EC-OECD Seminar Series on Designing better economic development policies for regions and cities

Development assistance and conditionality:

Challenges in design and options for more effective assistance

28 April 2017

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■ Background information

This paper was prepared as a background document to the OECD-European Commission Seminar on "***Conditionalities for More Effective Public Investment***" held on 28 April 2017 at the OECD Headquarters in Paris, France. It sets a basis for reflection and discussion.

■ About the Project

This seminar is part of a five-part seminar series in the context of an EC-OECD project "Designing better economic development policies for regions and cities". Other sessions in the series addressed the use of: contracts for flexibility/adaptability, performance indicators, financial instruments, and insights from behavioural science. The outcome of the seminars supports the work of the Regional Development Policy Committee and its mandate to promote the design and implementation of policies that are adapted to the relevant territorial scales or geographies, and that focus on the main factors that sustain the competitive advantages of regions and cities. The seminars also support the Directorate-General for Regional and Urban Policy (DG REGIO) of the European Commission in the preparation of the impact assessment for the post-2020 legislative proposals and to support broader discussion with stakeholders on the future direction of the delivery mechanisms of regional policy.

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Acknowledgements

This paper has been prepared under the guidance of Dorothee Allain-Dupre, OECD. The author is grateful to Peter Berkowitz, European Commission; Dorothee Allain-Dupre, OECD; Saleh Nsouli, former director, IMF; Professor Massimo Florio, University of Milan; William Tompson, OECD; Andrea Mairate, European Commission; and David Rinaldi, Centre for European Policy Studies; as well as all the participants at the OECD "Seminar on Conditionalities for More Effective Public Investment", held on 28 April 2017 in Paris, France, for helpful comments on an earlier draft. The views expressed here and any errors are those of the author alone and may not be attributed to the OECD, the European Commission, or the Brookings Institution staff and directors.

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Introduction: Objectives of development assistance, rationale for and taxonomy of conditionality

Development assistance in this paper is more broadly defined to include grant and loan assistance within and across sovereign territorial limits by governmental and non-governmental actors and agencies. Such assistance is motivated by altruistic, economic, political, military and humanitarian considerations. It is used to advance wide-ranging objectives such as minimising risks for loan repayment, efficiency, equity of the public sector, overcoming infrastructure deficiencies, promoting growth, facilitating poverty alleviation and good governance, combating terrorism, support for a specific ideology, influence peddling, and economic and political imperialism. The provision of such assistance is more often than not conditional as even unconditional assistance almost always carries some explicit preconditions and implicit conditions. Conditions are imposed as part of lending or grant assistance unilaterally or by mutual agreement of the donor and the recipient. These conditions form contractual terms of such assistance which bind the recipient to expected actions or results as a *quid pro quo* for receiving such financial assistance. These conditions can vary from being very vague to extremely clear and precise. They may impose formal binding requirements or simply indicate informal non-binding expectations.

The conditions imposed may be *ex ante* (pre-requisites), *ex post* or both. *Ex ante* conditions are imposed to ensure that recipients have conditions in place to make effective and incorruptible use of funds and to achieve mutually agreed-upon goals. *Ex post* conditions are imposed to monitor that the interim performance of the assisted programme is consistent with the expectations and to justify continuing assistance. *Ex post* conditions are also imposed to guide future assistance based upon past performance.

Conditions may be on consultations, transparency requirements related to project documents, procurement, reporting and auditing requirements and associated procurement, accounting and auditing systems (process and financial management conditionality), the use of inputs, or expenditures on authorised functions and objects, intermediate inputs (input conditionality), outputs – service delivery results in terms of quality, quantity and access (output conditionality) – or on outcomes (outcome conditionality) or impacts (impact conditionality). Process- and/or input-based conditionality is frequently practiced – it undermines recipient autonomy but affords greater leverage and control to donors. Output-based conditionality is rarely practiced, but offers a great potential for recipient autonomy with accountability for results. Outcome- and impact-based conditionality is occasionally used but dilutes recipient accountability to donors or citizens as many of the underlying factors would be beyond the control of public managers.

Conditions may also embody requirements for counterpart recipient funds to be eligible for donor assistance. Conditions may embody rewards for compliance and penalties for non-compliance. The conditions may relate to a geographic area, the whole-of-government, a level or branch of government, a sector, programme activity or specific subject area targets (OECD, 2013: 59). The conditions may relate to government processes such as the requirement for public consultation or having a participatory budgeting system or passing laws and regulations, or may be concerned with substantive aspects of government operations.

As suggested by Peter Berkowitz of the European Commission, the conditions on substantive aspects of government operations could be broadly classified into five categories:

1. **Macro conditions:** These conditions provide targets for selective macroeconomic indicators such as growth rate, inflation, exchange rate, balance of payments, international reserves, monetary policy indicators, and debt and deficit limitations. IMF programmes typically embody these conditions.
2. **Structural reforms conditions:** These conditions relate to reforms dealing with policies and programmes and practices intended to help improve the working of the public sector to ensure efficiency and equity of revenue generation and public provisions. The conditions specify reform measures regarding the structure and organisation of government, civil service organisation, management and accountability, tax reform, public spending, and regulatory reforms. World Bank and IMF lending and EU Structural Funds are replete with these conditions
3. **Governance and institutional reform conditions:** Governance is defined "as an exercise of authority and control to preserve and protect public interest and to enhance the quality of life enjoyed by citizens/residents" (Ivanyna and Shah, 2011). Thus, it relates to both the governance environment (quality of institutions and processes) and governance outcomes. Governance indicators are now being used as tools for conducting development dialogue, allocating external assistance and influencing foreign direct investment. For example, the World Bank's International Association allocation – a window of subsidised lending to the developing world – and the United States Agency for International Development's Millennium Challenge Account use various governance indicators as criteria for allocating external assistance. The post-2015 development agenda on Sustainable Development Goals gives even more prominence to progress in governance. Governance and institutional reform conditions relate to institutions of accountability in governance such as the role of parliament, judiciary, media and civil society in holding the government to account; government's commitment to upholding the rule of law, human rights and citizen empowerment. In general, such conditions are intended to ensure FAIR (fair, accountable, incorruptible and responsive) public governance.
4. **Fiduciary/financial accountability conditions:** These conditions are intended to ensure integrity in the use of funds by recipients. Over time donor emphasis has shifted from integrity in the use of assisted project funds to governmental systems i.e. overall integrity of government financial operations. Donors increasingly carry out detailed assessments of budgetary, accounting and auditing systems and impose conditions to improve the transparency and integrity of these systems. These conditions are commonplace in almost all donor programmes.
5. **Results-based conditions such as public service delivery and access conditions:** Traditionally, donor emphasis has been on input-based conditionality to ensure that assistance funds were used for the intended purposes. This resulted in donor micromanagement of the use of funds and lack of autonomy in project design and operations by the recipient, but without any assurance in achieving agreed-upon objectives due to the possibility of fungibility of funds and also because the inefficiency in spending and inappropriateness in design may result in project failure. Recognising this, the European Commission initiated limited emphasis on output-based conditions. The World Bank followed suit as did other aid agencies, imposing results-based conditions; the record of these agencies in imposing readily monitorable output-based conditions, however, remains weak. Much confusion in aided projects remains on properly defining inputs, intermediate

inputs, outputs, outcomes and impact and imposing conditions on outputs (service delivery performance), which are usually only within the control of a public manager.

The conditions discussed above have been a subject of controversy and debate. A prominent critic of such conditions notes that "Why would a donor pay a recipient to do something that is anyway in his own interest? And if it is not in his own interest, why would the recipient do it anyway?" (Streeten [1988] quoted in Martens et al. [2002: 12]). This paper will explore the rationale and incentives/disincentives regimes fostered by such conditions. It will focus, however, only on the first three types of conditions, as the remaining two have already received exhaustive treatment in recent OECD work. This focus is also justified as these three conditions are most relevant for discussions on effective delivery mechanisms of regional policy (particularly EU).

Rationale for conditionality

Donors have advanced a number of rationales for imposing conditions on their assistance.

- **Safeguarding repayment of donor loans:** A case is often made that conditionality of assistance is required to ensure that the project is implemented as agreed to ensure that the donor gets repaid according to the terms of lending (IMF, 2016). This is a weak argument as repayment of loans would depend critically upon a recipient's credit worthiness rather than any loan conditions. In addition, sovereign default on international borrowing has serious economic and fiscal consequences for the defaulter and as a result is relatively rare. International capital markets also exact a strong penalty for such defaults, thereby discouraging such perverse behaviour. Therefore, safeguarding repayment of donor loans may be a weak premise for imposing loan conditions (see also Collier et al. [1997]).
- **Strengthening recipient ownership of the assisted programmes.** Conditionality often forces a recipient to make political choices on reform options and to commit to specific policy prescription. In the absence of conditionality, such hard choices could not be made and policy makers may be inclined to simply kick the can down the road.
- **Ensuring integrity of donor-assisted operations.** This was traditionally done by having a special management unit run assisted operations and having appropriate budgeting, accounting and auditing of such operations. Such special arrangements impose significant additional costs for the recipient while limiting local autonomy and holding little assurance for the most effective use of donor funds. In view of this, in recent years donors have emphasised the reform of governmental systems to ensure integrity of operations rather than creating parallel systems. Minimum standards of transparency, integrity and accountability of governmental systems should serve as a pre-requisite for such assistance rather than imposing specific loan conditions.
- **Influencing recipient priorities or as an inducement/incentive for reform.** In cases where there are serious conflicts among donor and recipient priorities, it makes sense to use loan funds as an inducement to influence local priorities. Loan conditions could be used to achieve this change. The success of such conditions, however, may be limited by the extent of the fungibility of funds. In the extreme case, when the recipient already spends more than the assisted funds and it is an area of low priority for the recipient, loan conditions may not have much impact in changing recipient priorities.

