Review of Incentives and the Australian Aid Program

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Case Studies

ACRONYMS

ACP	African Caribbean and Pacific
ACP-EU	African Caribbean and Pacific – European Union
ADB	Asian Development Bank
AKWa	AusAID Knowledge Warehouse
AMC	Australian Managing Contractor
ARC	Australian Research Council
ARPP	Annual Report of Portfolio Performance
ASIA	Asia Regional Section
CIDA	Canadian International Development Agency
CPIA	Country Policy and Institutional Assessment
CPM	Country Program Manager
DAC	Development Assistance Committee
DFAT	Department of Foreign Affairs and Trade
DfID	Department for International Development
EU	European Union
EVAL	AusAID Program Evaluation Section
GoP	Government of the Philippines
GoPNG	Government of Papua New Guinea
HIPC	Heavily Indebted Poor Countries
HSIP	Health Sector Improvement Program
IMF	International Monetary Fund
KDP	Kecamantan Development project
LICUS	Low Income Countries Under Stress
LLDC	Least Developed Country
MCA	Millenium Challenge Account
MOU	Memorandum of Understanding
MPAC	Policy and Management Reform Section
NDoH	National Department of Health

NEIS	New Enterprise Incentive Scheme
NGO	Non Government Organisation
NHMRC	National Health and Medical Research Council
OECD	Organisation for Economic Co-operation and Development
ONA	Office of National Assessment
PAVGF	Philippines-Australia Vulnerable Groups Facility
PBA	Performance Based Allocation
PEM	Public Expenditure Management
PIA	Performance Information and Assessment Section
PMR	Policy and Management Reform
PNG	Papua New Guinea
PNGIF	Papua New Guinea Incentive Fund
PRO	Pacific Regional Organisation
PRSP	Poverty Reduction Strategy Paper
PWC	Provincial Water Company
SIDA	Swedish International Development Agency
SPA	South Pacific and Africa Branch
SPC	Secretariat of the Pacific Community
SPREP	South Pacific Regional Environment Program
SWAp	Sector Wide Approach
TAF	Technical Assistance Facility
USAID	US Agency for International Development
WTO	World Trade Organisation

EXECUTIVE SUMMARY

Background

The 2002 Ministerial Statement *Australian Aid: Investing in Growth, Stability and Prosperity* establishes incentive-based approaches and contestability as key principles of Australia's aid program. According to the Statement:

> *the introduction of greater contestability to our aid provides new avenues for Australia to support reform efforts in wider society and the private sector. Increasingly as the aid program engages in more coordinated sector wide approaches led by partner governments and in concert with other donors, there will be further opportunities for incorporating incentive approaches within programs. This will be matched by more effective policy engagement and dialogue with partner governments.*

The Statement endorsed the development philosophy underpinning incentive-based programs like the Policy and Management Reform Fund in the Pacific and the PNG Incentive Fund.

In September 2002, AusAID's Program Evaluation section undertook a quick, in-house Review of the Australian experience with incentives. The Review also included an analysis of other donors' approaches and mechanisms and the development of an in-house paper that identifies options and some practical guidelines, not necessarily limited to stand-alone 'incentive funds', for the application of incentives in bilateral and regional programs.

The principles identified in the Review regarding the good use of incentives in the aid program were endorsed by the AusAID Executive on 20 December 2002.

General Findings

The Review examined:

- theoretical and general literature discussion of incentives, contestability and conditionality in aid programs and elsewhere in the Australian public sector;
- other donors' experiences; and
- AusAID's experiences.

The review clarified that there are two purposes for using incentives and contestability in aid delivery:

- promoting behaviour change; and
- allocating aid in the most efficient manner.

The review found that both purposes can be met in aid delivery, but the first purpose (in effect, leverage) can only be achieved when the **aid funds on offer are significant relative to the existing supply and demand for reform.** This is unlikely to be the case when dealing with national governments considered as single entities (for example, any particular government as a whole is unlikely to seriously engage in reform for any amount of Australian aid money potentially on offer). Reform, particularly when considered for a whole country, is complex, long term, and generally requires major cultural and institutional change. For example, governments are loose alliances of reformists and anti-reformists; and society will always have a mix of vested interests and social and political forces for both conservatism and change.

The literature on the topic focused upon incentives and contestability *between* countries. High profile examples include the IDA Performance Based Allocation system and the newly launched US Millennium Challenge Account. The Review found **little evidence that such an approach would be appropriate** for Australia. Instead, there is much to be gained from considering incentives and contestability as tools to promote good governance *within* countries.

A core finding of the Review was the principle that incentives and contestability can be effective additions to aid delivery mechanisms **when a situation of competition can be established between a significant number of essentially similar organisations.** These organisations might be competing provincial governments, partner agencies, or even national governments; but for incentives to take effect the donor needs to easily shift resources from one entity to another. The rationale behind this finding is the need to have flexible alternative means to deliver aid (and a highly credible promise to use them) if a particular partner fails to respond to the incentives we establish. For incentives to work, we cannot have "all our eggs in one basket" and be fully committed to a particular means of supporting a single partner regardless of their performance. At a minimum, this may just mean we need to keep flexibility to switch between aid delivery instruments.

Accordingly, some of the most successful use of incentives was found **within countries at the project level**, for example a World Bank project in the Vietnam water sector which effectively set up a competition between water suppliers. The difficulty of setting up such a competition between national governments is the reason the review recommends against pursuing options such as those followed by IDA and the Millennium Challenge Account.

The Review agreed with and generalised a finding of the recent review of the PNG Incentives Fund that contestability is most effective if the entities competing for aid funds are **judged on the direction of improvement rather than against absolute standards**. In the absence of such judgements, there is little incentive for poor performers to reform and the system quickly becomes a predictable support for the more firmly established entities that arguably need aid the least.

The Review also emphasised the importance of establishing **criteria** for aid allocation within an incentives scheme that are as objective as possible, verifiable, within the control of the competing entities, correctly pitched at the development problem we wish to fix, linked to Australia's strategic objectives, widely publicised, and used as an entrée to policy dialogue. Contestable aid schemes can go badly wrong if the performance indicators for awarding funds are not very carefully chosen.

The Review found that some **forms of aid** such as SWAps and TAFs lend themselves to good use of incentives and contestability, but that this was far from automatic and care still needed to be taken in design to explicitly consider incentives. There is also considerable scope to make more use of incentives in more traditional project aid, and certainly in the development of program strategies.

AusAID's use of incentives to date

PMR AND THE PNG INCENTIVES FUND

The Review was positive about the use of incentives in both the PMR and the PNG Incentives fund. These two schemes are without doubt innovative experiments that may well point to a significant future direction for aid delivery. AusAID's experience in these schemes laid the foundation for the principles for incentives and contestability outlined above.

However, in each case it is clear that adjustments could be made to improve the effectiveness of the contestability elements. In neither case has the scheme been a great success to date in terms of leverage. The PMR Fund, while immensely valuable as a flexible mechanism to support high priority initiatives in the Pacific (including governance reform), is too small by an order of magnitude to leverage reform from poorer performing governments and, working at the national government level, has too small a "market" of recipients to get the full benefits of competition for aid funds. While demonstrating that leverage will occur once we have clarified the relevant processes, the PNG Incentive Fund has been plagued with context-specific (but solvable) problems relating to the mechanisms of the award process, choice of award criteria, and choice of eligibility criteria that determine which entities are in the "market" for awards.

In the case of the PNG Incentives Fund, the recommendations made by recent reviews of both the policy and program streams are strongly consistent with the principles established by the Incentives Review. The case of the PMR is more complex. In effect, only one of the functions of the PMR is to work as a contestable incentives scheme; all the more so since its $20 million budget now includes work to promote peace and nation-building. Consequently, it was outside the scope of the current Review to comment on the overall context of the PMR; although the full report makes some suggestions about how the Fund could make better use of incentives, consistent with the principles described above.

OTHER AUSAID USE OF INCENTIVES

The Review found other instances of effective and innovative (but often not designated as incentive or contestability mechanisms) use by AusAID of incentives and contestability; in a range of forms of aid including a SWAp, assistance for regional organisations, and TAFs. For example, the Philippines–Australia Vulnerable Groups Facility sets criteria for selection of programs to support and then uses partner government mechanisms to deliver the aid: providing incentives for Government of Philippines agencies to work in areas we regard as priorities; and ensuring more efficient allocation of our aid, ownership of programs, and sustainability.

There has been less success within AusAID in utilising incentives in traditional project aid (such as through the use of “stop-go” review points based on partner contributions) but there is scope even at the project level to copy World Bank models such as that in Vietnam.

Next steps – implications for AusAID

The steering group raised a number of issues such as other donors sending distortionary signals (as an extreme example China and Chinese Taipei in the Pacific) that may dilute our own incentives and contestability work; the importance of keeping a poverty focus; relationship with Poverty Reduction Strategy Papers; the difficulty of establishing appropriate criteria for contestable schemes; and ways to strengthen the *demand* for reform (eg by strengthening civil society or increasing transparency).

The steering group considered the issue of incentives and contestability to be of high importance for the agency, with implications for the way we perform many aspects of our business ranging from program strategies to individual designs. The Executive agreed with this and asked the Review to be given wide distribution both within AusAID and externally; and special attention be paid by line areas to ways in which they could incorporate the principles of the Review into Australian aid operations.

Some (by no means all) of the potential for experimentation by line areas with the principles of incentives is described below. **These are ideas to consider and should not be interpreted too prescriptively**; obviously other priorities and concerns will always need to be taken into account:

- Program Strategies
  - Should conduct an analysis of existing incentives structures and how they might be utilised or allowed for by carefully targeted aid interventions.
  - Should identify forms of aid that allow different potential recipients in some sense to compete with each other for Australian support.
  - Should identify forms of aid, more innovative than the AMC project model, that use partner government systems wherever possible and make it clear to partner agencies what they need to do to "deserve" the use of such aid.
  - Should not lose sight of the importance of promoting demand for reform by strengthening civil society.
  - Should not lose sight of the poverty focus of the aid program in the pursuit of incentives and contestability approaches.
- Regional or Multilateral Programs
  - Should try to set up competitive structures between similar entities, with well thought out and publicised allocation criteria.
- Projects
  - Designs should include analysis of how the existing incentives structure is an impediment or motivator for development objectives; and how the project intervention will impact upon this.
  - Should try to set up competitive structures between similar entities, with well thought out and publicised allocation criteria
- Technical Assistance Facilities, small grants schemes, etc
  - Without compromising their flexibility, should have clear and well publicised allocation criteria that we have thought through in terms of the messages and incentives they give out.

In trialling approaches such as these, line areas must keep in mind the importance of the principles identified in the Review, particularly those summarised above under the heading "General Findings".

MAIN REPORT

1 APPROACH

Acknowledgements

This review required the support and participation of many AusAID staff. Cameron Hill undertook the initial research. The report was written by Peter Ellis and Cameron Hill. A steering group of Greg Andrews, James Gilling, Georgina Harley, David Hook, Romaine Kwesius Gillian Mellsop, Deo Mwesigye, Allison Sudrajat and David Swan provided guidance. Around 35 staff were interviewed or participated in focus groups. Many other staff provided documents or anecdotes.

The views represented are those of the authors, not AusAID. They may differ from those of the steering group, participating staff, and other AusAID reviews.

EVAL would like to thank all those concerned in the review for their generous participation.

Terms of reference

This paper reports on a review of AusAID's use of incentives and contestability. The Terms of Reference for the review are in Annex A. The emphasis of the study is to determine the relationship between incentives and contestability in aid allocation, and governance standards.

Methodology

This review gathered information by the following means:

- search of articles and books found in the AusAID library, other donors' websites, miscellaneous general websites, and the AusAID Knowledge Warehouse (AKWa)
- brainstorms and discussions within Program Evaluation section, and ad hoc use of findings from previous reviews and evaluations undertaken by the section
- focus groups and interviews with selected AusAID staff
- analysis of the findings of recent major reviews of the PNG Incentive Fund policy and program schemes, and of the 1999 internal review of the Policy and Management Reform scheme

- collection and analysis of key AusAID documents that came to light during the above process (eg “Scoping the notion of ‘contestability’ and its application to the PNG program”; status report on the PNG SWAp)
- consultation with an internal AusAID steering group.

