Overcoming the Samaritan's Dilemma:

Collective Action Problems within Multilateral Agencies

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under the Direction of

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ABSTRACT

Large amounts of aid delivered to low-income countries with poor institutions and governance can create a cycle of aid dependence. As a result of this phenomenon, recipient governments have weak incentives to efficiently utilize received funds, and generate sustainable development. Despite that, multilateral agencies seem unable to withdraw support, or even assign penalties for such governments. Consequently, every successive round of interaction between aid receiving governments and multilateral agencies resembles a 'Samaritan's Dilemma' game. Under this, agencies are unable to threaten governments with aid termination, and recipient governments continue expending little effort towards efficiently utilizing development funds, and reforming domestic institutions. Such agents can only be induced to alter their behavior if multilateral agencies can credibly threaten them with aid withdrawal. This measure however is only successful if multiple agencies participate in shifting strategies. Collective action problems arise in such a scenario where individual agencies first, find it difficult to cooperate with others, and second, struggle to coordinate their actions. To demonstrate these challenges, I use a Public Good-Prisoner's Dilemma game to illustrate the first concern (cooperation problem) and an Assurance game to demonstrate the second (coordination problem). These two hurdles are presented as a possible explanation for why multilateral agencies have thus far, been unable to overturn the cycle of aid dependence.

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CHAPTER 1

INTRODUCTION

The idea that aid is a mechanism for inducing economic progress in developing countries is virtually an axiom in most aid donating countries and multilateral agencies. Aid comprises an integral part of the global development strategy, and it seems unlikely that it will be completely phased out, at least in the near future.

Support for aid is largely based on the assumption that it has welfare improving capabilities. However, there exist plenty of scenarios where aid or development assistance has not yielded such results. Most existing empirical work on the topic as well as my own findings suggests that the link between aid and economic progress has mostly been ambiguous. There remain notable examples of countries that have successfully made use of aid towards development generating activities, but there also remains a large pool of countries whose development outcomes are incommensurate to the scale of financial assistance they have received. Despite that, most of these countries continue to receive assistance in one form or another from multilateral agencies.

Cases such as those motivated my decision to study why multilateral aid agencies are disinclined to terminate their engagement with aid receiving countries even when there is no conclusive evidence that development assistance has yielded favorable outcomes. Particularly, I was curious about what agencies gained from such an interaction, and how exactly the benefits of continued aid assistance outweighed termination of disbursements.

To answer this question, I first went back to clarify what happens at the recipient government end of this interaction. I find that for governments in aid receiving countries, the discrepancy between aid flows and poor development outcomes can be attributed to an 'aid dependence' phenomenon. Aid dependence refers to a situation where the recipient government begins to rely considerably on foreign sources to perform key operational and fiscal tasks. Alternatively, it could refer to a situation where the recipient government is discouraged from expending any individual efforts towards inducing development because it knows foreign assistance is on its way. Such behavior is essentially motivated by the fact that recipient governments continue to receive development assistance even if they have made no concerted efforts to effectively utilize received funds. In fact, such guarantees can potentially induce 'moral hazard' behavior at the part of recipient governments, where they may pursue unproductive policies that are more likely to induce agencies to sustain funding.

In the long term, such reliance on aid also has consequences for the quality of institutions in developing countries. For instance, large amounts of aid can give rise to phenomena such as rent-seeking, fragmented budgets, and a crowding out of domestic investment. When aid is continuously delivered to countries with weak institutions, this can further undermine domestic incentives to make the difficult decisions needed to repair domestic institutions. In the absence of any multilateral agency penalties for such behavior, recipient governments are unlikely to amend such behavior.

The focus of my study then is on the response, or lack thereof of multilateral agencies to such behavior. We should expect there to be some consequences for misappropriation or under-utilization of aid flows from the multilateral agencies. Yet we still find that in some aid dependent countries, multilateral agencies are unable to effectively withdraw, or at least threaten to withhold development assistance.

I find that this behavior of multilateral agencies is driven by a need to supply 'warm glow' effects to donor country governments and constituents. 'Warm glow' refers to the utility, or internal satisfaction one derives purely from the belief that you are improving the well-being of others (Andreoni, 1991). Warm glow effects are different from altruism in that they do not depend on observing the utility of others. In this case, it refers to the satisfaction donors receive from allocating and distributing a certain amount of money for 'progress' in developing countries. Thus, agencies must find a way to pacify donor governments and constituents that the aid they are supplying is being put to use for 'development'. Poor evaluation, and feedback mechanisms, driven partly by poor institutional quality in aid dependent countries ensures that the only way agencies can achieve this is by emphasizing those parts of their performance that can readily be observed. This ultimately turns attention towards the quantity of projects initiated, and the amount of money disbursed. In such a setup, if an agency withholds funds from a particular project or country to 'punish' the recipient government, the donor community would interpret that as that agency's inability to leverage all its resources. Thus, stringent transfer rules are simultaneously linked to individual concerns for survival

Consequently, interactions between multilateral agencies and recipient governments come to resemble a Samaritan's Dilemma game. This game is an adaptation of Buchanan's (1979) original concept that a Samaritan's compassion, or failure to act strategically can actually lead to more sub-optimal outcomes. In my version of the model, externally it may seem that the multilateral agency is acting out of compassion, but essentially its failure to act strategically is driven by the idea that agencies must provide aid in any condition. I model this interaction using a two party game with ordinal payoffs. A multilateral aid agency acts as one player, and interacts with an aid dependent recipient government who is the player on the other side. The essential problem with this interaction is that there are no consequences associated with poor efforts from the recipient government side. Moreover, the level of effort expended in period (*t*-1) has little bearing on aid disbursed in period (*t*). Thus, many multilateral agencies behave as though they are not involved in a 'game;' there is a lack of strategic behavior on their part. Whereas one might expect agencies to behave as a Stackelberg leader, we find that multilateral agency strategy often does not respond to that of the recipient. In fact, aid provision is the dominant strategy for multilateral agencies, while 'low effort' toward institutional reform ends up being the response of recipient governments.

Breaking away from this setup is made all the more difficult because of each agency's concerns for survival and reputation. In terms of the survival, the presence of multiple agencies within a particular country can make it difficult for an agency to unilaterally impose harsh transfer rules. This is because governments can just as easily switch over to organize contracts and projects with another, more lenient agency. This can then drive more stringent agencies out of the market. In terms of reputation, the presence of multiple agencies within a country also often leads to a certain degree of tacit collusion between agencies. Benefits from this relationship include economies of scale in collectively soliciting donor funding, public support for each other's activities, and agreements not to actively undercut each other in other markets. Thus, any agency altering its strategy must also be prepared to bear the consequences of ostracism within the aid community.

To truly extract commitments from recipient governments, it is imperative that agencies jointly issue demands or threats. This however gives rise to two kinds of collective action problems, coordination, and cooperation. I will model the first using Public Good-Prisoner's Dilemma game, and the second as an Assurance game. The cooperation problem precedes the coordination one. Unless agencies do not first see merits to working collectively with others, it is unlikely that they will reach a stage where they begin considering assurance from others. These models will help illustrate what the challenges to collective action are, and from this, I will provide two potential sources that could help overcome these.

Thus, this thesis not only pinpoints the role multilateral agencies play in allowing aid dependence to continue, but also anticipates the challenges that arise in overcoming it. It also places the decisions of individual agencies within the context of the larger multilateral agency industry. In envisioning both hurdles and solutions to overcoming aid dependence, it pulls from psycho-social literature, and also adapts literature on social movements and welfare programs to the aid problem.

The thesis is arranged in the following format: Chapter 2 introduces the concept of development assistance, and provides an overview of its historical significance. Chapter 3 identifies aid dependence as a hindrance to optimal development outcomes in certain countries, and discusses the institutional damage it can potentially bring about in recipient countries. Chapter 4 then focuses attention towards multilateral aid agencies, and outlines the context in which they operate both internally, and externally. Based on this background, Chapter 5 provides an illustration of agency-recipient interactions as a Samaritan's Dilemma game. Next, Chapter 6 anticipates the hindrances to the collective action that is needed from the multilateral agency side to overcome aid dependence, and ends with some potential solutions to those hurdles. Chapter 7 concludes.

CHAPTER 2

OVERVIEW OF DEVELOPMENT ASSISTANCE

Development aid or developmental assistance is a transfer of economic resources from one wealthy entity (country or agency) to a presumably poorer country to facilitate economic development and welfare. Although development aid can be presumed to have strategic motives, facilitating development is its primary goal. Development assistance could take the form of a grant, loan, or technical assistance from an industrialized country (bilateral source), or from an intermediate organization (multilateral source).

My argument will focus exclusively on aid channeled through multilateral sources. Multilateral aid involves a joint delegation by donor countries with different interests to a single international agency, such as the United Nations Children's Fund or the Asian Development Bank. These agencies then further design, and set up projects, or pass on money to governments to implement them. Thus, multilateral agencies provide an institutional setting that responds to demands from donors as well as recipients (Martens, 2004: 20). As will be explored later on in this thesis, it is this need of multilateral agencies to respond to demands from both sides that set up the aid dependence problem in the first place.

Aid contributions qualify as multilateral assistance if: i) they are made from an international institution which conducts all or a significant part of its activities in favor of development, ii) from an institution whose members are governments, and; iii) whose funds from donor countries are pooled and become an integral part of the institution's financial assets (OECD, 2006: 22). Aid that does not fulfill these criteria is usually classified as bilateral assistance. The rationale behind donation pooling is essentially to dilute "donor identity," and allow multilateral agencies to disburse funds at their own discretion. Although this is largely the case, it by no means suggests that multilateral agencies are not highly sensitive to pacifying the demands of donors.

2.1 Aid Delivery through Multilateral Agencies

Industrialized or wealthier countries may choose to implement development through multilateral agencies because there are certain economies of scale and scope associated with them. Multiple actions by individual donor countries within similar sectors could develop redundant capabilities. Moreover, before disbursing money, each donor country may need to undertake the process of collecting information from recipient countries. A lack of this may cause repetition or redundancy. Multilateral approaches on the other hand are more capable of overcoming the problem of project overlap, even though they may not be completely free from it either. These agencies are also better able to maintain a database of information on developing countries, thus can reduce the costs of information gathering, while also enhancing the credibility of that information (Rodrik, 1996 in Martens, 2004: 20). Moreover, multilateral agencies can specialize in specific issues for which they may be the most superior source of worldwide information (the World Health Organization on health policy issues; the FAO in agricultural and food issues; etc.)

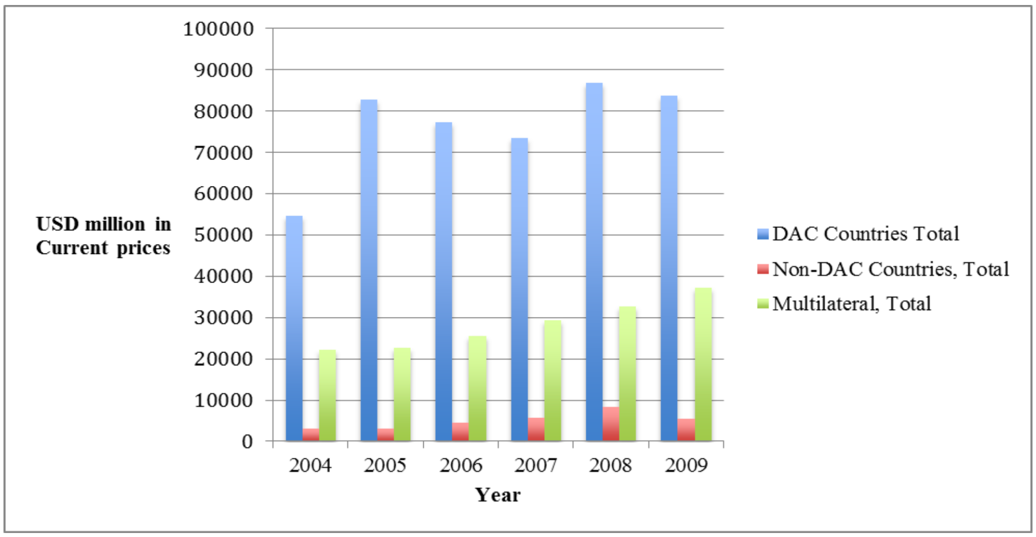
Generally speaking, multilateral aid agencies assume two main forms i) Multilateral development banks (MDB's) that operate on the basis of loans, and ii) Grant-based multilateral aid agencies (MGA's). The former refers to organizations such as the World Bank, Asian Development Bank, Islamic Development Bank, and Arab Bank for Economic Development in Africa among others. The latter includes, but is not limited to organizations such as the New Partnership for Africa's Development (NEPAD), and the various specialized agencies of the United Nations involved in thematic development programs (WHO, FAO, ILO, UNICEF, UNHCR, UNEP, etc.) Budgets for most of these agencies originate from the pockets of taxpayers in donor countries. This is particularly true for MGA's that are wholly dependent on donor funds. Contributions to such agencies are also usually based on GDP; industrial countries share the largest budgetary burden. This in turn makes it difficult to isolate donors' national, political and economic interests from agency decisions. MDB's on the other hand have relatively greater financial autonomy because their funds are mobilized on international capital markets instead of directly coming from taxpayers' money. Still however, they are answerable to multiple principles (member states) that populate their executive branches.

At least one-third of all development assistance provided by industrialized countries is channeled through multilateral agencies. The decision of industrialized countries to contribute both to multilateral agencies, while still maintaining independent bilateral aid systems is an attempt to further their particular aims (strategic foreign policy interests, support for former colonies, etc.,) and simultaneously achieve common goals (e.g., poverty reduction) at lower cost (Mavrotas and Villanger,2006). Moreover, public opinion surveys in donor countries suggest humanitarian and development motives are far more important than diplomatic or commercial objectives in explaining popular support for aid (McDonnell, Lecomte and Wegimont (2003).This argument is furthered by Martens et al. (2002, p. 37, 47, and 188-189) who argue that a donor countries often set up, and sustain multilateral agencies to make such agencies less susceptible to political demands that "force bilateral donors to pursue parochial, strategic and non-altruistic policies in recipient countries." In contrast then, multilateral agencies mostly exist for the purpose of furthering "non-strategic," and "altruistic" goals.

As can be seen in the graph below, though bilateral aid (DAC Countries

Total[1]) has always provided a greater share of development assistance than multilateral aid, multilateral aid has steadily maintained an upward trend over the 2004-2009 period.

Figure 1.1
Development Assistance Provided to All Developing Countries 2004-2009 (Constant 2006 USD Million)



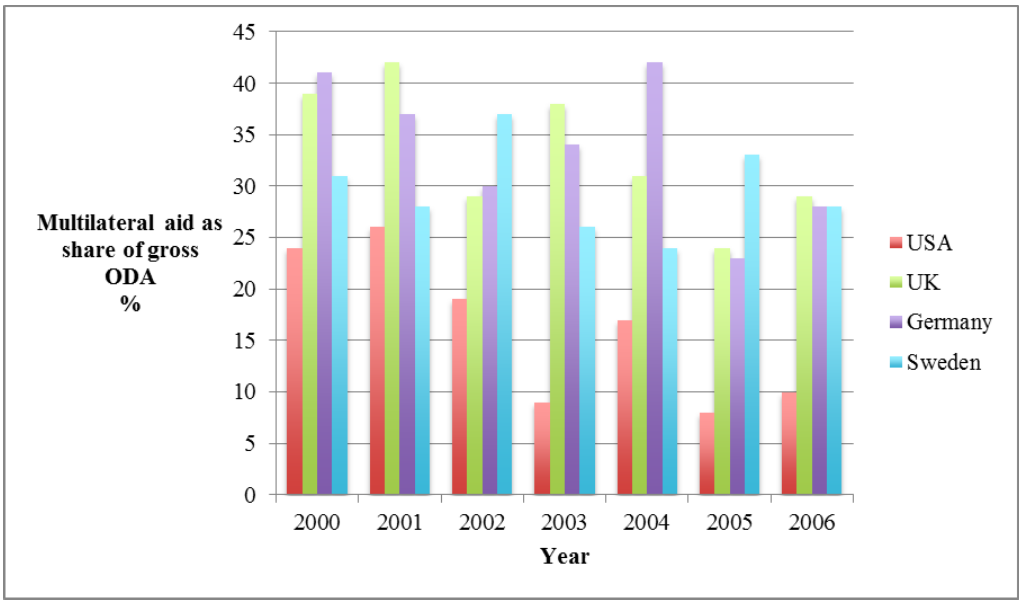
Source: OECD 2008 Development Assistance Committee Report on Multilateral Aid

As can be seen in Figure 1.2, multilateral aid that comrprises a large proportion of aid supplied by industrialized countries. I have listed below four prominent providers of development assistance (both multilateral and bilateral),

[1] Consists of OECD industrialized countries that are members of the Development Assistance Committee. Member states include: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain. Sweden, Switzerland, United Kingdom, United States

USA, UK, Sweden and Germany. With the exception of the USA, at least a quarter of all ODA from these countries was been supplied through multilateral agencies.