- **Paternalism:** The donor knows best what is good for the recipient. Donor conditions frequently embody an implicit judgment that the recipient lacks the knowledge to pursue economic policies that serve its best interest and donor agencies have better knowledge as to what would work best. The "Washington Consensus" and the "Modified Washington Consensus" are examples that shaped loan conditions in the 1980s and 1990s. Such policies, however, do not safeguard for aid dictum of "do no harm", as the consequences of failure of lending operations are only borne by the recipient.
- **Signaling** to safeguard the commitment to reform by the recipient. Conditionality is also advocated as an indication that the recipient is accepting conditionality and its associated possible adverse political consequences to demonstrate a commitment to reform. In practice, however, such signaling is typically done by recipients to shift blame to external actors to undertake domestically unpopular programmes or to attribute failure of such programmes.
- **Sustainability:** Loan conditions are sometimes advocated to sustain as assisted programme over political cycles to overcome time inconsistency of commitment. The success of such conditions is, however, not assured as the new political administration may seek to renegotiate or suspend such operations.

Conditionality and the donor – Recipient government relationship

Conditions the donor places on loans and grants are aimed at improving efficiency by reducing the distortions caused by political incentives. Conditions are required, in a large measure, because of the political costs of reallocating funds. Donor conditions make the shift of priorities more politically palatable for governments involved by shifting the responsibility for loss of political gains from government officials to the donor. The donor's ability to help a government reduce or remove the distortions on budgetary priorities depends on the political skills of the government's administrators. The challenge for administrators is to take credit for efficiency gains while placing blame for the accompanying political and personal losses on the donor.

Our discussion of donor-imposed conditions focuses on the incentives faced by a borrowing country's administrators and the donor's lending staff. The incentives of a country's administrators differ from those of the donor's staff because the conditions imposed on a loan also impose a political cost on a country's administrators. The important point to keep in mind when reviewing the effectiveness of donor-imposed conditions is that the willingness of a country's administrators to seek compliance with the donor's vision of reform depends on commonly shared development objectives. If there was a domestic commitment to conditions sought by the donor, then there would be no need for the conditions in the first place. Below we argue that inefficient use of public resources is the result of political incentives and that it is these political incentives which are the barriers to more efficient use of public resources. In this context, donor conditions are successful to the extent to which they acknowledge these incentives.

The donor's ability to attach conditions to loans is constrained by the political cost those conditions impose on country administrators. If the political cost of complying with loan conditions exceeds the political gain of obtaining the loan, country administrators will not comply with the conditions. On the other hand, if the cost of not complying with the conditions is greater than the cost of foregoing the loan, country administrators will not accept the loan. The effect of these constraints is that donor conditions generally require modest efficiency gains.

The political costs and benefits depend on the responsiveness of the government to political and public pressures, and the ability of the government to influence those pressures. Consider, for example, a donor condition that requires a government to reduce the number of its public sector employees. Reductions in public sector employment create a political loss in terms of a loss of patronage positions. Government administrators' willingness to accept and comply with this condition depends on their ability to minimise the political loss. This is accomplished by shifting the responsibility for the loss of jobs on the donor (Table 1) and by taking credit for the resulting efficiency gains.

Table 1. **Responses to donor conditions for reductions in public sector employment**

Administrative action	Political actions
Comply with the conditions	– take credit for improving public sector efficiency – take credit for obtaining donor loans or grants – blame the donor for painful cuts
Ignore the conditions	– take credit for saving public sector jobs – take credit for obtaining donor loans or grants – blame the donor for unrealistic conditions – place the blame for non-compliance elsewhere
Forego assistance	– take credit for maintaining independence from international lenders – blame the donor for attempting to interfere with domestic politics

The ability of administrators to take the actions listed in Table 1 depends on the political skills of the administrators and their opposition, and the severity of the conditions imposed by the donor. The severity of the conditions imposed by the donor will depend on how far the actual allocation of funds differs from the efficient allocation of funds. Unfortunately, the greater the political skills of administrators, the more likely it is that actual expenditure allocations differ significantly from the efficient allocation of expenditures.

Donor influence over political costs

The donor has influence over the political costs of conditions it imposes through the types of conditions imposed and through its influence over the public perceptions of those conditions. The types of conditions that the donor has imposed, and the political costs of those conditions, have varied substantially. The political cost of complying with a donor's condition depends on the level of flexibility administrators are given. The greater the flexibility, the more likely it is that administrators can reduce the political cost of compliance, but this flexibility may also lead to smaller efficiency gains if administrators can use flexibility to avoid compliance. Highly detailed, inflexible conditions are more easily monitored and, if complied with, are likely to generate the highest efficiency gains. However, these are also the types of conditions that are the most costly to comply with. The result is that donor lenders must assess the potential efficiency gains of compliance with potential political gains of non-compliance.

Public perceptions worsen the dilemma the donor faces with respect to the degree of detail and measurability it attaches to conditions. Although greater detail of conditions and more measurable conditions improve the potential for efficiency gains, they also create greater opportunity for attacks on the donor as unjustifiably interfering with domestic affairs. Measurable conditions also create the possibility that the donor will misjudge the appropriate level of fiscal adjustments. The result is that the donor must err on the side of insufficient adjustments since the political costs for the donor of imposing excessively severe conditions are significantly higher than the costs of imposing very lenient conditions.

Country administrators' influence over donor conditions

Prior to the imposition of donor conditions, administrators have strong incentives to influence the severity of the conditions. If administrators can convince donor lenders to impose conditions which are politically painless to comply with, then the administrators can reap a political windfall. That is, administrators can take credit for obtaining donor loans or grants, creating donor-verified public sector improvements, and avoiding painful adjustments. Consequently, donor lenders are likely to be facing administrators who overstate the cost of compliance. Using the relationship in Box 1, donor lenders would like to increase the cost of complying up to the point where it is equal to the cost of ignoring the conditions. Government administrators, to the extent that they can influence donor conditions, would like to overstate the cost of not receiving assistance and the cost of complying, but understate the cost of ignoring the conditions.

Administrators are also aware of the political pressures facing donor lenders. The donor may face strong incentives to lend to politically or militarily powerful countries. Administrators of these countries know this and use this knowledge to avoid impositions of conditions on assistance. The result is a tendency by the donor to impose more severe conditions on assistance to countries that have less international influence. The top ten borrowers from the World Bank, for example, represent the most populous and most militarily powerful countries receiving World Bank assistance. Yet, these countries faced a very small percentage of World Bank conditions. For example, conditions have been imposed on Brazil, the World Bank's ninth highest borrower, in 6 areas on a single loan (mainly general conditions such as "reduce subsidies" and "correct monetary policy") whereas Uruguay faced conditions in 27 areas on 2 loans (including very specific conditions such as "tax increase of 0.3% of GDP" and "reduce structural deficit to 2% of GDP") (see Huther, Roberts and Shah [1997]).

After donor staff have imposed conditions, they are open to "regulatory capture" – donor staff have a vested interest in acknowledging compliance with the conditions and defending the conditions imposed. In practice, this means donor staff are willing to overlook actions by country administrators to manipulate results to meet donor conditions either through favourable interpretations of events or through falsification of data or both. And, more subtlely, donor staff seek favourable readings of results.

The rest of this paper is organised as follows. The next section provides conceptual perspectives from game theory, public choice, fiscal federalism, political economy, new institutional economics and New Public Management literature on the design of external assistance and its potential impacts. The paper then provides an overview of historical evolution of perspectives on donor-recipient relations and on conditionality of external assistance. It highlights the developing consensus by the development assistance community on both the instruments of development finance and associated conditions. It also briefly notes progress, or lack thereof, for practice to conform to emerging consensus. The concluding section provides lessons on major issues in conditionality of development assistance.

Program design and conditionality: Conceptual perspectives

This section will reinterpret the basic concepts from a wide body of theoretical and conceptual literature to draw implications for the conditionality of development assistance. Six major perspectives will be highlighted.

Game theory

The focus here is on the donor-recipient strategic choices in the presence of conditionality of assistance. Using the game theory approach this section will illustrate the perverse incentives faced by donor and recipient administrators that work to compromise the effectiveness of imposed conditions and thwarting the objectives of development assistance. The section will further highlight approaches to improve positive incentives for compliance and effectiveness of development assistance.[1]

Placing loan (grant) conditions in a game theory framework

This section uses simple examples from game theory to illustrate the perverse incentives that virtually guarantee that loan conditions under the existing system will be non-binding or not complied with. It will begin with an example in which donor staff deal with a single group of country administrators to illustrate the technique. It will then consider a case where donor staff face two groups of administrators in a country: a progressive group and an entrenched bureaucracy. In both cases a country's compliance or non-compliance with donor conditions is influenced by the donor's willingness to maintain loans in response to non-compliance.