2 BACKGROUND, CONCEPTS AND THEORY

Why use incentives and contestability in delivering aid?

The review found prevalent two different rationales for the use of incentives or contestability in delivering aid:

- encouraging **behaviour change**, particularly in partner governments, but also in development stakeholders more generally (from now on referred to as the 'behaviour change' purpose)
- allowing a donor to determine the most **efficient allocation** of resources by 'picking winners' who are likely to make the most of support from a donor (from now on referred to as the 'allocation-efficiency' purpose)

There is no reason these two purposes should be met simultaneously in the aid context (although in other cases they may be intrinsically linked); but there is no reason why they should conflict either.

The microeconomics of incentives and competition

Economics is fundamentally concerned with incentives. It is a basic finding of microeconomics that optimal resource allocation will arise spontaneously *if* there is a smoothly operating market for all relevant goods and services (including labour, capital, etc) and agents within that market share in common the meta-incentive of maximising their individual utility by means of increasing their access to material goods. When such a system is working well, such a meta-incentive translates into many useful (for society) and practical incentives, eg:

- for those owning capital to invest it in the areas that provide the biggest return
- for workers to find the employment niche in which they perform best
- for retailers to lower prices until all goods and services have been sold.

In the terminology used in this review, the market incentive structure is aimed at both the behaviour-change purpose and the allocation-efficiency purpose. Policy makers who wish society to resemble the free market aim to both change the behaviour of agents to a more economically rational basis, and reap the rewards of the more efficient resource allocation that results.

It is well known that societies do not resemble smoothly functioning markets. Much of economics is devoted to considering the impacts upon incentives and resource allocation efficiency of imperfections in the market; imperfections which may include (for example) some form of state, business or union power in setting prices, or just the lack of a market for many items of material, cultural or social importance.

Two findings of microeconomics will be highlighted here.

First, markets function well (in terms of allocation-efficiency) when they consist of **large numbers of similar entities competing** on a level playing field. This provides numerous incentives to innovate, cut prices, ensure improved quality, etc. But competition only works because of the ultimate sanction – those who fail to compete are driven out of the market in the form of bankruptcy, unemployment or something similar. Non-market mechanisms (bankruptcy law, etc) are required to ease their return to a market – perhaps providing a different good or service.

Second, **state intervention into the market for a particular good can have predictable results.**[1] For example, setting a maximum or minimum price for a good will mean respectively that demand exceeds supply or vice versa; in both cases the net result being that some form of queuing mechanism (interpreted broadly) replaces the market as the allocator of resources, efficiency is lost and production declines compared to the equilibrium, no-intervention state.[2] The state can also change the incentives structure by subsidising or taxing a good. The result is a lower price and higher production, or higher price and lower production, for a subsidy or tax respectively. For example, in the case of a subsidy, those agents who were previously on the margin of seeking to buy the good decide to enter the market when the subsidy brings the price down; and agents who are on the margin of increasing production of the good decide to do so when the subsidy effectively increases the price they receive.

Applying these concepts to aid allocation and the concept of a market for reform,[3] we reach a useful conclusion. Aid donors are likely to be able to maximise allocation-efficiency and to change the incentives structure in a market for good governance when two conditions apply:

- There many entities (countries, provincial governments, organisations) competing for aid funds, in which the donor wishes to improve governance;

1 Care should be taken to remember we are discussing microeconomics, and in particular considering one market at a time, where different interventions and incentives structures do indeed have predictable and well-known results. The field of macroeconomics – predicting the impact on the economy as a whole of a large-scale government intervention – is less secure.

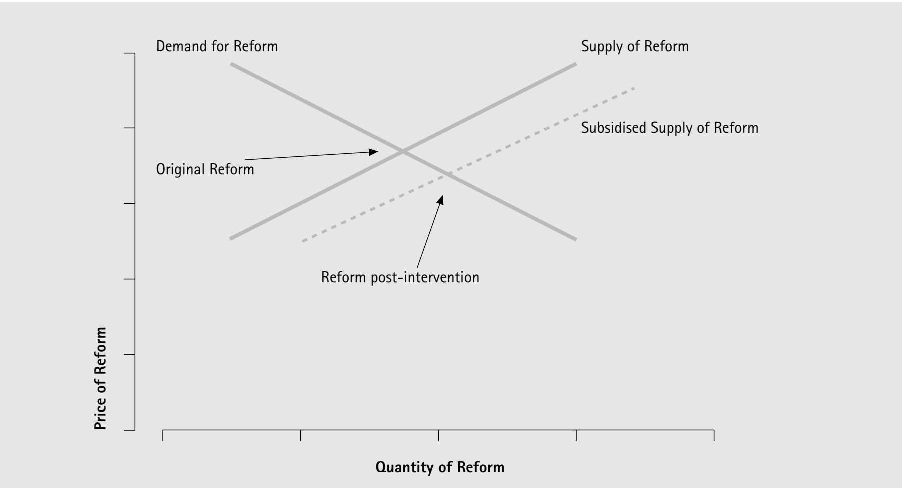
2 In the case of a minimum price, the amount suppliers will want to sell will be more than the equilibrium quantity and the amount demanders will want to buy will be less than the equilibrium quantity. Exchange only happens when both parties want to engage, so the amount sold will be that wished by "demanders" and suppliers will need alternative means (other than dropping their price) to decide who gets to sell the goods. The situation is reversed, with the same impact on production, when demand exceeds supply.

3 Where 'demand' for reform or good governance comes from the public, and 'supply' comes from various levels of government or similar organisations.

- The donor is in a position to materially move the supply curve to the right by subsidising reform; that is, the inputs (monetary or otherwise) a donor can provide or withhold are sufficient relative to the existing incentives structure for entities on the margin of improving their governance to take the extra step.

This conclusion is summarised in Figure 1.

Figure 1 **Implications of a competitive market for reform**



Expressing the concept in this form draws attention to a number of important facts with relation to particularly the behaviour-change purpose of aid incentives:

- The concept ‘price of reform’ may be misleading if it implies money
- The concept ‘quantity of reform’ might be misleading if it suggests a smooth continuum
- A subsidy for reform is still going to have only a small impact on the total amount of reform provided; we are hoping only to influence the behaviour of those on the margin of potential reform
- There may be potential for moving the demand curve for reform, although this will be difficult because the issues are likely to be socially and culturally based in a complex political environment.

CASE STUDY – THE AUSTRALIAN RESEARCH COUNCIL (ARC)

ARC's targeted research grants use incentives and contestability mechanisms to achieve policy outcomes. Grants are allocated competitively on the basis of qualitative, internationally peer review-judged criteria. The overall objective of is to increase the excellence and quality of research as well as to improve the governance of the national research system.

A recent assessment indicates that one Commonwealth dollar invested through the ARC results in at least five times more publications than one Commonwealth dollar allocated to university research through non-contestable processes.[4] More broadly, an independent evaluation of the views of independent international assessors found that 61% of research funded under the ARC's Large Grants Scheme was considered leading edge in the global arena. The evaluation also found that 85% of funded Large Grants produced high quality outcomes likely to exert an influence internationally.[5]

Based on these assessments, the ARC argues that Australia should increase the share of higher education funding that is allocated through contestable processes. This is in line with the Government's decision in 1999 to put all medical research institutes through the contestable processes of the National Health and Medical Research Council (NHMRC). The ARC has proposed that the balance between block and contestable funding for higher education be changed from the current 60:40 in favour of block funding to approximately 30:70 in favour of contestable funding.[6]

ARC grants aim both to choose the most efficient researchers to meet the research priorities set by the government; and provide incentives for researchers to move into particular fields that are more likely to achieve grants. Published reviews and discussion with academics suggests that they have been highly successful on both fronts.

Not all incentives are monetary; a factor that applies in any society, but more so in partially monetised economies such as some of those of most interest to AusAID. An AusAID review earlier this year pointed out:

> *"Different societies vary considerably in the nature of the incentive systems upon which they characteristically rely to organise their common objectives… Many traditional societies rely heavily on moral incentives and make relatively little use of coercive and remunerative incentives to sustain social action… PNG society is a 'traditional' though emerging modern culture"*[7]

4 ARC (July 2002). *Submission to the Higher Education Review*, p.8.

5 ARC Website – <http://wwww.arc.gov.au/strat_plan/performance.htm>

6 ARC, *Submission to the Higher Education Review*, p.2.

7 AusAID (4 April 2002) *Incentive Fund Policy Stream Review: Papua New Guinea* pp.13–14.

Non-monetary incentives are widespread and not confined to traditional value-based factors such as 'big man' prestige and clan affiliations. In one (relatively modernised) sector of particular interest to AusAID, a World Bank study found that prestige, reputation and expectations of job stability "should not be underestimated" as rewards for public servants that need to be considered in explaining the effectiveness or otherwise of the public sector. The Bank provides a useful summary of different incentives to be considered in public sector (shown below in Figure 2), and concluded that:

> *"The incentives created by different forms of pay and reward – and their impact on performance – can be complex. As an illustration, job security is generally an important element of a civil servants' total rewards. Thus, governments wishing to adopt new-public-management style contractual arrangements (to reward performance) may have to offer a higher base pay to compensate for lost job security."*[8]

Figure 2 **"Incentives to be a civil servant" (World Bank diagram)**

		contractually-provided		**non-contractual/ intangible**
		Monetary	**in-kind**	
current rewards	**base rewards**	1. base wage/ salary	2. health insurance	3. job security, prestige, social privileges
	allowances	4. transportation, housing, meals, telephone, travel, cost-of-living	5. transportation, housing, meals, travel	6. trips abroad, training
future expectations		7. pension	8. housing, land, etc.	9. reputation, re-employment after retirement

8 <http://www1.worldbank.org/publicsector/civilservice/agency.htm>

CASE STUDY – "MANUFACTURER OF THE YEAR" AWARD IN PNG

In PNG, the annual Manufacturer of the Year "Excellence Awards", established in 1996,[9] provide an interesting example of the use of non-monetary incentives to complement the profit motivation of an emerging modern economy.

In a smoothly functioning market, the push to optimise profit should be enough to motivate businesses towards excellence. In PNG, these prestigious and public "Excellence" awards are used to complement the profit motive as part of a deliberate (although not necessarily articulated) intervention on behalf of modernisation and monetisation, sponsored by major players in the private sector with an interest in the development of PNG as a market economy (the ANZ Bank, and the PNG Manufacturers' Council). Worryingly, there were less nominations for the Awards in 2002 than in previous years.[10]

AusAID's review of the Incentive Fund Policy Stream described the scheme as "highly successful", noting that "emphasis is more on status enhancement of individual recipients (and teams) than on monetary reward"[11].

Perverse incentives and moral hazard

Another concept from the microeconomics literature of interest to this review is that of moral hazard, or the broader topic of perverse incentives. Perverse incentives can be described as an incentive structure such that rational and maybe even well meaning agents will be motivated to undertake 'bad' actions – 'bad' of course meaning counter to those of the planner, state, or, in this case, aid donor. The classic examples come from centrally planned economies and from the business management literature and serve as warnings against badly chosen performance indicators.

9 <http://www.thenational.com.pg/1003/businessnews2.htm>

10 <http://www.postcourier.com.pg/20021003/business08>

11 AusAID (April 2002), *Incentive Fund Policy Stream Review*, p.14

CASE STUDY – THE NEW ENTERPRISE INCENTIVE SCHEME

A recent evaluation of the Department of Employment, Workplace Relations and Small Business' New Enterprise Incentive Scheme (NEIS) highlights some of the perverse incentives that can arise when such schemes are not well targeted or monitored. The scheme is aimed at extending the range of options available to unemployed people to find work by providing encouragement and assistance to those who wish to establish a small business.