Figure 1.2
Multilateral Aid as Share of Gross ODA from OECD Countries (%)



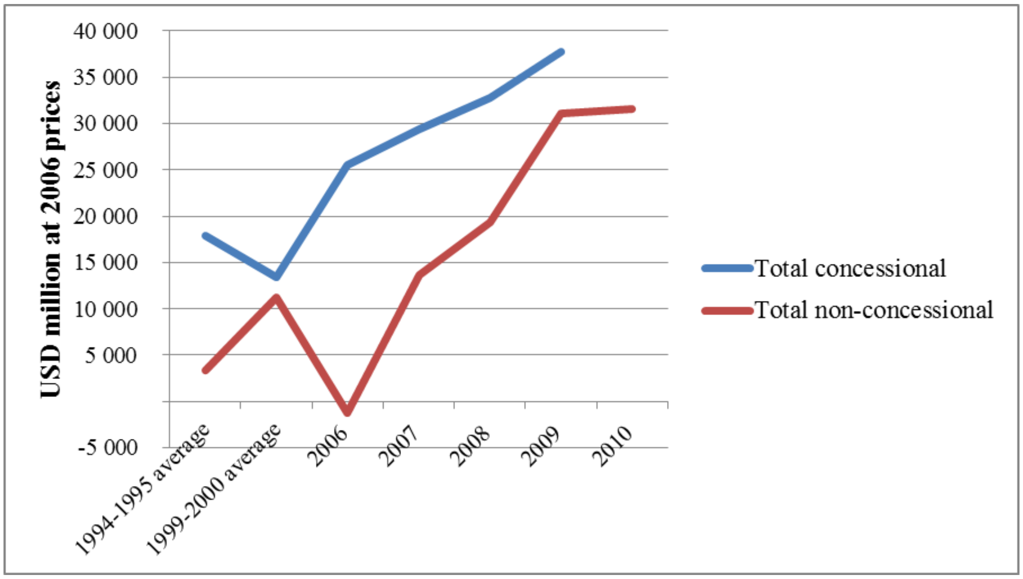
Source: OECD 2008 DAC Report on Multilateral Aid

Based on Figure 1.4, we can conclude that as of 2006, flows of development assistance from multilateral agencies have also been on the rise for both concessional and non-concessional aid. This is despite the fact that over the

2000-9 period, the relationship between aid and growth over the previous decade (1990-2000) has been empirically found to be negative[2].

[2] Rajan and Subramanian (2005), Hansen and Tarp (2000), Dalgaard and Hansen (2000)

Figure 1.3
Net Disbursements of Concessional and Non-concessional Development Assistance by Multilateral Agencies

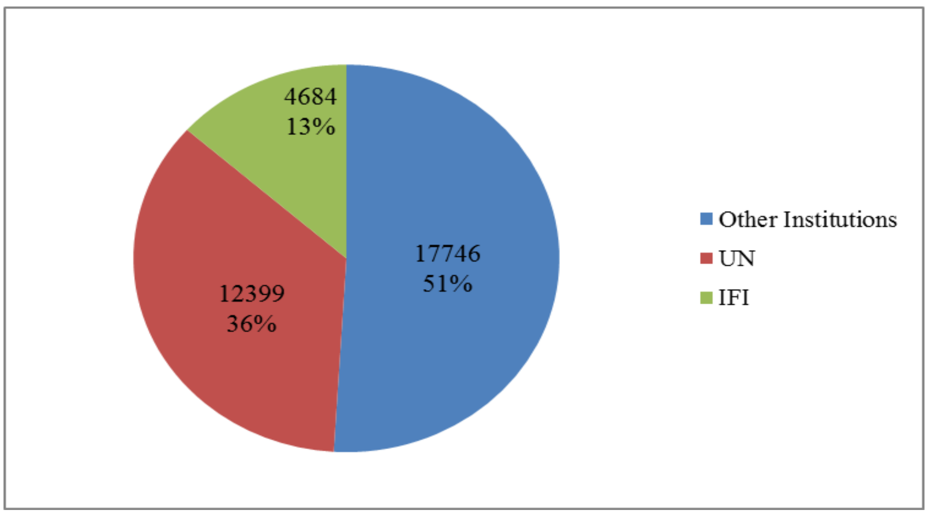


Source OECD DAC Aggregate Statistics

For the year 2010, a little more than half of all development assistance (50.9%) originated from regional or specialized agencies, or groups. These include European Union institutions, the Global Fund, the Islamic Development Bank and the OPEC Fund for International Development, among others. International Financial Institutions, such as the International Monetary Fund, World Bank, and the European Bank for Reconstruction and Development etc. provided around 35.6% of all development aid. Thematic agencies of the United Nations, such as the United Nations Development Program, Food and Agricultural Organization, and the United Nations Children Education Fund provided around

13.4% of all multilateral aid. By development assistance, I am referring specifically to funds that are designated especially for the purpose of encouraging development activity; other types of aid such as hazard relief or food aid are not included.

Figure 1.4
Concessional Flows by Multilateral Agency Type for 2010 (USD Million in 2006 Prices)



Source: OECD
International Financial Institutions (IFI): AfDB, AsDB, CarDB, EBRD, IDA, DB Sp.Fund, IMF, Nordic Dev.Fund
United Nations: FAO. UNAIDS, UNDP, UNFPA, UNHCR, UNICEF, UNRWA, UNTA, WFP, WHO, IAEA, UNECE and UNPBF)
Other Institutions: EU Institutions, GAVI, GEF, Global Fund, Montreal Protocol, Arab Funds(AFESD, BADEA, Isl. Dev. Bank and OFID

2.2 Motives for Development Assistance

The motives for providing development assistance vary substantially from donor country to country and from multilateral agency to agency. A donor government's decision to provide development assistance to developing countries is influenced in part by some, if not all of the following motives: i) moral and humanitarian concern, ii) national security concerns, iii) perceived long-term economic benefits from overall development. Donor nations frequently address aid motives related to security and gains from development through bilateral aid arrangements. The motives for simultaneously donating through multilateral agencies are more often altruistic and humanitarian. Multilateral agencies in particular pride themselves on being "independent of the interests of any single country member" (DFID).

That being said, we cannot disregard the fact that the survival of these agencies is mostly based on sustained contributions from donor countries and tax constituents within these countries. In that sense, multilateral agencies must demonstrate an unwavering commitment to pacifying both altruistic and 'warm glow' needs of donors.

An examination of a cross-section of multilateral agencies' goals and mission statements reveals a repeated emphasis on assisting developing countries to realize their own economic potential; references to other motives are notably absent. The African Development Bank states its mission as: "help reduce poverty, improve living conditions for Africans and mobilize resources for the continent's economic and social development. With this objective in mind, the institution aims at assisting African countries – individually and collectively - in their efforts to achieve sustainable economic development and social progress." The OPEC Fund for International Development, "to promote cooperation between OPEC Member Countries and other developing countries as an expression of South-South solidarity, and to help particularly the poorer, low-income countries in pursuit of their social and economic advancement." The United Nations Development Program (UNDP) advocates itself as helping: "developing countries attract and use aid effectively. In all our activities, we encourage the protection of human rights, capacity development and the empowerment of women" (UNDP).

The discourse on the moral obligation to assist countries unable to direct themselves towards a sustainable path on development presents a plethora of contrasting views. Arguments put forth by Peter Singer implore individuals to consider aid as an obligation of humanity. Singer (1972: 231-2) asserts that it is the moral imperative of individuals to leverage everything within their power to prevent something bad from happening, as long as we are doing so without compromising anything of comparable moral significance. This is supplemented with a more practical appeal that individuals in affluent nations can do something to reduce the number of starving people in the world without giving up basic necessities of life. Singer's argument also undermines the barriers erected by state boundaries, geographical remoteness, or cultural dissimilarities: "It makes no moral difference whether the person I can help is a neighbor's child ten yards from me, or a Bengali whose name I shall never know, ten thousand miles away" (231-2).

Other arguments that consider development assistance a matter of moral obligation connect assistance to the concept of justice, particularly distributive justice "Distributive justice is concerned with substantive principles for the just distribution of social goods within society, and in particular for the distribution of wealth and income" (Opeskin, 1996: 23). A commitment to distributive justice entails a significant role for the wealthy, who must redistribute income and wealth according to agreed criteria. Where need is the criterion of redistribution, a person's lack of goods thought essential to the realization of a minimum standard of well-being (e.g., food, clothing and medical care) provides the moral justification for the redistribution of resources to that person.

There is no doubt that prudential motivations can underpin the decisions of wealthy countries to provide development assistance to developing countries. These moral considerations are not completely removed from considerations of enlightened self-interest at the part of givers. This combination of two motives has come to be labeled "human internationalism" (Martinussen and Pedersen, 1999: 10). Based on arguments put forth by Olav Stokke, human internationalism is the universal acceptance of the obligation to fight global poverty by promoting economic, social, and political developments in the South. This is further tied to an assumption that a more equal distribution of global resources is in industrial countries' long-term vital interests (Stokke, 1989:23, cited in Martinussen and Pedersen, 1999).

2.3 Expansion of Development Aid

The practice of transferring resources from industrialized countries to developing countries in the form of aid mostly took off in the aftermath of the Second World War. This period was also characterized by rapid decolonization and the emergence of Third World countries. Arguably, it was both a combination of altruistic motivation, and strategic interests that catapulted the "urgent problems" of developing countries to the forefront (Ardnt, 1987: 4)

Policy mavens at the time rushed to find the most effortless and seemingly efficient panaceas to the newfound economic 'problems' of developing countries still economically precarious in their nascent stages. Then as now, debates raged over the ability of aid to accelerate their economic journeys. Some argued that the social and economic development of the poorer countries was the moral duty and responsibility of the richer nations, and economic aid merely the means by which this obligation would be discharged. Because it was given primarily for the benefit of the recipients, it would not require any reciprocal action. This line of thought was particularly couched in the rhetoric of altruism. Development aid was a 'free gift,' in the form of a unilateral transfer of resources that would result in mutually beneficial outcomes for all parties involved. The following excerpts from discourse on aid at the time are very illustrative of this mentality:

> “Why aid at all? The first response to this question is, of course, the moral one. Every accepted system of values in the world proclaims the duty of the rich and the privileged to help the poor and the deprived. Every religion, every article of humanistic faith, reminds the fortunate of the responsibility which attends good fortune. The growth and spread of civilization, the building of the communities which we have come to call nations, the common rule of individual and national behavior which makes possible our continued existence in a nuclear age, all these reinforce the proposition that it is the duty of those who have resources and skills to share them with those who have not. This is a deep and durable reason for support of development and for development aid.”
>
> - (The Pearson Report: A New Strategy for Global Development, 1970)

> “Economic aid is simply "help for others." As such, it is free in the sense that it does not (or should not) require any corresponding quid pro quo on the part of the recipient”
>
> - (Abbot, 1970)

On the other hand criticisms levied on aid considered the fact that it would promote dependency in the long run, mostly because it connoted unrequited action. Most critiques converged on the idea that externally provided assistance stifled initiative and gave international license to corruption and rent seeking (Abbot, 1970:1215). Another contentious issue was the use of rhetoric such as "free funds" and "giveaways," that signaled to the recipients that aid was essentially openhanded generosity and unlimited largesse. There are recorded instances, albeit scarce, of donors being concerned about the impact large amounts of aid would have on the behavior and attitudes of recipient governments (Knack and Brautigaum, 2004: 256). A cable from the State Department to the negotiators of the Marshall Plan in 1947 illustrates such concerns: “ Too little attention is being paid by the participants to the elements of self-help" (Hogan, 1987: 77-8 in Knack and Brautigaum, 2004: 257). Thus, even at the time, some concerns were expressed about how European countries were relying too much on external funding and not mobilizing resources themselves for their recovery.

Regardless, the development aid machine charged ahead full steam, attracting donors mostly because of the potential for economic progress that it offered. In particular, the emergence of the Harrod-Domar model[3], and the Financing Gap Approach[4] should be credited with the widespread optimism that poorer countries could be brought up to speed in a relatively short span of time. The predictions of the Harrod-Domar model were simple: an economy's GDP growth would be proportional to the share of investment spending in GDP. Most developing countries at the time were suffering from a chronic gap between absolute savings, and required savings for sustained investment, which in turn would induce growth. In this case, aid could serve as a gap-filling mechanism that would substitute domestic savings and foreign exchange earnings until developing

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[3] Assuming that output (Y) is proportional to machines (K) available at the beginning of the year, $Y(t) = \varphi K(t-1)$. Then $Y(t)-Y(t-1) = \varphi [K(t-1)-K(t-2)]$. The right-hand side is just last year's net investment $I(t-1)$. Dividing both sides by last year's output, we get GDP growth in the current year to be proportional to last year's investment/GDP ratio, considering investment net of depreciation $(Y(t)-Y(t-1))/Y(t-1) = \varphi I(t-1)/Y(t-1)$ (Easterly, 1997)

[4] Based on Walter Rostow's The Stages of Economic Growth (1960). This states that the financing gap is the difference the required investment and actual savings that is needed for a certain level of growth. To facilitate growth in developing countries, donors can fill the financing gap.

countries themselves took charge of filling that gap (Chenery and Strout, 1966: 697-727).

Implicit in this model was the assumption that recipient governments would make concerted efforts to effectively plug these gaps. There was also little consideration of the fact that every country would have varying timelines for reaching the desired levels of growth. Rather, it was simply assumed that this year's aid would go into this year's investment, which would go into next year's GDP growth (Easterly, 1997: 5). In the same vein, when the United Nations called for a decade of development in December 1961, it expected change to come fairly quickly as countries embarked on a trajectory that would lead toward increased self- reliance. Resolution 1710 (XVI) that called for the designation of this decade was optimistic in its expectation, "Member States and their peoples will intensify their efforts to mobilize and to sustain support for the measures required on the part of both developed and developing countries to accelerate progress towards self-sustaining growth of the economy.... taking as the objective a minimum annual rate of growth of aggregate national income of 5 per cent at the end of the Decade" (Resolution1710 (XVI), 1961).

2.4 Empirical Record of Development Assistance

This initial optimism has proven to be mostly ill founded. Qualitative and empirical evidence tracking the relationship between aid and development outcomes illustrates that the connection between the two has mostly been ambiguous, and generally fragile.

A survey of most cross country regressions on foreign aid and economic output (usually growth per capita) leads to the same conclusion: the overall benefits from foreign aid have been modest. To demonstrate this relationship empirically, I will first report Rajan and Subramanian's (2005) findings. Their sample includes all developing countries that have received aid during the postwar period. Their analysis looks at aid over the four time periods 1960–2000; 1970–2000; 1980–2000; and 1990–2000, and takes average annual growth rate of per capita GDP as the dependent variable. The explanatory variable of interest is the average ratio of annual external aid to GDP over that period to that country. Besides that, they control for initial income; initial life expectancy; a measure of institutional quality based on Hall and Jones (2003); a variable indicating quality of trade policies; a climate-based measure of geography based on Bosworth and Collins (2004)); external shocks (average growth and the variability of a country's terms of trade); government consumption; and revolutions (based on Banks (2004)).

