

# **The institutional economics of foreign aid**

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# Chapter 1                      Introduction

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## 1. THE SETTING

This book is about the institutions<sup>1</sup> that guide the behaviour of persons involved in the implementation of foreign aid programmes. 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. It analyses how these institutions affect outcomes of the aid delivery process. The analysis covers a variety of organisations, from taxpayers-donors, politicians, lobby groups, donor agencies and consultants in donor countries, to recipient organisations in beneficiary countries. 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

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<sup>1</sup> We stick to North's (1990) definition of institutions as the formal and informal rules, regulations, laws, contracts and agreements that guide people's behaviour. Organisations are the groups of people that adhere to a particular set of these rules.

*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 individual agents' incentives and constraints can divert 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 credible manner. For instance, for a given institutional setting in a donor agency, a project-based approach to institutional reforms is more exposed to moral hazard problems than a conditionality-based approach; project approaches allocate aid to inputs while conditionality approaches pay for results. For instance, evaluation studies show that the institutional reform performance of EC-financed Phare programmes in Central and Eastern European countries is negatively affected by the absence of conditionality (Martens, 2001). 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.

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. See for instance, White (1992) and Boone (1994). Generally, they conclude that foreign aid has no tangible impact on economic growth in the recipient countries. Burnside & 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?

While Burnside & Dollar (1996) present some econometric evidence in favour of the active hypothesis, Dollar & Svensson (1998) are more 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 & Svensson (1998) also note that about a 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 financial situation to service previous Bank loans and pressure from other donors and creditors to do so. 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 & Mahmood, 1992). More than a decade after the start of the great economic transition wave, 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 an 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 (Devarajan et.al. 1999; Haggard & Webb, 1994). 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 (Svensson, 1997; Mosley 1997; Collier et.al., 1997; etc.). It is not our intention to add to, or comment on, that literature. This book applies a particular type of institutional analysis, usually labelled as “agency theory”, to analyze the incentive problems that may occur in foreign aid delivery. The next 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.

## **2. INSTITUTIONAL ECONOMICS AND AGENCY THEORY**

Since 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 North (1990) and Williamson (1985), as well as various branches

of organisation theory, including property rights (Grossman & Hart, 1986) and incomplete contracts theory (Tirole, 1999), and its analysis of organisational design (Holmstrom & Milgrom, 1991; Aghion & 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 (for instance, Furubotn & Richter, Masten & Williamson, Laffont & Tirole, 1993).

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) and the potential costs of post-contractual uncertainty or absence of information (Williamson). 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 can not 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, can not 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 he would want to have full information and monitor every aspect of the agent's activities, he might as well carry out the delegated tasks himself; there would be no gain from delegation. Delegation may result in two types of problems. First, the agent may deviate from the instructions given by the principal and carry out the delegated tasks in such a way that it advances his own interests, rather than those of the principal. This is called moral hazard. Second, 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 & 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 (for instance, Pietrobelli & Scarpa, 1990; Trombetta, 1992; Killick, 1995). Murshed & 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, Guillaumont & Gunning (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) re-formulated 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 organisation-level data sets are available that allow to test organisations' 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, 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 we first scrutinise – in the next section - the existing principal-agent literature and examine to what extent some of its major findings can be transplanted to the institutions and organisations of foreign aid and yield novel insights concerning their performance.

### **3. SOME BASIC CHARACTERISTICS OF FOREIGN AID ORGANISATIONS**

Foreign aid grants are usually paid by citizens in a donor country, either as taxes channelled through an official aid agency or as voluntary donations given to non-governmental organisations (NGOs). Aid is normally not collected and dispensed by

private for-profit enterprises, unless they have set up a separate charitable organisation. However, private agents and enterprises may act as subcontractors in the execution of aid projects. Alternatively, foreign aid loans channelled through development banks are mobilised on international financial markets and passed on to recipient countries. Both loans and grants can be handled through bilateral as well as multilateral aid agencies. Both official and non-governmental agencies share some of the typical characteristics of public administrations.

### 3.1. Multiple principals and objectives

Economic analysis of public administrations started with Simon (1958) and Downs (1967). However, agency theory and asymmetric information models to investigate the behaviour of organisations emerged in the 1970's only. Most applications focused on private organisations where contractual exchange plays an important role. Applications to public administrations emerged fairly recently only (Martimort, 1991; Holmstrom & Milgrom, 1991; Tirole, 1994). The informational characteristics that distinguish public administrations from private enterprises can be summarised as follows:

- a) While private enterprises have only one objective - profit - public administrations usually have *multiple objectives*. An official bilateral aid agency aims, for instance, to build schools, hospitals, roads and to finance small-scale enterprises and privatisation programmes.
- b) While private enterprises have *multiple principals*<sup>2</sup> (shareholders) who share the same objective – profit - public administrations have multiple principals (politicians, parliamentarians, etc.) who rarely share objectives. While one parliamentarian prefers to allocate more resources to road construction in developing countries (he has a construction company in his constituency), another may want to prioritise research in aids prevention (his constituency includes a medical research laboratory).