The evaluation found a number of key problems with the incentive structures set up by the scheme:

- in terms of cost effectiveness, the cost per net employment outcome was high relative to other interventions. In fact, "a high proportion of participants could be expected to make the transition out of unemployment in the absence of the service";
- the scheme provided a disincentive to pursue equity objectives because it motivated providers to concentrate on those most likely to succeed at the expense of genuinely disadvantaged job seekers.[12]

Both of these problems derived from unclear objectives, a lack of targeting at the margins of the labour market and inadequate performance measurement criteria.

It quickly became obvious to the current review that a key issue relating to incentives and aid is that of unintentional, perverse incentives. These have the potential to easily outweigh the good impact of interventions into an existing incentives structure. It is very easy for a badly designed intervention – whether it be by a developing country state in its own economy, or by a donor in the public sector of a recipient state – to unintentionally cause considerable damage, often in wholly unanticipated areas.

12 Centre for Labour Market Research (May 2001). *Findings in the NEIS Evaluation: Report Prepared for the Department of Employment, Work Place Relations and Small Business*, pp.62–65.

CASE STUDY – GRADUATION FROM LEAST DEVELOPED COUNTRY STATUS

The United Nations manages a categorisation of countries that includes that of 'Least Developed Country' (LLDC). There are currently 49 LLDCs. Since the inception of the concept, only one country (Botswana) has ever graduated from LLDC status. LLDC status is determined against complex criteria, which take into account not just income per capita but a 'Augmented Physical Quality of Life Index' and an 'Economic Diversification Index'.

Certain benefits accrue to LLDC status, LLDCs – most of whom are in Africa – have been a focus point for some NGOs' and others' advocacy for a more poverty-focused allocation of aid. Perhaps more importantly, LLDCs have special status under WTO treaties and negotiations. Australia recently removed tariffs and quotas for imports from LLDCs plus East Timor.[13]

The benefits – real and perceived – accruing to LLDC status give governments of LLDCs and potential LLDCs incentives to:

- make their indicators worse, either by statistical legerdemain or by allowing development to genuinely go backwards or fail to progress
- talk down their country's development status in international fora, possibly with negative effect on investment and on business confidence, and on nation-building efforts

It is certain that the second of these steps has taken place; it is possible that the first has too.

Politics and incentives

The most important question in politics is probably how to establish a governance system that moves the interests of the governing elite so they are as much as possible in alignment with those of the 'nation', however defined. There is ample evidence that in developing countries this challenge is met particularly poorly. For example, Professor Ronald Duncan (amongst others) has suggested that the failure of the PNG constitution and electoral system to overcome sectional (particularly clan-based) interests is the prime cause of governance problems and development failure in that country. His suggested solution was support for the recent reintroduction of preferential voting.[14]

13 <http://news.bbc.co.uk/2/hi/business/2363115.htm>

14 In an interview with Peter Ellis, 2002. See also: <http://www.anu.edu.au/pad/reporter/volume/32/18/news/png.html>

This political aspect of incentives applies as much to aid as to other forms of state power. It is crucial that aid interventions consider the impact they are having on the political incentives structure – are they helping align the public sector's interests with 'poverty alleviation and sustainable development', or are they causing damage?

The *Assessing Aid* agenda

The development debate since the late 1990s has been dominated by research from the World Bank, and in particular the agenda set by the 1998 publication *Assessing Aid: What Works, What Doesn't, and Why*. The key relevant arguments from that document and similar work from the World Bank are:

- aid has a positive impact upon economic growth and upon other development indicators such as infant mortality if and only if (at least in the original, most dogmatic presentation) it is provided to countries with a good policy environment[15]
- consequently, an enormous increase in aid's capacity to address poverty would come from reallocating aid to poor countries with good governance[16]
- there is a "mountain of evidence" that conditionality has failed.[17] Supplying aid to a poor policy environment does not succeed in leveraging organisations to undertake governance reform, and may even be counter productive by subverting democratic processes and identifying supporters of reform with external interests[18]

15 World Bank (1998) *Assessing Aid: What Works, What Doesn't and Why*, pp.28–44. See also other World Bank working papers including: Dollar and Burnside (April 1998) *Aid, the Incentive Regime and Poverty Reduction* and Devarajan and Swaroop (October 1998) *The Implications of Foreign Aid Fungibility for Development Assistance. Assessing Aid* describes 'good policy environments' as including stable macroeconomic conditions, open trade regimes, and protected property rights as well as public bureaucracies that can deliver education, health and other public services (p.14). The findings of *Assessing Aid* have informed a range of subsequent literature, much of which has confirmed the broader hypothesis that "in the long run, the growth impact of aid is conditional on the degree of political and civil liberties in the recipient countries with institutionalised and well functioning checks on government power" – Svensson (1999) "Aid and Growth: Does Democracy Matter?" *Economics and Politics* 11 (3), p.275. The DAC's January 2001 Joint Development Centre/DACExperts' Seminar on *Aid Effectiveness, Selectivity and Poor Performers* also acknowledged "there is broad agreement that aid works better where government performance is better". See also: Beynon (2001) *Policy Implications for Aid Allocations of Recent Research on Aid Effectiveness and Selectivity*, Paper Presented at the Joint Development Centre/DAC Experts Seminar on *Aid Effectiveness, Selectivity and Poor Performers*.

16 Beynon (2001), *Policy Implications for Aid Allocations; Assessing Aid* (1998), p.1–27.

17 *Assessing Aid*, p.51.

18 Santiso (2001) "Good Governance and Aid Effectiveness: the World Bank and Conditionality." *Georgetown Public Policy Review* 7 (1), pp. 14–16.

- aid is highly fungible; that is, aid given to a particular organisation for a specified purpose frees up resources for other, possibly quite different, priorities.[19]

The key policy recommendations follow naturally from these findings; that, if serious about poverty allocation, aid should be directed at recipients with good policies and good governance where there are many poor people. In the terminology of our review, this policy prescription fits squarely under the 'allocation-efficiency' purpose for contestability of aid. There is considered to be little hope of policy leverage and little purpose in engaging with poor policy governments or organisations.

CASE STUDY – THE CASE AGAINST AID

Taken to its extreme in the hands of some commentators, the *Assessing Aid* argument implies the general insignificance and occasional negative impact of aid, particularly to countries with poor governance environment. In Australia, Helen Hughes has argued that Australian aid is "the main contribution to Papua New Guinea's problems since Independence"; apparently because it provided significant new opportunities for corruption among the PNG elite.[20] In general (not just PNG), aid has "kept in power governments that rob and pillage their citizens. Aid enables elites to live like princes… underwriting governments that fail their people."[21]

Hughes is critical of the World Bank argument that "aid works in countries that adopt reasonable economic policies"[22] on the grounds that it is too difficult to define good policy; and that in pragmatic reality, "aid has paid for armies, tanks and even missiles… Mobutu and Mugabe have clearly been kept in power by aid …. Middle Eastern and Latin American elites have been assisted by aid to pursue weak or even counterproductive economic policies for 50 years".[23] But her arguments are consistent with the *Assessing Aid* and related findings (just differing in the policy response!); for example by placing heavy emphasis on the importance of fungibility.[24] Her implicit argument is that, as a matter of fact (regardless of how it 'should' be allocated), aid seems to support poor policies; and that if the incentives are not there for good policies, aid will usually make them even worse.

19 Assessing Aid, 62–74; *Implications of Foreign Aid Fungibility*, 2–6.

20 "PNG in need for much more than money", *Australian Financial Review* 14 August 2002.

21 "Third World aid: is it part of the solution or the problem", *Australian Financial Review* 11 May 2002.

22 Hughes "Foreign aid offers a poor policy", *The Australian* 27 March 2002.

23 "Foreign aid offers a poor policy", *The Australian* 27 March 2002.

24 Although Hughes claims, incorrectly, that "the World Bank last referred to fungibility … in its 1949–50 Annual Report".

Poor Performers and LICUS

More recently, the conclusions of *Assessing Aid* have been toned down by donors in the face of pragmatic political reality. The World Bank recently produced an important paper on *Low Income Countries Under Stress* (LICUS) and the Development Assistance Committee of the OECD (DAC) is leading an ongoing debate on engagement with 'poor performers' and 'difficult partnerships'. The conclusion has been that donors cannot 'drop' these countries due to political considerations (it would be impossible in practical terms, for example, for Australia to cease support for PNG) and efforts are being made to find ways to 'engage differently'. The key policy implications are:

- use of knowledge instruments including technical assistance (probably grant-funded), rather than significant financial investment (particularly loans);
- a focus on building medium-term support for reform rather than imposing conditionality;
- in extreme circumstances, systematic use of alternative (non state) service delivery mechanisms.

According to DfID, good governance is not simply an 'independent variable' and "donors could not wait for better governance before engaging with poor performers".[25]

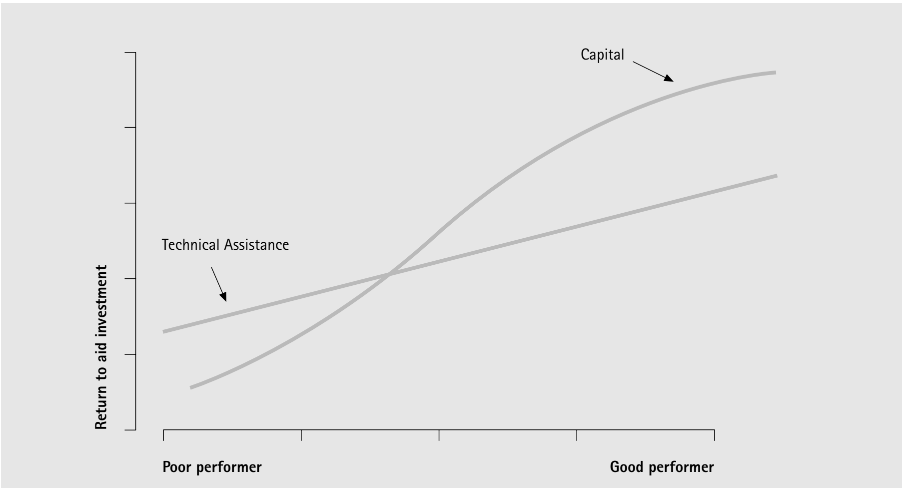
To date, this literature has failed to directly address the arguments of *Assessing Aid*. It starts from the pragmatic premise that 'we must do something' about poor performers and puts forth a plausible solution; but it does yet not provide significant evidence to counter the fundamental econometric findings about the importance of good policy environments for aid to be effective. That is, while most people agree conditionality does not work, there is as yet no convincing evidence that use of knowledge instruments *can* build medium-term support for reform.

Most of the discussion of 'poor performers' implies differing returns to different forms of aid. If we crudely divide aid into 'technical assistance' (focusing on knowledge transfer) and 'capital assistance' (focusing on meeting a public investment deficit) we can reconcile the *Assessing Aid* and *LICUS* agendas. *Assessing Aid* implies increasing return to capital aid for better governance recipients (it is worthwhile noting the little remarked upon fact that the econometric work on which *Assessing Aid* is based excluded technical assistance from its definition of aid). There is no reason to believe that technical assistance is more effective in poor performers than in good performers; but it is plausible (not demonstrated by evidence sighted by this

25 AusAID report from the DAC 29.10.2002.

review) that it has some positive return (the DAC consensus on 'poor performers'), probably increasing as governance in the recipient moves from 'poor' to 'good'. Figure 3 illustrates this. At some point (where the two lines cross), the return to capital-based aid exceeds that from technical assistance and the composition of an optimal aid package should change accordingly. Incidentally, Figure 3 implies that aid of either kind is more efficiently allocated to good performers; but assumes some value in aid even for poor performers, if there are imperatives (such as the need for regional stability, preventing national collapse, or other foreign policy interests), other than maximum return from aid.

Figure 3 **Returns to aid implied by LICUS and similar approaches**



As well as being a useful tool for considering the best form of aid to give 'poor performers', Figure 3 casts light on one aspect of the aid and incentives issue. Anecdotal evidence is strong that recipients prefer capital to technical assistance. The latter is particularly vulnerable to being perceived as intrusive; culturally, politically or otherwise inappropriate; pushing the donors' agenda; jobs for donor nationals; etc.[26] If recipient governments prefer capital-intensive aid, and donors have an explicit policy to provide more technical assistance to poor performers, there is an incentive (albeit probably a relatively slight one) for poor performing governments to exert effort to become a 'good performer' and accrue the rewards of greater autonomy, less intrusive advice, etc. that they see such governments enjoying.