The authors report both OLS findings, as well as IV estimates. Their results show that from the period 1960-2000, in four out of the five OLS regressions, the estimate of the aid coefficient is negative, with the only significant estimate being the one for the longest period 1960-2000. The magnitude in this case suggests that an increase in aid of 1 percentage point of GDP would lower long-run growth by about 0.07 percentage points per year. This negative correlation could be due to the fact that aid flows are influenced by a country's situation. Overall however, the authors are unable to find evidence of a robust positive correlation between aid and growth.

These estimates are difficult to take seriously because of the problems of endogeneity. If multilateral agencies respond to the needs of poor governments, and are motivated by suffering in the recipient country, the lower the growth (and the more the suffering), the greater the more likely it is that that government will receive development assistance. Thus, this negative correlation between aid and growth but this does not reflect causation from aid to growth.

To control for endogeneity however, the authors also provide IV Estimates. OLS estimates are likely to be biased downwards because donors give aid to countries that are doing poorly. The IV estimates are able to correct for negative endogeneity bias, as evidenced by the fact that all IV estimates are consistently greater than the OLS estimates. Even after instrumenting for endogeneity, we find an ambiguous link between aid and growth.

Table 2.1
IV Estimates for Impact of Aid on Growth for the 1960-2000 Periods

	(1) 1960_00	(2) 1960_80	(3) 1970_00	(4) 1980_00	(5) 1990_00
Aid/GDP	-2.551 (1.08)	1.353 (0.34)	0.829 (0.19)	1.313 (0.22)	13.514 (0.83)
Initial per cap GDP	-1.124 (4.40)***	-1.074 (1.76)*	-1.472 (4.60)***	-1.288 (2.90)***	-1.138 (1.51)
Initial level of life expectancy	0.038 (2.13)**	0.065 (1.41)	0.045 (1.88)*	0.061 (1.44)	-0.006 (0.06)
Institutional Quality	4.035 (2.32)**	7.923 (3.15)***	3.354 (1.48)	2.409 (0.78)	5.280 (1.24)
Geography	0.430 (3.26)***	-0.180 (0.76)	0.407 (2.57)**	0.601 (3.14)***	0.315 (0.88)
Initial Level of Government Consumption	-0.007 (0.39)	-0.015 (0.43)	-0.020 (1.01)	-0.046 (2.30)**	-0.031 (0.98)
Revolution	-1.258 (2.52)**	1.082 (1.02)	-1.357 (2.74)***	-0.344 (0.55)	-1.767 (2.21)**
Terms of Trade Growth	0.015 (1.79)*	0.011 (1.81)*	0.030 (2.46)**	0.011 (0.59)	-0.042 (0.99)
St. dev. of TOT growth	-0.014 (1.36)	0.002 (0.20)	-0.033 (2.22)**	-0.013 (0.53)	-0.120 (1.97)*
Initial level of policy (Sachs-Warner)	1.934 (3.48)***	1.549 (1.57)	2.215 (4.00)***	2.339 (3.11)***	0.764 (1.30
Observations	74	61	80	81	79
R^2	0.77	0.57	0.72	0.59	0.52

Source: Rajan and Subramanian (2005)

All standard errors are robust and reported below coefficient estimates. ***, **, and * denote significance at 1%, 5%, and 10%, respectively

Rajan and Subramanian's sample is limited to 2000, so I will conduct my own empirical analysis to determine if this aid-growth relationship has persisted over the 2000-2009 period. First I will do an overall evaluation of the 1990-2009 periods after which I will limit myself to 2000-9. In all cases, the dependent variable will be the average annual growth of per capita GDP. I will present both OLS, and IV estimations.

I control for some of the same variables as Rajan and Subramanian, but replace the Sachs-Warner policy variable with measures for control of corruption[5] and regulatory quality[6]. I also include a variable for ethnic fragmentation,[7] based on the theory that ethnic fractionalization leads to higher levels of government consumption and diverts resources away from macroeconomic expenditure needed to promote and sustain economic development (Annett 1999). Although my choice of regressors is not comprehensive, but my selection encompasses the

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[5] Based on World Bank's Governance Indicators, control of corruption" measures perceptions of corruption, conventionally defined as the exercise of public power for private gain. Includes the effects of corruption on the business environment, "grand corruption" in the political arena, and the tendency of elite forms to engage in "state capture"

[6] Based on World Bank Governance Indicators, includes measures of the incidence of market-unfriendly policies such as price controls or inadequate bank supervision.

[7] Reflects probability that two randomly selected people from a given country will not belong to the same ethno-linguistic group. The higher the number, the more fractionalized the society. The definition of ethnicity involves a combination of racial and linguistic characteristics.

macroeconomic and institutional variables that potentially explain the link between aid and growth.

To limit endogeneity associated with the regressors in cross-section regressions, the values of the potentially endogenous covariates are for the beginning of the relevant time period, while exogenous variables (such as terms of trade changes) are averages over the relevant time horizon. I account for lagged effects by looking at aid intensity values levels in 1990 to estimate growth outcomes in the 2000's. My sample consists of all developing countries that received multilateral aid over the period from 1990-2009 for which data are available.

Summary statistics for all variables used are below, and the results of the regression of GDP growth on lagged aid are presented in equation (2) for both OLS and IV estimates.

Table 2.2
Summary Statistics for Period: 1990-2009

Variable	Mean	Std. Dev.	Source
GDP Growth	2.023845	2.133856	WDI
ODA as % of GDP	18.05758	14.04508	WDI
Initial GDP	-0.69726	5.277042	WDI
Investment % of GDP	24.91924	11.80014	PWT
Inflation at initial period	219.1714	1051.593	WDI

Government Expenditure	12.16655	7.716202	PWT
Initial M2/GDP	31.5268	23.07216	WDI

Table 2.3
Summary Statistics for Period: 2000-2009

Variable	Mean	Std. Dev.	Source
GDP per Capita Growth (%)	3.005593	2.256166	WDI
Lagged ODA	8.336267	9.543537	WDI
ODA % of GDP	10.35277	11.16476	WDI
Control of Corruption	-0.41715	0.562317	World Bank Governance Indicators
Regulatory Quality	-0.34691	0.623635	World Bank Governance Indicators
Initial GDP	1.593963	4.263248	WDI
Government Expenditure (% of GDP)	11.13913	9.396125	PWT
Inflation in begging period	20.46835	71.88268	WDI
Ethnic fragmentation	0.504753	0.248442	Alesina et. aalaalal (2003)
Initial M2/GDP	38.58999	34.09253	WDI
Openness	84.16324	37.56375	PWT
Investment (% of GDP)	25.50709	11.74083	PWT

OLS estimates for both lagged aid, and contemporaneous aid for the 2000-9 period are negative, but statistically insignificant. In Equation 1, government expenditure is negative, and statistically significant against GDP growth, indicative perhaps of the nature of macroeconomic choices made by recipient governments. Although statistically insignificant in the other two equations, government expenditure maintains the same coefficient in the other two equations as well. It is surprising to see a negative coefficient on regulatory quality as well in equation 3.

Table 2.4
Impact of Aid on Growth for the 1990-2009, and 2000-2009 Periods
(OLS Estimates)

Equation	(1) OLS 1990-2009	(2) OLS 2000-2009	(3) OLS 2000-2009
ODA/GDP per capita	.0058 (.158)		-.0411 (.0319)
Lagged Aid		-.024 (.0301)	
Initial per cap GDP	.253 (.0967)***	.075 (.050)	.073 (.040)
Government Expenditure	-.066 (0.035)*	-.027 (.025)	-.0343 (.0230)
Openness	-.0015 (0.007)	.002 (.0091)	.0065 (.007)
Investment	-0.0155 (.0251)	-.030 (.031)	-.0383 (.0289)**
Initial M2/GDP		-.0116 (.007)*	.0073 (.007)
Inflation		-.006 (.002)***	-.0072 (.0021)***
Ethnic		-2.98 (1.35)***	-3.571 (1.306)***
Control of Corruption		.190 (.5791)	.2577 (.7086231)
Regulatory Quality		-1.11 (0.749)	-0.924 (.517)*

N	46	41	47
R^2	.3503	0.3425	0.3812

All standard errors are robust and reported below coefficient estimates. ***, **, and * denote significance at 1%, 5%, and 10%, respectively

Table 2.5 presents IV estimates.

Table 2.5
Impact of Aid on Growth for the 1990-2009 Periods
(IV Estimates)

Equation	(1) IV Estimates 1990-2009	(2) IV Estimates 2000-2009	(3) IV Estimates 2000-2009
ODA/GNI per capita	.0030 (.192)		-.0411 (.028)
Lagged Aid		-.024 (.0257)	
Initial per cap GNI	.009 (.068)	.075 (.043)*	.073 (.040)
Government Expenditure	.130 (0.082)	.027 (.006)*	.050 (.0293)
Openness	-.008 (0.007)	.002 (.0078)	.00511 (.0171)***
Investment	.0356 (.0251)	-.0305 (.0272)	-.033 (.0255)
Initial M2/GNI		-.0117 (.0062)*	-.007 (.008)
Inflation		-.007 (.0015)***	-.0078 (.0019)***
Ethnic		-2.98 (1.15)***	-3.429 (1.12)***
Control of Corruption		.198 (.4953)	.190 (.439)
Regulatory Quality		-1.11 (0.640)*	-0.7651 (.443)*
N	36	41	42
R^2	.1507	0.3425	0.3646

All standard errors are robust and reported below coefficient estimates. ***, **, and * denote significance at 1%, 5%, and 10%, respectively

Even the IV estimates are not sufficiently different. Both Rajan and Subramanian's findings, and my own estimates point towards the conclusion that there is no robust positive relationship between aid and growth for all aid-receiving countries over the 1960-2009 periods. Even when we correct for the negative endogeneity bias in OLS, we are unable to find conclusive proof that aid is positively associated with growth.

2.5 Criticism of Development Aid

Academics and aid critics alike have scrambled to find explanations for why aid does not work and to propose alternative means of aid disbursement. For the most part, poor aid outcomes are rationalized by blaming corruption and institutional weaknesses both on the part of multilateral agencies and recipients. These critiques are occasionally accompanied by mentions of poor quality institutions, weak rule of law, an absence of accountability, and tight controls over information. There have been a number of studies that have verified the negative relationship between political and administrative organization, and positive aid outcomes: Svensson (1999) finds that the long-run growth impact of aid is conditional on the degree of political and civil liberties in the recipient country; Collier and Dollar (2000), demonstrate that only countries with strong institutions can optimally utilize aid. Knack and Keefer have gone so far as to say that high quality public institutions have a greater influence on development performance, than sound economic policies (Knack and Keefer, 1995; World Bank, 1998a). Although these problems have been pinpointed, critics have still not addressed why serious efforts to overcome these challenges have not been extended.

Hence, it has been well established that poor institutions and governance yield disappointing aid results, and it is important to acknowledge that there are many reasons why governance and the institutional environment may be poor in developing countries. Bureaucratic capacity and anti-corruption norms have further been weakened by two decades of economic crisis, and leaders with short term horizons may see little point in the long-term task of building a capable bureaucracy. Before taking this point for granted, it is important to consider what prevents multilateral agencies from ceasing their engagement with such recipients, and what allows for recipients to continue making decisions on a short time horizon basis. As I will present in the following section, this is a problem is attributable to dependence on aid. Large amounts of aid delivered over long periods, create certain incentives for governments that have the potential to undermine good governance and the quality of state institutions (Brautigaum, 2000: 1). These incentives are not always acted on, but when they are, large amounts of aid may reduce local ownership, accountability and democratic decision-making, while fragmenting budgets and lowering tax effort. This in turn reinforces the institutional problems that created the problem of aid ineffectiveness in the first place. Moreover, such is the nature of this phenomenon, that in the long term, it creates disincentives for both agencies and governments to change the rules of their engagement. Hence, there is a weakening of incentives at the collective action level to improve this relationship, and to step up efforts to carry out development objectives.

CHAPTER 3

AID DEPENDENCE

3.1 What is Aid Dependence?

Dependency represents an attitude or belief that outside help is imperative for a group to solve its own problems. Within the context of aid, a recipient country is considered aid dependent if a disproportionately high degree of its fiscal expenditure comes from foreign sources. The reliance on aid may stem from operational needs of the country or from a "psychological" reliance on the part of recipient leadership. Thus, aid dependency is accompanied by a host of problematic behavioral and functional consequences. For example, it can undermine both government confidence, and initiative: "A country is aid dependent if it will not achieve objective X[8] in the absence of aid for the foreseeable future" (Lensink and White, 1999). This can either be because independent initiative seems arduous: "[aid dependence] is a state of mind, where aid recipients lose their capacity to think for themselves and thereby relinquish control" (Sobhan, 1996: 122), or because recipient countries are ill equipped to

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[8] Although the authors do not specify what exactly these 'X' objectives may be, we can presume they are referring to development facilitating projects, such as the delivery of basic social services such as schooling, transportation, utilities etc.

perform operations and maintenance, or even deliver of basic public services without foreign aid funding and expertise (Bautigram, 2). Finally, the most pessimistic view of aid dependence is presented by Roger Riddell "[aid dependence] is that process by which the continued provision of aid appears to be making no significant contribution to the achievement of self-sustaining development" (1996: 24).

3.2 Aid Dependence in Recipient Countries

Aid dependence can impede optimal aid outcomes through its negative impact on governance and institutions surrounding development in recipient countries. High levels of aid can potentially block governance improvements in two major ways. First, the way in which aid is disbursed and utilized can induce 'institutional destruction' that weakens rather than builds institutions. Secondly, aid dependence weakens recipient country incentives to reform governance structures and improve institutions dealing with aid. Thus, aid dependence institutionalizes incentives that make it more difficult to overcome the obstacles involved in building a more capable and responsive state and a foreign aid system more conducive to development.

Before delineating the mechanism through which aid dependence weakens institutions, it is important to establish the connotation of certain terminology that will be used hereon. "Institutions" are defined as formal and informal rules that are, in fact, followed by most affected individuals. Such rules structure incentives in human exchange, whether political, social, or economic. “Incentives” include the rewards and punishments that are perceived by individuals to be related to their actions and those of others. “Development” and “development cooperation” refer to improving the material conditions of individuals, often through processes of deliberate intervention. “Sustainability” pertains to the longevity of development cooperation’s benefits, rather than particular projects or activities themselves (Ostrom et. al, 2001: xiv).

3.3 Aid Dependence and Institutional Destruction

In the recipient country aid dependence can effect institutions by: weakening institutional capacity, siphoning off scarce talent from the bureaucracy, weakening accountability, encouraging rent seeking and corruption, fomenting conflict over control of aid funds, and alleviating pressures to reform inefficient policies and institutions.

An integral concern with institutions is the notion of humanly designed constraints; a key aspect of all institutions are shared rules about what actions individuals must take, must not take, or are permitted to take in particular settings. Rules are generally enforced by agents responsible to external authorities or to those directly involved (or both) for monitoring conduct and for imposing sanctions. “These prescriptions are the rules of the game that coordinate human interaction; they structure incentives in human exchange, whether political, social, or economic” (North, 1990: 3). The rules, norms, and shared strategies are constituted and reconstituted by human interaction in frequently occurring or repetitive situations (Crawford and Ostrom, 1995: 582). By constraining behavior, institutions increase the predictability of human interactions and thus make possible some activities that would not otherwise be possible. Aid dependence, and the associated institutional destruction however relaxes many of these rules, and thus generates incentives for recipient countries that are misaligned with the achievement of development.

Aid dependence has arisen is a problem partly due to the fact that donor governments place pressure on multilateral agencies to disburse everything in their budgets, as opposed to emphasizing observable results. As a result, agencies have mostly undervalued the importance of local experimentation and learning, and reduced local incentives to participate in the development process (Birdsall and Savedoff, 2010).