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<sup>2</sup> In agency theory, multiple principals situations are known as joint delegation of tasks.

- c) While private companies can measure the opportunity cost of alternative options in terms of profits, public administrations have *no clearly defined or measurable trade-off* between their multiple options. This is likely to result in potential inconsistencies and contradictions, and inefficient resource allocation. Political principals (parliamentarians) may delegate an unclear or even inconsistent set of instructions to an official aid agency; consequently, the agency can not perform optimally.

The organisational characteristics of NGOs are not fundamentally different from those of official aid agencies. They have multiple principals (members) who may share a vaguely defined objective (“combat poverty”) but hold multiple opinions on the more detailed objectives (give food aid, provide education, support enterprises) and the trade-offs between these often hard-to-verify objectives. Single-issue NGOs have an advantage in this respect: their field of action is more narrowly defined and resources will be more concentrated. Furthermore, contrary to governments and public administrations, NGOs often lack clear decision-making rules, for instance through majority voting, or a CEO with a large degree of autonomy and responsible to the Board. They are more dependent on internal grass-roots democracy procedures and reaching a consensus, which increases internal transaction costs to arrive at a decision. Because of this multiple principals and objectives problem, both official aid agencies and NGOs require general policy “slogans” behind which all members can rally and that hide differences of opinion on objectives and trade-offs: “fight against poverty”, “first things first”, “aid, not trade”, etc. However, semantic synthesis is not enough to overcome the potential for inconsistencies in the underlying objectives.

These informational characteristics complicate the internal organisation of public administrations in general and official aid agencies in particular, and NGOs. They affect organisational performance and the incentives for individual agents in organisations to pursue their tasks.

Performance incentives are necessarily weak in public administrations (Dixit, 1997). Civil servants usually have to do with a fixed salary and, from time to time, a promotion to a higher salary level. Performance-linked salaries, based on a single measurable and consistent indicator, would be hard to define in most public services. Even if it would be feasible, it would create trouble because it would steer officials

towards a single goal, thereby neglecting some of the others goals and disrupting any political consensus among multiple political principals on their multiple objectives. This is an intrinsic predicament of public administrations. In official aid agencies, pay is usually fixed and not linked to any performance indicator. Some multilateral development banks link pay to the volume of loans approved. This may result in biased performance incentives, steering loan officers away from wider development objectives and undermining the financial viability of the bank.

Another consequence of multiple principals and objectives is procedural bias in public administrations, including in aid agencies. McCubbins, Noll & Weingast (1988) explain how elected political principals impose administrative procedures on their unelected implementation agents that reduce discretionary decision-making margins. This keeps ownership of decisions in the hands of the politicians. At the same time, bureaucracies have a tendency to develop their own procedures and increase their complexity beyond those imposed on them by their political principals. Bureaucrats do this because risk-taking is not rewarded in a fixed salary system. There is no incentive to appropriate the consequences of risky decisions. Elaborate and complex procedures help to avoid exposure and diffuse risks, especially in those domains where political pressure is highest. For instance, bilateral agencies will establish elaborate consultation networks and procedures with NGOs in their own country, less so with NGOs in recipient countries. They will work out complex tender and contract procedures to diffuse possible criticism from aid services suppliers, but they will allocate comparatively less resources to the verification of the ultimate results of aid projects.

Multilateral aid agencies may be somewhat shielded against direct political pressure from their member states. First, to the extent that they are banks and dispense foreign aid in the form of loans, they do not spend tax revenue. This reduces political pressures associated to spending decisions on tax money. Second, although development banks do not pursue profit targets per se, they need to ensure their financial viability. This puts constraints on the range of development aid options and objectives that they can pursue. Third, even if they do operate on the basis of grants financed from tax revenue, they can often play off member states with different objectives against each other and build majority coalitions in the Board to advance the agency's interests. In the case of UNDP, where both donors and beneficiaries are members of the decision-making

council, this often results in a stand-off between net contributors and net recipients with the latter representing a majority in terms of countries. In the case of the European Commission, only donor countries are members of the decision-making council. However, the unanimity rule in EU decision making makes it harder to play off members against each other.