26 See any hostile recipient country press complaint (eg numerous in PNG or Vanuatu about the number and influence of foreign advisers). The review was also told by AusAID staff that recipient officials from several countries had expressed more interest in capital-intensive aid than technical assistance.

Criticisms of *Assessing Aid*

One stream of literature has criticized both the econometric basis of the *Assessing Aid* agenda and the overall hardline 'governance first' philosophy it espouses. There are several lines of attack in this school of thought:

- technical (econometric) grounds for disputing the importance of the interaction between governance and aid impact found in cross-country comparisons[27]
- criticism of the simplicity of the central thesis that aid will or will not work to the exclusion of more sophisticated consideration of how different forms of aid may work: "the unresolved issue in assessing aid effectiveness is not whether aid works, but how and whether we can make the different kinds of aid instruments work better in varying country circumstances"[28]
- concern that the *Assessing Aid* agenda implies aid should only be provided to those who least need it[29]

These criticisms are largely cogent. Some of these concerns are in effect addressed by the recent moves towards consideration of LICUS and engaging with poor performers, noted above. The main residual implication for this review is the importance that Australia not adopt a 'black and white' approach that might implement an overly stern and formulistic real-world version of the Dollar and Collier research on optimal aid allocation.

27 Lensink and White (1999) *Are There Negative Returns to Aid?*, pp.3–12.

28 Hansen and Tarp (2000). 'Aid Effectiveness Disputed', *Journal of International Development* 12, p.397.

29 Ostrom et al. (2002) *Aid, Incentives and Sustainability: An Institutional Analysis of Development Cooperation* (Stockholm: SIDA), pp.100–102.

3 OTHER DONORS' EXPERIENCE

Inter Country

In response to the finding of studies like *Assessing Aid*, the vast majority of literature, both academic and from other donors, on contestability and performance allocations in aid has concentrated on performance at the inter-country level.

This is reflected most strongly in the link between *Assessing Aid* and IDA's country-based competitive allocations. Drawing from the study's findings, the IDA system attempts to systematically target – through the application of a Performance Based Allocation system – aid to those high poverty countries with sound policies and institutions. Similar country-based criteria underscore the Asian Development Bank's (ADB) recent policy statement on Performance Based Allocations (2001), the US Millennium Challenge Account and the efforts by the European Union (EU) to enhance the effectiveness of aid to ACP countries.

CASE STUDY – IDA'S PERFORMANCE BASED ALLOCATION

In 2001, the 12th IDA Replenishment meeting underscored the importance of linking lending to policy performance and further strengthening IDA's resource allocation in this regard. Each year the Bank conducts a performance assessment for all its borrowing countries, both the IBRD and the IDA. The exercise, known as the Country Policy and Institutional Assessment (CPIA) evaluates each country on a range of criteria that are grouped into four clusters:

- economic management;
- structural policies;
- policies for social inclusion and equity; and
- public sector management and institutions.

The CPIA consists of twenty criteria that aim to capture a broad range of policy dimensions of an effective poverty reduction and growth strategy. The ratings focus on the quality of each country's current policies and institutions. Overall, the thrust of the Bank's effort to improve the CPIA process is to develop quantitative and objective reference indicators where possible.

Two additional steps are included. First, to capture the important dimension of quality of development project and program management, the Bank's Annual Report of Portfolio Performance (ARPP) is used to determine a score for each country's implementation performance. On the basis of these measures, the IDA Performance rating is constructed as the weighted average of the CPIA (80%) and the ARPP (20%).

Second, an additional weighting, the 'governance discount' is introduced in recognition of the major impact of governance of the quality of countries' performance. This approach has been aimed at giving a much higher profile to governance issues and "has effectively moved this issue to the center of IDA's dialogue with affected countries". [30]

The strong link between lending and performance has resulted in an increasing concentration of lending to countries where policy performance is most conducive to effective resource use.[31] As a result, "the good performers are allocated some 80% more than the average per capita and three times as much as the poor performers....The rationale is partly that this should serve as an incentive for the non-performers to adjust their policies; partly that aid only works when the policies and institutions of the recipient countries are good and sound"[32]

The development of contestable and competitive inter-country mechanisms based on the fulfillment of certain performance criteria, particularly in the area of governance, have gained momentum. The Heavily Indebted Poor Countries (HIPC) initiative, for example, makes access to debt relief assistance dependent upon sustained implementation of integrated poverty reduction and economic reform programs at the country level. This includes the use of an assessment instrument that represents a set of measures deemed indicative of the overall quality of a country's Public Expenditure Management system, and includes both performance (level of arrears, timeliness of reporting) and institutional indicators (internal audit, medium-term expenditure framework).[33]

As many of these initiatives are fairly recent and yet to be formally evaluated, it is difficult to draw robust conclusions as to their broader impacts – both positive and negative – upon existing incentive structures. However, it is clear that there are several key issues that need to be considered in assessing the efficacy of these types of approaches in setting up appropriate incentive structures that are able to produce behavioural change and/or increase resource allocation effectiveness.

30 IDA (January 2001) *Linking IDA Support to Country Performance: Recent Experience and Emerging Trends*, p.7.

31 IDA Website – <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/IDA10>

32 Engberg-Perdersen (2000) *The Future of Aid: Poverty, Performance and Politics*, Discussion paper for the Conference on Aid and Development, SIDA, Stockholm 20–1 January, p.9.

33 IMF and IDA (March 2002) *Actions to Strengthen the Tracking of Poverty-Reducing Public Spending in Heavily Indebted Poor Countries (HIPCs)*, p.4 – <http://www.worldbank.org/hipc/hipc-review/tracking.pdf>

CASE STUDY – USAID MILLENNIUM CHALLENGE ACCOUNT

On March 14, President Bush announced the creation of a $5 billion per annum (by 2006) Millennium Challenge Account (MCA). It is the largest increase in US foreign assistance for 40 years. The President stated that the new funds would be used for countries that "root out corruption, respect human rights and adhere to the rule of law, as well as encourage open markets and sustainable budget policies".[34] The administration has indicated that judgments about which nations will get the money and which will not would depend on their scores on a range of performance tests.[35]

According to the Administrator of USAID, Andrew Natsios, the MCA will "create the reward system to accelerate the development process by giving to the reformers in developing countries a powerful tool to use against those forces opposed to transformational change" and "may have as much influence on countries which do not qualify as those that do". It will "reward past performance rather than future promise, the old system of conditionality which has not worked".[36]

In developing its performance measurement criteria, the US will use the IDA framework as a starting point and will be developing 16 indicators that will fall into: governance and transparency; macro-economic and micro-economic reform; and health and education policy. To qualify as a better performer, a country would have to score above the median on half of the indicators in each of the three policy areas. The US now has interest groups working on these indicators and these groups will be using international standards of best practice as their base.[37] Experts have predicated that countries like Senegal, Ghana, Bolivia and Honduras might qualify early on and that a second round might include India and Jordan.[38]

The MCA proposal also envisages 'exceptional cases' where performance will not be the sole indicator of assistance levels:

- because some scores will correlate with income, separate competitions will be run for countries with incomes below $1,435 and those with incomes between $1,435 and $2,975
- the Board administering the MCA Corporation will also be encouraged to identify special transition support for a small number of countries that barely miss the list of better performers.

In these cases, regular development assistance can be made available to improve their chances in future competitions.[39]

34 USAID Website – <http://usaid.gov/press/releases/2002/fs_mca.html>

35 "Bush Plan Ties Foreign Aid to Free Market and Civic Rule." *The New York Times*, 25 November 2002.

36 Transcript of Andrew Natsios' Address to DAC, 21 October 2002.

37 Comment from DAC Secretariat to AusAID Paris.

38 *The New York Times*, 25 November 2002.

39 AusAID, (December 2002) *CORPOL Factsheet on MCA*.

A key problem with all these approaches, as with traditional modes of conditionality, is that of ensuring ownership, capacity and sustainability for reform. This problem is acknowledged by the IMF and IDA in relation to the reforms required to access the HIPC initiative:

> *"the key risk is that the finalized assessment and action plans may not be embraced broadly throughout the government, or the capacity to implement technical assistance programs may be very weak, and either problem could lead to partial or ineffective implementation of the actions required to strengthen PEM systems."*[40]

A second problem is that basing incentives on 'one size fits all' measures of country performance comparison may not capture country-specific, contextual factors.[41] That is, comparisons between countries may be less valid than comparisons of a country's performance at two different points in time.

A third issue, expressed at 12th IDA Replenishment meeting by some donors, is the concern that the frameworks may have too much of a punitive slant, not balanced by an effort to reward efforts toward reform.[42] This concern is reflected in the Bank's recent *Country Development Partnership in Governance* in Thailand, an initiative that indicates a move away from a punitive approach and toward a partnership model based on the identification of common objectives and incentives.[43] According to one discussion of this issue, "donors should be prepared to reward domestic reform efforts by increasing external assistance". A key implication is an increase in the flexibility of aid allocations and aid instruments to support developing countries' reforms as they arise.[44]

40 IDA and IMF (2002) *Actions to Strengthen*, p.25.

41 IDA (May 2001) *Adapting IDA's Performance-Based Allocations to Post-Conflict Countries*.

42 IDA (September 2001) *Enhancing IDA's Performance-Based Allocation System*, p.4.

43 Under this model, the performance of the program is measured through the attainment of agreed benchmarks, and public workshops will be held every six months to discuss the reform progress. See: *The World Bank and Thailand: Building a Partnership for Reform*. – <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS>

44 Nunnenkamp (1995) "What Donors Mean by Good Governance: Heroic Ends, Limited Means and Traditional Dilemmas of Development Cooperation." *International Development Studies Bulletin* 26 (2), p.13; see also: Hiemenz (1989) *Development Strategies and Foreign Aid Policies for the 1990s*, Kiel Discussion Paper 152.

A fourth, related problem arises from the very nature of *ex-post* or retrospective incentive mechanisms. By focusing on countries that already have adopted sound policies and institutions, they do not address the key issue of how best to 'hook into' reform processes *as they actually occur* in order to maintain their momentum. The timing of interventions in this respect may be crucial as it can affect both the willingness and capacity to 'follow through' with reforms.[45] The Bank has acknowledged this in its efforts to improve the links between the CPIA, the ARPP ratings and country level processes like the formulation of Poverty Reduction Strategy Papers (PRSP).[46]

Finally, the use of uniform, country-based contestable funding mechanisms in the exceptional circumstances faced by conflict and post-conflict countries is likely to be ineffective. This is reflected in IDA's recent acknowledgement of the inapplicability of its PBA framework to these situations. The application of low performance ratings and low IDA allocation norms in these countries can often occur at a time "when these countries may have an exceptional need for resources with which to consolidate peace and begin the process of economic and social recovery".[47] Accordingly, the Bank has moved to elaborate a different set of performance indicators that have been specifically tailored to the problem of designing sustainable incentives in post conflict countries.

45 The importance of the timing of incentives was recently emphasised at the DAC meeting on *Poor Performers: Basic Approaches for Supporting Development in Difficult Partnerships*, 27 November 2002. According to the DAC, during the reform process "there is a crucial role for development agencies to nurture actors from inside and outside the state who can have an influence ...Political leaders, policy reformers and other elite groups can play a decisive role. They are likely to have multiple interests and may be persuaded to make new trade-offs between personal and public, and short and long-term interests", p.11.