Secondly, part of the path to good governance involves learning. In most cases, besides the disbursal of funds, multilateral agency initiatives are also accompanied with the provision of technical assistance. Yet, these technical assistants often do not transfer skills but simply do the work themselves or set up bypass units[9]. Knack and Brautigaum (2004) find that this has been the case in a number of Sub-Saharan African countries. This can greatly limit a central (or local) government's ability to learn skills for more effectively managing and administering. Governance improves by the continual practice of these skills; this applies to the crafting of policy as much as to the implementation of projects. Coupled with the guarantee of aid funds, the accompaniment of this expertise can often discourage local development practitioners to conceive their own implementation frameworks. In fact, as E. V. K. Jaycox, once World Bank Vice President articulated, technical assistance is "a systematic destructive force which is undermining the development of capacity . . . most of this technical assistance is imposed, it is not welcome and there is no demand for it really, except on the donor side" (Jaycox, 1993, p 73). Perhaps a little hyperbolic, this statement does convey the message that individuals at the receiving end do not play an active role in determining the direction of this assistance. In fact, in some cases, once ministries sense that this is the pattern of assistance, they may take a back seat knowing there is little chance that they can steering the development ship: "Once they understand that agencies mean to set policy, ministries become passive. Individual officials have negative incentives to disagree with the agency staff since this will only serve to delay the arrival of the much-needed

[9] An OECD study of the aid system in Mali showed that between 1985 and 1995, the majority of agencies used project implementation units rather than working through the regular bureaucracy; some agencies, including the World Bank, used them for all of their projects in Mali.

resources" (Knack and Brautigam, 2004: 262). The Lesotho example illustrates this quite phenomenon quite well. Because of climate and topographical limitations, Lesothian politicians and citizenry view agriculture as a marginal occupation. Despite that fact, ministers in Lesotho stepped aside as multilateral agencies pushed for, and implemented projects focusing on agricultural production. In 1981, the UNDP Resident Representative counted 61 separate donors financing agriculture projects in Lesotho. In total, donors put in $10 million annually into agriculture, yet agricultural production steadily declined for the 1980-4 period. Even so, the ministers did not object to any aid receipts (Morss, 1984: 468).

Continued over long periods, such behavior not only resigns recipient governments to keep their hands off of implementation efforts, but also retards the progress of institutions that could possibly take over the responsibility for the development process independently. Even the World Bank has conceded that in countries with weak institutions, "the Bank's interventions may have delayed the development of effective, self-reliant cadres and institutions" (Kapur e.al 1997 in Knack and Brautigaum, 2004: 262) In sum, long term technical assistance without skill transfer, and the external design of policies, programs, and projects undercut the learning processes that developing nations inevitably undergo. Extended over time, this can promote apathy, resentment, and low levels of confidence within the recipient government (Bräutigam and Botchwey, 1999: 11).

In administering these multiple projects, agencies still require the assistance of local staff. However, trained and capable people are scarce in developing countries. Agencies consequently bid up the price of capable staff, pulling them both from the private (productive) sector and from the government by offering them remuneration at levels significantly higher than those in the local market[10]. This then weakens institutions by creating resentment and lower morale for the majority of civil servants that are "left behind" in the government (Cohen, 1992, 493-500). Hence, aid dependence can contribute to the erosion of state capacity by hiring the most qualified staff away from their government positions, and through ready provision of technical assistance (often without charge), undermining the incentives to develop capacity locally.

A reliance on external sources for a large proportion of the government's budget can create an additional cluster of institutional problems for governments that are aid dependent. Maintaining budget discipline becomes particularly difficult for aid dependent countries because aid flows hamper government ability to adhere to a particular budget. As the fiscal years of multilateral agencies, and recipient governments rarely coincide, and as agencies announce new projects at varying points in the recipient government's fiscal year, supplementary budgets have to be routinely approved to make allowances for new projects and programs. This then reduces the ability of planners to produce realistic estimates and weakens incentives for staff to control spending (Brautigam. Botchwey, 1999: 15). Budget fragmentation is another serious problem that occurs when agency staff negotiate directly with line ministries or with regional or local governments

[10] Although the authors base these conclusions based on field experiences in Kenya, where, a donor-funded agricultural project hired seven local economists away from the civil service, offering monthly salaries of US$3,000–$6,000, compared with government salaries of approximately US$250, we should expect to see this poaching affect in a number of donor funded projects in developing countries where trained labor is scarce.

to disburse funds directly at those levels. This occurs despite the fact that budgetary centralization is formally required for aid projects. As a result, projects are often implemented outside of any public investment program; the government may not even know of their existence (Nordås 1998: 24). In Senegal in 1995, the Ministry of Planning, which was responsible for evaluating and approving all investment projects, was only able to account for half of the aid-funded projects that were actually being implemented; the other projects apparently were negotiated directly between line ministries and agencies (Carlsson et.al, 1997 in Brautigaum and Knack, 2004: 261) . In Mali, line ministers, and aid agencies both were complicit in circumventing the National Planning Directorate (DNP) responsible for appraising agency projects and ensuring they were in keeping with national priorities (OECD and UNDP, 1997 in Brautigaum and Knack, 2004: 261). Rather, ministries coordinated with agencies independently to negotiate projects directly amongst themselves. For agency staff looking to boast high project numbers, this removed all the requisite procedures needed to receive approval and access. For ministries, this afforded better opportunities to seek direct funding. Such behavior, when validated by external agencies only disintegrates coordination and reporting mechanisms between local and central governments.

Going back to the macro level, aid dependence can also create a long term 'soft budget constraint,' whereby governments receiving large amounts of aid may engage in riskier fiscal behavior, knowing they are likely to be bailed out. A diversity of aid channels makes it easier for national-level government officials and politicians to protect their vested interests in particular projects by excluding aid projects from – or misrepresenting them in public budgetary processes and fiscal statistics. Sometimes, this creates a 'fungibility' problem whereby aid is treated as an exogenous increase in the fiscal budget, and inspires a crowding out of domestic resources from a particular development activity in the aid receiving sector, towards very different and potentially undesirable activities[11]. Hence, aid intended for crucial social and economic sectors often merely substitutes for spending that the recipient government would have undertaken anyway; the funds freed are spent for other purposes. In some cases, this reduces recipient effort within that particular sector as well (Devarajan and Swaroop, 1998:1).

Dependence on aid can also give impetus to rent seeking and corruption. It is easy to conceive this problem if we think of aid as a common pool resource (Svensson, 2000: 438). Various social groups within the recipient country compete over this common-pool resource. These groups can misappropriate aid directly, through seizure of power, or through manipulations of bureaucrats and politicians to implement favorable transfers (Benhabib and Rustichini, 1996:126). In this case, aid dependence not only provides a common pool resource to fight

[11] A recent *Lancet* study found that in all developing countries, government domestic spending on health between 1995 and 2006 in U.S dollars rose by 100%; support from the IMF increased by 120% and the World Health Organization by 88%.

over, but also discourages these groups from coming to a consensus over ending their misappropriation efforts. This is because sustained flows of aid signal to social groups that there is still time in the future to come to a resolution over this problem. It also encourages a postponement of stabilization until an unforeseen point in the future when aid will be ended.

Other concerns surrounding aid dependence and its negative impact on budget governance turn to the fact that aid reduces pressures to generate revenues from domestic taxation. This in turn can turn aid dependent countries into 'rentier states'. Rentier states are those states that live largely off unearned income: the state is resourced with little organizational or political effort on the part of the state apparatus, and especially little such effort in relation to their domestic populations (Moore, 2004: 304). Hence, aid that comprises a substantially large part of a government's receipts reduces the government's need for directly taxing its citizens. This therefore expands executive authority at the expense of political accountability, and prevents countries from reaping the 'governance dividend' that comes from the social contract that is implicit in the generation of tax revenues (Moore 2004). Compared to dependence on a relatively broad tax base, the dependence of a state on aid flows for revenue tends to generate certain "political pathologies" that undermine accountability norms within a state. As the state apparatus, and the people who control it have a "guaranteed" source of income that makes them independent of their citizens (potential taxpayers), they feel little pressure to use scarce administrative resources to promote broad economic development when the state can feed itself from aid flows. This reduction in direct taxes can also discourage citizens from engaging in politics in a "civic" (deliberative, institutionalized, and compromise-prone) fashion; absence of direct taxes reduces the likelihood that citizens will be motivated to engage in politics through a sense of a right to influence the use of "their" own money (Moore, 2004: 306-8). Revenue generated from aid receipts can also contribute to an erosion of 'horizontal' accountability between the executive and other government branches, as governments have greater incentives to make discretionary use of unearned revenues bypassing the effective checks and balances from control authorities and opposition parties (Acosta and de Renzio, 2008: 7).

An empirical evaluation of aid dependence and institutional quality demonstrates a similar relationship between long-term aid dependence and institutional quality. Aid dependence can be determined in a number of ways: as a function of the size and duration of aid, the type of aid, and the way aid is managed. Since processes of aid dependence involve a psychological state, and are also difficult to measure, we need a proxy measure. Possible proxies include various measures of aid intensity: aid as a percentage of GNP, central government expenditure, current revenue, gross domestic investment, or imports. I will mostly be focusing on aid intensity: the proportion of a country's GNI that is comprised of foreign aid. It is difficult to establish a threshold for aid dependence, but based on Knack's (1999) methodology, I will consider any country whose ODA receipt is more than 5 % of GDP to be aid intensive.

Table 3.1 provides an overview of the level of aid intensity in Highly Indebted Poor Countries, as well as in Least Developed Countries according to UN classifications. These classifications are likely to cover a significant portion of aid dependent countries, and the mean values of 11.5% and 8.2% for both groups respectively corroborate this assumption. The list of countries with high aid intensity is in the Appendix. Although no formal threshold for aid intensity exists, I based my cutoffs on Knack's (1999) assessment. Thus, my sample consists of all countries that have development aid comprising more than 5% of their total GDP.

Table 3.1
Aid Intensity for Period 2002-2009

Classification	Net ODA Received (% of GNI)	Net ODA Received (% of Gross Capital Formation)	Net ODA Received (% of Imports)
Heavily indebted poor countries (HIPC)	11.5	52.9	27.6
Least developed countries: UN classification	8.2	36.5	22.4

The fact that aid dependence has been a largely ignored phenomenon is reflected in the paucity of empirical work on this topic. Knack (1999) is one of the few who provides a statistical picture of the correlation between aid intensity and institutions. I will first report his statistical findings, and then present my own regression results.

Looking at the period from 1982-1995, Knack measures institutional quality with a subjective index from the International Country Risk Guide (ICRG), a commercial service that provides information on political risks to overseas investors and lenders. The ICRG reports index scores by summing the following three 6-point scales: corruption in government, bureaucratic quality, and the rule of law. He proxies aid dependence with two measures of aid intensity: official development assistance as a percentage of GNP and as a percentage of government expenditures, averaged over the years 1982 to 1995. Regressors include the initial ICRG value, population change, and change in per capita income. Changes in population are used as a control because if there are economies of scale in establishing effective institutions, population increases could be associated with improvements in the ICRG index. Changes in per capita income might also affect institutional quality, independent of aid intensity. Declining income levels would be expected to lead to deterioration in institutional quality, through decreases in tax revenues, lower salaries for government officials, and so forth. Increases should have the opposite effect (Brautigaum, 2000: 1).

If aid dependence erodes the quality of governance, then countries with higher aid levels should exhibit declining scores on the ICRG index over time, relative to other countries. Accordingly, the dependent variable analyzed in Table 3.3 is the end of period (1995) ICRG value minus the initial (1982 for most countries, and 1984 for most others) value. Knack's findings are summarized in Table 3.2.

Table 3.2
Aid Dependence and the ICRG Quality-of-governance Index

Equation	OLS (1)	OLS (2)
Dependent Variable	ICRG Index Value	
Constant	8.475 (0.984)	8.535 (1.051)
Initial ICRG index value	–0.770** (0.083)	–0.740** (0.087)
Population change/ initial population	–0.640 (1.837)	0.027 (1.933)
GDP p.c. change/ Initial GDP p.c.	2.027** (0.748)	1.231 (0.801)
Aid/GNP	–0.067** (0.021)	
Aid/govt.		–0.027** (0.010)
N	80	68
Mean dep variable	+2.45	+2.75
Adj R^2	0.55	0.54
Standard error of estimator	2.29	2.2

Knack's results suggest that for the 1982-95 period, higher levels of aid and institutional quality are negatively associated. Thus, aid intensity has an unfavorable impact on the quality of governance. Even when economic decline is held constant, this relationship holds.

To determine if this relationship between aid intensity and institutional destruction has persisted over the last two decades, I regressed aid intensity (measured by proportion of ODA comprising GDP) on three different measures of governance and institutional quality. I included all of the countries listed in Table 3.2, but due to data unavailability, some were dropped from the sample.

Instead of using one composite index such as the ICRG, I examined government effectiveness, rule of law, and control of corruption independently. Similar to Knack's methodology, I also controlled for population change, GDP change and initial governance values. I also consider Executive Constraints which is essentially concerned with checks and balances between the various parts of the decision-making process. Originally created as part of the Polity IV Project (Marshall and Jaggers 2002), the Executive Constraint score rates the level of accountability political executives. In this index, a score of 1 suggests unlimited authority, while 7 signifies significant checks on authority.

All three of my dependent variables were obtained from World Bank Governance Indicators. Point estimates represent the governance score for each country, where (-2.5 = low; +2.5 = high). Government Effectiveness in this case captures "the quality of public service provision, the quality of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government's commitment to policies" (Kraay, Koffman, Mastruzzi, 2010:4). The main focus of this index is on “inputs” required for the government to be able to produce and implement good policies and deliver public goods. Rule of Law captures the extent to which “agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence” (Kraay, Koffman, Mastruzzi, 2010:4) . Control of Corruption captures perceptions of the extent to which “public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests” (Kraay, Koffman, Mastruzzi, 2010:4).

As can be seen from the summary statistics, most aid dependent countries start off with sufficiently low scores (denoted by means of initial governance values), and maintain negative values up till the most recent years.

Table 3.4 presents results of the regression of aid intensity on three indicators for institutional quality. With the exception of corruption, the coefficient of aid intensity is negative and statistically significant for Government Effectiveness and Rule of Law. For both Corruption, and Rule of Law, the initial value of their respective indexes is positively associated with eventual index values. Due to data constraints, my sample sizes were extremely small. Moreover, it was difficult to obtain observations for more precise estimates of bureaucratic quality. Some other dependent variables I considered included i)Quality of

Budgetary and Financial Management, and ii) Fiscal Efforts, but data shortage did not allow me to include those.

Table 3.3
Summary Statistics

Variable	Obs	Mean	Std. Dev.	Source
Government Effectiveness	51	-0.7594026	0.5223697	World Bank Governance Indicators
Rule of Law	51	-0.6953415	0.6571897	World Bank Governance Indicators
Control of Corruption	50	-0.631442	0.4853915	World Bank Governance Indicators
Aid Intensity	55	17.07305	11.41494	World Development Indicators
Population Change	55	0.5024308	0.2427324	World Development Indicators
GDP/Initial GDP p.c	50	0.8683663	0.7196139	World Development Indicators
Executive Controls	42	3.97619	1.731883	Polity IV
Initial Control of Corruption	53	-0.6480454	0.5246826	World Bank Governance Indicators
Initial Government Effectiveness	53	4.018868	1.726385	World Bank Governance Indicators
Initial Rule of Law	53	-0.6329964	0.7287136	World Bank Governance Indicators

Still however, on the basis of these results, we can conclude seems that aid intensity is negatively associated with government effectiveness, and rule of law.

Table 3.4
Institutional Quality and Aid Dependence

Equation	(1) Corruption OLS	(3) Government Effectiveness OLS	(4) Rule of Law OLS
Aid % of GDP	.008 (.006)	-.0114 (.004)**	-.008 (.004)*
Initial Corruption Control index value	0.677 (.124)***		
Initial Government Effectiveness index value		0.033 (0.034)	
Initial Rule of Law index value			.569 (.152)***
GDP p.c. change/ Initial GDP p.c.	.0577 (0.075)	.327 (.134)**	-.07388 (.104)
Population change/ initial population	-.003 (0.230)	-.575 (.369)	.0188 (.2614)
Executive Controls (=1 if unlimited authority)	.143 (.103)	-.089 (.123)	-.109 (.091))
Mean dep. variable	-.631	-.759	-.695
N	40	42	42
R^2	.5961	0.3779	0.6415

3.4 Aid Dependence and Recipient Country Efforts to Reform Institutions

The costs associated with dependence induced institutional destruction are exacerbated by the fact that aid dependence can undermine recipient country incentives to bring about a reform of their domestic institutions. Thus, besides affecting the institutions that provide the setting within which improvements in aid management must occur, aid dependence also affects the incentive structure for the actors that must cooperate to overturn aid dependence, and its associated consequences. Although the main thrust of this paper is that change cannot come without the participation of aid agencies, this section addresses why recipient countries do not demand a change in the multilateral aid structure.

