipient government, may also oppose an institutional change that would imply aid flows conditional on performance, rather than ex post unconditional disbursements.

5 Multiple principals (donors)

Foreign aid differs in yet another important way from domestically financed services - - foreign aid is handled not by one but multiple agencies. When the donors are not fully coordinated, this can give rise to severe collective action problems. An interesting historical parallel is the success of the Marshall Plan (see Knack and Rahman, 2004).

The relative success of the Marshall Plan has been attributed to the difference between the group of recipients. Unlike most recipient of foreign aid during the last decades, Westers Europe had a huge advantage in putting aid to effective use. It had skilled labor, experienced managers and entrepreneurs and reasonably efficient legal and financial institutions. The public administrations were also considered relatively competent. However, differences on the donor side may also have contributed to the great success of the Marshall Plan (Birdsall, 1999). Marshall Plan recipients had to deal only with one single donor, in contrast to the large numbers of bilateral and multilateral donors and NGOs that are active in the foreign aid sector today. De Long and Eichengren (1993) further argue that the Marshall Plan assistance, "history's most successful structural adjustment program", was not disbursed in the form of a huge number of separate donor managed projects in each recipient country. As noted in Knack and Rahman (2004), aid success stories in Taiwan, Botswana, and Korea have also been attributed to the presence of a dominant donor (Brautigam, 2000).

The median number of official donors in recipient countries in 2000 was 23 (Acharya et al. 2003) and in the typical African recipient foreign aid is provided by "some thirty official donors in addition to several dozen international NGOs....through over thousand distinct projects and several hundred resident foreign experts" (van de Walle 2001).

Why would the fact that multiple donors are involved with each recipient affect the efficiency in which aid is given and used? Aid involves a set of collective action problems. When there are multiple donors, each concerned partly with the development in the recipient country but also with domestic concerns, individual donors will typically not internalize the full costs of a foreign aid project, while at the same time fully internalize the short run benefits, or in some cases fully internalize the costs but not the social benefits. Specifically, one donor's action may - - indirectly or directly - - influence the efficiency of other donors actions. This externality is typically not taken into account when a decision is made. The collective action problem may severely influence the efficiency of foreign aid and more generally the recipients own financial ability and administrative capacity to govern.

The costs associated with the proliferation of donors can be grouped into three broad categories. The first is the increased transaction costs associated with numerous and diverse donor rules and procedures for managing foreign aid projects and programs (Berg 1993). The Tanzanian government, for example, have to prepare about 2,000 reports of different kinds to donors and receive more than 1,000 donor delegations each year (World Bank 2003). Duplications of analytical work such as poverty assessments, public expenditures reviews, governance and investment client assessments are other examples of increased costs of implementation. Easterly (2003) notes that authors of these reports are frequently unaware of recent studies on the same topic in the same country funded by a different donors.

The second type of costs arises from the fact that in many cases, foreign aid projects are associated with large fixed costs and high returns to scale. If each donor works on their own individual projects, these returns to scale may go unexploited.

The third category is less direct in that it affects the recipient's financial ability and administrative capacity to govern (Knack and Rahman 2004). First, donors have tended to provide project aid - - either working with individual line ministries, or engaging provider under local governments or by directly funding frontline providers (schools and health clinics) - - rather than budget support. Although this is slowly changing and budget support has its own limitations, this response, while officially a response to inadequate institutions and government capabilities in the recipient country, is also influenced by the fact that the each individual donor fully internalize the individual costs and benefit of a project but do not fully internalize the more diffuse notion of strengthening the recipient's own financial, budget, and service delivery systems as budget support is thought of doing.

Second, donors tend to support only capital spending (investments), expecting the recipient government to supply complementary inputs (staffing and maintenance). In this case, each individual donor in effect treats the budget for recurrent expenditures as a common-pool resources (Brautigam 2000), producing a tragedy of commons in which roads are built but not repaired, and schools and clinics are constructed but not staffed. Moreover, noting the widespread failure by recipient country governments to maintain infrastructure funded by foreign aid once construction is completed, the donors have often reached the wrong conclusion about causes. Specifically, many observers have pointed to the lack of "ownership" not about the failure to internalize the externality, i.e. the reduced capacity to maintain other donor funded projects if a new project is initiated. Advocates of financial sustainability emphasize the importance of local ownership of projects, and they promote interventions that only require start-up funding which then can be maintained locally without external support (Kremer and Miguel 2004). When the real problem is the proliferation of donors, such a recommendation may only exaggerate the problem.[9]

[9] Ownership becomes an issue when donors fund projects that recipient governments are not interested in. If it is not a project that encourages a new approach through its