46 IDA, *Enhancing IDA's PBA System*, pp.9–10.

47 IDA (May 2001) *Adapting IDA's Performance-Based Allocations to Post-Conflict Countries*, p.1.

CASE STUDY – ACP-EU

Under the Contonou Convention of June 2000, the new development pact between the EU and ACP countries, 'indications', not 'entitlements' will structure allocations. Allocations will no longer be automatic or frozen and will be subject to revision in light of developments in need and performance.[48]

'Needs' criteria will include per capita income, population size, economic and social development indicators, level of indebtedness and dependence export earnings. 'Performance' will be based on an assessment of:

- progress in implementing institutional reforms
- country performance in the use of resources
- effective implementation of current operations
- poverty alleviation or reduction
- sustainable development measures
- macroeconomic and sectoral policy performance.[49]

It is useful to look at inter-country allocation schemes such as those used by IDA, the US Millennium Challenge Account, and the ACP-EU agreement through the theoretical filter of the discussion in the previous chapter.

First, it is apparent that the schemes are motivated by both purposes identified for using contestable aid, although the Millennium Challenge Account has a much greater focus on encouraging behaviour change than do the others.

Second, in terms of the conditions for successful use of incentives for behaviour change these schemes have dubious potential:

- There *is* a significant number of entities (in this case, recipient governments) competing for aid funds – but it is unclear whether they are competing on anything resembling a 'level playing field'. Specifically, it is unclear whether cross-country comparisons against absolute standards will allow meaningful competition (some countries are already so far 'ahead'), compared to comparisons of a country with its own past performance.
- At the level of competing countries, there *isn't* sufficient reason to believe that even the significant resources on offer from the US Millennium Challenge account will be adequate to materially 'move the supply curve to the right'.

48 ACP-EU Agreement – <http://europa.eu.int/comm/development/cotonuo/overview_en.htm>

49 ACP-EU Agreement

The above discussion should not be taken as showing donors' consensus moving towards competitive country allocations for aid. The multilateral development banks and the US are clearly 'ahead of the pack' in this area. Representative of other, particularly Asian, donors is Japan's position; reported to be based on "avoiding politicisation" and reliance on regional peer pressure to maximise developing countries' ownership and avoid a sense of interference.[50]

Intra Country

Relative to the amount of information on the application of incentive mechanisms at the inter-country level, discussions of intra-country incentive mechanisms are sparse. This reflects the fact that genuinely contestable, large-scale intra-country funding mechanisms like AusAID's PNG Incentive Fund are innovative and unusual.[51]

Nevertheless, the experiences of the World Bank in Vietnam and Indonesia as well that of other bilateral donors provide some suggestive conclusions as to the considerations that need to be addressed in improving the effectiveness of contestability and incentive mechanisms at an intra-country level.

Various incentives and signals are implicit in the range of country programming options available to donors and not simply confined to programs explicitly designated as 'incentive schemes'.

BUDGET SUPPORT – EARMARKED OR OTHERWISE

Some of the potential means of different donors to ensure the accountability of aid – in particular earmarking (allocating expenditure to specific sectors, sub-sectors, or items) and any form of straightforward budget support – will involve little positive use of incentives. In the case of earmarking, for example, even if the donor carefully picks the sector with the highest return to aid investment, no real incentive is given to the recipient to engage in that sector; and, given fungibility, there is doubt that even allocative efficiency purposes would be served. The exception to this rule would be if a donor planned to earmark aid for sectors (or agencies) that planned to undertake particular reforms, thereby creating competition between recipients to make themselves eligible for the earmarked support. The Review could not find an instance of a donor using this earmarking/contestability hybrid.

50 AusAID report from the DAC 30.10.2002.

51 Comment from DAC Secretariat.

PARALLEL SYSTEMS

Other donors have more experience and views on the question of whether to use recipient systems (central governments, individual line agencies, provinces) or to locate a program in external, parallel systems (contractors, local or domestic NGOs).

Contractor-delivered project aid delivery is fraught with well documented problems with developing ownership in the partner government, sustainability after project completion, diversion of scarce management resources, neglect of fixing the 'real problem', ie. government systems; and the establishment of parallel systems. According to the critics, project aid has too often contributed to aid fragmentation, overwhelmed developing country management capacity, undermined local ownership and yielded limited and often unsustainable results.[52] These issues are enhanced but not materially changed when seen through the incentives filter.

However, one potential use of parallel systems for aid delivery is of particular interest though in the incentives context. Civil society programs that are located with local NGOs and communities can clearly galvanise external demand for reform upon governments through contestability processes. This is one of the key rationales underpinning the World Bank's Kecamantan Development project (KDP) that makes program funds contestable across a range of villages and local authorities for a variety of activities. They can also affect the 'supply' of reform to the extent that government authorities see their interests in terms of increased responsiveness to ascendant demand. A third incentives aspect of such interventions is the motivation they provide to recipient governments to provide the reforms sought by donors and argue for funds to return to central government delivery mechanisms.

52 CIDA (October 2000) *Planning and Implementation of SWAps: An Overview Issues Paper* – http://www.ccic.ca/archives/devpol/2000/ca27_cida_background_swaps.htm; DfID (1998) *Developing SWAps in the Health Sector: An Issues Paper for DfID Advisers and Field Managers*, Institute for Health Sector Development – <www.ihsd.org>

CASE STUDY – THE WORLD BANK KECAMATAN DEVELOPMENT PROJECT

The Kecamantan Development Project (KDP), launched in Indonesia in 1998, has been referred to as an 'outstanding' model of participatory development. The stated objectives of the current phase of the KDP project are to:

- support participatory development planning and development management in villages
- support a broad program of social and economic infrastructure construction in poor villages
- strengthen local formal and informal institutions by making them more inclusive, accountable and effective in meeting villagers' self-identified development needs.

Villages participating in the KDP can submit proposals for a wide range of activities, from village infrastructure projects to seed capital for small business creation or expansion – what is termed an "open menu" approach.[53]

The development rationale underpinning the KDP is that the direct transfer of funds and the creation of parallel systems to oversee program implementation will catalyse incentives for creating improved local 'markets' for reform. On the 'demand' side this has involved helping villagers demand accountability from both the government and their neighbours and, though participatory approaches, to take responsibility for the investments they deem important.[54] On the 'supply' side, government officials' have supported the KDP in the hopes of benefiting from the associated political capital, even though they have no access to the funds themselves.[55]

Clearly the major risk of these approaches is that such incentive structures may not be sustainable beyond the life of a program. This has been one of the major criticisms of the KDP. By creating a parallel delivery system outside government institutions, the project risks 'bypassing' government to the extent that neither adequate benefits, funding, nor strong governance will continue once the program finishes.[56] This is because such mechanisms provide little capacity to reward or penalise recipient government performance and policy over the longer term.[57]

53 Edstrom (March 2002) "Indonesia's Kecamantan Development Project, Is It Replicable: Design Considerations in Community Driven Development?" *World Bank Social Development Papers* 39, p.3.

54 Edstrom "Indonesia's KCP", p.2.

55 Edstrom, "Indonesia's KCP",p.3.

56 Edstrom, "Indonesia's KCP" p.9–10.

57 Foster and Leavy (October 2001) *The Choice of Financial Aid Instruments*, Centre for Aid and Public Expenditure, Working Paper 158, p.4–16.

COMPETITION BETWEEN AGENCIES

The application of incentive mechanisms through and between government agencies and other providers can overcome these problems of sustainability by linking funding and contestability more directly to partner government policy, performance and institutional reform. This approach is clearly evident in the World Bank's approach to the Water Supply sector in Vietnam in which Bank funding for provincial water supply agencies is based on the fulfillment of a number of criteria encompassing both relative performance and competitiveness. In these sorts of cases, it is envisaged that the presence of a clear 'market' for service delivery/policy reform can enhance aid effectiveness under the behaviour-change as well as the resource-efficiency criteria.

A key precondition for this kind of approach is the presence of a clearly definable, nascent 'market' for service delivery – the presence of a significant number of entities (provincial governments, line agencies, private service delivery organisations) that will compete for aid funds. Identifying such markets in areas like policy reform and in more 'pure' public goods service delivery areas like law and justice, primary health care and basic education will potentially be more problematic and restrictive, thereby diminishing the incentive effects of contestability. Moreover, problems like corruption and lack of capacity inevitably make it harder to collect the types of performance information necessary to ensuring the effectiveness and integrity of these types of mechanisms.

CASE STUDY – THE WORLD BANK IN THE VIETNAM WATER SECTOR

The World Bank's Water Supply project in Hanoi, Haiphong, Quang Ninh and Danang aims to improve the quality of water supply in the four cities through the renovation of existing facilities in order to effectively meet growing demand. As part of its strategy, the Bank aims to commercialise local water companies to make them more responsive to consumers and financially self-sufficient. This strategy is based on the lesson that in the Vietnam water sector "reliance on government subsidies is not sustainable and frequently leads to persistent financial shortfalls which reveal themselves through deteriorating service standards to customers".[58] It also clearly rests on the presumption that there exists a nascent and sustainable 'market' for improved water supply facilities in the targeted provinces.

58 World Bank (March 2001) *Vietnam Water Sector Project: Project Concept Document*, p.14 –<http://www.worldbank.org/sprojects/Project.asp?pid=P004830>

Accordingly, the Bank has actively sought to build contestability and incentive mechanisms into the project through the introduction of performance and eligibility criteria that will structure Provincial Water Company (PWC) access to project funds. This includes a "performance route" designed to motivate existing PWC operators to:

- improve performance to the levels required to access funds
- make improvements quickly as funds are available on a 'first come-first served' basis
- continue to enhance performance in order to access larger funding components.

It also includes a "competition route" whereby PWCs will lodge competitive bids against one another to design, build, lease and operate assets.[59]

The experiences of other donors suggests that allocation decisions based on the relative merits of using government versus parallel systems are also likely to be driven by a range of other factors that are outside the parameters of this review. These include, but are not limited to:

- donors' domestic accountability requirements
- cases of blatant and sustained corruption or human rights abuses
- the difficulty of a particular operating environment.[60]

What this review does suggest, however, is that programming allocation decisions need to take into account the very different incentive structures – both 'demand' and 'supply' side – that flow from using government versus parallel systems.

SECTOR WIDE APPROACHES (SWAPS)

Sector Wide Approaches (SWAps) represent another aid modality that can be considered in the light of incentive structures and contestability mechanisms. The growing interest in SWAps among donors like DfID and CIDA reflects widely documented concerns with traditional approaches to development assistance, in particular the project modality. CIDA is currently involved in about a dozen SWAps, mostly in Africa, as well as a number of non-sectoral 'program-based' initiatives.[61] DfID supports SWAps in health, education, roads, agriculture and forestry in eight countries of sub-Saharan Africa, and in several Asian countries.[62]

59 WB, *Vietnam Water Sector Project*, 8–9.

60 Foster and Leavy, *Choice of Financial Aid Instruments*, pp.17–23.

61 CIDA (September 2002) *Canada Making A Difference in the World: A Policy Statement on Enhancing Aid Effectiveness*, p.7.

62 See: <http://www.keysheets.org/red_7_swaps_rev.pdf>

One of the major benefits of SWAp approaches is that they offer a mechanism for linking *mutually agreed* sectoral performance targets to overall funding allocations, thereby providing an incentive for sustainable policy reforms and/or more effective service delivery. In traditional projects, the focal point of accountability and incentive relationships has been the donor and the project entity. In SWAps, the main locus of these relationships shifts to the government ministry or agency responsible for implementing reforms and "the developing country government, in turn, is accountable to its own citizens as well as funding agencies for performance in the sector".[63] A recent assessment of SWAps funded by the Swedish International Development Cooperation (SIDA) found that these approaches can overcome many of the problems encountered in traditional aid by "improving incentives, accountability and sustainability".[64]

In terms of incentives, a further advantage of SWAps is that they also provide a mechanism for enhancing overall levels of aid contestability. Once targets and measures have been mutually agreed, contestable, performance-based funding could be applied not only to the size of funding at various levels of governments (ie national versus provincial) but also between competing modes of service delivery (government versus NGO or private sector).[65]

By linking funding to overall sectoral budgetary allocations and performance, SWAps also provide a mechanism for minimising the problems arising from fungibility. Several studies of other bilateral donor funding have recently indicated that aid fungibility is more likely to occur *within* rather *between* sectors.[66] Well monitored and coordinated sectoral support programs thus can go a long way to reducing those potentially perverse effects that dilute the overall returns from aid and that detract from impact.