Reform of recipient country institutions will benefit the aid system in general, but will require sacrifices from those who benefit from the current system. This requires a high degree of commitment and forward-looking mentality on the part of decision makers in recipient countries. Thus, any successful approach to such a problem must focus on how to generate appropriate incentives so that the time, skill, knowledge, and genuine effort of multiple individuals are channeled in ways that produce jointly valued outcomes (Ostrom et.al, 2002: xiii). What aid dependence does is reinforce motivational constraints that lower recipient country incentives to acknowledge institutional weaknesses and positively cooperate to amend.

Development capacity, defined as "the ability of people, institutions and societies to perform functions, solve problems and set and achieve objectives" (UNDP, 2006: 5) hinges critically on positive motivation from the recipient end. Motivational problems in the development sector have, for a long period received inadequate attention because of the unquestioned assumption that members of the public and development sector are inherently motivated by humanitarian goals, and by the desire to contribute to future generations.

Literature on public-sector agencies is rife with optimism that domestic governments are intrinsically motivated to work for the betterment of others. Adam Smith in *The Theory of Moral Sentiments* asserts that: "how selfish soever man be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it, except the pleasure of seeing it" (Smith, 1969: 47, in Pilliavin and Charng, 1990: 27). Benabou and Tirole (2003) argue that public sector workers may enjoy exerting effort at work or intrinsically value their contribution to output. However, it is also important to realize that every public organization is comprised of individuals who also maintain individual incentives and may not always wish to participate in joint efforts to reform faulty institutions.

The difficulties with recipient country institutional reform can be envisioned if we consider i) institutional reform to be a public good, ii) government budgets as common pool resources, iii) moral hazard problems.

3.4.1 Institutional Reform as a Public Good

Reforms of the institutions and rules in the aid system that can help to manage development actions have the characteristics of a public good. Public goods (and services) are those goods that are consumed jointly by a community where it is difficult to exclude consumption by non-contributors, and one person's consumption does not subtract from the availability of the good for others. In a basic public goods problem, a set of actors, who are all in similar positions, must decide whether or not to take costly actions that generate a net loss for each individual but that produce a net benefit for the affected actors as a group. When the direct benefits to a person providing the public good are less than the benefit derived from it, private effort or investment in producing the good may not be forthcoming. Standard theory holds that public goods will therefore be under-produced.

New rules regarding the operation of the aid system reflect the public goods problem because the costs of participation are high for individuals (in terms of time, and the risk of losing rent seeking benefits), the benefit of participation is high is the group is successful. Yet, the benefits of public goods will be enjoyed by all, regardless of participation. Moreover, reforms qualify as public goods also because the use of these rules by one person does not subtract from the availability of the institutions for others (Gibson et. al , 2005:54). Thus, devising new rules is a second-order, public- good problem. The second-order dilemma of public goods arises from an individuals' incentive to free ride on a mechanism to solve the provision problem (first order dilemma of public goods) (Okada, 2006:1) Even when the actors who are directly involved have the authority to make their own collective-choice rules, one cannot automatically presume that they will invest in this costly effort (the time costs of organizing and sitting in meetings) to reach agreement on a new set of rules to improve their joint outcome.

3.4.2 Government Budget as a Common Pool Resource

While reform of institutions, and of the aid system can be thought of as public goods, thinking of the government budget as a common pool resource also demonstrates the problems of collective action. A common pool resource is a type of good whose size or characteristics make it costly, but not impossible to exclude potential beneficiaries from obtaining benefits from its use. Moreover, unlike public goods, the use of common pool resources by one user reduces resource availability for others. These two characteristics—difficulty of exclusion and sub-tractability in turn create potential Common Pool Resource dilemmas in which people following their own short term interests produce outcomes that are not in anyone's long-term interest. When resource users interact without the benefit of effective rules limiting access and defining rights and duties, substantial free-riding in two forms is likely: overuse without concern for the negative effects on others, and a lack of contributed resources for maintaining and improving the Common Pool Resource itself (Ostrom et al. 1999: 278-9).

It is important to focus on government budgets, because as mentioned previously, for countries with high levels of aid intensity, a significantly large proportion of the budget is comprised of foreign aid. What aid dependence and donor largesse can do in this case, is create an illusion that the fiscal commons is unlimited and subject to few constraints. This is because aid dependence creates a soft budget constraint: expectations of bail-out in case of financial trouble weaken incentives to economize on costs, and thus generate resource waste and rigidity within the enterprises (Eriksson, 1999: 190-1). Soft budget induced by aid dependence shape actors' behavior by reassuring them that there will be an external accommodation of fiscal gaps, and hence assures them that they can dip into the common resource pool with little or no cost (Campos and Pradhan, 1996: 19). The harvesters of these common resources in this case are bureaucrats, and local and national politicians who keep increasing their demands on the recurrent budget with calls for increased investment spending. Hence, increasing demands on limited financial resources can lead to serious irresponsible budgetary behavior, where common-pool resources can be overused, congested, and even destroyed. Thus, the problem concerning common-pool resources is that without effective institutions, users harvest too much from them.

3.4.3 Moral Hazard Problems

Moral hazard refers to the problem of inducing agents to supply proper amounts of productive inputs when their actions cannot be observed and contracted for directly. To understand moral hazard on the recipient end, it must be considered that development assistance is essentially an exchange between aid agencies and recipient countries. Implicit in this transfer is the assumption that recipient governments will leverage their political and economic institutions to effectively implement development activities that are now affordable due to foreign funds. Over time however, a reliance on financial support from an external body causes aid to become a substitute for local resources. Moreover, an implicit understanding that aid will continue to flow suggests that the flow of revenues to the state is no longer determined by government efficiency. This then breeds a tendency for governments to underinvest in developmental capacity.

The general idea of moral hazard originates from the difficulties of insurance companies to create effective insurance institutions. At least some individuals will be more careless after obtaining insurance, and insurance companies cannot afford to monitor each individual's behavior at all times. Since observing actions is costly, and since the individual is now protected from loss, the protection itself may reduce the likelihood that the actor takes preventive measures (Gibson et al., 2002, 42-3). Thus, recipients are encouraged to delay these reforms even longer than they would have in the absence of aid, "The indiscriminate availability of aid creates a moral hazard, where aid availability, by 'insuring' incompetent governments from the results of their actions, allows governments to postpone reform efforts and weakens their incentive to find alternative revenue sources" (Bräutigam 2000: 24).

CHAPTER 4

MULTILATERAL AID AGENCIES

It is important now to account for the role multilateral aid agencies play in furthering the phenomenon of aid dependence. In this section, I hope to outline the structure of multilateral aid agencies, as well as the 'industry' setup that comprises the inter-agency interaction arena. Firstly, this will help determine how aid dependence also affects aid agencies. Secondly, this will lay the foundations for the Samaritan's Dilemma game illustrating agency-recipient interaction in Section 5. Lastly, intra-agency structures, and the inter-agency interface will allow us to determine what factors are impeding reforms of the multilateral aid system.

4.1 Aid Agencies Overview

Multilateral aid agencies are positioned between two publics: (a) the public at the receiving end of aid, and (b) those who supply aid budgets to these agencies. Discussions on the motives of aid agencies, especially those highlighting purely moral or humanitarian ones, explain only one side of the aid delivery chain. However, multilateral agencies must also pacify the demands of their patrons (donor countries, and taxpayers within those countries). Alongside the provision of aid for humanitarian concerns to satisfy pure altruism[12] demands, aid agencies must also continue to deliver aid to satisfy donor demands for 'warm glow'.

What exactly characterizes warm glow? Essentially, it is based on the idea that people have a taste for giving, either because it confers on them a higher status, or because they simply experience a 'warm glow' from having 'done their bit'" (Becker, 1974). Thus, donor governments, and tax payers within those countries will feel good simply from the act of giving, whether they get any results or not. To the extent that warm glow drives public support for donor activities, development results are simply a fringe benefit (Gibson et al, 2005: 88).

Bolstered by such sentiments, multilateral agencies also often enter into aid relationships with the belief that unless they have not provided development assistance, progress in the targeted countries will not be catalyzed. Moreover, agencies may also perceive themselves as the sole providers of assistance to developing countries. Governments rife with corruption and carrying the burden of poor credit ratings are unlikely to attract growth capital, even at extraordinary interest rates. The view of many agencies may be that without their programs targeting these problems, national governments and national markets will not be solve them.

[12] Based on Andreoni's (1989) classification of pure altruism as a case where individuals demand more of a public good (development in this case) without any additional expectations, similar to unconditional charity and some intergenerational transfers.

Thus far, I have only discussed the 'external' motivations of multilateral aid agencies. However it is also important to recognize that these agencies operate as organizations, and as such must also pacify the needs of their own constituents. Moreover, the multilateral development assistance arena is comprised of a number of agencies that must also determine a way to coexist. Both the internal motivations of donor agencies, as well as inter-agency interactions determine how multilateral institutions cope with the problem of aid dependence.

4.2 Internal Motivations of Multilateral Agencies

With the proliferation of multilateral aid agencies, there has been a development of a specialized development aid industry, complete with a market, demands for competence, competition, and so on (Raffer and Kunibert, 1996 in Martinussen and Pederssen, 1999: 177). Thus, the only difference between development aid and other industries is that its goals are generally humanitarian, and its self-perception, idealistic. As a result of its idealistic nature, the aid industry falls prey to two main problems that contribute to its inability to reform itself, and to participate in collective efforts to curb aid dependence. These are: bureaucratization, and self-overestimation.

Bureaucratization occurs as a problem because actors within these agencies feel forced into complex solutions for intricate, but very concrete problems of poverty and development. Moreover, they must show all necessary considerations to avoid being criticized for idealistic reasons, such as for not achieving high goals. The setup of the aid industry, combined with the bureaucratic nature of individual agencies gives rise to a host of bureaucratic dysfunctions.

It is easy to envision why this is so if we consider the fact that the success of a bureaucracy depends on: (i) high quality feedback from beneficiaries (recipients), (ii) high incentives to respond to such feedback iii) easily observed outcomes, and iv) competitive pressure from other bureaucracies and agencies (Wilson, 1989:115).

The high quality feedback that is necessary for the efficient functioning of bureaucracies is often unavailable to multilateral agencies, especially in situations where recipient countries are institutionally weak. Due to moral hazard problems, and the desire to sully exploit the Samaritan's Dilemma, recipients do not have the incentive to relay correct information. This phenomenon will be spelled out more fully in section 5.

The ability to observe outcomes easily and objectively is also severely lacking within the aid industry. This is because of self-overestimation driven largely by the fact that aid industry is comprised of active participants that accept and support the idealistic goals for aid, thus reducing the ability to be self-critical; and because aid achieves legitimacy through the idealistic goals just as much as through the results that can be shown. Aid agencies are different from other organizations in that their sponsors (donor countries and constituents) judge them mostly by their public announcements; the donors are more concerned with the extent to which the agency is doing the things they need them to do. (Seabright, 2002: 34). This however is extremely difficult to evaluate, since there is frequently no obvious mechanism for transmitting the beneficiaries' view. Consequently, foreign aid bureaucracies respond to the difficulty of monitoring results by skewing the composition of their output in favor of items that are more observable to those outside the aid agencies[13] [14]. Even when targets are set, failure to meet them can lead to a redesign of the programs to make them seem more successful. One example is the World Bank-supported Social Action Program in the 1990s in Pakistan, where numerous "results-based" targets were set for the health, education, and rural water supply sectors. When performance was unsatisfactory, the program was amended halfway through, and excluded numerical targets (Easterly, 2002: 29).

Aid dependence only further encourages such beliefs because it demands increasing volumes of aid over time. Because agents within any firm (in this case employees of aid agencies) are prone to emphasizing only those aspects of

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[13] Tirole (1994) has a principal-agent model that also delivers the prediction that government agencies producing multiple outputs will focus their efforts on the observable ones

[14] The Paris Declaration on Aid Effectiveness (2005), emphasizes "recording of project title and descriptions", and "detail of project descriptions" as stated goals in the pursuit of greater transparency and learning.

performance that are rewarded, there are greater rewards for disbursing more money, than for implementing efficient and self-sustaining projects (Pendergrast, 1999: 7-8).

Knack and Eubank (2009:7) also note that agencies are constrained by the need to convince their sometimes-skeptical principals (donor country governments and taxpayers) that aid produces visible and measurable results. Thus: “Aid agencies want to be able to identify their own contributions, often through distinct projects, to facilitate feedback to taxpayers and sustain political support for aid flows. A new hospital is easier to showcase than the outcome of policy reform or budget support” (World Bank, 2004: 216). Moreover, as quantitative indicators can easily be observed by government officials and ultimately the taxpayers, and given the “competing needs for public funds, evidence of non-expenditure of funds is used in debates to argue for a budgetary reduction to a particular agency. Thus, all public agencies face the need to spend allocated funds within short time horizons in order to justify receiving further budgetary allotments” (Ostrom et.al 2005: 124).

Such conditions also discourage efforts for an ex-post evaluation of aid effectiveness, which in turn further discourages efforts to limit aid dependence and breeds moral hazard problems. Since nobody can tell whether aid agency efforts are really making a difference, actors within the agency can choose to engage themselves in projects that will not yield best outcomes. Although we can safely assume that aid agencies in general would like to make good investments in aid projects and programs, those that yield the most "development" per "dollar," the employees of that agency know that the agency has difficulty in judging their performance, except perhaps by looking at how much money in total they have disbursed.

4.3 Multilateral Agency Industry Structure

Competitive pressure or demands for accountability from other bureaucracies and agencies is mostly absent in the multilateral aid industry. Overall, the setup of the aid industry is not conducive to the establishment of a competitive relationship between agencies, and for the most part, the aid industry faces a non-competitive market structure (Easterly, 2002: 32).

The nature of the good being provided, and the demand structure itself also contributes to a non-competitive market structure. For aid agencies as a whole, market power is greater and the degree of inefficiency and output restriction worse because the demand for foreign aid is more inelastic than in many other types of bureaucracies. The degree of innovation in foreign aid is also fairly low, removing one possible source of disruption that could potentially break up this collusive setup.

This setup is also facilitated by the attitude the development assistance community, and individual agencies are most likely to survive indefinitely (the probability that world poverty will soon end is extremely low). These conditions give strong incentives for agencies to cooperate because they know any “rogue” behavior today jeopardizes the long stream of future benefits from cooperation. This outcome is also predicted by the theory of repeated games that states that a possibility of cooperation in the future induces agents to cooperate in the current period.

There are also economies of scale benefits that can be yielded by agencies that decide to present a common front. This is specifically the case for revenue solicitation. Most agencies garner revenues from the same sources (refer to Section 2.1), thus it makes sense for them to bargain collectively for higher budgets from donors. Aid agencies also cooperate in multiple markets (countries), and undercutting one's rivals in one market will lead to retaliation in other markets, making deviation from cooperation less likely.

The collusion among aid bureaucracies is probably more passive than active. It is not that aid agencies go out of their way to reach collusive agreements. Rather, they refrain from competition out of recognition that competition would be mutually destructive, and the conditions described above make this a stable equilibrium (Easterly, 2002: 32-3). The public disclosure requirements of aid bureaucracies further bolster the extent of this relationship. Deviation from standard aid practices is less likely to occur because agencies cannot operate in secrecy; cooperative agreements break down more easily when the other parties cannot observe the deviant's behavior. Hence, multilateral agencies have come to form a 'cartel of good intentions' that unites multilateral aid organizations with different objectives and agendas.