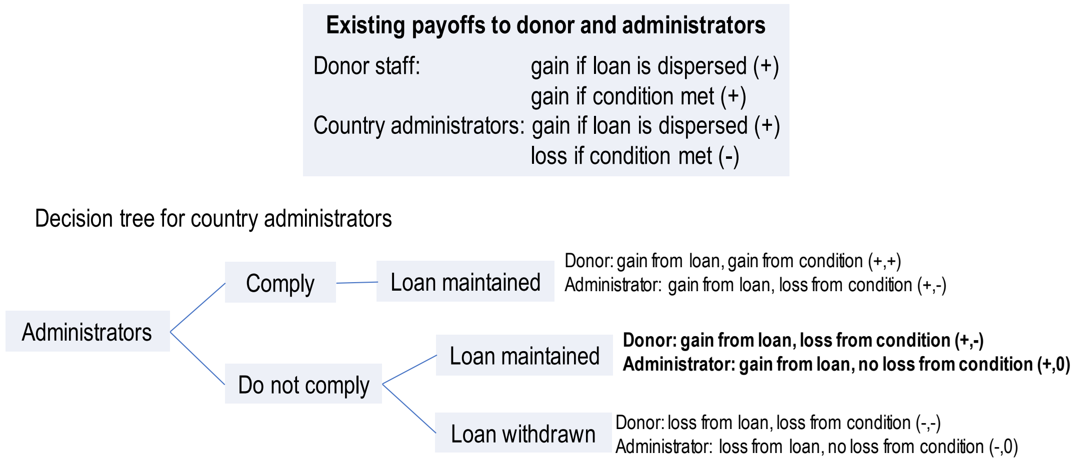
Consider the case where the donor disperses a loan with a condition that will impose a political cost on the country's administrators. The donor staff benefit from the loan (it improves the country's welfare and enhances donor staff stature) and it benefits from the condition imposed if that condition is met (it improves the efficiency of provision of public services). The country's administrators benefit from the loan (they can take credit for the projects the money is used for) but the administrators face a political loss from complying with donor conditions (through losses of patronage positions, for example).

The donor's best possible outcome is that administrators comply with the condition and receive the loan (which generates two positive results). The administrator's best possible outcome is that the loan is made but the conditions are not complied with (which generates one positive result and no negative result).

The important point here is that country administrators know how the donor values each possible outcome. If the administrators do not comply with the condition, the donor's preferred result is that the loan is dispersed anyhow. The outcome is that country administrators do not comply with conditions and the donor maintains the loans since it is preferable to withdrawing the loan. Given the existing incentive structure, neither donor nor country administrators can improve their outcome by changing their responses (see the decision tree for country administrators in Figure 1).

The outcome of this process is clear from past aid evaluation results: donor officials tend to rate ongoing loans and grants as satisfactory (even when conditions are not being met) because they believe that dispersing the loan is preferable to acknowledging non-compliance (which would force a withdrawal of the loan). Once the project is completed, the incentives for over-estimating compliance are removed. Consequently, evaluations of completed projects generate lower assessments of satisfactory outcomes.

Figure 1. **Decision tree for country administrators**



Note: Outcome in bold is the (Nash) equilibrium outcome.

A numerical example

Suppose that the value to donor staff of dispersing a loan is 0.5 and the value of compliance with the loan is also 0.5. If the loan is complied with, the donor staff receive a payoff of 1. Also suppose that the value of a loan to country administrators is 0.5 but that the value of compliance is -0.5 (see payoff matrix).

Table 2. **Payoff matrix in a two-player game**

Actions of donor administrators	Actions of country administrators	
	Compliance	Non-compliance
Loan maintained	(1, 0)	**(0.5, 0.5)**
Loan withdrawn	(0.5, -0.5)	(0, 0)

Note: Nash equilibrium outcome is in bold.

The order of payoffs in the matrix are (donor, country administrators). For example, if the condition is complied with, the payoffs from the upper left box are: donor staff benefit from the loan (+0.5) and benefit from compliance (+0.5), for a payoff of 1, country administrators benefit from the loan (+0.5) and lose from compliance (-0.5), for a payoff of 0.

In this example, donor staff receive a higher payoff from maintaining the loan regardless of the action taken by the country administrators. Country administrators have a higher payoff from non-compliance regardless of the action taken by the donor staff. The result is that the loan is maintained and the loan is not complied with.

A three-player example

Now consider a slightly more complicated case where donor staff face two groups of administrators within a country with differing incentives. Progressive administrators may favour donor conditions as a method of encouraging more efficient use of public resources. Entrenched administrators may view donor conditions as politically costly in terms of reductions in patronage positions, reduced opportunities for corruption, or less support (political or financial) from enterprises benefiting from subsidies. In this case, the interests of the donor and progressive administrators coincide but compliance will depend on the outcome of a political battle between progressive and entrenched administrators.

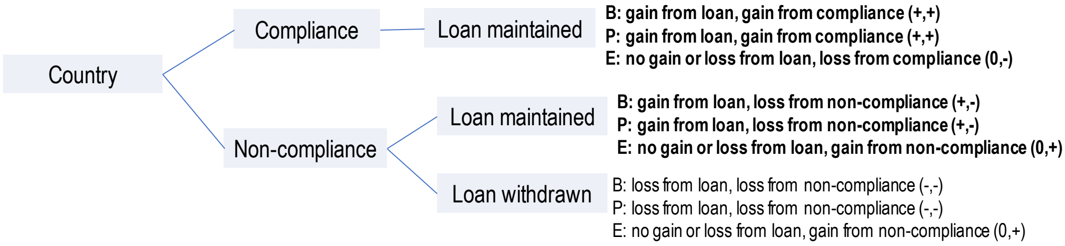
If progressive administrators win the battle on compliance, the donor and progressive administrators benefit from the loan and from compliance while the entrenched administrators do not care about the loan but lose from compliance. If progressive administrators lose on compliance, the donor must decide whether to maintain or withdraw the loan. The donor, and the progressive administrators, are better off if the loan is maintained even though the donor's condition is not complied with. Since the outcome of political battles usually depends on compromise, the entrenched administrators can use the donor's willingness to provide the loan as a means of discouraging compliance. The result is that the donor's desire to disperse the loan actually diminishes the likelihood of compliance (see Huther and Shah [1996]; Huther, Roberts and Shah [1997]).

There are two stable outcomes from this process (as illustrated in the decision tree in Figure 2). If the progressive administrators win the domestic political battle, then the donor will disperse the loan and the country will comply with the condition. If the entrenched administrators win the domestic political battle, then the donor will maintain the loan even though the country does not comply with the condition. Since the outcome of most political battles is some form of compromise, the donor's known willingness to maintain loans despite non-compliance reduces the possibility of compliance.

Figure 2. **Donor loan conditions for a country with conflicting administrative goals**

Payoffs to donor and administrators	
Donor staff (B):	gain if loan is made (+)
	gain if condition met (+)
Progressive country administrators (P):	gain if loan is made (+)
	gain if condition met (+)
Entrenched country administrators (E):	not significantly affected by loan (0)
	loss if condition is met (-)

Decision tree with conflicting interests of country administrators



Note: Both compliance and non-compliance with loan maintained are stable outcomes highlighted in bold (actual outcomes depend on domestic political battles).

Improvements in donor-imposed conditions suggested by game theory

There are two approaches suggested by the games outlined above that will lead to greater compliance with donor conditions. One approach is to increase the cost of non-compliance to country administrators. The other approach is to reduce the payoffs to donor staff of maintaining the loan when country administrators do not comply with the loan. This section describes potential applications of these approaches. The descriptions are meant to be illustrative examples rather than an exhaustive list of possible improvements (see Table 3).

Increasing the cost of non-compliance is a difficult subject in part because the citizens of countries seeking donor assistance would typically bear the burden of donor-imposed penalties. Other penalties face the same credibility problems that loan withdrawals face. Restrictions on future loans, for example, have the same incentive problems as current loans – country administrators know that the donor has an incentive to make the loans regardless of compliance. Additionally, country administrators may have short enough time horizons that they do not care about the existence or conditions of future loans.

One method of raising the cost of non-compliance would be to impose a higher level of administrative burden on donor loans to a non-complying country. The administrative burden could be increased through more frequent audits of the country's loan portfolio or requirements of additional background material to accompany future loan requests or adding an additional risk premium to the borrowing rate. Raising the administrative costs, however, is unlikely to influence compliance if country administrators have a sufficiently short time horizon or if the administrative burden is borne by politically weak groups within the government.

The alternative to raising the cost of non-compliance is to reduce donor staff's incentives to disperse loans. One method of reducing incentives would be to issue a rule which links the promotion of task managers or division chiefs with the per cent of loan conditions that are complied with. This method would convince country administrators that their lack of compliance would lead to the loan being withdrawn. The drawback is that this rule creates incentives for donor staff to require very lenient conditions.

A method which would avoid the problem of excessive leniency is to reward donor staff based on improvements in service delivery quality and access and economic and quality of life indicators. This creates incentives for donor staff to design loan conditions that: 1) can and will be met; 2) focus on service delivery, economic and quality of life improvements; and 3) provide alternatives to status quo situations that are not generating improvements.

One outcome of a shift in focus to improvements in service delivery, quality of life indicators would be greater flexibility in the use of donor funds. Since many of the donor's projects are undertaken in conditions of uncertainty, it is inevitable that some of these projects will fail. If the focus for administrators is on the results of funding rather than the project itself, then both donor and country administrators will be more willing to discontinue unproductive projects.

Shifting donor staff incentives away from loan dispersal makes the threat of withdrawing loans credible. This is one of the useful paradoxes of game theory: the reduction of flexibility of donor staff to acquiesce to non-compliance strengthens the position of donor staff. Increased credibility of loan withdrawal, in turn, raises the cost of non-compliance to country administrators.

Table 3. **Examples of approaches to improve incentives**

Approach	Method	New incentives
Increase cost of non-compliance	Impose higher administrative burden for non-compliance	Comply or face greater oversight
Change donor staff incentives	Link promotion with compliance	Impose very lenient conditions
Change donor staff incentives	Link promotion with outputs improvements in service delivery quality and access	Impose conditions that service delivery quality and access indicators be improved

Limitations of the examples presented here

The methods described in Table 3 are meant to represent simple examples rather than an exhaustive list of incentive improvements. Further, it should be noted that in the interest of simplicity, game theory approach presented here is static, while in practice development aid is a dynamic game with repeated interactions of multiple stakeholders. In the context of the EU, the game is even more complicated, since there is an additional dimension that the rules that govern the disbursement of aid are negotiated between donors and beneficiaries.