63 *Planning and Implementation of SWAps: An Overview Issues Paper, October 10, 2000. <http://www.ccic.ca/archives/devpol/2000/ca27_cida_background_swap.htm>*

64 Ostrom, *Aid, Incentives and Sustainability*, 2002, p.106, Foster and Leavy, *The Choice of Financial Aid Instruments.*

65 The public goods problem has been raised in relation to the problem of 'decentralisation' in a recent WHO study of SWAps which concluded that "there is as yet little experience of how to implement a SWAp using a decentralised local government structure". (September 1999) *Lessons of Experience from Sector-Wide Approaches in Health* <http://www.odi.org.uk/pppg/cape/papers/lessons.html>

66 See: Pack and Pack (1990) "Is Aid Fungible: the Case of Indonesia." *Economic Journal* 100, 188–94; Pack and Pack (1993) "Foreign Aid and the Question of Fungibility." *Review of Economics and Statisics*, 258–65; and Feyzioglu, Swaroop and Zhu (January 1998) "A Panel Data Analysis of Foreign Aid Fungibility." *The World Bank Economic Review* 12, 29–58.

Evidence from DfID suggests that the impact of these incentives in sectoral level interventions will be highest in those cases where:

- donor flows represent a significant share of public funding for the sector (ie. leverage); and
- the major donors providing the funding are able to reach agreement with the Government on the policies, plans and expenditure programs to be implemented within the sector (ie., donor coordination and high level sectoral planning).[67]

Of the criteria for successful SWAps identified by DfID, the first corresponds to the finding in this review about the importance of resources needing to be materially important relative to the existing incentives structure – our capacity as donors to move the supply curve to the right, in the terminology used earlier. The current review would add to DfID's findings the importance of having a competitive market of alternative delivery mechanisms within the sector. This gives donors a menu of options, short of complete withdrawal from the SWAp, to exercise that leverage. Based on the discussions of SWAps cited above, this competition seems most likely to occur between different levels of government and is surely a prerequisite for successful use of incentives and contestability.

'DEVELOPMENT COMPACTS'

A final aid modality that lends itself to thinking more comprehensively about sustainable incentives is that embodied in emerging discussions of the concept of 'development compacts'. The idea of compacts takes the idea of SWAps to a higher level – broader national and cross-sectoral priorities – and involves the cooperation of multiple donors working with recipients to define key reform goals, indicators and measures at the national level. According to one author, the concept:

> *"aims at still broader frameworks of development cooperation which need not be restricted to one donor and one recipient but may involve several parties, including the multilateral agencies....Commitments by the recipient government should not be restricted to policy reforms but should create the conditions for social progress and 'good governance'....Commitments by the donor parties should not be limited to foreign aid and debt relief, and should include on a reciprocal basis trade policy, access to markets, investments and other matters affecting development opportunities of the South. A fundamental prerequisite is that the national authorities themselves should elaborate the reform programs included in the compact; these should not be imposed from the outside."*[68]

67 Foster and Leavy, *The Choice of Aid Instruments*, pp.21–8.

68 Stokke (1995) *Aid and Political Conditionality*. London: Frank Cass, p.80.

By linking levels of funding and contestability with national reforms and budgetary processes, the compacts approach moves beyond the SWAp in that it directly addresses the possibility of fungibility *across sectors* whilst attempting to ensure appropriate levels of ownership and sustainability. Development compacts could also provide a mechanism for linking into recipient generated poverty reduction instruments like the Poverty Reduction Strategy Papers (PRSPs).

This type of approach has been recently forwarded by CIDA in the form of its proposal for selected 'enhanced partnerships'. CIDA's proposal embodies some of the key principles underpinning the compacts concept in that it envisages a more strategic approach to support based on the identification of mutual obligations and incentives on the part of both donors – increasing funding, debt relief and trade opportunities as a reward for reform; and recipients acceptance of and commitments to the principles of good governance, the rule of law and the mobilization of domestic resources for development.

A further advantage of the development compacts approach is that it presents a potential mechanism to ameliorate the problem of multiple donors competing against one another to provide project funding in a particular country. This competition can undermine both the coherence of reform processes (as recipients play donors off against one another) and can produce perverse incentives arising from factors like fungibility (as a variety of donor monitoring and incentive mechanisms operate independently of one another).[69] The concept envisages a preceding process of high-level and sustained donor coordination and cooperation before joint strategies, indicators and obligations are defined.

As with SWAps, the development of such compacts as effective incentive mechanisms will clearly depend upon the extent to which aid represents a significant share of national budgetary resources and can give donors leverage. Again, importance should be attached to the existence of multiple competing recipient entities (different sectors, different agencies, different levels of government). On a formidable practical note, they will also be limited to those situations where possibly multiple donors and recipients are able to reach agreement on the policies, plans and expenditure programs as well as the key performance indicators through which the rewards for improved performance and disincentives for non-performance will be applied. Experience with Development Compacts has not advanced to the stage where their success or otherwise can be judged; but there seems at least a possibility that there can be effective use of contestability and incentives, if logistical and political difficulties and sensitivities can be resolved.

69 This underscores the fundamental importance of donor coordination practices in addressing the fungibility issue at the national level (eg. Australia-New Zealand donor harmonisation in the Pacific). One problem that was raised in the review was that donor coordination will not always simply be a 'technical' or administrative issue but is often linked to broader political and strategic issues (eg. impact of China-Taiwan recognition issue in distorting aid allocations in our region).

CASE STUDY – 'ENHANCED PARTNERSHIPS' AND AID EFFECTIVENESS IN CIDA

The 'development compacts' concept has been elaborated in CIDA's recent policy statement, *Canada Making a Difference in the World: A Policy Statement on Strengthening Aid Effectiveness* (September 2002). According to CIDA, compacts are 'enhanced partnerships' in which partners "have articulated shared objectives and agreed-upon responsibilities". Under this mutual obligation approach, developing country partners should be committed to sound policies, good governance and the rule of law and to mobilizing resources for development. In return, developed countries should be committed to supporting these reforms through increased aid flows, enhanced debt relief and a more open trading system.

CIDA will:

- select a limited number of the world's poorest countries for an enhanced partnership relationship
- ensure that the criteria used to select such a list of countries for enhanced partnerships will include a high level of poverty as measured by per capita income and a commitment to development effectiveness, as demonstrated through efforts to reform governance, ensure local ownership of poverty reduction strategies, end corruption and make effective use of aid monies
- allocate to countries selected for enhanced partnerships a greater share of the incremental funds and strategically allocate resources to a small number of sectors in these countries.[70]

This approach conforms with CIDA's broader argument, expressed at the recent DAC *Network Meeting on Good Governance*, that coercion and conditionality were not viable options in dealing with 'poor performers'. Instead, in improving aid effectiveness in poor performing countries such as Haiti, CIDA is looking toward enhancing the flexibility of aid funding in order to take advantage of reform opportunities as they arise.[71]

70 CIDA (2002) *Canada Making A Difference*, pp.11–2

71 AusAID report from the DAC 29.10.2002.

4 AUSAID'S EXPERIENCE

The Policy and Management Reform (PMR) Fund

Australia's PMR Fund for the Pacific region was established in 1995–96 and has seen rapid growth since that date. It was established to promote economic and public sector management reforms, both by supporting actual activities and by giving Australia leverage in influencing partner government policy:

> *"Because funds are allocated between countries on the basis of demonstrated commitment to reform, and are additional to bilateral programs, the use of this mechanism substantially reinforces Australia's policy dialogues in the region".*[72]

The PMR is allocated in part to individual countries and in part to regional projects. PMR allocations aims are:

- increasing the efficiency, effectiveness and transparency of government in areas such as planning, financial management and budgeting, and service delivery;
- assisting the development of appropriate policy frameworks for foreign trade and investment and the local private sector; and
- improving natural resource management

Recently, the PMR's role was further extended to cover work to promote peace and nation building.

The PMR Allocation Criteria state that PMR funds are "allocated competitively between countries on the basis of demonstrated commitment to reform". Country Program Managers treat the PMR allocation as a 'top-up' to their country program rather than an allocation to be managed separately. Regional allocations are treated similarly by their managers:

> *"It was apparent ... the PMR funds are radically fungible, further making their attribution to specific projects a somewhat arbitrary exercise. For example, Solomon Islands PMR was increased by $0.5m in the course of this financial year (1999–2000). Although this money is allocated to a specific reform activity, the impact of the change was to free up the remainder of the country program to fund other activity that would not meet the PMR criteria. Similarly, the Government of Tonga is seeking PMR funding for an activity currently funded from the country program. Should a PMR allocation be granted for this project, the effect would be to free up the Tongan country program for another (not necessarily reform activity) rather than to increase the reform activity in the program."*[73]

72 Downer, *Australia's Overseas Aid Program 1996–97*, p.27

73 *Desk Review of the PMR Fund*, p.3

The 1999 review of the PMR made a number of significant findings and recommendations that are still pertinent today, particularly in the context of the current review of incentives. The key recommendations include:

- In contrast to IDA Performance Based Allocations, PMR allocations were apparently made on the basis of both commitment *and* potential to change, rather than just past policy performance – and rightly so. For example, the flexibility of the PMF fund at the time the Government of Vanuatu entered into their Comprehensive Reform Program meant Australia was in a position no other donor was to provide a welcome reward for a reform minded government and a vital source of assistance.
- However, there is little reason to believe that PMR has been a factor in shaping the dramatic difference in the status of reform in different Pacific countries at different times. In situations such as Solomon Islands, Vanuatu and Samoa the external circumstances that dictate whether reform will take place and be successful (including ADB or other conditionality, political violence, or endogenous will to reform) far outweigh the incentive effect of Australia's PMR. As one interviewee in the 1999 review said, "the [name withheld] Government is happy to go at its own pace of reform and are not going to speed it up for a million Australian dollars".
- Despite this, there is significant potential to better use the PMR as an entry point to policy dialogue with partner governments. The review found that some leverage is being exerted, particularly at the individual project level, and suggested that this leverage and the value of policy dialogue could be greatly enhanced by a number of simple changes:
  - Increasing the rigour of PMR country allocations by documenting progress and potential against the reform areas under the Forum Economic Ministers 1997 Action Plan;
  - Not making multiyear commitments of PMR;
  - Presenting the annual system of country allocations to partners as the most rigorous, objective and non-discretionary possible; reinforcing this presentation of the system at each High Level Consultation, and using this as an entree for policy dialogue on progress against the allocation criteria;
  - Resisting the temptation to use PMR to fund reform activities unless the whole partner government is assessed to be reform minded (and funding such activities from existing country programs);
  - Decreasing the amount of PMR allocated to regional agencies and activities to around 10%; not using the PMR to adjust for concerns about the size of country program allocations; and (in general) not confusing its incentive and reform-support objectives with other allocation needs.

The PMR Fund gives an interesting insight into the practicalities of incentives in the aid program. In the context of the principles emerging in this review, the key points are:

- limited leverage – Australian aid is not enough to tempt a reluctant partner government into reform
- limited competitive market of potential recipient countries, particularly those on the margin of reform – casting into doubt the success of either the allocation-efficiency and especially the behaviour-change purposes of contestability and incentives
- while accepting the donor consensus that conditionality (ie based on future policies) has failed, there is usefulness in comparing governments' current to their own past performance and rewarding and supporting incremental change
- some potential for using the scheme as a starting point for meaningful policy dialogue – and the importance of clear, well publicised and as objective as possible criteria for allocation.

The above discussion applies to the PMR as an incentive scheme. It should not be taken as a more general summary of the value of the PMR as a whole.

The PNG Incentive Fund (PNGIF)

The PNGIF is an A$155 million five year facility that "aims to encourage the efforts of both private and public sector organisations in PNG to participate in, and contribute to, national development." It has two components: a Program stream which has funded nineteen Awards totalling K121m and a (now suspended) Policy stream that approved four awards, all in the Health sector, totalling K2m. Both streams of the PNGIF were subject to review in 2002, providing the incentives review with much useful material.