This leads to a problem where multilateral agencies agree to "log-roll"[15] each other, that is, they conditionally support the objectives and decisions of other agents as long as there is a tacit agreement that others will reciprocate, and support their own objectives. Thus, one aid agency will not criticize another agency's interventions; the second will reciprocate such critical restraint. This collusion destroys information, since one aid agency knows more about bad performance of another agency than outside evaluators. Overall critical evaluation of past aid efforts is suppressed by all agencies because it threatens the overall aid budget. This is based on Pritchett's model of why it "pays to be ignorant" (2002). The model shows how "advocates" of particular issues or solutions - the public action equivalent of entrepreneurs - have incentives to under invest in knowledge creation because having credible estimates of the impact of their preferred program may undermine their ability to mobilize political (budgetary) support. Overall, multilateral agencies are disinclined to provide accurate feedback for fear that it may take away from the development assistance pot.

The non-competitive industrial structure has also set a precedent whereby any agency that deviates from standard aid procedures is vulnerable to public relations attacks by the other agencies. Thus, agencies acquiesce in a cartel out of good intentions. The fact that agencies are immune from competitive pressure

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[15] Based on Anthony Downs' (1957) theory that in in all economic or public-choice models of democracy, candidates seeking to maximize the number of votes, or some equivalent thereof will behave as "political chameleons," and assume whatever position is necessary to win support for their own position.

may explain the inefficiency of foreign aid and for its disappointing output. The cartel can threaten with public embarrassment any agency tempted to shift from producing visible low return outputs to invisible high return outputs, since the rogue agency will have little to show. International donor conferences on harmonization bring senior managers of aid agencies "in close contact with colleagues from other agencies, pushing them to align with recognized international best practice and not be seen as laggards" (de Renzio, 2005: 11). Thus, individual aid agencies cannot profile and position themselves independently of each other; they need to move according to the evolving policies and roles of others as well.

CHAPTER 5

SAMARITAN'S DILEMMA

Aid dependence affects not only the interactions between agencies and recipients, but is also exacerbated with every successive round of aid transfers. I will demonstrate this interaction by adapting Buchanan's concept of a Samaritan's Dilemma game (1979), and convert it into a sequential game between multilateral agencies and recipient governments. This game will illustrate that dependence riddled recipient governments will not be induced to improve institutions in the absence of stringent transfer requirements, or 'credible' threats from agencies. Instead, they will continue on their aid-dependent trajectory because they receive no signals from agencies that their behavior has been a) identified, and so, b) must be amended.

5.1 Overview of Samaritan's Dilemma

The Samaritan's Dilemma (Buchanan, 1975) has been used in a number of instances to identify disincentives generated in charity situations and in unconditional government welfare schemes. Many examples of Samaritan's Dilemma can be culled from development agencies' experiences. Fisher (2001: 74) talks about how farmers receiving food aid in southern Sudan stopped farming and participating in income-generating activities because they had a guarantee of food transfers from the United Nations. Maren (1997) argues that the supply-driven aid to Somalia in the 1980s led directly to famine in the 1990s. Eriksson (2000) cites a number of instances where soft budget constraints occur when kind-hearted government officials repeatedly bail out state-owned enterprises, which then proceed to continue spending more than their budgets. In their desire to help however, the Samaritan-agencies have, on a number of occasions produced poor, and sometimes catastrophic outcomes.

Buchanan (1975) first introduced the term Samaritan's Dilemma to show that altruism induces recipients to exhibit adverse behavior in the absence of strategic behavior from the donor side. Building on Buchanan's work, a number of authors have emphasized the idea that in a setting characterized by altruistic transfers, potential recipients may behave in a socially inefficient manner in an attempt to manipulate the magnitude of these transfers (Bruce and Waldman, 1991: 1345). In the context of aid, the Samaritan's Dilemma makes predictions about a two-way relation: Donors will disburse foreign aid according to the expected needs of the poor, in turn adversely affecting the recipients' incentives to carry out policies that would reduce poverty. Unless concerted efforts are made to change this, this cycle will continue to perpetuate itself.

The ‘adverse behavior’ exhibited by a recipient country refers to the consequences of institutional destruction: rent-seeking, crowding out of investment, moral hazard, etc. On the agency side, Buchanan finds that altruists (Samaritan’s) place greater emphasis on maximizing short-term utility as opposed to prioritizing long term utility gains (1975: 83). As such, the altruist simply focuses on transferring charity to the recipient, instead of realizing what could make this relationship more fruitful in the long run. Thus, the Samaritan does not have the foresight to institute regulatory mechanisms in the form of ‘credible threats’ or carefully constructed transfer rules that do not yield perverse incentives. Credible threats in this case suggest a tightening of conditions surrounding aid transfers, or even the possibility of ceasing aid transfers. Transfer policies refer to the Samaritan’s motivations for transferring funds in the first place, as well as the methods employed in transferring those resources. Perozek’s (2005) study of intergenerational transfers between parents helps illustrate the importance of transfer rules; if a child understands the altruistic transfer rule, he will behave so that the probability of becoming impoverished is higher. This is done in to receive a greater amount from his parent. This problem also arises because altruistic parents cannot credibly condition future transfers on the behavior of the child. This analogy holds quite well for the agency-recipient interactions in an aid dependent setting.

5.2 Aid Dependence and Institutional Destruction

Before discussing the outcomes of the Samaritan's Dilemma game between aid agencies and recipients, I will combine the actions of aid agencies, and recipient governments to show how development assistance to a country already affected by aid dependence is underutilized.

As established previously, many agencies enter into aid relationships with developing countries because they believe their assistance will being about positive welfare in those countries. Thus, their motivations are seemingly altruistic. However, as I have argued so far, the incentive structures within the multilateral aid agency system creates a discrepancy between what is perceived to be altruistic behavior at the part of the agent, and what is actually welfare improving for recipient governments.

It is easy to see how this is so if we take a look at an individual Agency's utility function. Its utility function can be denoted as: $U_A=S+\delta U_R$. U_A here is the utility of the Agency; S is concern for survival, which refers to guarantees that agencies will continue receiving financial support from donors; U_R is the Agency's perception of country R's '(Recipient's) utility, and δ is the satisfaction agencies gain from the perception that they have played a role in inducing R's well-being. The problem of aid dependence is essentially rooted in the fact that agencies are basing their perception of Recipient's welfare on the amount of money disbursed. This is essentially brought on by a failure of agencies to evaluate development outcomes, and problems of moral hazard and adverse selection problems from the recipient end. As a result, agencies may believe that they are benefiting from altruism, when in fact they are simply deriving utility from 'warm glow.' In other words, agencies believe they are leading to the betterment of recipient countries (pure altruism), when in fact, they are simply benefiting from the act of giving.

At the recipient government end, knowledge that the multilateral agency's utility function includes U_R dampens motivation to extend high efforts towards implementing sustainable development efforts. This is because governments receive assurance that as long as they are living in poor conditions, agencies will rush to improve what they believe to U_R by disbursing more money.

Besides that, foreign aid flows of the past can have other negative effects on the recipient government's propensity to take responsibility for development activities. Raschky-Schwindt's (2005) model of the effects of disaster relief on recipient efforts to provide hazard relief offers valuable insights into the behavior of recipients when guarantees of donor relief exist. For the purpose of this paper, I will apply their model of hazard relief to development assistance. In this version of the model, however, we will assume that the recipient has experienced foreign aid in the past, and has, over time become dependent on aid.

Every round of development aid transfers T increases the utility of the government in country R by a) increasing the consumption possibilities and b) contributing - directly or indirectly - to efforts towards economic development. In this model, domestic efforts towards development are determined by τ, the level of the proportional tax rate chosen. This model then focuses on the effect of aid transfers T, on the recipient government's choice of tax rate τ, with $\tau \in (0,1|Y_R)$ that maximizes the utility of the representative person. Development levels d, are determined by tax revenue τY_R as well as the fraction, α, of foreign aid per capita, T, that is utilized for development purposes where $d = \tau Y_R + \alpha T \leq 1$

Owing to institutional destruction, α, the fraction of foreign aid per capita allocated towards development efforts become smaller over time. As for τ, the government's choice of tax rate is subject to a trade-off: On the one hand, a rise in the tax rate reduces the disposable income and therefore the consumption possibilities for individuals, yet on the other hand it increases the probability of development taking place. However, with the guarantee of aid funds, the weight placed on τ as a development generating resource also diminishes over time. This negative effect on the tax rate stems directly from the interchangeability of past foreign aid ($\partial\tau / \partial T < 0$), known as the fungibility effect. Fungibility has a negative effect on development, because it can create 'rentier states,' and because the recipient government now has a “guaranteed” source of income independent of their citizens (potential taxpayers), the social contract between the state and its people weakens, and the incentive to appease the population through development efforts weakens. Thus, the government of the recipient country is induced to shirk responsibilities.

Hence, as outlined above, the level of commitment to development by the recipient is not driven simply by the recipient’s choices, but by the agency’s behavior as well. This interaction can be explained by adapting the two-by-two game as originally used by Buchanan (1977) where the aid agency is set as the Samaritan (Player A), and a recipient country as a Recipient (Player B).

5.3 Samaritan’s Dilemma Game

Based on Bruce and Waldman’s (1991) study of intergenerational transfers between altruistic parents, and children, I will assume that aid transfers take place in two periods. Aid agencies will provide aid transfers in both periods, while the recipient government will make decisions regarding the level of effort expended towards development in the first period. I will demonstrate the outcomes of the second period in the following section. A key assumption in this game is that the aid agency cannot make a formal commitment to discontinue the transfer of development assistance. Thus, a "threat" by a potential agency not to give additional support to an agent because he squanders it is not credible if the recipient knows that, ex-post, it will be in the donor’s (altruistic and warm glow) interest to give such additional support. Poor feedback mechanisms and a desire to exhaust budgets ensure that most decisions about development assistance are actually made by the agencies themselves. Even if a Recipient expends low effort, the aid agency will not discontinue aid transfers, especially because low effort translates into low ‘development’. In a multi-period sequential game, it becomes evident to the recipient that the agency’s pure strategy is to continue the provision of aid.

This outcome is inefficient because the welfare of both individuals could theoretically be improved if at the outset the agency made a binding commitment not to provide aid if the recipient failed to utilize it optimally. Although his total resources would not be enhanced by the commitment, the recipient would gain by such an arrangement in the long run because he could utilize his resources more efficiently over time. In doing so, he increases not only his own welfare but also that of the agency, via the agency’s "true" altruism. In other words, there is a problem of time consistency: intertemporal equilibrium may be in conflict with (Pareto) optimality (Lindbeck and Weibull, 1988: 1166-7).

This effect can be modeled using a two party game model with ordinal payoffs, wherein both parties benefit if the Samaritan (agency) chooses to help and the recipient chooses to exert high effort, but the recipient benefits even more if they receive the help but extend only low effort. The payoffs can be illustrated as such:

Recipient

		High Effort	Low Effort
Samaritan	No Aid	2, 1	1, 2
	Aid	4, 3	3, 4

For the Samaritan, the second row (Aid) will always be preferred to the first (No Aid); the payoffs for Row 2 are greater than Row 1. He will choose Aid regardless of what Player B might choose, or is predicted to do so. This is because of his utility function $U_A=S+\delta U_R$, where he receives warm glow benefits simply from the act of giving. Moreover, given the way donor allocations to agencies are determined, S, agency survival also depends on the continuous delivery of aid. Hence, giving aid is the Samaritan's pure strategy.

This behavior holds even when the Samaritan recognizes that the recipient exists as a choice making entity that 'opposes' him in a game-like situation. In other words, the recipient acts strategically. Thus, the Samaritan faces a fundamental problem: he is better-off helping no matter what the recipient does; in game theory terms, extending help is his dominant strategy. The Recipient on the other hand is not in the same position as the Samaritan. Since this is a sequential game, the Recipient has the opportunity to base his effort on the Samaritan's action, observed or predicted. If the Samaritan does not provide Aid, the Recipient can expend High Effort. However, as has been established previously, in an aid dependent situation, the Recipient is nearly positive that Aid will be provided, and will always choose Low Effort. Over time, Recipient becomes aware of the Samaritan's payoff matrix, and becomes confident that the Samaritan will choose the second row. Moreover, institutional destruction generates perverse incentives that reward low effort, and places greater value on short-term gains. Hence, the "solution" of this simple game would seem to be the fourth cell, with payoff (3,4). Payoffs for the Samaritan however, would be maximized in the third cell, where aid provision is coupled with high effort from the Recipient [Payoff (4,3)]. It is difficult for him to maneuver a shift away from cell IV in and of himself. There needs to be some change in behavior or strategy which induces the Recipient to make the shift as well. Credible threats or more stringent transfer rules are some possible ways this can be achieved.

Outcome in Cell IV may be predicted to emerge as the continuing solution of the sequential game unless the Samaritan recognizes the strategic prospects open to him and begins to behave accordingly. The first step in achieving a Cell IV outcome is for the Samaritan to recognize that he is in a 'game' with the Recipient and understand that his own choices influence the choice behavior of the Recipient. In other words, the Samaritan must behave as a "Stackelberg leader" anticipating the likely responses of the Recipients. A Stackelberg leader is the first mover in a sequential game. He is termed a leader because he makes his strategic choice taking into account that the second mover, the follower, will make an optimal choice conditional on his own choice (Stackelberg, 1943 in Albæk, 1992: 76).

According to Buchanan, if the Samaritan knows precisely what the expected utility payoffs of the Recipient are, he can ensure that an outcome of Cell III is achieved (1975: 72). This he can do by switching his utility indicators from Cell IV (Aid, Low Effort), to Cell II (No Aid, Low Effort). This change however has time and effort costs associated with it that are not incurred within the current system. This strategy will surely be difficult for the Samaritan, because giving aid is his pure strategy. Although threats to end aid may force him to suffer disutility, it is important for him to accept the prospect of personal injury in the short run. Still aid dependence and its associated negative effects can only be curbed if Samaritan's instill in the Recipients the 'fear' of punishment. In the short run, this will hurt the Samaritan, but there will be offsetting long-term utility gains in sequential game. However, once the tradeoff between short-term utility and long-term utility is acknowledged to be present, the Samaritan's behavior will be determined by his subjective discount rate. If this is sufficiently high, he may choose to behave non-strategically, even in the full recognition of the game situation he confronts. This decision to do so, however depends on what the subjective discount rate of the Samaritan is; a high discount rate suggests that the provision of aid may still remain the dominant course of action.

5.4 The Agency-Recipient Bargaining Arena

The discussion above has so far treated agency recipient government interactions as being strictly dyadic. Many of these interactions however are conducted in an environment where multiple agencies exist. Once recipient governments develop an understanding of agency disbursement patterns, they can successfully avert pressures to reform by switching from one agency to the next. Most recorded evidence of such behavior is present in bilateral interactions[16], but we can expect it to carry over into the multilateral agency arena as well. The recipient knows that a threat to withdraw support from one agency will be compensated by another agency's willingness to add yet another project to their repertoire. While agencies may not overtly compete with each other for projects, or undercut each other in specific countries, the desire to boast greater project numbers suggests that they would avail the opportunity to take on new contracts.

Thus, the more 'enlightened' Samaritan's might have to compete with those that choose a softer strategy with recipients. This raises the possibility of Bad' Samaritans driving the 'good' one out of the market" (Schmidtchen, 2002:483). In such a case, commitment mechanisms may be ineffective unless

[16] Ostrom et al cite an example of an aid project initiated in Orissa India, where the Swedish International Development Cooperation Agency threatened to discontinue funding for a project because of lapses in follow-through on agreements, however the Orissa Forest Department simply threatened that aid could instead be sought from the Japanese agencies instead.

uniformly adopted by all, or at least the majority of agencies. If recipient governments receive credible threats from multiple sources, and have few ‘substitute’ agencies, the pressure to reform domestic institutions, and efficiently utilize development assistance becomes difficult to ignore.

As continued delivery of development assistance to aid dependence has continued the multilateral aid community has not come together to tackle this issue. Section 6 will unpack why this has not taken place.