Game theory conclusion

While recognising these important limitations of this approach, our conclusion is that raising the cost of non-compliance is a less effective approach than reducing the payoffs to donor staff. The method that most effectively addresses the existing incentive problems is the one that shifts the goals of donor staff away from the technical and somewhat arbitrary questions of compliance with conditions towards a focus on results – measurable improvements in service delivery quality and access. The question that should be asked is how have country administrators used the donor loan to improve quality of life indicators or, more broadly, using a former World Bank President's direction –"has the loan made progress in 'putting a smile on a child's face?'".

The adversarial situation described above is one of a traditional borrower and lender. However, the donor's role is larger than that of a traditional lender since it has a stronger interest in the general well-being of the borrower than does a private sector lender. It is this larger interest that is interfering with the borrower-lender mechanisms that work in the private sector. The factor that has complicated the donor's incentive structure is that conditions are tied to loans that provide the potential for efficiency gains.

Success or failure of conditions must be measurable by a mutually agreed to method. Conditions are of little use if administrators can avoid compliance (through budget manipulation, for example). Once measures of success are agreed to, administrators must be given complete flexibility to meet the conditions. This flexibility does not guarantee an efficient outcome – conditions imposing civil service cuts, for example, may lead to lower levels of basic services rather than fewer central administrators. This type of example suggests that conditions on expenditures should be abandoned in favour of conditions on the level of public goods or services provided.

Our suggestion is that the donors improve the incentives facing own staff by shifting the focus of conditions to results in terms of service delivery quality and access and quality of life indicators. Because many quality of life indicators change slowly, many conditions will need to be evaluated based on interim indicators. For example, if conditions are imposed that require a country to improve its literacy rates, an interim indicator would be increases in enrollment rates, graduation and dropout rates. If conditions are based on longevity, infant and child mortality rates would provide an interim indicator of the success or failure of conditions.

Public choice perspectives

Public choice literature focuses on the self-interested behaviour of actors (principals and agents) that defeats the public interest objectives of development assistance.

Public choice literature distinguishes a broad spectrum of aid agencies that range from wholly motivated by altruism on the one extreme and those guided by economic and political imperialism. The first extreme is purely motivated by altruism, i.e. to help disadvantaged individuals and nations overcome hunger, disease, deprivation, poverty and conflicts. At the opposite spectrum, external assistance serves as a tool to advance economic, political and military interests. In general, aid agencies will be distinguished by relative weights assigned to altruism versus self-interest and this emphasis will have profound implications for donor-recipient relations. The literature similarly places governments on a governance spectrum that ranges from those pursuing the doctrine of common good on the one extreme to those preserving the interests of governing elites. The latter type governments are subject to capture by dictators, bureaucrats or interest groups. Such governments may maximise economic rents for dominant interest groups (as in the leviathan model) or may advance compulsion or coercion. A leviathan government acts purely in its own self-interest relatively unconstrained by the voters. It usually is thought to be interested in maximising own size constrained only by its ability to extract tax revenues from the taxpayers or financial assistance from abroad (Boadway and Shah, 2009: 28). Public choice literature in general endorses self-interest doctrine of government and argues that that various stakeholders involved in policy formulation and implementation are expected to use opportunities and resources to advance their self-interest.

To overcome donor failures, subjecting aid agencies to greater transparency, task specialisation, risk and reward sharing with recipient governments is expected to help restrain donor emphasis in advancing self-interest. To limit government failures, subjecting governments to competition within and beyond government, greater transparency and accountability to citizens can help restrain leviathan tendencies (Dollery and Wallis, 2001). Therefore, donor conditionality should focus on fostering competitive public service delivery to ease supply constraints, sunshine provision and redress mechanisms, and enhancing voice and exit options for citizens' choice and holding government to account.

Limitations of the approach

Public choice approach offers important clues to the lack of development effectiveness of external assistance. It also offers useful suggestions to overcome underlying constraints. However, some suggestions such as risk and reward sharing with recipients and exit and voice options for enhanced government accountability have proven difficult to achieve in practice.

Fiscal federalism perspective

Fiscal federalism literature is focused on safeguarding donor objectives while creating an incentive regime that respects local recipient autonomy but strengthens recipient accountability to overcome perverse fiscal behaviour of recipients. The literature highlights that the design of assistance must be consistent with its objectives and each assistance programme must have a singular focus as combining multiple, often conflicting, objectives in a single programme compromises the effectiveness of the entire programme. This literature provides useful specific guidance on the design of the programme and associated conditions to achieve the stipulated objective. The literature highlights fungibility of conditional assistance, flypaper effects (money sticks where it lands) and fiscal illusion (diminished local accountability associated with fragmented finance and resulting in leviathan governments) as discussed below.

A federal form of government has a multi-order governance structure, with all orders of government having some independent as well as shared decision-making responsibilities.

Federal compact may entail both partnership and a principal-agent relationship. In decentralised federations, partnership principles dominate intergovernmental fiscal relations. Fiscal federalism principles therefore place a strong emphasis on strengthening partnership arrangements in the design of higher level fiscal transfers. This is done by ensuring that higher level general purpose assistance is non-intrusive and does not impair local autonomy and the design of specific purpose assistance should focus on creating incentives to accomplish partnership objectives while avoiding higher level control and micromanagement. These principles also recognise real life impact of these transfers on local fiscal behaviours. Table 4 provides a taxonomy of various type of fiscal transfers and potential impacts.

Table 4. **Taxonomy of grants and their potential impacts: A stylised view**

	Grant (G) objectives		
Grant type	Increase in spending on assisted service	Results-based accountability	Recipient autonomy/welfare
General purpose (unconditional): lump-sum transfers			
Budget support	< G (amount of grant)	None/low	High
Budget support with pre-requisites	< G	None/low	Medium
Specific purpose (conditional): block, programme or project transfers			
Non-matching with input or process conditionality	≤ G	None/low	Medium
Non-matching with output conditionality	≤ G	High	High
Open-ended matching (input conditions)	**> G**	Low/medium	Low
Closed-ended matching with binding constraint (input conditions)	≥ G	Low/medium	Low
Close-ended matching with non-binding constraint (input conditions)	≤ G	Low	Medium

Notes: G: amount of grant funds; matching provision: requiring grant recipients to finance a specified percentage of expenditures using their own resources. This requirement serves to ensure local ownership and commitment to project goals; open-ended matching: the grantor matches whatever level of resources the recipient provides; closed-ended matching: the grantor matches recipient funds only up to a pre-specified limit.

Source: Boadway, R. and A. Shah (2009), *Fiscal Federalism: Principles and Practice of Multi-order Governance*.

Table 4 shows that the choice of grant instrument must be based on its objectives. General purpose grants are more suitable for preserving local autonomy. Output-based conditionality is more desirable when the objective of the grant is to ensure improvement in service delivery performance while respecting local autonomy. If stimulation of expenditure is the main objective then open-ended matching transfers would be desirable, but these grants impair local autonomy. The empirical literature shows that USD 1 received by the community in the form of general purpose transfers tends to increase local public spending by more than a USD 1 increase in residents' income (Rosen and Gayer, 2005). Grant money tends to stick where it first lands, leaving a smaller than expected fraction available for tax relief, a phenomenon referred to as the "flypaper effect". The implication is that for political and bureaucratic reasons, grants to local governments tend to result in more local spending than they would have had the same transfers been made directly to local residents. An explanation for this impact is provided by the hypothesis that bureaucrats seek to maximise the size of their budgets, because doing so gives them greater power and influence in the community (Filimon, Romer and Rosenthal, 1982). Another important observation noted by this literature is that specific purpose grants typically yield a smaller increase in spending on the assisted category than the size of the grant, with the remainder going to other public goods and service, and tax relief. This is the so-called "fungibility effect" of grants. The fungibility of conditional grants depends on both the level of spending on the assisted public service and the relative priority of such spending. For example, if the recipient's own financed expenditures on the assisted category exceed the amount of the conditional grant, the conditionality of the grant may or may not have any impact on the recipient's spending behaviour: all, some or none of the grant funds could go to the assisted function.

Why are conditional closed-ended matching grants common in industrial and developing countries when they seem ill-designed to solve problems and inefficiencies in the provision of public goods? The answer seems to be that correcting for inefficiencies is not the sole or perhaps even the primary objective. Instead, grants are employed to help local governments financially while promoting spending on activities given priority by the grantor. The conditional (selective) aspects of conditions on the spending are expected to ensure that the funds are directed toward an activity the grantor views as desirable. This, however, may be false comfort in view of the potential for fungibility of funds. The local matching or cost-sharing component affords the grantor a degree of control, requires a degree of accountability by the recipient and makes the cost known to the granting government.

Conditional closed-ended matching grants have advantages and disadvantages from the grantor's perspective. While such grants may result in a significant transfer of resources, they may distort outputs and cause inefficiencies, since the aid is often available only for a few activities, causing overspending on these functions while other functions are underfinanced. If capital outlays are subsidised while operating costs are not, grants may induce spending on capital-intensive alternatives and sometimes create white elephants – the projects that could not be sustained.

Conditional open-ended matching grants are the most suitable vehicles to induce lower level governments to increase spending on the assisted function (Table 4). If the objective is simply to enhance the welfare of local residents, general purpose non-matching transfers are preferable, as they preserve local autonomy.

To ensure accountability for results, conditional non-matching output-based transfers are preferable to other types of transfers. Output-based transfers respect local autonomy and budgetary flexibility while providing incentives and citizen-based accountability mechanisms to improve service delivery performance (see Table 5 for a comparative perspective on traditional versus output conditionality and Box 1 for an illustrative example).

Fiscal federalism literature argues that the design of grants must be consistent with their objectives and it is desirable to have a singular focus – a single grant instrument for a single clearly specified objective. Further, the allocation criteria must be simple, objective, transparent and fair. Table 6 presents key objectives sought in these transfers and examples of design consistent with those objectives.