### **3.2. A broken information feedback loop**

The above cases of multiple principals and objectives have been analysed in detail in the relevant agency theory literature and are easily applicable to various types of aid agencies. However, 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 can not modulate payments (rewards to the agents) in function of performance. Although donors are typically interested in ensuring that their funds are well spent, it is extremely difficult for them to do so, since there is frequently no obvious mechanism for transmitting the beneficiaries' view to the sponsors. Even if there would be such a mechanism, beneficiaries' views are likely to be biased because (a) they do not pay for their benefits and (b) their preferences and objectives are unlikely to fully coincide with those of the donors. In addition, ascertaining the beneficiaries' views in developing countries – often with low levels of democracy and literacy – may not be easy, or even possible, in many cases. Instead, the sponsors must rely on various indirect indicators of programme performance.

This typical characteristic of foreign aid delivery processes stands at odds with the established neo-classical view of the efficiency of public institutions, as originally formulated by Becker (1983) and recently restated by Whitman (1995). According to that view, competition between politicians to get (re-)elected makes them exercise pressure on public institutions to do what the beneficiaries – whom they represent – want. Dissatisfied taxpayers and beneficiaries can lean on their political representatives to

exercise political pressure on the public administration or agency to improve the performance of particular transfer programmes. The efficiency hypothesis assumes that donors and beneficiaries are well-informed about the programmes. In the case of foreign aid, geographical and political separation between these two groups increases the costs and decreases the benefits of information. For taxpayers-donors, it is very costly to obtain reliable information on the outcomes of the programmes that they finance. The *intended* beneficiaries are not voters in the country that pays for the aid and thus have no real political leverage over domestic politicians who approve these programmes, which allows the latter to use these programmes for different political purposes.

This broken feedback loop induces stronger incentive biases in foreign aid – compared to domestic wealth transfer programmes - diverting it from its original purposes. It explains, for instance, why the interests of domestic suppliers of aid goods and services – consultancy companies, experts, suppliers of goods – dominate decision making: they are the direct beneficiaries of aid (they receive the contractually agreed reward) and have direct leverage on domestic political decision-makers. They have first-hand information on the outcomes of the aid programmes in beneficiary countries and they are part of the constituency of the decision-makers in the donor country. Their informational advantage may make them the *ultimate* beneficiaries of foreign aid. The *intended* beneficiaries' interests are geographically and politically too remote to overcome the direct beneficiaries' leverage. This shift away from a neo-classical perfect information feedback loop to a broken information feedback loop typical in foreign aid is probably one of the most important contributions of this book to the debate on the performance of foreign aid.

### **3.3. The institutional reform dimension**

Apart from the above-described inherent problems of foreign aid, including multiple principals and objectives and a broken information feedback loop, there is a third institutional and informational dimension that runs through the studies in this book: the increasing focus of foreign aid programmes on institutional reforms in the recipient countries.

This shift in the composition of foreign aid started in the 1980s, when foreign aid programmes shifted away from a pure investment project focus towards policy and institutional reform. This shift occurred because of (a) growing awareness that recipient countries lacked an appropriate institutional and policy environment to make aid work in a competitive market environment and (b) donor and creditor concerns about the deteriorating financial situation of many developing countries in the early 1980s. To meet these concerns, a fast-disbursing non-project financial instrument was required in the form of structural adjustment programmes that targeted financial aid on overall balance of payments and budgetary support, not on specific investment projects. Disbursement was usually conditional on economic policy changes and institutional reforms. It accelerated in the early 1990s when the so-called transition economies emerged on the foreign aid scene. The wave of transitions from centrally planned to market economies further emphasised the need for institutional and policy reform<sup>3</sup> programmes.

In the case of EU foreign aid, for instance, the shift towards institutional reform is quite obvious. In the early 1990s, the Phare and Tacis technical assistance programmes for the transition economies in Eastern Europe emerged. They focused predominantly on institutional reform. By 1999, they represented nearly a third of all EC-managed foreign aid (EC, 2000). In the meantime, EC aid to Sub-Saharan Africa, the Mediterranean, Asia and Latin America also shifted attention to institution building. Last but not least, the growing volume of institutional economics studies of development issues has no doubt served as a more theoretical platform in support of this trend. Many studies have demonstrated the strong positive correlation between the quality of institutions and the level of economic development (for instance, World Bank, 1997; Clague, 1998).

This shift away from traditional investment projects towards institutional reform programmes has implications in terms of performance incentives in principal-agent relations in foreign aid implementation, as well as for the overall performance of foreign aid programmes. Traditional investment projects produce tangible outputs that are fairly

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<sup>3</sup> “Institutional reform” and “policy reform” are considered as virtually synonymous expressions in this text: all government economic policies, and changes therein, aim to redistribute wealth, either directly through fiscal redistribution or indirectly through changes in property rights systems. All these policies are implemented through changes in formal institutions or legal systems.



easily verifiable and measurable, such as roads, schools and hospitals, institutional reform programmes produce less tangible outputs that are much harder to verify. Reform projects produce intangible outputs, such as draft laws, organisational reform plans, policy advice and trained staff. Their ultimate impact is more diffuse and hard to verify and consequently more easily subject to post-contractual uncertainties. To the extent that aid aims to achieve institutional reforms in the recipient country, monitoring of outcomes and impact becomes more difficult compared to traditional investment projects. Increased difficulty and cost of monitoring facilitates moral hazard and adverse selection in foreign aid programmes, and makes it easier to diverge programmes from their original purposes.