CHAPTER 6

COLLECTIVE ACTION PROBLEMS

This section will evaluate why multilateral agencies are not making more concerted efforts to overturn the Samaritan's Dilemma, and in turn, counter aid dependence. Why are they unable to position themselves as Stackelberg leaders in their interactions with aid dependent countries?

Any discussion of a change in an agency's strategy towards recipient government must consider also their decision-making possibilities within the context of their position within the multilateral aid organization network. An agency's demands are unlikely to be seriously received until and unless they are echoed by others within the multilateral agency community; there is more 'weight' to such threats. Secondly, the easy substitutability of multilateral agencies for recipient governments also places severe limitations on an individual agency's ability to pressurize governments to take up institutional reform more seriously. Unwilling governments can just as easily switch over to another aid agency that is not as selective in its decisions

Thus, an agency's decision-making matrix must also take into cognizance the strategies of other multilateral agencies.

This then implies the need for collective action between multilateral aid agencies. In the subsequent sections, I will recommend a possible course of action that aid agencies can adopt that can potentially ameliorate the problem of aid dependence. Based on the costs and payoffs associated with this inter-agency strategy shift, and in light of the existing incentive structures in the multilateral aid industry, I will first identify what are potential sources of hindrance to this collective strategy shift. Following this, I will use a Prisoner's Dilemma, and Assurance game framework, to illustrate how these problems are manifested. Third, I will present two sources that could provide an impetus to resolve collective action problem. One of these solutions is 'internal' to the multilateral agency network, and will emerge from initiatives taken by actors within the community. This solution will most likely affect payoffs by decreasing costs associated with engaging in collective action. The second solution I propose will come from 'external' sources. Specifically, I look to donor countries and constituents who can alter their demands to focus more heavily on observable outcomes. This can potentially shift the manner in which agencies are evaluated, and make it imperative for them not to simply 'move money'.
This solution can encourage collective efforts by improving the benefits associated with a joint strategy.

I will start with an overview of the incentive structures in place within multilateral agencies. It is important to outline what incentives are at play for aid agency individuals, and how these incentives aggregate to shape an agency's external strategy. I will then outline the alternative delivery mechanism that could be adopted by agencies to overturn the cycle of aid dependence. This alternate aid modality, providing aid *ex-post* has the potential to induce recipient governments to expend greater effort towards reforming domestic institutions. However shifting towards this would have implications for the existing operational strategy of most multilateral agencies. Thus, I anticipate how these incentives would be challenged under the more stringent strategy I am suggesting multilateral agencies pursue.

This will then lead into a discussion on two potential hindrances to collective action. Firstly, I will discuss the Prisoner's Dilemma situation that arises when individual agencies are unwilling to incur private costs to adopt the new strategy, but still hope free-ride from other agencies' commitments. The Prisoner's Dilemma game will help outline hindrances to cooperation between multilateral agencies.

The second challenge I discuss regards inter-agency efforts to coordinate actions. In most cases, agencies will only arrive at this stage once they are at least partially convinced about the merits of the new strategy. However, as I will present, unless agencies can coordinate their actions and receive assurance from other players that they too will participate in the collective adoption of this new strategy, no agency will truly commit to action.

Finally, I will identify and discuss two potential sources that could direct agencies away from the suboptimal Nash equilibrium (Prisoner's Dilemma), and the Uncooperative Equilibrium (Assurance) towards socially optimal outcomes whereby agencies collectively adopt the new aid disbursing strategy.

6.1 A Formal Analysis of Incentives in Multilateral Agencies

Incentives are the principal variable affecting organizational behavior (Clark and Wilson, 1961), and individuals contribute personal efforts towards organizations because of incentives (Bernard, 1938: 139). The individual is always the basic strategic factor in organizations, and any effort undertaken by organizations must satisfy some aspect of the contributor's motives. Within an organizational setting, there are two main motives pursued by individuals: self-preservation, and self-gratification. Within multilateral aid agencies, the former motive could refer to the need for agency staff to retain their material and professional standing within agencies, while the latter could pertain to the need for warm glow, or benefiting from the act of giving. Bernard (1939) in his seminal work on organizational incentives argues that organizations can exist only when consistent with the satisfaction of these motives, unless, alternatively, they can change these motives.

The types of incentive systems existing within organizations can be classified into three broad categories (i) Material incentives, (ii) Solidary incentives, and (iii) Purposive incentives.

Briefly, material incentives refer to rewards that have a monetary value or can easily be translated into ones with monetary benefits. These include money in the form of wages, salaries and "fringe benefits." Solidary incentives consist of rewards that are basically intangible, and are derived mainly from the act of associating. They can include rewards such as congeniality, the sense of group membership and identification, and the status resulting from membership. Similar to solidary incentives, purposive incentives are intangible, however, their awards are derived from the stated ends of the association rather than from the simple act of associating (Clark and Wilson, 1961: 134). Within this context, 'purpose' refers to explicitly stated substantive goals which are suprapersonal (i.e., they will not benefit members directly and tangibly) and which have nonmembers as their objects**.** As a whole, purposive incentives are inseparable from the ends being sought. Members of organizations hoping to enjoy purposive rewards are brought together to derive benefit from the ideals of the organization, as opposed to enjoying the monetary rewards from performing for organizations, or from the benefits of enjoying the presence of other members of the organization (Clark and Wilson, 1961: 134-5).

6.2 Shifting Agency Strategy and Implications for Agency Staff

The strategy shift that I propose is a move towards channeling aid ex-post. A concern associated with ex-ante agreements is that they leave room for a "promise now but delay delivery until later" mentality, but under this disbursement strategy, donors disburse funds only after recipients have met the earlier established conditions (can be a variety of targets, such as the number of children enrolled in primary schools, number of roads constructed).

Instead of providing ex-ante aid aimed at 'buying reforms,' and affecting developmental change, multilateral agencies in this scenario would turn their focus towards ex-post verification and instead 'reward' reforms or development outcomes. Ex-post provision of aid has been linked to a number of benefits missing in existing aid practices. Particularly, it has been credited with allowing full utilization of disbursed funds, and overcoming the moral-hazard and principle-agent problem between agencies and recipients countries. Additionally, it has also been proposed as a check on fungibility by overcoming the problem of missing information on where disbursed funds are being used (Svensson, 1999). If ex-post aid provision were set in place in its more accurate form, aid would mostly be targeted towards countries that have adopted good policies, and utilized past development assistance in a more fruitful manner.

There are however, a host of problems associated with this shift. Donor funding under an ex-post regime creates fewer rewards for employees of the multilateral agencies. Given that agency performance is often evaluated on the basis of aid disbursed and projects initiated rather than actual outcomes, ex-post conditionality requires a new institutional constellation on both sides of the aid exchange. Greater responsibility is now placed on recipient governments, while agents in multilateral agencies now become responders rather than initiators. Moreover, this handing over also implied a concomitant decline in an agency's authority over its own aid packages. This could dampen agency staff efforts to participate in efforts to implement ex-post allocation programs; if professional advancement continues to be related to the size of one's portfolio of projects, agency staff may well lack the discipline not to lend to marginally deserving or temporarily virtuous countries ((van de Walle, 2000: 4) in Ostrom et. al, 2001:101). Another consideration for multilateral agencies can be that their source of revenue, donations from developed countries may steadily narrow if most of development assistance is being transferred towards countries that are successfully taking charge of their own development destiny. This would then reduce the necessity for development assistance, especially because funds are often solicited on the basis of the expected needs of the 'poor.'

The success of this shift in policy is heavily contingent upon the level of participation from multiple multilateral agencies. As the aid agency-recipient interaction arena consists of multiple agencies, there can be a 'race to the bottom' effect if there is no coordination among agencies, and if they differ on the threshold levels that need to be met in order for a recipient country to qualify for further rounds of development assistance. Moreover, the publicly available information about aid agency policies also makes it more difficult for agencies to break away from the informal cartel of agencies, where a tacit agreement to "log-roll" each other exists. Thus individual agencies are unlikely to take on the daunting task of making the switch independently. North (1990: 22) has suggested that the demand function for expressing convictions is negatively sloped: "The evidence we have with respect to ideologies, altruism, and self-imposed standards of conduct suggest that the trade-off between wealth and these other values is a negatively sloped function." Collective action theory also predicts that there will be few heroes or martyrs except when the cost of heroism or martyrdom is cheap: "ideologies matter, but only when the price of expressing them is quite low" (Lichbach, 1996: 12). Moreover, "the lower the price of ideas, ideologies, and convictions, the more they matter and affect choices" (North, 1990: 40).

It is possible to lower the costs of expression if 'institutions' reduce the price paid for convictions, thereby allowing ideology to guide action (North, 1990:43). Bringing about an ideological and operational shift in the approaches to development assistance is made all the more difficult by the necessity for multilateral agencies to work together to implement newer approaches. Difficulties arise as a consequence of both the "stickiness" of existing institutions and practices, and more importantly due to collective action problems. This is coupled with the fact that the informal "cartel of good intentions" consisting of multilateral agencies has locked many agencies into a position where they fear the reputational consequences of breaking from existing disbursement strategies.

For one thing, a move towards ex-post aid provision entails acknowledgment that there are some problems within the current development assistance system. This would challenge both the need for self-preservation, and self-gratification that are currently sustaining agency staff behavior. Secondly, as mentioned previously, ex-post aid can potentially limit the benefits and authority of agency staff as responsibility for project design and appraisal has been moved over to recipient governments. Moreover, as agencies are currently rewarded on the magnitude of projects initiated, as opposed to their ability to yield results, this aid modality can pose a threat to monetary incentives of agency staff.

The apprehension surrounding ex-post aid is further heightened by the fact that the benefits associated with it remain largely uncertain. This is especially because agencies are unsure about other agencies' views on it, and the perceived benefits from engaging in collective action seem not only risky, but also uncertain. Under conditions of uncertainty, an agent is unaware of whether the actions available to him will have a certain outcome (Harsanyi, 1977:23).Particularly in this case, individual agencies are unsure if their decision to move over to ex-post aid has a guaranteed outcome of inducing institutional reform. The likelihood of governments switching over to another agency instead looms large in the face of such uncertainty.

If a number of multilateral agencies do decide to undertake this effort, there will be economies of scale of sorts where the social and operational costs of switching strategies will be minimized. If this is the case, then why don't agencies coordinate efforts, and work collectively to transition towards ex-post aid?

In some cases, this shift away from ex-ante provision would also involve extremely high initial startup costs. Empirical evidence has shown that aid is not always directed towards countries where strong conditions prevail, yet there is a strong bias towards "always" disbursing aid to the ex-ante designated recipient, irrespective of that recipient's performance and (irrespective of) the conditions in other potential aid recipient countries (Svennson, 2003: 398). This is done in order to minimize transaction costs, defined as "the effectively *realized* opportunity costs to organize a transaction: the costs to search for a partner, find the right information, measure quantities and qualities of the traded goods and services, negotiate a contract, plus monitoring and enforcement of that contract" (North,1990) and Coase (1937). Thus, for this institutional setting, there is a trade-off: the more an agency invests in realized transaction costs, the lower the potential *ex-post* costs. Although it is likely that the marginal costs of *ex-post* aid will diminish over time, the startup costs could possibly deter agencies from making the shift away from an embedded system. Lastly, the 'warm glow' effects of providing aid could also be reduced because aid is being withheld from countries that are unable to make progress.

Given the current structure of multilateral aid agencies, the possibility of moving away from *ex-ante* aid provision towards more stringent transfer requirements possibly sets up a trade-off between monetary and purposive rewards. It can be debated that this poses a threat to solidary incentives as well because some individuals within these agencies may find themselves cleaved into two fragments between those who want to make the shift, and those who are content with how things are progressing. Even so, this antagonism is arguably rooted in the priority allocated to monetary rewards (rewards based on project involvement) versus purposive gains (more useful allocation of development assistance). Solidary incentives, or the rewards from group membership do come into play when we consider the fact that there are multiple such organizations in the development assistance community. For one thing, membership in the informal 'cartel of good intentions' entails bearing reputational consequences of breaking away from the norm of providing aid ex-ante. On the other hand, from a purely survival perspective, there is a legitimate fear among agencies of being the only ones imposing more stringent aid transfer policies. This is particularly heightened when commitment to *ex-post* aid from other agencies cannot be obtained. In turn, agencies can logically become fearful that recipients will exercise their bargaining power to take up a project offered by another aid agency.

As success of agencies is measured more by volume rather than quality, agencies can become disinclined to take the risk of being deemed a 'failure' by donor sources, and be perceived as idle within the development assistance community. The organization's executive then alters its motives in response to the behavior of contributors, or potential contributors, to the organization. Thus, the fear of being isolated can stymie any individual efforts that could be taken by multilateral agencies.

The challenges associated with multilateral agencies shifting strategies towards recipient governments can be easily conceived if we envision the *ex-post* delivery mechanism to be a public good. I deem it to be so because i) it can only fully be supplied through joint efforts, ii) benefits associated with it are non-excludable and non-rival, and iii) it is in the overall benefit of everyone to move towards it, but individuals still have a temptation to free ride on it.

These factors then contribute to inter-agency collective cooperation and coordination problems. The cooperation problem is essentially a motivational concern, and is driven by perceived high costs of engaging in collective action. This problem can be demonstrated as a Public-Good Prisoner's Dilemma Game. It concerns the decision of individual agencies to participate in the process of providing reform when a temptation to free ride exists.

In a scenario where agencies do find that the benefits of cooperation outweigh the costs, an inter-agency coordination problem arises. This can be demonstrated as a First Mover Problem/Assurance Game. Whereas in the Prisoner's Dilemma, each individual prefers free riding to participating, in the assurance game, "participation is preferred to inactivity under the right condition- the condition being that "enough others" also participate to make collective action possible" (Chong, 1991: 11).

6.3 Inter-Agency Cooperation: Public Good-Prisoner's Dilemma

To start off, I argue that agencies will not engage in collective action because of a public good problem. In this case, the public good is the joint provision of a new aid disbursement strategy. The costs of participation in this endeavor are high, and involve time, and the risk of injury. Individual agencies unwilling to pay these costs may convince themselves that other agencies may make the effort to supply ex-post aid, regardless of whether they participate. Hence, there is a tendency to free ride. This is because agencies are free to avoid the costs to avoid the costs, but involuntarily experience the benefits. However, this line of thought will not just be specific to one particular agency; all agencies will refuse to participate thinking they are the only ones abstaining.

Before proceeding further, I will qualify how ex-post aid is a public good. A pure public good is one whose benefits are non-rival and non-excludable. Although a collective strategy to reverse aid dependence via *ex-post* aid delivery is not a pure public good, it still maintains some characteristics of non-rivalry and non-excludability. The benefits in this case refer to the eventual dissolution of the aid dependence cycle, and the enhanced ‘development’ that will result from that. It is also possible that the cost of operating in certain countries improves if *ex-post* aid is able to induce institutional reform, and limit rent-seeking and fungibility. This could also reduce administrative and monitoring costs for all agencies.[17] In this case, non-rivalry occurs because one agency benefiting from witnessing enhanced growth does not prevent another agency from doing so. Non-excludability means that no agency can in fact be prevented from benefiting. Overall in comparison to the costs incurred, these benefits seem considerably small especially because they take away warm glow effects to non-cooperating agencies.

It is easy to envision how collective action problems may arise in such a scenario. Lichbach (1996: 13) summarizes collective action dilemmas quite succinctly when he claims that collective action is in the interest of all, but in the self-interest of none. Moreover, as Popkin argues: “Collective action … requires conditions under which agents will find it in their individual interests to allocate resources to their common interests and not be free riders” (Popkin, 1979: 253). It is highly possible that individual strategic behavior might prevent agencies from

[17] Sundberg and Gelb (2006) also estimate that nearly one-fifth of total ODA, valued at $4.5 billion to Africa in 2004, was taken up by expenditure on “technical cooperation.” Most of this aid comprises the hiring of foreign advisors, financing training programs, producing analytic reports, and evaluating expert advice.

participating. Once they do decide to cooperate, however, they will face a second dilemma, that of coordinating their actions with each other. This is particularly difficult because ‘everyone will stand around waiting for others to pay the heavy start-up costs needed to initiate the process’ (Chong, 1191: 118).