Third, individual donors typically work with counterparts in the local bureaucracy and attract these local experts by paying salary supplements to the most talented local staff (Knack and Rahman 2004). Since the distinction between purely private consulting work for a donor and official work in the local bureaucracy is often blurred (Cohen and Wheeler 1997), this practise distorts incentives for civil servants to turn their attention away from their other responsibilities - - even those with greater impact on development - - and toward donor projects (Knack and Rahman 2004). This distortionary effect of donor behavior do not only effect the division of effort for staff in the administration, but also affects the overall allocation of talent within the recipient country. When high level managers in the civil service can make 10 times as much working directly for a donor, the most talented staff will leave the public sector to work for a donor (Knack and Rahman 2004). Similarly, in many African countries, working for a donor is much more profitable than most entrepreneurial endeavours. In short, the most talented people will tend to work for donors rather in the civil service or in the private sector. Similarly to the investment contra recurrent expenditures decision, donors, in deciding whether to hire the better-qualified civil servants or agents in the private sector, treat the government bureaucracy, or more generally the pool of talented people, as a common-pool resource. While the decision of an individual project manager of whom to hire may not have much effect on the recipient government's ability and administrative capacity to govern, when each individual donor manager act in the same way, the aggregate effect may be large. The total effect may be even more detrimental taking into account the incentive effects of the local staff working on donor projects. As financial return of working for a donor is relatively much higher than other work,

demonstration effect, or specifically designed as a one-time intervention, such an approach contradicts ownership and would not be sustainable (World Bank 2003).

talented local staff have incentives to protect and extend aid projects for which the they benefit, regardless of their merit (Knack and Rahman 2004).

There is also some cross-country evidence that suggests that the costs associated with the proliferation of donors can be substantial. Knack and Rahman (2004) show that a higher donor fragmentation (reflecting the presence of many donors with a small share of aid) is associated with a decline in bureaucratic quality. These results, however, should be interpreted as suggestive rather than providing causal evidence.

Should donors thus refrain from hiring local staff or ensure that they are paid according to what they make in their current occupations? The answer is most likely no. The resource injection from high donor-paid salaries potentially has a positive net impact on development, despite the adverse impact on the functioning of government (Knack and Rahman 2004). However, this also implies that the same benefits may be obtained without the negative effect on government's ability to implement and formulate their own policy.

The recent trend toward budget support are viewed by many as a means of reducing transaction costs and providing both donors and recipients with incentives to focus on strengthening financial, budget, and public service delivery systems.

Institutional arrangements, such as designating a lead donor for the country or sector, as a way to get individual donors to internalize the full costs and benefits of a foreign aid project or program would be a way forward, although it may not be politically feasible. It should also be noted that efforts are underway to improve donor coordination on one aspect of this problem, namely efforts to reduce transaction costs by harmonizing operational policies and procedures and establishing a web site to disseminate information on completed and planned country work. An assessment of to what extent these initiatives have improved outcomes, would be highly valuable.

6 The foreign aid dilemma

The core problem facing the donor community is that it wants to assist poor countries to alleviate poverty. Poverty in turn is a function of both exogenous and structural features for which the recipient government can do little about - - at least in the short run - - and the recipient government's policy decisions. This simple fact has two stark implications.

First, good aid projects/programs will typically be associated with high risk. The very reason why the recipient is in need of foreign aid is that its own institutions are weak and this will affect the expected return to aid. Thus, to allocate aid only to recipients with well-functioning institutions and good policies will typically not be optimal if poverty alleviation is the dominant criteria for foreign aid. However, because of the broken information (accountability) feedback loop, voters and politicians in the donor country face a moral hazard problem. Observing poor outcomes, they do not know to what extent this was a result of an ex ante good aid project/program with a risky return or poor design or implementation of the donor. Realizing this, the donor will tend to choose projects/programs that minimize the risk of bad publicity, not those that ex ante maximize expected poverty alleviation.

Second, to the extent the recipient expects that the foreign aid is governed by poverty alleviation, the recipient may have little incentives to exert high effort (or channel its own resources) toward achieving this objective. It may very well be so that interventions that would assist the poor are implicitly taxed, if these intervention would result in that less aid is received in the future. This "samaritan's dilemma" is made worse by moral hazard problems

- - that is the donor cannot perfectly distinguish if a poor outcome is the result of low effort (bad policies) or bad luck (Svensson 2000).

Over the past few years, several donors have argued for a shift in foreign aid practises. In part as a response to the incentive problems highlighted above and disappointment about the aggregate effects of foreign aid during the last four decades, the argument is that donors should try to harmonize their support around recipient systems (see for example World Bank 2003). When the recipients have a well-functioning national development strategy and a budget process that can serve as a common framework and institutions in place to hold both politicians and providers at least partly accountable for their actions, these recommendations make a lot of sense. However, if foreign aid should also be primarily channeled to poor countries, there are few potential recipients that fulfill the necessary criteria. While this problem is sometimes swept under the rug, the World Bank for example explicitly argues that these conditions are not prerequisites for the shift in foreign aid policy. Even in their absence, harmonization and pooling of aid - - typically as budget support - - can offer significant benefits and reduce transaction costs (World Bank 2003, p. 212-213). In short the argument for an alternative way to give foreign aid is that it would reduce transactions costs but also shift the responsibility and hence accountability toward the recipient. This would build recipient capacity and create stronger incentives (and time for) monitoring and evaluating impacts and results.