Table 5. **Traditional and output-based (performance-oriented) conditional grants**

Criterion	Traditional grant	Output-based grant
Grant objectives	Spending levels	Quality and access to public services
Grant design and administration	Complex	Simple and transparent
Eligibility	Recipient government departments/agencies	Recipient government provides funds to all government and non-government providers
Conditions	Expenditures on authorised functions and objects	Outputs-service delivery results
Allocation criteria	Programme or project proposals approvals with expenditure details	Demographic data on potential clients (service population)
Compliance verification	Higher level inspections and audits	Client feedback and redress, comparison of baseline and post-grant data on quality and access
Penalties	Audit observations on financial compliance	Public censure, competitive pressures, voice and exit options for clients
Managerial flexibility	Little or none. No tolerance for risk and no accountability for failure.	Absolute. Rewards for risks but penalties for persistent failure
Local government autonomy and budgetary flexibility	Little	Absolute
Transparency	Little	Absolute
Focus	Internal	External, competition, innovation and benchmarking
Accountability	Hierarchical and to higher level government, controls on inputs and process with little or no concern for results	Results-based, bottom-up, client-driven

Source: Shah, A. (2007a), "A practitioner's guide to intergovernmental fiscal transfers", Chapter 1, in: Boadway, R. and A. Shah (eds.), *Intergovernmental Fiscal Transfers*, World Bank, Washington, DC

Box 1. **An output-based transfer for school finance: An illustrative example**

Allocation basis to state/local governments: school-age population – population aged 5-17.

Distribution basis for service providers: equal per pupil to both government and non-government schools.

Conditions: universal access to primary and secondary education. Non-government school access to poor on merit. Improvement in achievement scores and graduation rates from baseline for each school. No conditions on the use of funds.

Penalties: public censure, reduction of grant funds and risk of termination with persistent non-compliance. Grant funds automatically decrease if parents pull their children out of non-performing schools.

Incentives: grant funds increase automatically as school attracts more students. Retention of savings for optional use from better management of resources.

Impact implications: encourages competition, innovation and accountability to citizens for improving quality and access. Automatic monitoring and enforcement provisions through parental choices of voting with their feet.

Source: Shah, A. (2007a), "A practitioner's guide to intergovernmental fiscal transfers", Chapter 1, in: Boadway, R. and A. Shah (eds.), *Intergovernmental Fiscal Transfers*, World Bank, Washington, DC

Table 6. **Principles and better practices in grant design**

Grant objective	Grant design	Examples of better practices	Examples of practices to avoid
Bridge fiscal gap	Reassignment of responsibilities, tax abatement, tax-base sharing	Tax abatement and tax-base sharing (Canada)	Deficit grants, wage grants, tax by tax sharing (People's Republic of China, India)
Reduce regional fiscal disparities	General non-matching fiscal capacity equalisation transfers	Fiscal equalisation with explicit standard that determines total pool as well as allocation (Canada, Denmark and Germany)	General revenue sharing with multiple factors (Brazil and India); fiscal equalisation with a fixed pool (Australia, People's Republic of China)
Compensate for benefit spillovers	Open-ended matching transfers with matching rate consistent with spill-out of benefits	Grant for teaching hospitals (South Africa)	Closed-ended matching grants
Set national minimum standards for merit public services	Conditional non-matching output-based block transfers with conditions on standards of service and access	Road maintenance and primary education grants (Indonesia before 2000); education transfers (Brazil, Canada, Chile, Colombia); health transfers (Brazil, Canada)	Conditional transfers with conditions on spending alone (most countries), pork barrel transfers, *ad hoc* grants
	Conditional planning-based capital grants to overcome identified infrastructure deficiencies based on a defined national standard, with matching rate that varies inversely with local fiscal capacity	Capital grant for school construction (Indonesia before 2000), highway construction matching grants to states (United States)	Formula-based capital grants. Capital grants with no matching and no future upkeep requirements, US federal grant for bridge to nowhere in Alaska, Indonesia DAK grants.
Influence local priorities in areas of high national but low local priority	Open-ended matching transfers (preferably with matching rate varying inversely with fiscal capacity)	Matching transfers for social assistance (Canada before 2004)	Ad hoc grants
To provide stabilisation	Capital grants, provided maintenance possible	Capital grants with matching rates that vary inversely with local fiscal capacity	Stabilisation grants with no future upkeep requirements
Promote competition among local governments	Project or output grants using certification or tournament approaches	Albania, Russian Federation	

Notes: Certification grants: the grantor promises assistance if certain pre-requisites specified by the grantor are fulfilled, e.g. requiring appropriate systems of financial management and accountability being in place prior to release of grant tranche. Tournament grants: the grantor offers assistance to the top performers in a competitive grant programme based upon pre-specified criteria for ranking performance.

Source: Adapted from Boadway, R. and A. Shah (2009), *Fiscal Federalism: Principles and Practice of Multi-order Governance.*

Summing up, the fiscal federalism literature provides the following guidance on instrument choice:

- Conditional non-matching output-based grants (no input conditionality but expectations regarding maintenance of agreed-upon standards and achieving expected results in service delivery) for merit goods such as education and health.
- Conditional matching grants for spillovers in some services such as transportation with matching rate consistent with benefit spill-outs.
- Equalisation grants to ensure that all local governments have the fiscal capacity to provide reasonably comparable levels of basic local services.

- Capital grants for infrastructure if low fiscal capacity.
- Capital market finance for income-generating infrastructure if higher fiscal capacity.
- Public-private partnerships for infrastructure finance if feasible, but keeping public ownership and control of strategic assets.

Beyond grant assistance, the fiscal federalism literature also provides guidance on debt desirability and affordability. It argues that the fiscal capacity of the recipient government and the type of investment are important criteria in deciding on the type of financing that may be desirable.

Table 7 highlights these choices. For fiscally poor recipient governments, bond finance would not in general be feasible. They would instead have to rely on grants for social infrastructure investments and in addition on loan finance for revenue-producing investments. Richer local jurisdictions would have access to a wider array of financing instruments, including bond finance.

Table 7. **Sources of capital financing would differ by type of investment and fiscal capacity of the recipient government**

Type of capital investment	Fiscally poor government	Fiscally rich government
Revenue-producing investment	Loans and grants	Loans and bonds
Social investment	Grants only	Loans and grants

Source: Petersen and Valadez (2004), "Borrowing Instruments and Restrictions on Their Use." p.54

While much of the guidance from the fiscal federalism literature is cast in a multi-order governance framework within a nation, basic principles of this guidance are applicable to external development assistance. For example, this literature would argue against lending programmes of external assistance for social investment and governance and institutional reform to fiscally poor developing countries. It also argues against input-based conditionality in both loan and grant assistance to support improved access to merit public services and for poverty alleviation and argues for output-based conditionality to meet such objectives (see also OECD [2013] and [2014] for guidance on the design and conditionality of assistance for regional development under multi-order governance to foster "mutual dependency" and overcome perverse incentives under principal-agent type of relationship).

Limitations of the approach

In the international context, with multiple donors with conflicting interests, donor harmonisation is costly and difficult to achieve. Donor shopping could undermine incentives and accountability regimes created by following fiscal federalism. Further in the international context, moral suasion and institutions of executive federalism are unlikely to work effectively. Nevertheless, the principles offered by the fiscal federalism approach, as adopted in international assistance, has the potential to make a significant positive impact on aid effectiveness.

New Public Management perspectives

New Public Management (NPM) attributes failures of aid effectiveness primarily to the civil service regimes in aid agencies and recipient countries. These regimes support rigid rules-driven civil services with lifelong rotating appointments that discourage risk taking and task specialisation and have little accountability for results. Civil servants are incentivised to spend public and aid monies by following financial and procedural controls and are not held to account for failures in service delivery performance. Aid agency staff similarly face incentives to maximise aid flows whereas relatively less attention is paid to the effectiveness of such assistance. In any case, their career progression is directly linked with approval and disbursements of such assistance following complex procedures and is delinked from results on the ground. NPM brings a focus on the results-based chain in public management as illustrated in Figure 3.

Figure 3. **Results-based chain: Application in education**

Programme objectives	Inputs	Intermediate inputs
Improve quantity, quality and access to education services	Educational spending by: age, sex, urban/rural; spending by level; teachers, staff, facilities, tools, books	Enrollments, student-teacher ratio, class size

Outputs	Outcomes	Impact	Reach
Achievement scores, graduation rates, drop-out rates	Literacy rates, supply of skilled professionals	Informed citizenry, civic engagement, enhanced international competitiveness	Winners and losers from government programmes

Source: Shah, A. (2005), "On getting the giant to kneel: Approaches to a change in the bureaucratic culture".

New Public Management approaches are concerned with creating a human resource management environment that affords public managers autonomy and flexibility and holds them to account for results – rewards them for success and punishes them for persistent failures (Table 8).

Table 8. **On making the dog wag its tail: The NPM perspectives**

Human resource culture in aid agencies and recipient governments	New Public Management reform perspectives
– Rigid rules	– Managerial flexibility
– Input controls	– Results matter
– Top-down accountability	– Top-down and bottom–up accountability
– Low wages and high perks	– Competitive wages but little else
– Lifelong and rotating appointments	– Contractual appointments
– Focus on jack of all trades staff	– Task specialisation
– Intolerance for risk/innovation	– Freedom to succeed/fail. Ample rewards for success but persistent failure subject to separation.

Source: Shah, A. (2005), "On getting the giant to kneel: Approaches to a change in the bureaucratic culture".

Such approaches are characterised as New Public Management and have the following common elements:

- contracts or work programme agreements based on pre-specified outputs, performance targets and budgetary allocations
- managerial flexibility, coupled with accountability for results

- use of subsidiarity principle in assigning responsibility to various orders of government
- competitive public service provision.

