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Aid and donor trust in recipient country systems☆

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ABSTRACT

The 2005 Paris Declaration on Aid Effectiveness sets targets for increased use by donors of recipient country systems for managing aid. The target is premised on a view that country systems are strengthened when donors trust recipients to manage aid funds, but undermined when donors manage aid through their own separate parallel systems. This study provides an analytical framework for understanding donors' decisions to trust or bypass country systems. Empirical tests are conducted using data from three OECD-DAC surveys designed to monitor progress toward Paris Declaration goals. Tests show that use of recipient country systems is positively related to (1) the donor's reputational stake in the country's development, as proxied by the donor's share of aid provided to the recipient; (2) the trustworthiness or quality of those systems, as measured by cross-country corruption indicators; and (3) donors' risk tolerance, as proxied by public support for aid provision in donor countries. Findings are robust to corrections for potential sample selection, omitted variables or endogeneity bias.

1. Introduction

The literature on growth and development now recognizes a key role for the quality of public institutions. Yet, little is known about how to apply this insight constructively in the design of development assistance. "Good governance" in the form of capable and accountable state institutions emerged only over the course of centuries in the West, and it may be impossible for today's developing countries to follow similar paths in a dramatically compressed time frame. Historically unprecedented progress on health outcomes and education enrollment may contribute to unrealistic expectations regarding donors' role in accelerating institutional development in poor countries. Even in relatively technocratic areas (e.g. civil service and legal/judicial reform) of public sector governance, success rates for donor projects are low and the evidence base underpinning the design of interventions is thin or absent (IEG, 2008).

Moreover, there is growing recognition that international aid – and particular donor practices – can unintentionally weaken governance in recipient countries. Aid – like natural resource revenues – can encourage rent seeking and undermine governmental accountability to its own citizens, by reducing its dependence on domestic taxpayers for revenues (Collier, 2006; Knack, 2009; Moore, 1998). Donors can also undermine government capacity, when they fragment their aid among too many projects, sectors and countries, and insist on delivering aid using their own reporting, procurement and other procedures (Brautigam and Knack, 2004). As the World Bank's Assessing Aid report acknowledges: "At times, donors have hindered the creation of effective public sectors because they saw end runs around local institutions as the easiest way to achieve project success" (World Bank, 1998: 84).

These arguments have attained the status of conventional wisdom within the international aid community. The importance of delivering aid in ways consistent with long-run institutional-strengthening is a major theme in the Paris Declaration agenda for reforming aid practices. The Paris Declaration (PD) created a set of numerical indicators on improved "alignment" of aid activities with country systems and inter-donor coordination, to be monitored through surveys of donors and recipient countries, with defined targets for the year 2010.

Although the PD principles and associated indicators reflect a broad consensus within the donor community (most notably in the OECD Development Assistance Committee), the empirical basis for this new aid effectiveness agenda is thin (Easterly, 2007). Advocacy

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for reform of donor practices is based on theory, intuition and scattered anecdotal evidence.[1] This paper does not attempt to add to the thin evidence base underpinning the Paris Declaration principles and indicators. Rather, it is premised on the fact that they have been endorsed by the DAC bilateral donors and multilateral agencies providing the bulk of ODA. Donor behavior is assessed relative to donors' own assertions about what constitutes more effective aid practices.[2]

We provide a theoretical framework for understanding the incentive problems among donors that can produce suboptimal levels of harmonization and alignment in their aid activities. This framework and supporting empirical evidence are relevant so long as most of the donor community believes that use of country systems is currently below the optimal level. The caveat is that we cannot offer confident conclusions about which donors are really providing "better" aid, in the absence of more evidence on how using country systems affects either the quality of systems or development outcomes.

To preview, a donor's trust in a recipient's aid management systems is determined in our framework by three broad considerations:

1. Confidence it will reap sufficient benefits from investing in recipient country systems;
2. Trustworthiness of those systems, as measured for example by corruption ratings;
3. Trust in aid's effectiveness in general, on the part of its domestic constituents.

"Trust" in our terminology does not necessarily imply an absence of perceived risk, i.e. a belief that a recipient is particularly trustworthy. Nor does it necessarily imply the presence of significant risk. Rather, trust – as reflected in a donor's decision to use country systems – is a behavior, not a belief. Trust is facilitated by low perceived risk, a high tolerance for risk, and ability to internalize the benefits from investing in country systems.

The next section provides the theoretical underpinning for these arguments, including a formal model of the donor's decision to manage aid using its own systems or recipient country systems. Section 3 describes how the model's concepts can be operationalized and its predictions tested using a panel dataset based on the Paris Declaration's three monitoring surveys, with donor–recipient pairs as the main unit of analysis. Empirical results reported in Section 4 are largely consistent with the predictions of the theoretical framework. A variety of robustness tests in this section address potential concerns regarding sample selection, omitted variables and endogeneity bias. The final section summarizes and concludes.