#### **4. PERFORMANCE INCENTIVES IN THE FOREIGN AID DELIVERY CHAIN**

Let us now move from these general institutional and informational aspects of foreign aid to the more specific findings of the studies in this book. Each study focuses on a different set of institutions and agents in the aid delivery process and examines their specific informational problems. In a standard official bilateral aid setting, the chain of principal-agent relationships starts with taxpayers as principals, who wish to transfer part of their income to recipients in other countries. They delegate the implementation of this transfer programme to their representatives (parliamentarians, politicians) who become their agents. These agents, in turn, become the political principals to an aid agency in charge of implementation of aid programmes. Within the aid agency, a hierarchical command chain creates a further series of principal-agent relationships. When actual implementation is subcontracted to a private consultant or aid services supplier company, the task manager in the aid agency becomes a principal to the contractor, who is his agent. Depending on the contract he gets, the contractor may also be an agent to the recipient agency or counterpart administrator in the beneficiary country. He may end up being an agent to two principals, putting him in a typical joint delegation situation. The recipient agent, in turn, is an agent to his political principals and the beneficiary population at large. Each of these principal-agent interfaces in the long chain of command creates a potential for incentive misalignment and moral hazard. As such, the

final outcome of the aid process may be quite different from the original objective envisaged by the taxpayer, the aid agency or the recipients.

Many variations on this standard chain of command are possible. Aid agencies may chose to implement a project directly, without passing through a private contractor; or they may provide non-project structural adjustment aid that does not require implementation through technical assistance. Alternatively, donor country citizens may prefer to allocate aid through an NGO. This skips the political representation part of the scheme but decision making needs to be done anyway, by the (un)elected Board members of the NGO. Otherwise, NGO aid goes through similar delivery steps. Another alternative is to channel aid through multilateral organisations. In that case, several donor country governments delegate implementation responsibility to a multilateral organisation; again a case of joint delegation. Last but not least, donor country governments may set up a multilateral development bank that mobilises financial resources on international capital markets rather than using taxpayers' money.

Each of the four papers in this book looks at a specific part of the principal-agent chain. Paul Seabright examines performance incentives inside donor agencies. Peter Murrell analyses the incentives in the interactions between donors, contractors and recipients. Uwe Mummert investigates what happens inside the recipient country once the recipient government has decided to formally adopt a donor's institutional reform proposal. My own study covers the evaluation feedback loop between the contractor's performance and the donor's aid objectives. The studies emphasise institutional and policy reform programmes and not more traditional investment projects, though many of their findings may be applicable to the latter type of aid as well. The main difference between institutional reform and investment projects is that the outputs of the latter type are mostly physical and therefore more readily observable and measurable, making them less easily subject to moral hazard and adverse selection. The trend towards more institutional reform aid thus increases the probability of moral hazard in aid.

#### **4.1. Performance incentives inside aid agencies**

The first paper, by Paul Seabright, examines the incentives and biases in the behaviour of foreign aid agencies. He focuses on two informational problems in aid agency behaviour, namely inputs bias as a result of the broken feedback loop and problems caused by multiple principals and objectives.

Typically, officials in an aid agency perform a multiplicity of tasks – which is quite normal for large organisations. However, depending on their incentives, certain tasks will receive more attention than others. The disruption in the performance-payment feedback loop, combined with the difficulties of measuring performance, results in an apparently disproportionate focus on "input" activities - budgets, personnel - at the expense of attention given to the quality of "outputs" - the actual results of the aid programme. Budgets, contracts and spending on projects are relatively easy to monitor compared to the outputs produced by the projects or the impact of these outputs, especially when institutional reform projects are concerned. The interdependence of tasks means that incentives for the performance of one will affect the performance of the other, either positively or negatively. For instance, one task may be the preparation of project proposals while the other consists of screening them in a quality support group: the more rigorous the screening, the fewer proposals will pass. Another example concerns positive complementarity between financial management and project implementation: the more efficient the former, the smoother the latter.

Two ideas are important here. First, when agents' salaries are not directly linked to ostensible performance, demonstration of their abilities and career concerns dominate their behaviour. Second, when an agent faces multiple tasks that compete for his time, he will focus on those that are more likely to satisfy his career concerns. This may motivate him to focus on tasks that are more easily monitorable by his superiors. However, to the extent that easily (e.g. input-related) and less easily (e.g. output- or results-related) monitorable tasks are complementary and equally important for the overall performance of aid programmes, management will have to ensure that incentives for easily monitored tasks are less high-powered in order to avoid agents diverting effort away from less easily monitored but still important tasks. Reality is often different however. Careers are often build on demonstrating good performance in more easily monitorable tasks, such as "committing and spending budgets". This may provide an explanation for the "inputs bias" that is so often observed in aid agency behaviour (for instance, EC 1997).