The concern with such approach is the increased fiduciary risks of channeling untied funds for the recipient to use, although due to the fungibility of aid, fiduciary risks are also present when aid is given as project support. The political economy literature dealing with poor countries and Sub-Saharan Africa in particular, has pointed to severe and structural problems of accountability. In many African countries, power is concentrated to a small pool of elites interconnected by common schooling, marriage, friendships, shared ethnicities or religion. Sustaining this power balance is costly and public funds are fueling a system of patronage politics, where patrons give clients material rewards for their political loyalty and services (Reinikka and Svensson 2004). The patronage system takes different forms, including government actors diverting public resources for their own campaigns and those of friends and family, and financing of local and private causes, including distribution of private goods such as salt, sugar, and beer to neutralize voter dissatisfaction. The political parties must also supply patronage goods to their workers and members. In a rural setting, an important way of maintaining an effective political organization is through personal presence, which means a well-staffed institutional hierarchy all the way down to the village level. This model assumes substantial resources, and diversion of public resources is often the only source of funding available. Given the political situation in many recipient countries, striking the right balance between when to pool and align their support around the recipient's system and when to basically continue with current practise while at the same time trying to minimize or at least reduce transaction costs, is tricky. Specifically, if the incentives to reform, including possibly political reforms, are too weak or proceeds to slow, channeling large untied funds to the recipient may help the current elite to cement their position, at least in the short run. Such an outcome may be difficult to sell to the ultimate principals of foreign aid (voters in the donor countries) and donors thus face a difficult pedagogic task of convincing voters in their countries that such a risk is worth taking to avoid a backlash. Promoting citizen voice is a complementary, but for donors probably the most difficult, strategy. Identifying what type of aid interventions can strengthen the relationship of accountability between politicians, service providers and beneficiaries is probably the most important issue facing the donor community today. As the knowledge is limited and as traditional approaches to improve governance have produced weak results in most developing countries, experimentation and evaluation of new tools to enhance accountability should be high on the agenda among donors.

7 Conclusion

In this paper I have highlighted some of the most important incentive constraints facing donors and recipients. Some of these incentive constraints, like multiple objectives, difficulties in measuring output or outcomes, and weak performance incentives, are problems most public agencies face, although they are often more pronounced in donor agencies. Others, like multiple agents (donors) and a weak or broken information/accountability feedback loop between beneficiaries (in the recipient country) and voters and politicians (in the donor country) are unique to the foreign aid sector. I have argued that the donors' incentives also influence the recipients' behavior, and their ability to use aid productively.

This paper is not a survey of the various incentive problems in foreign aid and when discussing how to make foreign aid more effective, one needs to take a much broader approach. Still, while many other factors influence how aid is disbursed and used, the incentive problems raised in this paper are likely to be among the leading candidates for understanding donor (and recipient) behavior. To improve the way foreign aid is disbursed and used, one needs to explicitly address, or relax, these incentive constraints

Table 1: Probit model of reform, 1980-95

Dep.var.	*c*	*demo*	*stability*	*ethnic*	*ethnic*^{2}	*tenure*	*tenure*^{2}
reform	-.098	.585	-1.30	5.93	-6.51	-.089	.0033
	(.304)	(.224)	(.330)	(1.43)	(1.53)	(.043)	(.001)

Note: Standard errors in parenthesis. All variables except the constant (c) are significant at the 5-percent level. 220 observations (reform episodes). Predictability (p>.05) = .75. Log likelihood: -119.8.
Source: Svensson (2003)

Table 2: Disbursement decision, 1980-95

Equation	(2a)	(2b)	(2c)
Dep. var.	*sft*	*sfwb*	*sfc*
constant	1.23***	.680***	1.94***
	(.154)	(.126)	(.255)
estimated reform	-.056	.065	-.088
	(.058)	(.045)	(.111)
logGDPc	-.010	-.003	-.065**
	(.013)	(.010)	(.027)
logpop	-.018**	.015**	-.038***
	(.008)	(.006)	(.012)
debt	.0004**	.0002*	.0003**
	(.0002)	(.0001)	(.0001)
No.	208	209	182
R2	.12	.05	.17
S.E. regression	.141	.107	.208

Note: OLS estimation with White-heteroskedasticity-consistent standard errors in parenthesis. *Estimated reform* derived from Table 1. *** [**] (*) denote significance at the 1 [5] (10) percent levels.
Source: Svensson (2003)

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