While there seem to have been serious implementation problems with the PNGIF, the current incentives review considers the PNGIF's experience to be of utmost value for AusAID (and potentially the donor community as a whole) in considering intra-country incentives and contestability models, because of its use of significant resources with real leverage to exert on marginal potential reformers; and its access to a highly competitive 'market' of possible aid recipients.

The reviews of the two streams of the PNGIF were both positive about the concept of the Incentives Fund and the possibility of using incentives to motivate behaviour change in PNG.

LESSONS FROM THE PNGIF

The (currently suspended) policy stream provides an object lesson in managing incentives. The key issues in its demise were:

- that the coherence of the scheme in terms of poverty reduction was comprised by a lack of matching between the allocation of the awards and the key objectives of the PNG program;
- lack of adequate attention to governance issues during the design, with the result that the process led funds to be awarded (but not delivered) to organisations that clearly had serious governance problems;
- poor transparency of award selection process; and
- choice of performance indicators that were not capable of independent verification, and of performance outcomes that were not under the control of the competitors or realistic goals for some competitors with the market of potential awardees coming from a heterogeneous starting point.

These problems would appear to be eminently solvable, if not in the PNG context, at least in principle should the model be adapted to elsewhere.

The program stream appears to have been fairly effective within some significant but not insurmountable constraints. The key relevant points identified in the review are:

- levels of ownership for PNGIF activities seem to be higher than in many comparable activities funded under the normal project-centred approach;
- the choice of selection criteria means that most of the Awards fund activities do not meet the social and economic needs of most of the population, particularly the rural poor;
- the PNGIF is oriented towards funding capital works rather than rehabilitation and recurrent expenditures, resulting in sustainability issues;
- the selection process and award size heavily bias the Fund towards well established elite organisations; and competition is inhibited because the eligibility criteria for applicants are so restrictive.[74]

While these problems have seriously compromised the performance of the PNGIF to date, they can be addressed, and the PNGIF review team has made recommendations that would substantively and simply remedy them.

74 All of these points are drawn from: (April 2002) *PNG Incentive Fund: Policy Stream Review*; (September 2002) *Draft PNG Incentive Fund: Program Stream Review.*

IMPLICATIONS

The PNGIF is instructive because it is a model that can be applied in an environment potentially meeting all the important criteria for successful use of incentives and contestability in the aid program:

- there is a competitive market of potential awardees; and
- there is evidence that Australian funds are sufficient to exercise leverage over the agencies competing for awards, to the degree that some are changing behaviour.

The findings of the PNGIF reviews confirm that in this situation, incentive-based allocation of aid can work if care is taken over a few other principles, emerging as a theme in the current review of incentives:

- careful consideration of who should be competing for awards;
- comparison of agencies' current performance with their own in the past, rather than making unfair cross-sectional comparisons;
- clear, objective, and robust verifiable allocation criteria pitched at a level under the control of those competing for awards; and
- criteria in accord with Australia's development objectives and directly related to key poverty reduction objectives and goals.

Other PNG experience

Examining the sectors or subsectors where Australia has assisted PNG confirms the international finding that aid is fungible, and all the more so when directed to projects or programs that are likely to be a high priority for the recipient government. For example, as donor (ADB and Australian) aid for medical supplies and equipment in PNG increased, the initial net effect was an increase in funds directed to the sector; but this quickly stabilized and in 2002 GoPNG funding was dramatically decreased, leaving Australia to effectively take responsibility for maintaining service delivery. In effect, Australian aid provided an incentive to GoPNG to prioritize other programs. However, the overall impact of this is not necessarily bad; GoPNG resources directed to the health sector as a whole increased in real terms by 4% over the last five years[75], showing that fungibility in this case (consistent with international literature cited earlier) probably occurs within the health sector rather than across the GoPNG as a whole.

There is also evidence that fungibility does not apply to all sectors. In road maintenance in PNG, for example, there is no relationship between donor and GoPNG funds, suggesting that the matter is simply not a priority for GoPNG and would not be funded without donor support.

75 *PNG Health Services Improvement Program: Update Paper Number Four*, November 2002

The fungibility of some but not all aid to PNG has implications for use of incentives in the aid program. Most important is the danger that Australian funding in a sector or sub-sector could reduce the incentive for partner government funding. There is no obvious solution for this, but it is clear that relying too heavily upon project delivery mechanisms could contribute to the problem. The PNG Health Services Improvement Program (see case study) seems to be the most promising possible approach.

CASE STUDY – THE PNG HEALTH SWAP

In February 1999, Minister Downer approved the development of a sector-wide approach (SWAp) in health in PNG.[76] Since then a National Health Plan (2001–2010) has been agreed to form the overall policy framework for the sector; Australia and PNG have agreed to use existing sector planning mechanisms to direct both donor and government resources; a trust account has been developed; the number of projects has been reduced; a monitoring mechanism put in place; and health funding agreements between national and provincial governments established. The HSIP approach where the GoPNG takes leadership in managing resources is both achievable and preferred by GoPNG staff.

AusAID funds are provided through a Trust Account, not directly to the budget. Ultimately, funds will be delivered through both the national and provincial governments. The rate of increase of provision of funds will "depend upon performance … whilst the details of exactly how this will be operationalized will be developed over the next few months, it is expected that a very pragmatic approach will be developed that emphasises simple performance indicators, clear and transparent measurement criteria, and mutually agreed rewards and sanctions. It is also expected that initially the focus will be on rewarding good performance (via recognition, increased funding etc) rather than punishing poor performance. However, as we go down this road, AusAID will need to be prepared to follow through on agreed consequences for poor performance and potentially reduce some or all funding to particular provinces."

It is too early at this stage to assess the performance of the HSIP, other than to observe that it has done well to establish the building blocks. The HSIP works on the incentive structure in several ways:

- provinces will be competing against each other for funds on the basis of performance agreements with the NDOH; and

76 *PNG HSIP: Update Paper Number Four.*

- the NDOH's own funding will be performance-based and pushed towards what AusAID regards as good behaviour; the price for AusAID's use of NDOH systems being a 'seat at the table' to discuss policy and management issues by using the GoPNG systems (a model preferred by the recipients) in one sector it provides motivation for other GoPNG departments to emulate the National Department of Health (NDOH) and hence possibly get the same good treatment from the key donor; and motivation for the NDOH to not stuff up their chance to escape from relentless project coordination meetings.

The incentives aspects of the HSIP seem to be primarily motivated by the allocation-efficiency purpose. However, there are some elements that potentially aim at behaviour change, particularly through the use of competition between provinces and policy leverage at the national level. It seems to the current review that the primary challenge, from the incentives perspective, will be to use the HSIP to influence policy with the NDOH itself, an agency that is clearly not in a competitive market and from which it will be politically very difficult for AusAID to withdraw funding and make promises of incentives (rewards and punishments) credible.

Project level experience with incentives

As was seen in the discussion of other donors' approaches, considerable potential exists for relatively traditional project-delivered aid to make better use of incentives.

One issue that was raised with the review was the possibility of incorporating stronger 'stop-go' review mechanisms in projects to establish partner ownership and commitment to the project. AusAID is moving in this direction in other contexts; most importantly, stop-go points based on contractor performance are being used quite seriously in several programs.

However, this review could not find an example of an AusAID project that had reached a stop-go point, dependent upon partner inputs and progress to date, and been terminated. The probable failure of any threat to do so (and hence, lack of credibility of incentives for partners to provide the relevant inputs) comes because such a process would violate one of the principles set out earlier in this report. In this context, there is no adequately competitive market of potential aid recipients; there are too many 'transaction costs' and sunk resources for AusAID to shift funds from one project to another in any but the most extreme circumstances. For example, the Bapedalda East Java Institutional Strengthening project in AusAID's Indonesia program included a stop-go process by which agreement to proceed was made conditional upon progress to date at a specified review point. However, EVAL's recent *Review of Institutional Strengthening and Technical Assistance Facilities* found that AusAID could not exercise the stop option without penalty.

Other uses of incentives seem to be more potentially fruitful than blunt threats to withdraw assistance from any particular project. As in other instances cited earlier, successful use of incentives and contestability at the project level seems likely to occur when there is a competitive market of potential aid partners, and Australian aid is sufficient to leverage behaviour change. The Philippines-Australia Vulnerable Groups Facility featured in the case study below is one example where such a situation exists and can be used to solve the standard aid delivery problems of ownership and sustainability, as well as serve the allocation-efficiency and behaviour change purposes of using incentives and contestability.

CASE STUDY – PHILIPPINES-AUSTRALIA VULNERABLE GROUPS FACILITY (PAVGF)

The objective of the PAVGF is to increase basic social services to vulnerable groups by funding selected, successful and well-targeted GoP programs or projects that provide such services but which face budgetary constraints. The PAVGF has so far financed three projects since its inception in January 2000.

The logic underpinning the PAVGF is congruent with the allocation-efficiency dimension of incentives. Assistance is only provided through programs that reduce poverty among vulnerable groups, have a proven track record and that are already strongly supported by the GoP. The criteria governing the selection of projects for funding under the PAVGF include:

- programs must reduce poverty and improve equity and governance;
- activities must adhere to GoP policies and have a high GoP priority;
- activities must be currently operational and performing well;
- implementing agencies must demonstrate a commitment to their programs; and
- programs must be sustainable within likely future PAVGF funding and GoP budgets.

VGF's success is therefore seen to rest with its ability to "reward demonstrated implementation performance in the social sector and provide existing programs with the capacity to expand or hold their position during periods of extreme budgetary constraint"[77]

By working through existing GoP systems, the PAVGF also indirectly addresses the behaviour-change dimension of incentives. By stipulating internal governance criteria for GoP programs that receive budgetary support – evidence of effective monitoring, evaluation and accountability processes – the PAVGF exerts a potential incentive for implementing agency reform in key areas such as accountability and procurement.

77 PAVGF (September 1999) *Project Design Document*, p.13.

Other approaches

A large range of AusAID activities potentially make significant use of incentives and contestability principles. Just two forms of aid – TAFs and project support through Pacific Regional Organisations – are highlighted below. The findings confirm those of the rest of this Review as to the importance of particular principles.

CASE STUDY – TECHNICAL ASSISTANCE FACILITIES (TAFS)

A number of TAFs are widely considered successes. The recent review of institutional strengthening and of TAFs found some impressive achievements and high yield activities. For example, in one case these included high profile, effective, low cost interventions that facilitated significant benefits in areas such as money laundering and banking reform.

TAFs are usually seen as valuable because of their flexible, in-country management and their ability to respond quickly to a range of requests for short-term assistance. The recent review confirmed their value in this context. However, there is an incentives dimension of TAFs that is not often explicitly recognized. One of the key strengths of TAFs is that their demand-based approach has potential to greatly increase partner government ownership over specific aid interventions. However, the TAF is intrinsically demand based only for sub-activities. By establishing the overall focus of the TAF (eg 'reform') we establish a donor-driven incentive for agencies to engage in a particular activity, through the implicit compact "If you engage in reform, we will support you". By having clear criteria for approval of sub-activities, we can give an even more precise message about what sort of behaviour we wish to encourage.

The implications are clear. For TAFs to make most use of incentives they should:

- have a clearly stated focus;
- have open and clearly understood criteria for sub-activity selection that will push partner agencies into particular areas of interest to AusAID; and
- allow a number of partner agencies to apply for support, to increase competition and the possibility of rewards in the form of technical assistance going to those areas that are both allocation-efficient and inclined to behaviour change.

CASE STUDY – PACIFIC REGIONAL ORGANISATIONS (PROS) PROJECT FUNDING

PROs receive funding in three forms: core, program and project. MOUs are entered into with each organisation, based on agreed Program Strategies. Ministerial agreement has just been reached for proposed increased contributions to programs to be offset by reductions in projects.[78] The motivation for this change is the need to adopt a more partnership-based approach to the PROs. Specifically, directing too large a proportion of funds through projects can entail excessive management and reporting costs for both AusAID and the PROs and potentially lead to a more confrontational approach if AusAID sees the PRO as a contractor rather than a partner organisation worth strengthening in its own right.