On the other hand, organisations may rationally place "too much" emphasis on input tasks, provided these reveal information about talents that may be valuable in output tasks, and in spite of the fact that the incentives to perform the output tasks well will thereby be blunted. Separating the input tasks from the output tasks would be too costly in terms of failing to exploit the links between these skills. Bundling the tasks together may be the lesser of two evils even though it inevitably leads to a misallocation of agents' efforts towards the inputs. Separation of tasks is important for relatively junior members of an agency, because of the greater information about their skills that such separation yields. Too much generalism among junior staff makes it harder to allocate them subsequently to responsible positions in the organisation. Empirical studies of bureaucracy have often failed to distinguish between those aspects of bureaucratic behaviour that reflect poor organisational design and those that are unavoidable consequences of the kind of activity the organisation is obliged to undertake. Some features of organisations, though perhaps regrettable, are the inevitable result of the fact that individuals' behaviour cannot be precisely monitored.

Multilateral aid agencies, like the World Bank or the European Commission, are cases of joint delegation from multiple principals or member states. On the one hand, joint delegation may induce credible competition between members, enhance the credibility of the agency and allow it to resist pressure from individual members. For instance, it may enable the agency to commit itself to procedures that would not be easy to implement for a bilateral donor, such as transparent and competitive procedures for tendering and procurement, and a commitment to avoid linking aid to narrow considerations of market access or the fortunes of particular political and economic interest groups. However, this commitment may be easier to deliver on the side of input procedures (tendering and contracting) than on the side of the preparation and selection of projects. This latter fact further reinforces the input bias already described. Joint delegation may also achieve economies of scale and scope. For instance, a single aid accounting system or a single set of procedures can be shared by different aid instruments. Multilateralism can also enable the exploitation of economies of scale and scope that are beyond the capacity of bilateral donors.

Joint delegation may on the other hand result in confusion over objectives, or in agencies pursuing their own interests. For instance, sharing of tasks may generate distortionary incentives and divided loyalties to different principals. Another example is that of a multilateral aid agency that reports on the “needs” of beneficiary countries and may have an incentive to exaggerate these needs in order to boost the importance of the agency. Similarly, it may bias reporting on the beneficial impact of aid programmes to justify its activities. Other beneficiary countries and member states may be aware of this over-reporting but not take any action because it benefits them too when their turn comes. The potential for wide variations in performance in cases of joint delegation indicates that a multilateral agency that fails to exploit the benefits that come from the presence of multiple principals is actually likely to perform worse than would bilateral donors. If it cannot find ways to do so it cannot really justify its existence.

#### **4.2. Moral hazard in donor-contractor-recipient relations**

Peter Murrell’s paper moves away from donor agencies and into the domain of interactions between donors, their (sub-) contractors and the recipients of the aid. He also focuses more on the specific incentive problems posed by institutional reform aid and identifies the following actors in a principal-agent model: the donor principal (the political superiors in donor agencies), the donor agent (the direct administrator of a programme, a task manager), the contractor (a profit-seeking consultancy or a non-profit NGO) who has a contractual relationship with the donor agent, the recipient principal (political superiors in the recipient agency), the recipient agent (the institution that is the formal beneficiary of the project). Given the inherently incomplete contract between donor agent and contractor, there is a margin for manoeuvre in project implementation. The equilibrium outcome will depend on who is in control, the contractor, the recipient, or both. Each of these situations is likely to push the actual project outcome away from the intended outcome. The model allows us to examine two sources of information problems that are at the basis of this performance bias:

First, moral hazard in the donor-contractor-recipient relationship is caused by incomplete contract and imperfect knowledge about the contractor’s activities, especially in the implementation of institutional reform programmes. As explained earlier, the latter

produce less tangible outputs which leaves more freedom to the contractor, whose reward is not dependent on achievement of targets; he usually receives a fixed lump sum payment only. As a result, he may collide with the recipient to bend the project to their common interest. Traditional inputs-driven project-based approaches to institutional reform, as practised by most technical assistance programmes, such as the European Commission's Phare and Tacis programmes, are therefore unlikely to yield the intended results.

The nature of the contractor, whether a non-profit NGO or a profit-seeking consultancy, affects project implementation: non-profit contractors may be more inclined to forgo contractual rents in order to achieve a reform agenda; for-profit contractors are not. It may thus be better to contract implementation of institutional reforms to NGOs that specialise in the issue at hand. This suggests that important project implementation decisions will be in the hands of the implementers, those working on the ground. These decisions cannot be contracted, because of imperfect information. They also cannot be second-guessed during evaluation, or at least during any evaluation that is not based on knowledge as intimate as that of the implementers.