2. Theory

The Paris Declaration calls for increased use of recipient systems in managing aid, but it explicitly acknowledges that weak country systems make aid less effective. Recipients, with technical assistance from donors, are therefore urged to strengthen their public financial management (PFM) systems. In the meantime, using those systems, despite their flaws, is believed to strengthen them in the medium or long run: "Donors can help build capacity and trust by using country systems to the fullest extent possible, while accepting and managing the risks involved…" (OECD, 2009a: 27). On the other hand, bypassing country systems undermines them, by diffusing accountability and fragmenting policy and planning processes (Mokoro Ltd., 2008a; OECD, 2009b). Moreover, donors often staff their own parallel aid management systems by "poaching" the most talented government officials.

Donors' incentives to trust country systems (or alternatively to micro-manage aid using their own parallel systems) depend in part on their perceived trustworthiness. Where recipient aid management systems are stronger, corruption scandals tarnishing the donor agency's reputation are less likely to occur, and aid-funded programs are more likely to be selected and implemented more efficiently. The Paris Declaration recognizes that weaknesses in country systems sometimes justify donors' decisions to bypass them. The developmentally-optimal level of trust by donors in country systems varies positively with the quality of those systems. In certain cases, trust may be inefficiently high. Jansen (2009: 23) reports on rampant corruption in a donor-funded natural resource management project in Tanzania, where "the financial management system which the Norwegians chose to trust functioned very badly."

For a given level of trustworthiness of country systems, donors' trust in them can vary substantially because they have different mandates and face varying degrees of political pressure from their taxpayers and elected overseers. Multilateral donors can differ from bilateral donors, and some bilateral donors may be constrained more than others by limited support for foreign aid on the part of politicians and the public. Pressures to demonstrate visible achievements (that can be attributed plausibly to a donor agency's own aid funds) to skeptical taxpayers or elected officials will increase further the tendency to free ride on other donors' contributions to strengthening country systems (Williamson and Agha, 2008: 34). When bilateral donors use aid to advance diplomatic or commercial objectives, incentives to rely on their own parallel systems for aid delivery will be further aggravated. For example, using their own procurement rules will likely advantage donor-country contractors.

If using country systems for managing aid does strengthen them, then donors' use of country systems (in the absence of coordinated action) is likely to be sub-optimal. The benefits of using country systems are mostly external (benefiting other donors) and realized only over the long term, while costs are short term and fully internalized by the donor. When donor agency i undertakes any action to strengthen recipient country systems, it is in effect providing a public good for other donors. Stronger aid management systems reduce reputational and fiduciary risks and increase the developmental impact of aid funds not only for donor i's future aid, but also for other donors. Meanwhile, donor i incurs the full costs, in exposing its current aid funds to higher risks than if it bypassed recipient country systems. The benefits are not wholly external, however: when a donor has a larger share of the aid "market" in a country, it will internalize more of the benefits from any investments in strengthening country systems. Donor i's use of country systems is then expected to be positively related to its share of total aid that is received by a given country, controlling for quality of recipient systems.

2.1. A model of trust in country systems

These incentives facing aid agencies can be captured in a simple model. A representative donor agency i maximizes its value function V_i by allocating its aid budget between donor-managed (D_{ij}) and recipient-managed (R_{ij}) activities in recipient country j, so $A_{ij} = D_{ij} + R_{ij}$. Outputs Q_{ij}^{D} are produced solely by D_{ij}. Outputs Q_j^{R} are produced by R_{ij} and by $R_{-ij} = R_j - R_{ij}$ contributed by all other donors $-i$ operating in recipient j.[3] The link between D_i spending and Q^{D} output is more

[1] See World Bank (2003: ch. 11) for representative anecdotes. Azam et al. (1999) construct a formal model with learning-by-doing externalities in tax administration, in which aid dependence with low institutional capacity can be an equilibrium outcome. What little systematic empirical evidence exists in support of the Paris Declaration agenda bears mostly on its harmonization provisions, not the alignment provisions that cover (inter alia) use of country systems. Anderson (2011), Djankov et al. (2009), Knack and Rahman, (2007) and Knack and Smets (in press) all provide empirical evidence on the adverse effects of fragmenting a country's aid among a larger number of donors.

[2] Here we follow Easterly (2007) and Easterly and Pfutze (2008: 3-4): "The academic aid policy literature and the aid agencies themselves agree on many elements of 'best practice' … By taking this consensus as our standard, we are asking in effect if aid agencies operate the way they themselves say they should operate."

[3] For simplicity the subscript j indexing recipients will be suppressed henceforth.