The current approach contrasts with that set out several years earlier in the *1999-2001 Pacific Islands Development Strategy*, itself a significant reform from previous arrangements. The 1999–2001 Strategy set out to do the opposite; to set core and program funding "at lower levels than are now paid" with the balance allocated competitively to projects. The intention was to use competition mechanisms to improve the quality of projects and provide incentives for PROs (ie., both the 'allocation-efficiency' and 'behaviour-change' motivations for use of incentives).

The change has come about because of the management costs for both the PRO and AusAID of individually funded projects and the difficulties of seeing the relationship as fully partnership-based in the context of competitive allocation of funds and dangers of perceived or actual AusAID micromanagement. The reform is supported by recent independent (managed by PIA) in-depth reviews of SPREP and SPC, both of which identified reasons, in the interests of the management of the regional organisations, for increasing the emphasis on program funding. For example, the review of the SPC recommended "...it would be useful if a greater percentage of funding support for the organisation were made in the form of voluntary contributions with greater flexibility in the use of program funds (possibly even untied)."

While efforts will continue to be made to incorporate elements of an incentives approach by favouring the "more strategic and sustainable PRO programs", the need for change from the initial project-based approach indicates a salutary lesson on the dangers of adopting a hardline competition and incentives-based approach. It is important that any such approach not impose unacceptable additional costs in terms of (micro)-management, including any developments that can compromise the development of partner organisations. One way around this problem seems to be picking the appropriate level (in this case, program rather than project) for competition.

78 (4 October 2002) Ministerial Submission: *Pacific Regional Organisations: Aid Allocations*

Program Strategies and Incentives

Incentives clearly have an important part to play at the country strategy level. One of the principles supported by this review is the importance of intra-country incentives regimes for aid allocation; meaning at a minimum the establishment of a competitive market of potential aid partners. This approach needs to be taken up at the country strategy level, with potential impact on the focus of an entire program of assistance, if significant leverage over partner behaviour is to be achieved.

CASE STUDY – 'PROGRESSIVE ENGAGEMENT' IN THE PHILIPPINES' PROGRAM

Under this process, the first level of Australian support is on a small scale and progression to larger activities is dependent upon the demonstrated performance and commitment of the particular partner agency at the earlier stage. Commitment is assessed by the priority accorded an activity by the partner agency in the allocation of resources within existing budget settings.[79] One of the main general principles is that whilst planning for the Philippine country program strategy should be long term (10 years), commitments should be short term (2–3 years). This approach has been generally well received from the GoP because it imparts a high degree of ownership and the logic of progressive engagement has fed into individual projects and programs like the Philippines Australia Vulnerable Groups Facility, the Philippines Australia Local Sustainability Program and the Basic Education Assistance to Mindanao project.

The recent mid-term review of the Philippines country program strategy found that the principle of progressive engagement "is a very important approach to managing risk in the Philippines" and "provided a way for AusAID to identify productive areas of engagement and efficient counterparts, and to test effectiveness of approaches to delivery assistance before large-scale resources are committed".[80]

The review also recommended that in order to improve the integrity of incentive signals, the principles and the criteria underpinning progressive engagement need to be more fully articulated to counterparts and partners. In particular, the point at which 'disengagement' from a particular partner agency becomes an option needs to be more fully elaborated. Signalling of this point and the criteria underlying it will prove to be the critical incentive 'test' of progressive engagement, particularly if the budgetary situation of the GoP continues to decline.[81]

79 *Philippines Country Program Strategy*, 1998/99 –2002–03.

80 (March 2002) *Mid Term review of Philippines* CPS, p.36.

81 *Mid-term review of Philippines* CPS, p.36.

Strategies like progressive engagement are clearly not universally applicable across the variety of country contexts and capacities in which AusAID operates. Strategies for enhancing incentives need to be tailored to meet particular country program objectives, individual country circumstances and the activities of other donors.

In this regard, the enhanced partner dialogue capacity of AusAID envisaged by the *Strategic Plan*[82] necessarily implies an improved capacity to underpin the program strategy process with high-quality analysis of both existing incentive structures within a partner government as well as the likely effects of particular forms of aid interventions upon these structures. This analysis could encompass both the behavioural-change as well as the allocation-efficiency aspects of incentives.

In terms of behaviour-change, the *Strategic Plan* offers an opportunity to better identify those partner government and service delivery agencies operating at the 'margins' of reform. As argued, it is these agencies that will be the most responsive to the application of various forms of incentives aimed at pro-poor reform. In terms of allocation-efficiency, improved partner dialogue also presents an opportunity to better identify those priority areas where there exists nascent 'markets' for policy reform/service delivery and the sorts of flexible and contestable delivery mechanisms, including SWAps or TAFs, that would further catalyse these markets.

82 (2001) *AusAID Strategic Plan*, p.10–3.

5 FINDINGS AND PRINCIPLES

The following principles apply for best use of contestability and incentives in the aid program:

- Incentives and contestability in aid delivery can be motivated by either of two purposes – allocation-efficiency or behaviour-change – and design of any particular intervention should be carefully thought through in the light of which (or both) of these purposes is served
- Incentives and contestability to improve aid effectiveness and to motivate behavioural change for development should be regarded as an issue at all levels of programming – in particular, of most importance within a specified country allocation, not just a matter of allocation between countries (a mistake fallen into in the general international debate)
- The Australian aid program should make more use of incentives and contestability of aid delivery, particularly at the intra-country level, building on the experience of the PMR scheme and the PNG Incentives Fund. Incentives and contestability should be treated as a key means of ensuring aid effectiveness, particularly in poor governance environments.
- An analysis of the existing incentives structure and our potential impact upon it should be undertaken in designing any major new aid intervention; and in particular when developing program strategies and identifying appropriate sectors and form of delivery for AusAID intervention. Incentives analysis should take into account both monetary and non-monetary incentives and pay due attention to social, cultural and political factors
- Where possible, aid should be allocated competitively between a significant number of comparable potential aid partners (possibly different government agencies), for each of whom Australian aid is a material additional resource
- Particularly when dealing with poor performing countries or agencies, contestable allocation should be based on the direction of *improvement* rather than on *absolute* standards; ie, competitive allocation should be based at least in part on comparison with individual agencies' past performance rather than cross-sectionally with other agencies
- As a useful checklist, criteria for aid allocation within an incentives scheme should be:
  - as objective as possible, independently verifiable and show performance under the control of those competing for funds
  - connected to Australia's strategic objectives
  - publicised widely and used as an entrée for policy dialogue with partner agencies

- Non-project forms of aid such as SWAps and TAFs offer significant potential to make better use of incentives but will not get the incentives right unless principles such as ‘working with a market of competing, marginal reformer, potential aid partners’ are followed
- Better use should be made of contestability and incentives principles even in traditional project aid; every effort should be made to find potential markets of competing partner organisations with which formal incentive-based aid allocation structures can be established
- Contestability approaches should carefully consider the management costs of different forms of competition
- Incentives and contestability approaches must not lose sight of the overall poverty reduction objective of the aid program

The following table codifies the core principles with relation to the case studies examined by this review. It can be seen that no particular case study satisfies all the suggested principles, although some (eg the ARC competitive grants scheme, and the World Bank’s water project in Vietnam) come very close and are undoubtedly good practice examples of highly effective contestability and incentives schemes.

Case study	Purpose – behaviour change or allocation-efficiency	Competition between a significant number of similar entities	Donor input a significant marginal addition	Criteria adequately reflect policy aims	Formal, transparent and rules-based approach	Longitudinal rather than just cross-sectional comparisons
ARC	Efficiency	Yes	Yes	Yes	Yes	No
PNG Manu-facturer of the Year	Behaviour	Yes	No	Yes	Yes	No
New Enter-prise Incent-ive Scheme	Efficiency	Yes	Yes	No	Yes	No
LLDC status	Efficiency	Maybe	Maybe	No	Yes	No
IDA	Efficiency	Maybe	Maybe	Yes	Yes	No
MCA	Both	Maybe	Maybe	Yes	Yes	No
ACP-EU	Efficiency	Maybe	Maybe	Yes	Maybe	No
Kecamatan project	Both	Yes	Yes	Yes	Yes	No
Vietnam water project	Both	Yes	Yes	Yes	Yes	No
CIDA enhanced partnerships	Both	No	No	Yes	No	No
PMR	Both	Maybe	No	Yes	No	Yes
PNGIF	Both	Yes	Yes	No	Yes	recommended
PNG Health SWAp	Efficiency	Maybe	Yes	Maybe	Maybe	No
PAVGF	Efficiency	Yes	Yes	Yes	Maybe	No
TAFs	Efficiency	Maybe	Yes	Yes	No	No
Pacific Regional Organisat-ions projects	Both	Maybe	Yes	Yes	No	Maybe
PHIL program strategy	Efficiency	Yes	Yes	Yes	No	Maybe

ANNEX A – TERMS OF REFERENCE

Terms of Reference for review paper on use of incentives

QUESTIONS

1. What impact – primarily examining impact in line with their objectives, but also unintended impact – have AusAID's Incentive Schemes had on the behaviour of targeted organisations (governments, government agencies, other organisations, etc), and **how might that impact be increased in future use of incentive approaches?**
2. What have been the impacts of administering these schemes on Australian (particularly AusAID) relationships with partner governments and other partner organisations?
3. Have the Incentive Schemes delivered high quality aid to support reform, and **how can future use of incentives be targeted to assure higher quality and appropriate focus?**
4. What have been the strengths and weaknesses of the design and implementation of the Incentive Schemes? What are the relative strengths and weaknesses of the different approaches (for example, the PMR scheme works at the country level and is additional to country program allocations, while the PNG Incentive Fund represents a possible transfer of resources from the Government of PNG to other organisations within PNG or even to other countries).
5. What criteria (implicit and explicit) have been used for allocation of funds, have these criteria been effective, and **what criteria might be more appropriate for future schemes?**
6. What is international experience and guidance on incentive schemes and **how might they be useful for AusAID?**
7. How can incentives and contestability contribute to a "**second generation**" **approach to governance** in the aid program?
8. **What innovative options are available** to AusAID to incorporate incentives and contestability of aid allocation into our programming? – including but not limited to Sector Wide Approaches, stop/start decision points in projects and programs, and leverage for AusAID involvement in policy making (a "seat at the table")

PRIMARY SOURCES OF INFORMATION

1. Guidelines, criteria, project documentation, etc for the PMR and the PNG Incentive Fund
2. 2000 MPAC review of PMR
3. 2001 EVAL review (soon to be published) on Australia's assistance in the Asian economic crisis
4. 2002 Draft Mid Term Review of the PNG Incentive Fund
5. Interviews with AusAID officers (incentive scheme managers; other SPA and PNG CPMs and directors; posted officers; officers in ASIA and other Asian desks with experience in promoting good governance)
6. Interviews with selected partner organisation officials
7. Interviews with DFAT and ONA officials and appropriate outside experts
8. Literature (including academic papers, donor websites, donor policies, World Bank research papers, etc) on incentive schemes and on conditionality

OUTPUTS AND TIMING

1. Report not more than 30 pages with an Executive Summary not more than 3 pages addressing the above questions but focusing on AusAID's use of incentives and other donors' approaches rather than the future
2. Options paper, following Executive and agency consideration of the first paper

Review of Incentives and the Australian Aid Program
Evaluation and Review Series
No. 32 June 2003

This Review examines international and Australian experience with the use of incentives in aid delivery.

The Review found that there are two purposes for using incentives and contestability in aid delivery; promoting behavioural change and allocating aid in the most efficient manner. Both purposes can be met in aid delivery, but the first purpose can only be achieved when the aid funds on offer are significant relative to the existing supply and demand for reform.

A core finding of the Review was that incentives and contestability are most likely to be effective additions to aid delivery mechanisms when a situation of competition can be established between a significant number of essentially similar organizations, particularly when competition is established within a country rather than between countries. The Review found that incentives will be most effective when the donor sets appropriate criteria for aid allocation and is in a position to easily shift resources from one entity to another.

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