This brings us to the second issue that goes to the core of the institutional reform debate: the desirable extent of foreign donor leverage in domestic reforms and the representativeness of the recipient organisation. In the "interest group" case, the recipient agent acts on behalf of some narrow interest group, rather than in the interests of a broader political spectrum. In the ideal – though perhaps somewhat utopian – "embedded" case, when the recipient principal and his agent(s) represent the same broader interests, the benefits derived from the reform depend on the fit between the proposed reform and the wider interest of the recipient country. If embeddedness is the case, then the donor has an interest in facilitating – rather than trying to prevent – post-contractual adjustment in the outputs of the project; that will only increase the benefits derived from the project by the beneficiary country. In the interest group case, the reverse is true and stricter monitoring will be required.

A peculiar situation arises in the case of EU aid for institutional reforms in its candidate member states in Central and Eastern Europe. There, the EU is not so much concerned with the welfare of the recipient country but rather the strict implementation of

the *Acquis Communautaire*<sup>4</sup>. It may therefore seek an alliance with recipient country interest groups that share the EU's interest. Also, the contractor can be a non-profit organisation with a specific agenda, an interest group in its own right, that is willing to forgo some of the contractual rents in order to achieve its own agenda. This could be the case in so-called *twinning* projects under the EC-financed Phare technical assistance programme in candidate member states, where technical assistance is not normally provided by commercial companies but by government administrations from EU member states. The paper shows that the presence of interest groups and embeddedness multiplies the difficulties that donors have in ensuring that the independent contractors carry out their activities productively.

There is great paradox in the optimal configuration of the control of projects. If efficiency is the goal, contractors who are unfamiliar with a country should be given control of projects and contractors who are familiar with a country should be given less control. The paradox is resolved by noting that embeddedness implies that it is productive to stimulate bargaining between contractor and recipient.

#### **4.3. From *de jure* to *de facto* institutional reform in recipient countries**

The paper by Uwe Mummert deals exclusively with institutional reform aid and the informational problems that it induces in principal-agent relationships in the recipient country. Whereas Murrell's paper examined how donor-financed contractors could achieve formal *de jure* reforms in recipient countries, Mummert examines what happens *de facto*, once the *de jure* reforms are approved.

'Normal' institutional reform processes are home-grown and the outcome of domestic economic, social and political forces. Donor-financed institutional reform projects transplant 'foreign' institutions into a domestic institutional setting. This includes cases such as IMF and World Bank supported structural adjustment programmes, reforms related to membership of WTO, or transposition of the EU *Acquis* to candidate member states. For such reforms to be successful, the transferred

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<sup>4</sup> The set of EU rules, regulations and directives which all member states have to adhere to.

institutions have to be not only *de jure* (formally) integrated into the formal institutions of the recipient country but also *de facto* embedded into the informal socio-economic institutions of the recipient society.

Effective institutional reform implies that *de jure* changes affect the *de facto* choices of the actors to whom the rules apply. Thus, it focuses on the ‘embeddedness’ of reforms in the wider socio-economic environment, the ties between society and government agents that are in charge of implementing reformed institutions, the power of *informal* institutions in social networks and how they might provide obstacles to effective institutional reforms.

The model developed in the paper distinguishes between two levels of principal-agent relationships in the recipient country. Political principals, who adopted the donor-induced institutional reform, delegate the task of implementation and verification to government agents, in return for a reward. Since political principals are unable to observe all the actions of government agents, moral hazard may occur. These agents, in turn, give instructions to citizens to modify their behaviour in accordance with the new institutions. However, government agents do not operate in a social vacuum: they are embedded in social networks that include the citizens to whom they give instructions but who may also exercise various types of social and economic pressure on them. Citizens may informally influence the government enforcement agent through bribes or social sanctions. As a result, collusion of interests between enforcers and citizens and deviations from the intended outcome of the reform may occur. In order for legal *de jure* reform to be effective, legal sanctions must be strong enough to penetrate the inhibitive layer of informal non-legal sanctions. The model describes the mechanics of resistance to reforms and the cost-benefit calculations implied by these mechanics. Particular types and sources of resistance to reforms are explored: the tension between *proscriptive* and *prescriptive* content, cooperation-defection differentials and the extent of fragmentation in society.