The following function is an adaptation of Lichbach (1996) and Hardin’s (1971) individual functions demonstrating the linkage between a Public Good Problem, and a Prisoner’s Dilemma to group functions. I have assumed that individuals within agencies are homogenous, and their preferences are in alignment with those of reflected in the strategy adopted by the aid agency.

$$U_i = b/n \, {}^{n}\Sigma_{j=1} \, k_j - ck_i$$

where U_i is the utility of each agency (comprised of individuals)

b/n is the benefit to *i* of any person’s contribution of one unit of resources towards the Public Good, $b \geq 0$

c is the cost to *i*, each agency’s contribution of one unit of resources toward the Public Good

k*i*= 0 if *i* does not contribute any resources towards the Public Good;

1 if *i* does not contribute any resources towards the Public Good; and

N= {1,.....,n} is the members (agencies) in the group

There is only a binary choice of contribution; agencies either contribute one unit of resources towards participation, or do not participate at all. On the other side, any benefits yielded from this good are also shared equally amongst all group members. There is no discrimination between participants and non-participants. The cost for each agency is *c* times number of units provided k_i.

If we also assume that the number of multilateral agencies are fixed, and do not change over time, it is easy to pinpoint the non-excludability of this good; *j* agency cannot exclude agency *i* from the benefits of increased development. These problems arise because the benefits from *ex-post* aid induced development are voluntary, but the costs are privately incurred (Lichbach, 1996: 37).

N consists of two groups of agencies: *P,* who decide to participate in efforts to shift towards ex-post aid, and *A*, those who abstain from this shift. The payoff for *P* in this case is P(m), if *m* others are cooperating, while the payoff for *A* is A (*m*) if *m* others cooperate. A Prisoner's Dilemma is defined if:

$$A(m) \geq P(m+1), \text{ and}$$

$$A(0) \leq P(n)$$

Essentially, the payoffs for *m* agencies that abstain from making the shift is greater than or at least equal to the payoff for (*m*+1) participants. However, the benefits of participation from all are much higher than the payoffs from abstention.

Considering the individual agency utility function: $U_i = b/n \, {}^{n}\Sigma_{j=1} \, k_j - ck_i$ and given that contributions can only be binary, the Public Goods problem raises a Prisoner's Dilemma problem if: $b \geq c$, and if $c \geq b/n$, that is, the benefits from ex-post aid are at least equivalent to the costs of making the shift, however the individual costs of participating exceed the benefits. Thus, every agency's marginal cost is greater than its marginal benefit. However, the total benefit from collective participation is higher than total costs.

Based on the assumptions outlined above, the Public Good-Prisoner's Dilemma game with N players can be presented as such:

All Agencies except *i*

	0 pick P n-1 pick A	1 picks P n-2 pick A	2 pick C n-3 pick A		j pick C n-j-1 pick A		n-1 pick P 0 pick D
Participate	$(b/n) - c$	$(2b/n) - c$	$(3b/n) - c$	...	$[\{(j+1)b\}/n]-c$	…	$(nb/n)-c$
Abstain	0	b/n	$2b/n$	…	jb/n	…	$(n-1)b/n$

Adapted from Lichbach (1996)

Herein lies the collective action problem; a gap exists between individual Nash equilibrium (do not participate), and socially optimal outcomes (participate). *A* is every player's best reply to other players' choice of *A,* and so, participation by everyone is "both individually inaccessible (no one will take the first step towards it) and individually unstable (everyone will take the first step away from it)" (Elster, 1984: 21). A change in the payoff structure can potentially induce cooperation in this case. This can be achieved either through an increase in benefits associated with cooperation, or through a decrease in the costs of participation. Moreover, cooperation in a collective action good can be facilitated by social incentives: such as the desire to gain or sustain friendships, maintain ones social standing, and avoid ridicule and ostracism. Particularly for public-spirited collective action, reputational concerns determine participation. If interests of agencies are aligned, a refusal to contribute may cause doubt as to one's reliability and dependability. Social interaction promotes not only the development of mutual obligations and commitments, but also the formation of other-regarding interests (Chong, 1991: 13).

6.4 Inter-Agency Coordination: Assurance Game and First Mover Problems

If social and psychological incentives are effectively utilized to transform the Prisoner's Dilemma, agencies must then confront another challenge in collective action, that of coordinating their actions. This type of coordination problem is better known as an "assurance game." Whereas in the Prisoner's Dilemma, each individual prefers abstaining (free riding) to participating, in the assurance game, participation is preferred to inactivity *under the right condition-* the condition being that *"*enough others*"* also participate to make collective action possible. In an assurance game, collective action may be frustrated because everyone wants to follow the lead of others. Until the movement becomes viable, the social pressures and incentives to participate remain latent. Therefore unless there are some leaders who are willing to pay the heavy startup costs of collective action in the absence of these incentives, mass coordination will not occur. The leader however, only makes his move if he has some guarantee that others will follow in his wake. If an individual acts alone, he will be swiftly and harshly punished, an outcome that potentially gives the rest of the group a small amount of cathartic, albeit sadistic pleasure. An all-out effort by the individual and the rest of the group however, produces satisfaction for all concerned.

The most central concern in cooperative games is that of uncertainty and complete information about other actors' likely behavior. For cooperation to succeed, it is not just imperative that each individual has an idea about the preferences of others, but rather that others are also aware of his own preferences and strategies (Schofield, 1965: 218 cited in Chong, 1991: 118). Thus, common knowledge is the problem. Based on Chong (1991), we conclude that uncertainty in such scenarios can sufficiently alter the payoff matrix facing individual agencies.

Number of Cooperators

		$<l$	$l<\ldots< v$-1	$\geq v$
Agency	**Participate**	-(c +c')	b-c-c''	$2b$+b'-c
	Abstain	0	b	$2b$

If fewer than k agencies cooperate, shift towards ex-post aid is highly unlikely to be successful because recipient countries will instead substitute such agencies for those with less stringent rules. Moreover, there are reputational consequences associated with being part of a small few that break away from the status quo, as the ‘strength in numbers’ benefit does not exist here. Those costs are denoted by c'.

There is also a window for number of cooperators between l and v-1, where there are advantages to being a defector. Here as in the previous scenario, this decision also carries reputational costs (c''), although a higher number of participants could suggest that $c'' \leq c'$

The best case scenario is one where more than v agencies decide to participate in making the shift towards ex-post aid. Although we are unsure about what exact value this will take, given the nature of the donor-recipient bargaining arena, we can safely say that it definitely represents the majority of agencies [(N +1)/2]. The payoffs from participation when $m\geq v$ are associated with additional benefits, represented by $2b+b'$ where ($2b$) represents more of the collective good that is being provided, and b' represent the social and psychological gains from participating in an industry wide effort. The rationale behind *b'* is that is that as group size increases, the temptation to free-ride becomes a consideration because of the belief that a single agency's contribution will make no perceptible difference to the overall actions of the group. However, social and psychological incentives *b*', also known as separate or selective incentives successfully counter this problem because they offer agency's benefits that are independent of the collective good. In some senses, they provide solidary incentives. According to Olson, selective incentives are defined to be greater in value, in terms of each individual's preferences than each individual's share of the collective good (1965: 57).

Even so, precise estimates of these parameters are difficult to obtain. Thus, a certain degree of uncertainty always persists within these games. An agency that is overly pessimistic about the possibility of collective action will set its value for *k* and *v* to be extremely high, and may abstain from participation. Thus, every agent's decision to participate will be determined by his belief in the likelihood that certain levels of participation will be attained. More specifically, cooperation will be an agency's best course of action if they believe that the probability of other agencies participating is at least equal to, or greater than the ratio of costs (*c*) to additional benefits (*b*') beyond the basic public good *b.* Similar to the Prisoner's Dilemma, agencies will be induced to participate if costs of participation are lowered, or if the selective benefits accompanying contributions are increased. Additionally, in assurance games, the higher the probability that other agencies will participate, and the more likely it is that an agency will participate in the switch.

6.5 Overcoming Collective Action Problems

Inter-agency collective efforts to demand, and induce reform within aid dependent countries are currently suspended because individual agencies either find the benefits from participation to be too menial, and the costs (both reputational and transaction) to be too high. I propose two solutions below that tackle either of these concerns.

6.5.1 Political Entrepreneurs

Thus far, the discussion of inter-agency dynamics has assumed all agencies to be equal in i) terms of the market share they hold (proportion or scale of projects), ii) the amount of authority they can exert on recipients (assumption that every agency's threat carries equal weight), and are iii) equally reliant on donors for funding.

This is a fairly broad assumption to make because there is a great deal of heterogeneity within multilateral agencies. As a result of these differences, some agencies have less to lose from risk taking, and are not as susceptible to concerns of reputation and survival. Such agencies are strongly positioned to solve the first-mover problem associated with assurance games. Collective action literature makes references to 'political entrepreneurs,' agents who are responsible for organizing the group's production efforts, and to provide creative solutions (Lichbach, 1996: 156). However, these agents are normally identified as third party arbiters, who simply end up receiving a share of the profits made by the group. Instead, I am proposing that a 'political entrepreneur' from within the aid community can rise to the challenge and be the first to implement ex-post aid. For instance, agencies such as the World Bank or IMF for instance, maintain relatively strong market shares, and are well established within the development assistance system as leaders in both program implementation and knowledge generation.

If we relax the assumption that agencies make their decisions simultaneously, it is possible to see how the presence of political entrepreneurs can help reduce the costs associated with participation. As 'early' participants, political entrepreneurs can influence the 'latecomers'' decision to participate. As the number of previous participants increases, the reputation costs to subsequent participants decreases. The presence of an entrepreneur who initiates the switch to the new strategy can also help reduce transaction costs for other participants. Once latecomers are able to observe how the entrepreneur is able to design the new strategy towards recipient governments, their own uncertainty, and information costs are minimized.

6.5.2 *Pressure from Donors*

Multilateral agency concerns of survival are largely based on financial support from donor countries. Moreover, the compulsion to exhaust budgets, and keep up sustained flows of development assistance year after year have built into them, concerns of supplying warm glow to donor governments and constituents.

However, if there were a shift in the manner in which agencies were evaluated, towards a greater emphasis on observable aid outcomes, agencies are likely to perceive greater benefits from ex-posts aid. This in turn would induce greater cooperation, and subsequently, coordination between multiple agencies.

These 'shifts in demands' could be conveyed in a number of ways. One possible channel is if donor governments endorse this new aid modality, and reflect that preference by supporting agencies inclined towards it. Taxpayers can move agencies towards this delivery method if they make demands for more tangible and detailed evidence on the projects their money is being channeled towards. If ex-post aid is seen to fulfill to these demands it is likely that agencies will work to change their practices to cater to donor needs. Additionally, if these demands are made of all agencies, we can safely assume that the reputational consequences of breaking from the cartel's delivery methods will also sufficiently lessen. Thus, in terms of payoffs, this will affect both the costs associated with participation, and the perceived benefits from provision of the collective good.

CHAPTER 7

CONCLUSION

My goal in this study was to establish that multilateral aid agencies have the ability to curb aid dependence, but are not exercising that power. My contribution is to highlight the factors that are preventing agencies from taking the necessary steps to end the cycle of aid dependence, and demand institutional reform in recipient countries. Traditionally the blame for poor aid outcomes has fallen on agents within recipient countries, but as I have demonstrated, aid agency staff also play a role in allowing aid dependence to persist.

The actions of multilateral agencies however are limited by the need to satisfy donor demands that agency budgets be exhausted. Moreover, as agency performance is evaluated on the basis of how many projects they have initiated, and how many funds they have disbursed, any policy that restricts either is unlikely to be adopted. Thus, agencies are unable to credibly threaten to withdraw financial and operational support from countries that have become aid dependent. Moreover, even if they do decide to impose stricter aid transfer conditions, recipient governments can easily substitute one agency for another that may already be operating within their country. This, along with reputational concerns of being the only agency within the broader multilateral aid industry that is making demands of recipient governments further deters any attempt at the part of individual agencies to alter the nature of their engagement with aid dependent governments.

As I argue in this thesis, aid dependence could potentially be remedied if a majority of agencies band together to jointly demand reform from aid dependent countries. One way I recommend agencies could achieve this is by moving towards an *ex-post* delivery of aid. I anticipate that under this system, governments will naturally move towards stronger institutions that facilitate the kind of progress that will be rewarded.

This joint shift in strategy however is complicated by collective action problems within agencies. It is difficult for agencies to first decide whether to cooperate with other agencies to make this shift especially when the benefits from ex-post aid are uncertain, and the costs seem considerably high. Secondly, once an individual agency does decide to work with others to shift strategies, it needs guarantees that others are also committed to action. Otherwise the costs of being a minority outweigh the benefits, and the agency will opt out of participation. I identify these two to be hindrances to collective action within multilateral agencies. Finally, I present two sources through which collective action could be facilitated. One is the emergence of a 'political entrepreneur' from within the multilateral agency cluster, and the other is a shift in the manner in which donor countries and constituents evaluate performance of agencies. These two are selected for their ability to mitigate some costs associated with ex-post aid, while also improving the perceived benefits associated with it.

APPENDIX

AID INTENSITY BY COUNTRY (2002-2009 AVERAGES)

Country	ODA as a % on GNI	Net ODA received (% of imports of goods and services)	Net ODA received (% of gross capital formation)
Afghanistan	37.00		199.69
Benin	9.39	28.38	47.28
Bhutan	11.62		22.47
Burkina Faso	12.78	50.12	75.43
Burundi	38.85	100.77	351.42
Cambodia	9.45	12.45	48.17
Cameroon	5.42	17.25	32.82
Central African Republic	7.95		96.81
Chad	8.87		28.07
Comoros	8.71		81.98
Congo, Dem. Rep.	27.05		205.50
Congo, Rep.	6.62	6.59	19.54
Djibouti	11.57	22.61	83.89
Eritrea	23.63		120.08
Ethiopia	14.29	45.43	62.76
Gambia, The	15.17	24.01	61.64
Ghana	9.78	16.827	40.44
Guinea	7.58	19.64	40.42
Guinea-Bissau	23.02	60.41	280.67
Guyana	13.70	13.13	54.82
Haiti	12.44	22.41	34.21
Honduras	5.92	7.47	20.75
Kiribati	14.68		
Kosovo	14.17		52.88
Kyrgyz Republic	10.86	17.823	58.04
Lao PDR	12.15	37.86	60.25
Lesotho	5.77	5.10	25.15

APPENDIX

AID INTENSITY BY COUNTRY (2002-2009 AVERAGES) (Continued)

Country	ODA as a % on GNI	Net ODA received (% of imports of goods and services)	Net ODA received (% of gross capital formation)
Liberia	61.97	27.73	333.46
Madagascar	12.38	32.34	54.99
Malawi	21.10	46.51	107.8
Mali	13.16	30.53	56.72
Marshall Islands	33.80		
Mauritania	15.42		64.49
Micronesia, Fed. Sts.	42.20		
Moldova	6.02	7.36	25.22
Mongolia	11.33	16.63	37.10721397
Mozambique	26.11	46.64	24.50116611
Nepal	6.122	18.51	58.85020348
Nicaragua	17.40	23.83	103.7431126
Niger	13.65	45.48	111.5582282
Rwanda	20.07	73.12	
Samoa	11.58	15.45	
Sao Tome and Principe	22.85	55.39	37.56
Senegal	8.80	19.64	287.5
Sierra Leone	31.80	80.11	247.61
Solomon Islands	30.92	49.40	87.88
Tajikistan	10.82	12.03	58.34
Tanzania	12.86	43.30	285.87
Timor-Leste	39.09		19.79
Togo	6.19	10.19	44.33
Tonga	10.46	17.85	
Tuvalu	30.41		64.64
Uganda	13.91	45.17	58.22
Vanuatu	13.11	18.32	72.17
Zambia	16.80	34.43	

Note: Only countries with ODA as % of GNI> 5% included.
Source: World Bank Development Indicators

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