There are two alternate approaches to results-based accountability that have been implemented by a selected group of countries, one relying on market-like arrangements and the other on managerial norms and competence (Table 9). The former strategy, "making managers manage", used by New Zealand, specifies contracts with budgetary allocations and competitive pressures. The latter approach, "letting managers manage", is practiced in Australia and Sweden. Both strategies provide the flexibility public managers need to improve performance. The critical differences between them are the reliance on incentives and competitive spirit in the first and good will and trust in the latter. The two approaches take different perspectives on how to reward public servants. The performance-based contracts reward the chief executive financially if the organisation achieves its performance targets. The empowerment approach holds that public servants are more motivated by the intrinsic rewards of public service than material benefits. The contract-based approach relies on incentives and competitive market mechanisms to enforce the accountability of public managers. The empowerment approach simply hopes that managers will be ethically and professionally motivated for performance.

Table 9. **Comparison of two alternate results-based accountability approaches**

Theoretical models	Make managers manage	Let managers manage
Strategies	Market-like arrangements	Managerial norms and competence
Mechanism	Contracts	Empowerment
Commonality	Give public managers the flexibility they need to improve performance	
Differences	– Using specific, tightly written performance contracts that leave little room for trust – Motivate improvements with extrinsic rewards	– Implicitly trusting public managers to exercise their judgment intelligently – Motivate primarily by the intrinsic rewards of public service
Examples	New Zealand	Australia, Sweden, United States

Source: Shah, A. and C. Shen (2007), "A primer on performance budgeting".

It is important to stress that managerial accountability must be based on outputs rather than outcomes, as outcomes are beyond mangers' direct control, difficult to define and quantify, and impossible to use as a costing basis. Major justifications for including output-based accountability are:

- It is difficult or implausible to link outcomes directly with managerial actions and decisions as outcomes are remote in time and space from what the programme does and how it interacts with other factors. The extent of a manager's direct control over outputs is usually much more substantial than outcomes.
- Outcomes are immensely difficult to identify, and certainly difficult to quantify. The timescale for measuring outcomes normally spans sometime after the programme intervention, and is generally not in sync with the same budgeting cycle.
- Calculating the cost of the effort to achieve outcomes can be more difficult than costing outputs (Kristensen, Groszyk and Bühler, 2002: 16). Outcomes are typically achieved not just as the result of a single intervention by one programme in isolation, but by the interaction of a number of different planned/unplanned factors

> and interventions. Hence, it is inappropriate and unrealistic to hold public managers accountable for outcomes. The focus on outputs as practiced in Malaysia and New Zealand offers greater potential for accountability for results. Outcomes, however, should be monitored and could be the basis for cabinet accountability; an exclusive emphasis on quantitative output measures without a focus on at least some form on outcomes can distort attention in delivery agencies and run the risk of losing sight of the bigger picture of the impact of their programmes on citizens and society.

On the way to fostering outputs-based accountability, it is essential to provide more managerial flexibility through relaxing central input controls. Relaxing central input controls operates at two levels: first, the consolidation of various budget lines into a single appropriation for all operating costs (salaries, travel, supplies, etc.); second, the relaxation of a variety of central management rules that inhibit managerial flexibility, particularly the personnel management function where most central rules exist. Personnel cost is generally the largest component of operating expenditures, and it makes little difference to consolidate budget lines if central rules in this area prevent any flexibility. Sweden's experience in dismantling central control over human resource management offers some interesting insights. Sweden gave full autonomy to line agencies to hire, fire, and set terms of employment and career development of their employees. Agencies were given full authority to manage personnel costs. The agencies made their employees contractual employees. This decentralised management of personnel and personnel costs resulted in major cost savings and performance improvements and also gave line agencies flexibility to meet changing demands for their services on a timely basis (Blondal, 2003).

NPM influences are noticeable in recent emphasis on results-based accountability in donor-recipient relations (European Commission, 2015). These perspectives, however, had little impact in reforming the human resource management framework in aid agencies and recipient country civil service regimes and the human resource regimes remain impermeable to newer views on incentives for results-based accountability.

Limitations of the approach

The effectiveness of the NPM (results-based management) approach critically depends upon the public management paradigm in place in donor and government agencies. Unless these agencies embrace results-based management and evaluation as the human resource management paradigm, results-based accountability will have little impact on aid effectiveness.

Political economy perspectives

Political economy perspectives bring together an analysis of specific interests of economic and political actors and institutions and reflect upon timing, sequencing, consensus building for feasible and effective reform. Such perspectives are helpful in designing conditions of such assistance for forging recipient ownership and commitment to reform. For external assistance, political economy perspectives require analysis of stakeholders both on the donor and on the recipient side.

On the donor side, various principals and their agents with wide-ranging perspectives, objectives and approaches are involved. Various citizens' groups (principals) may have different perspectives on feasible reform options, the type and amount of assistance required, and may have concerns about the effectiveness of such assistance. Some groups may be committed to the status quo and may oppose all reforms. Donor political regimes (primary agent) may have own priorities in terms of targeting of country assistance. Donor agency staff (secondary agents) mediate government and citizen mandates. Various independent contractors and sub-contractors (experts and consultants) may be involved in project implementation and monitoring of progress and results. Both the donor agency staff and contractors may have self-interest in maximising such assistance even when such assistance is deemed ineffective. Conditionality of such assistance may help donor agency staff get buy-in from the political and legislative regimes as well as citizens at large. Such an environment will be conducive to having soft conditions based on prior actions or during the period of assistance. The conditions will also depend on country ranking on donor priorities. Assistance from international or multinational agencies will also be guided by the interests and views of dominant shareholders.

On the recipient side, there is a complex web of stakeholders and their interests. These include political, executive, legislative, military and judicial institutions and associated stakeholders, civil society and special interest groups, experts and contractors, and citizens at large. Their perspectives and interests are often in conflict and change dynamically over time. Forging a consensus for externally assisted tasks is an uphill task and most countries may lack mediating institutions to develop even a rough consensus. This would be especially true when the institutions of accountability in governance are weak and citizens lack the empowerment to hold the government to account. Therefore, commitment to and ownership of such projects that is critical to project success may be in a flux. Even the potential beneficiaries of such projects may not be able to organise to present a unified platform. Under such circumstances, recipient governments typically have a short-term political horizon and may be willing to accept unrealistic conditions for assistance knowing fully well that those will not be fulfilled. Dictatorial regimes headed by military, feudal, political or bureaucratic regimes are often guided by short-term self-interest as opposed to public interest in negotiating external assistance. These regimes often seek to maximise such assistance to legitimise and perpetuate their dictatorial regimes.

An analysis of various stakeholders on both the donor and recipient sides can be helpful in designing conditions that would work in specific case study countries. Such conditions could play a critical role in changing the payoff matrix for various stakeholders to create a winning coalition for reform.

A vast literature has emerged on political economy of conditionality in aid programmes (see, for example, Alesina and Drazen [1991]; Svensson [2000]; Drazen [2002]; Mayer and Mourmouras [2002]; Joyce [2004]). This literature concludes that in the absence of recipient country ownership, lack of credibility of sanction in the event of non-compliance undermines the effectiveness of conditionality. On the other hand, in the event the recipient fully owns the reform programme, and is committed to donor conditionality, special interest groups may still undermine the success of such reforms. Therefore, design of assistance must develop mechanisms to deal with these important impediments to the success of the external assistance programme (World Bank, 2005).

Limitations of the approach

The approach requires a deeper understanding of political and institutional malaise in the country and the relevance of various stakeholders to champion reforms. External donor agencies typically do not have such in-depth knowledge. In the event they do, due to the politically and culturally sensitive nature of these issues, donor views have the potential of being misused by interest groups opposed to serious reforms. In view of this, the utility of this approach in practice is significantly compromised.

New institutional economics perspectives

New institutional economics (NIE) is concerned with minimising the transaction costs associated with donor-recipient interactions and holding both donors and recipient governments to account for results by their citizens as governors/principals. This framework offers helpful guidance in structuring donor-recipient interactions and the conditionality of such programmes. It brings a heightened focus on facilitating network governance by local governments to foster competition and enhance the quality of and access to public services.

According to the NIE framework, on both the donor and the aid recipient side, various orders of governments (as agents) are created to initiative collective action to serve the interests of the citizens as governors/principals. The jurisdictional design should ensure that these agents serve the public interest while minimising the transaction costs for the principals.

The existing institutional framework does not permit such optimisation, because the principals have bounded rationality; that is, they make the best choices on the basis of the information at hand but are ill-informed about government operations. Enlarging the sphere of their knowledge entails high transaction costs, which citizens are not willing to incur. Those costs include participation and monitoring costs, legislative costs, executive decision-making costs, agency costs or costs incurred to induce compliance by agents with the compact, and uncertainty costs associated with unstable political regimes (Horn, 1995; Shah, 2007b). Agents (various orders of governments) are better informed about government operations than principals are, but they have an incentive to withhold information and to indulge in opportunistic behaviour or "self-interest seeking with guile" (Williamson, 1985: 7). Thus, the principals have only incomplete contracts with their agents and have further imperfect knowledge about their activities and associated impacts. Such an environment fosters commitment problems because both the donor and the recipient's agents and contractors may not follow the compact.