Informal institutions are not inflexible and may also evolve as a result of reforms in formal institutions. As long as the net benefit from cooperation exceeds the benefit from defection, the new institution will be accepted. Assuming that cooperation-defection differentials are variable across a population, a sufficient condition for successful reform



therefore would be to have a critical number of agents with positive cooperation-defection differentials. That lowers the cost of social sanctions for others so that their cooperation-defection differential becomes positive and compliance with the reform will gradually spread. The informal institutions that opposed it will disappear or be adapted. For example, as soon as the volume of private entrepreneurial activity reaches a critical mass, the rules and regulations that promote such enterprises will be gradually accepted in society.

The extent of segregation in society and entry barriers to segregated groups may also affect the effectiveness of reform. In highly fragmented societies, it is very difficult for economic actors to change groups in order to escape restraining informal institutions within their group. Fragmentation determines whether informal institutions that resist reform will be perceived as subordinate to the formal institutions, as well as the intensity of the impact of informal institutions on the dynamics of the market processes. Empirical research has shown that ethnic, linguistic and social fragmentation in society is indeed a significant determinant of economic development.

#### **4.4. The role of evaluation in foreign aid performance**

Finally, my own paper examines the informational problems in foreign aid programmes from a purely domestic angle. It focuses on the dichotomy between the objectives of two sources of *domestic* demand for foreign aid, taxpayers who have a genuine desire for wealth redistribution, and suppliers of aid services who are seeking business opportunities. While the first group attempts to maximize consumer surplus, the second are profit maximizers. The role of the domestic politician, as political head of the aid agency, is to try to marry both objectives in the implementation of the aid programme. Contrary to Murrell and Mummert, I do not take into account the welfare objectives of the recipient country.

Because of the broken feedback loop between the beneficiaries and the donor country, the risk of moral hazard by aid services suppliers is very high. This can only be overcome by the introduction of an explicit information feedback mechanism: formal evaluation of aid programmes. For a given aid budget, there is an optimal share of that

budget that should be spent on evaluation studies in order to maximize the impact of that budget. That optimal share strikes a balance between spending more money on aid projects to achieve objectives and spending more money on suppliers' supervision so as to ensure adequate performance for every unit of money spent on projects.

However, since evaluation is usually handled by the aid agency itself, it is subject to the politician's interest in keeping the middle ground between the opposing objectives of taxpayers and suppliers. Consequently, evaluation will be manipulated in function of these interests. Aid agencies and their political 'owners' have several instrumental variables at their disposal to do so. First, they can reduce the share of the aid budget spent on evaluation. This eases performance pressure on suppliers and enhances their profit margins. On the other hand, it does of course reduce programme performance and thus consumer surplus for the taxpayers. Second, they can vary the quality of evaluations by manipulating the ratio of budget spent on evaluation data gathering to budget spent on projects. Lower-quality evaluation studies are defined as having larger standard deviations for the observations on project performance variables. With large standard deviations, confidence intervals become wider and it becomes more difficult to prove that a performance variable is off target. The final decision on budget share and quality of evaluations is determined by the composition of the political constituency that elected the politician. If taxpayers are predominant in that constituency, political principals will be inclined to increase spending on evaluation; if suppliers are predominant, the reverse will be true. Manipulation of the quality of evaluations allows politicians to drive a wedge between the interests of opposing constituencies, for instance in a coalition government. Less reliable reports satisfy suppliers because they make it more difficult to credibly criticise their performance; at the same time, it satisfies taxpayers' wishes to have performance feedback. Coalitions are not only held together by the glue of transfers but also by information smokescreens that veil opposing views and contradictory information.

In short, because of the broken 'natural' feedback loop in foreign aid, inserting an explicit evaluation function in foreign aid programmes is necessary to overcome moral hazard on behalf of aid services suppliers. But it is not a miracle solution to eliminate performance problems. Evaluation itself is subject to moral hazard, induced by the same institutional and political incentives that affect aid projects performance.

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What lessons can we learn from these four studies? They show that the *nature* of foreign aid – with a broken information feedback loop – combined with the *nature* of public administrations (including aid agencies) in general – with multiple hard-to-measure objectives and often multiple principals too – put a number of inherent constraints on the performance of foreign aid programmes. All these constraints are due to imperfect information flows in the aid delivery process. Informed institutional design (of contracts, aid agreements, budget allocation mechanisms) can mitigate the impact of some of these informational constraints. However, most aid agencies and programmes work with fairly standardised institutional set-ups that leave little room for variation. Any deviations from the standard set-up are time-consuming, complex and costly to implement, unless there is a strong political will to go ahead. The range of foreign aid performance objectives that each type of aid agency can address with reasonable chances of success is limited. Since most aid agencies intend to pursue a wide range of objectives and address an ever larger set of problems in strongly variable environments, they could usefully apply the findings of modern institutional economics and organisation theory so as to improve their performance and chances of success in meeting their objectives. Similarly, they would also benefit from accepting the – often political – limits to their range of effective actions. Making these limits more explicit would be an important step in that direction.

## **5. APPLICATIONS TO EU AND OTHER FOREIGN AID PROGRAMMES**

This research project has been successful in terms of its own objective to help explain the causes of the persistent problems and behavioural patterns in EC foreign aid, identified earlier on in the foreword to this book. It points out two factors: multiple political principals and multiple objectives. A national minister in charge of a bilateral donor agency can take political ownership of his development policies and strategies; s/he defends them in parliament where a coalition or political majority reduces the number of political principals from many to one. By contrast, an EC commissioner in charge of foreign aid has to deal with fifteen member states and hundreds of European

parliamentarians, without a political coalition to support the proposed policies in the Council or in the European Parliament. Consequently, policy and programme objectives will tend to be broader, vaguer and less well-defined, taking into account the views and opinions of a wide range of parties and making implementation more difficult and less efficient. The absence of majority voting for most decisions in the Council makes the situation even worse. Furthermore, member states compete with each other to get the largest possible share of the EC's aid contracts cake. They provide political support for their own private aid services suppliers in this competition. National aid service suppliers actively lobby their political representatives in Brussels for that purpose; national representatives in EC foreign aid decision-making committees spend a considerable part of their time exploring and pursuing contract opportunities for national suppliers. This focuses attention very much on inputs and procurement procedures (budgets, contracts, tenders, etc.), thereby further tilting the bias in favour of inputs and away from outputs and performance. Because of the lack of single political ownership at EC level and intensive competition between member states, inputs bias in EC aid is likely to be stronger than in bilateral aid programmes.

Fortunately, this research has also pointed out means to mitigate at least some of the consequences of the biased performance incentives that underlay the EC's institutional set-up and in particular those of its foreign aid programmes. Ideally, the number of political principals overseeing EC foreign aid could be reduced to one if the Commission had a political majority in Council and Parliament and if majority voting were introduced. However, this will require more fundamental EU institutional reforms that go far beyond the domain of foreign aid only. As a second-best solution, the creation of an EC foreign aid agency may be a step in the right direction, provided that it gets clear mission orders, reducing the number of objectives, stating them more clearly and limiting interference by multiple principals. Finally, enhanced monitoring and evaluation of aid programme outcomes could help to strengthen the information feedback loop between beneficiaries and donors/taxpayers. But it is unlikely to be effective unless fully independent from political principals who manage aid programmes. Last but not least, one can conclude from this research that the usual suspect for poor performance of EC aid – the presumed lack of human resources - is unlikely to be the real culprit. Human resources are bogged down in unproductive and inefficient administrative procedures and inputs-related approaches, drawing them away from more results-oriented tasks. Increasing the number

of staff without fundamental changes in the incentives structures would only worsen input bias because it would create opportunities to pile up more ineffective layers of procedures. The only real solution is a fundamental reform of the incentives that staff are confronted with.

This research has not only contributed to our understanding of the predicament of EC aid but of foreign aid programmes in general. The models, techniques and interpretations developed here have wider application potential to all types of foreign aid institutions and organisations. All official aid agencies are public administrations and therefore subject to the same incentive biases as ordinary public administrations, caused by multiple objectives and principals. Even NGOs may be subject to some of these biases. That explains their weak leverage, procedural bias and, in general, the imperfect information environment in which they operate. Moral hazard and adverse selection are facts of life in such an environment. On top of that, foreign aid suffers from a broken feedback loop between beneficiaries and decision-makers that induces stronger performance biases compared to ordinary domestic public administrations and the transfer programmes that they operate.

Multilateral development banks, although they are confronted with multiple principals too, tend to suffer less than multilateral grant donors from biased performance incentives. First, they operate mostly with money borrowed from capital markets, not fiscal revenue paid by taxpayers in member states. This reduces political pressure and keeps political interference in decision making more at bay. At the same time, they are banks, which disciplines behaviour in terms of project selection and financial performance risks; it often clarifies financial trade-offs between multiple objectives and thereby streamlines decision-making.

This research project has been successful in achieving its own objectives: it has clarified performance problems in foreign aid institutions in general, and in the EC as an aid agency in particular. It has shown that the EC's predicament is by no means exceptional in the world of foreign aid, that it is due to institutional incentives structures and that there are ways to improve this performance. It remains to be seen, of course, to what extent the findings of this research will be taken seriously and contribute to policy decisions.

This book is meant to be an original and innovative contribution to the debate on the performance of foreign aid programmes in general, and in particular on the role of the institutional set-up and incentives provided by the organisations that manage these programmes. It is certainly not the definitive view on that subject but may provide an encouragement for decision-makers in foreign aid to become more creative in the design of the institutional aspect of programmes and take into account the contributions that institutional economics can make to facilitate their mission. We also hope that this book will have laid the theoretical foundations for more empirical research in this direction.

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