The NIE literature identifies two types of problems in such an agency relationship. First, the agent may not follow the mandate from the principal and instead design programmes to advance its own self-interest. For example, aid agency contractors may choose a project design that profits them most. This is termed the moral hazard of such an agency. On the recipient side, government may delay much needed reforms expecting future external financing. Second, the agent may manipulate the information he/she conveys to the principal to undermine the principal's interests. For example, aid agency contractors and/or evaluators may exaggerate the success of the project in reporting results to taxpayers in donor countries. This may lead to project selection bias in favour of projects where the results are easy to manipulate, e.g. technocratic reform projects would be preferred over investment projects. This is recognised as the adverse selection problem in the literature. Note that both the moral hazard and the adverse selection problems also manifest themselves on the recipient side of aid as well. The challenge is to mitigate these problems by designing incentive regimes that encourage agents to be truthful to their principals (see also Martens et al. [2002]). This challenge becomes even more formidable with external assistance programmes that are aimed at governance and institutional reforms in developing countries as monitoring of the results-based chain becomes more difficult compared to investment projects. These problems are compounded by the trend away from investment projects and towards more aid for institutional reforms. Difficulties in measuring and monitoring results heighten moral hazard and adverse selection in external assistance for institutional reforms and make detection of non-compliance and enforcement more difficult. That is why most such assistance programmes simply require passing of laws and regulations with little or no oversight on implementation and enforcement. In the end one does not really know what the real impact of such assistance was although evaluation by objectives would term such projects successful. This suggests that strengthening the post-project independent evaluation function may not help to narrow the zone of ignorance by the principals. Multiple factors contribute to this difficulty: evaluation methodologies that focus on programme objectives, moral hazard in donor financing of such evaluations and imperfect access to project knowledge by evaluators.

The situation is further complicated by three factors: weak or extant countervailing institutions, path dependency, and the interdependency of various actions. Countervailing institutions such as the judiciary, police, parliament and citizen activist groups, are usually weak and unable to restrain rent-seeking by politicians and bureaucrats. Historical and cultural factors and mental models by which people see little benefits to and high costs of activism prevent corrective action. Further empowering local councils to take actions on behalf of citizens often leads to loss of agency between voters and councils, because council members may interfere in executive decision making or may get co-opted in such operations while shirking their legislative responsibilities. The NIE framework stresses the need to use various elements of transaction costs in designing jurisdictions for various services and in evaluating choices between competing governance mechanisms.

Further complications on the recipient side arise from breakdown of vertical co-ordination with multiple orders of government and horizontal co-ordination among governmental agencies themselves and between government agencies and groups. A structure of resource dependency vitiates against collective action in the interest of the common good because of the tragedy of commons associated with common pool resources. This scenario results in failures in vertical and horizontal co-ordination in a multi-organisation partnership (Dollery and Wallis, 2001).

One possible solution is to introduce a market mechanism of governance, whereby a contract management agency enters into binding contracts with all partners. However, this solution is unworkable because the potential number of contingencies may simply be too large to be covered by such contracts. A second approach to overcoming horizontal co-ordination, the so-called hierarchical mechanism of governance, relies on institutional arrangements to clarify roles and responsibilities and to establish mechanisms for consultation, co-operation and co-ordination, as is done in some federal systems. Such institutional arrangements entail high transaction costs and are subject to a high degree of failure attributable to the conflicting interests of partners.

Given the high transaction costs and perceived infeasibility of market and hierarchical mechanisms of governance for partnerships of multiple organisations, a network mechanism of governance has been advanced as a possible mode of governance for such partnerships – the kind to be managed by local governments. The network form of governance relies on trust, loyalty and reciprocity between partners with no formal institutional safeguards. Networks formed on the basis of shared interests (interest-based networks) can provide a stable form of governance if membership is limited to partners that can make significant resource contributions and if there is a balance of powers among members. Members of such networks interact frequently and see co-operation in one area as contingent on co-operation in other areas. Repeated interaction among members builds trust. Hope-based networks are built on the shared sentiments and emotions of members. Members have shared beliefs in the worth and philosophy of the network goals and have the passion and commitment to achieve those goals. The stability of such networks is highly dependent on the commitment and style of their leadership (Dollery and Wallis, 2001).

Local government has an opportunity to play a catalytic role in facilitating the roles of both interest-based and hope-based networks in improving social outcomes for local residents. To play such a role, local government must develop a strategic vision of how such partnerships can be formed and sustained. But then the local government requires a new local public management paradigm. Such a paradigm demands local government to separate policy advice from programme implementation, assuming a role as a purchaser of public services but not necessarily as a provider of them. Local government may have to outsource services with higher provision costs and subject in-house providers to competitive pressures from outside providers to lower transaction costs for citizens. It also must actively seek the engagement of both interest-based and hope-based networks to supplant local services. It needs to develop the capacity to play a mediating role among various groups. In most recipient countries, local governments are hamstrung by the policy and legislative framework to play such a role.

By the NIE framework, the situation on the donor side is no different. Donor citizens as governors/principals have incomplete contracts with their agents (governments) who in turn have unenforceable contracts with their sub-agents (aid agencies) and who in turn have even more unenforceable contracts with their independent consultants and providers. Agents may not act in the public interest as political finance weakens this agency relationship and legislatures may not be able to exercise due oversight on the executive. Information asymmetries abound in citizens-legislature-executive-aid agency-contractors relationship. Only the aid agency staff and contractors have better knowledge about aid effectiveness and it is in their rational interest to withhold such information from governments, aid agencies and citizens so that support for such assistance does not wither away in the event non-effectiveness of such assistance gains currency in public opinion.

In donor-recipient relations the NIE framework argues for complete contracts with fully enforceable conditions. International organisations could play for-fee roles of contract management agencies on behalf of donors and recipients. However, as noted earlier, potential contingencies in practice may be too large to make such contracts unworkable and unenforceable. A network form of governance where the recipient country or an international agency co-ordinates the activities of all donors offers some potential, but may not work due to high transaction costs associated with such co-ordination and lack of loyalty, trust and reciprocity in an international setting. A network form of governance may, however, be worth trying for expanding access to clearly defined global public goods.

Limitations of the approach

As noted earlier, the NIE framework emphasises citizen empowerment and governments acting as agents of people fulfilling contractual mandates. Complete contracts, however, remain infeasible and agency problems at best could be mitigated to some extent with absolute transparency, home rule, strengthening counter-veiling institutions, and accountability and redress mechanisms, but could never be overcome completely.

A synthesis of conceptual perspectives

Various conceptual approaches briefly sketched in the previous section highlight the following issues in external development assistance and associated conditions.

- ***Donor-recipient relations:*** The approaches highlight the complexity of such relations and conflicting interests of various stakeholders on either side and offer predictions as to the final outcome of such interactions. All approaches predict sub-optimal outcomes unless the design of such assistance addresses to mitigate the perverse incentives faced by various stakeholders in these repeated interactions. Individual approaches differ on the underlying critical factors guiding such relationships and the means to overcome those constraints (see Table 9).
- ***Multiplicity of donor and recipient stakeholders:*** All approaches with the partial exception of game theory recognise multiplicity of stakeholders on both sides of the equation. While there may be confluence of interests by principals on both sides, principal-agent conflicts on either side dominate and guide donor-recipient relations. The approaches recognise the possibility of collusion by agents of the donor and the recipient to maximise aid flows without worrying about the effectiveness of such assistance.
- ***Role of citizens on both sides:*** With the sole exception of the NIE approach, the role of citizens as governors/principals is not sufficiently recognised by various conceptual approaches discussed here.
- ***Improving aid effectiveness:*** Various conceptual approaches provide differing perspectives on improving aid effectiveness. Game theory emphasises that improving donor agency incentives and accountability mechanisms and credibility of sanctions and imposing higher administrative costs for assistance in the event of non-compliance will represent a welfare improving proposition for both the donor and recipients. Public choice theory argues for greater competition and voice and exit options. Fiscal federalism literature emphasises better design of such assistance to promote partnership within and beyond governments. It further argues that there should be singular focus in each grant instrument. Grant design should be consistent with its objective, respect autonomy but enforce accountability for results. It encourages use of lending instruments for income-producing physical investments but discourages their use for governance and institutional reforms. It also emphasises a strong role of executive and legislative federalism within the nation for horizontal and vertical co-ordination. Political economy perspectives suggest taking a closer look at recipient country institutions and building effective coalitions for reform. NPM emphasises reforming the bureaucratic culture of aid agencies and recipient governments to embrace results-based management and evaluations. The NIE argues for citizen empowerment through localisation, direct democracy provisions, letting the sunshine on government operations through transparency requirements and lowering the transaction costs for citizens to hold government to account.
- ***Implications for conditionality of assistance:*** All approaches argue for the conditionality of external assistance but argue against input-based conditionality. However, various approaches differ as to the type of conditions to be imposed.
  - Game theory suggests conditions should assure that both the donor and the recipient share both the rewards of success and the consequences of failure. For example, for a failed loan-financed project, the donor must also bear partial financial consequences of the failure. This is intended to mitigate somewhat the adverse consequences of “loan approval and disbursement culture” with no attention to results.

– Fiscal federalism literature argues against input- and process-based conditionality that undermines recipient autonomy and instead advocates output-based conditionality to enforce results-based accountability. It favours the golden rule of borrowing, i.e. borrowing for capital investments only and no borrowing to finance operating expenditures (for example expenditures associated with institutional and governance reforms). It discourages general budget support if the aim is to finance merit public services.

– NPM argues for conditions that help monitor the results-based chain but for holding the recipient to account for service delivery performance (output accountability).

– The NIE advocates contractually enforceable conditions on both the donor and the recipient for specific results to be achieved and having the requisite governance environment to hold the aid agency and recipient government to account for direct democracy and sunshine provisions, observance of the subsidiarity rule and lowering the transaction costs to hold various agencies and government to account (Table 10).

Table 10. **Implications of conceptual perspectives for loan/grant conditions: A synthesis**

Features	Alternative conceptual approaches					
	Game theory	Public choice	Fiscal federalism	Political economy	New Public Management	New institutional economics
Donor-recipient relations	Non-cooperative strategic behaviours by donor and recipients lead to sub-optimal results.	Donor and recipient collusive behaviour to the detriment of public interest.	Partners with shared objectives but varying perspectives on how to achieve them. Conflicting interests mediated through higher order incentives.	Collaboration to build domestic consensus for reform.	Human resource incentives in both aid agencies and government work to undermine aid effectiveness.	Conflicting interests and values of principals and agents on both sides. Principals on both sides have incomplete contracts and imperfect knowledge about agents' behaviuors and activities. Agents on both sides disconnected from their citizens (principals/ governors).
Multiplicity of donor stakeholders	Partially recognised	Recognised	Recognised	Recognised	Recognised	Recognised
Multiplicity of recipient stakeholders	Partially recognised	Recognised	Recognised	Recognised	Recognised	Recognised
Role of citizens on both sides	Not addressed	Limited role	Limited recognition	Modest recognition	Modest recognition	Strong emphasis on citizens as governors but role circumvented on both sides

Table 10. **Implications of conceptual perspectives for loan/grant conditions: A synthesis** (*continued*)

Features	Alternative conceptual approaches					
	Game theory	Public choice	Fiscal federalism	Political economy	New Public Management	New institutional economics
Improving aid effectiveness	Address donor agency incentives and accountability and impose higher administrative costs for future assistance in the event of non-compliance.	Greater competition, voice and exit options.	Making design consistent with objectives. Singular focus. Respecting recipient autonomy but having accountability for results. Institutions of executive and legislative federalism.	Focus on recipient country institutions.	Focus on reforming civil service culture and introducing results-based management and accountability.	Citizen empowerment through home rule, bill of rights, direct democracy provisions such as referenda and recall; redress mechanisms, and letting the sunshine on government operations and reducing transaction costs to hold government to account.
Implications for conditionality	Ensure that both donor and recipient share both the rewards of success and risks of failure.	Focus on the governing environment as a pre-requisite of assistance.	Input- and process-based conditionality impairs recipient autonomy and may create white elephants. Output-based conditionality respects autonomy and enhances accountability for results. General budget support less desirable to ensure minimum standards of merit services. Borrowing not desirable for operating expenditures.	Detailed analysis of country's political, economic and social institutions should be a pre-requisite for assistance. Conditions should facilitate coalition building for reform.	Monitoring of results-based chain but output-based accountability for both donors and recipients.	Contractually enforceable conditions on both donor and recipient to emphasise specific results to be achieved, sunshine provisions, citizen empowerment and lowering transaction costs to hold both parties to account for contract performance. Local government to be given an enhanced role in service delivery and oversight of higher level government's activities in local area.
Should conditionality be dispensed with altogether	No	No	No	No	No	No

International development assistance: Evolving perspectives on donor-recipient relations and on conditionality of assistance

Conditionality of international development assistance has been a subject of perennial controversy and debate. This debate had a significant impact on the design and delivery of external development assistance with a trend away from donor-imposed design and conditionality to somewhat participatory approaches to the same with recipients given significant opportunity to influence donor-driven programme design and conditionality. Annex A provides an overview of such evolution by individual multilateral institutions. This section traces the evolution of this thinking both in loan and grant assistance and provides a discussion of outstanding issues.

Evolving landscape on the conditionality of development assistance

Loan conditions

IMF, World Bank and European Investment Bank lending instruments and conditionality have evolved over time. Until the early 1980s IMF loan conditions focused on macroeconomic policies and IMF staff had a free hand carrying out the diagnostics and developing conditions that a borrower must accept. In the ensuing two decades, the demand for IMF lending softened and the IMF carved out a growing role in competition with the World Bank, the Asian Development Bank, the Inter-American Development Bank among others in lending assistance for structural reforms. This led to an explosive growth in IMF conditions with an average of 17 conditions per programme per year. However, various evaluation studies suggested that these conditions had little structural depth and weak compliance (IMF, 2007). The international financial crisis of 2008 led to an explosive demand for the IMF's stabilisation assistance programme. This helped the IMF to streamline its conditionality in 2009 and have a greater focus on areas of its competency. The requirement that all conditionality must be macro-critical – that it is critical to the achievement of macroeconomic programme goals – was reinforced. More recently income inequality and unemployment concerns led the IMF to emphasise "macro-social" criticality of its loan conditions. Recent guidelines (IMF, 2016) also emphasise recipient country inputs on loan design and conditionality. The overall thrust of the new guidelines is to have greater parsimony in conditions (now about five or less per programme per year) and greater flexibility in programme implementation provided there is assurance of achievement of programme objectives.

World Bank loan instruments and conditions have also significantly evolved over time. Prior to the 1980s World Bank lending assistance was focused on physical and social infrastructure projects with conditionality on procurement, implementation monitoring and auditing.

The effectiveness of these loans was measured by project outcomes and by pre- and post-project rates of return. Compliance record with these conditions was good and a large majority of these projects had "successful" outcomes, but about a third of such "successful" operations were not sustainable. The project rates of return, however, appeared less useful as they showed a consistent over-optimism in *ex ante* rates of return. However, in the World Bank's judgement, these projects could not address the broader policy and institutional malaise that hindered development. In the early 1980s, the World Bank brought a greater emphasis to policy and institutional reform through policy-based lending programmes. Policy-based lending brought a newer kind of conditionality in lending that emphasised broader policy reforms through legislative and executive actions. These conditions varied in terms of specificity, clarity, monitorability, enforceability and difficulty in implementation. Conditions also varied by the economic and political clout of the borrowing countries. Large upper middle-income borrowers typically faced softer conditions whereas small low-income countries were subjected to a degree of detail that could be misconstrued as micromanagement by an external aid agency. The conditions typically embodied the so-called "Washington Consensus" on policy reform and emphasised trade liberalisation, privatisation, public enterprise reforms, and fiscal policy and tax administration reforms.

The conditionality of World Bank lending accompanied by newer windows such as enhanced assistance from China for infrastructure assistance contributed to a softening of the demand for World Bank lending during the period 2001-05. Subsequent World Bank internal management reviews of adjustment lending (World Bank, 2005) stated that changed economic circumstances in recipient countries called for a move from adjustment lending to programmatic lending to have a sharper focus on governance and institutional reforms. Programme lending through development policy and sectoral development loans would provide opportunities to develop comprehensive medium- to long-term reforms. Loan conditions for such programmes are intended to emphasise country ownership and sustained commitments to reform and strict compliance with loan conditions would be de-emphasised provided the client is on track in achieving mutually agreed reform objectives. Table 11 highlights the principles adopted by the World Bank for development policy lending.

Table 11. **Good practice principles for development policy lending by the World Bank**

Ownership	Reinforce country ownership
Harmonisation	Agree up front with the government and other financial partners on a co-ordinated accountability framework
Customisation	Customise the accountability framework and modalities of World Bank support to country circumstances
Criticality	Choose only actions critical for achieving results as conditions for disbursement
Transparency and predictability	Conduct transparent progress reviews conducive to predictable and performance-based financial support

Source: World Bank (2007), "Conditionality in development policy lending", p.i, http://siteresources.worldbank.org/PROJECTS/Resources/40940-1114615847489/Conditionalityfinalreport120407.pdf.

In conclusion, both World Bank lending instruments and associated loan conditions have undergone profound changes over the last 50 years. It should be noted nevertheless that while instituting this new shift in emphasis on results in development policy lending, the World Bank continues to follow traditional conditionality in its investment project assistance. There has been greater flexibility in lending instruments and associated conditions for development policy in recent years. A significant part of lending simply provides general budget support. Lending emphasis have shifted from the "Bank knows best" to joint learning and a greater focus on an enabling environment for better economic and social outcomes. There is a greater emphasis now on local ownership. Still, there are residual concerns with the mutual accountability framework as donor agency staff are incentivised to approve and disburse loans with little accountability in the event of failure. The system of frequent rotating appointments shields individual World Bank staff from accountability for failure while taking credit for loan approval and disbursement. The burden of failure rests solely on the recipient's shoulders with no adverse consequences for the World Bank as the World Bank being the prime creditor would almost always be repaid. This contrasts with private bank lending where loan failures have consequences both for the lender and the borrower. These perverse incentives are at the heart of the problem of limiting development effectiveness of loan conditions.

Grant conditions

EU member states and the European Commission provide development assistance in the form of grants. Together, they constitute the largest donor of such assistance.

EU/EC policies on conditionality have evolved over time. Traditional conditionality with unilateral input- or process-based donor conditions with little harmonisation across member states and the EC dominated the EU aid regime in the late 20th century. The EU also imposes political conditionality relating to democratisation and human rights in recipient countries. Non-compliance with these conditions led to inconsistent sanction responses across countries (see Del Biondo [2011]). EU aid programmes suffered from excessive concerns with input-related tasks and financial and procedural controls and insufficient attention to project quality and almost no attention to results (see Seabright [2002]; Martens et al. [2002]). Martens et al. note:

> … policy and program objectives will tend to be broader, vaguer and less well defined, taking into account the views and opinions of a wide range of parties and making implementation more difficult and less efficient. The absence of majority voting for most decisions in the Council makes the situation even worse. Furthermore, member states compete with each other to get the largest possible share of the EC's aid contracts cake. They provide political support for their own private aid services suppliers in this competition. National and service suppliers actively lobby their political representatives in Brussels for that purpose; national representatives in EC foreign aid decision making communities spend a considerable part of their time exploring and pursuing contract opportunities for national suppliers. This focuses attention very much on inputs and procurement procedures (budgets, contracts, tenders, etc.), thereby further tilting the bias in favour of inputs and away from outputs and performance. Because of the lack of single political ownership at EC level and intensive competition between member states, input bias in EC aid is likely to be stronger than in bilateral aid programs. (p.31)

However, with the dawn of the 21st century, the EU has actively pursued to improve aid effectiveness by playing an active role in important international agreements that aim to reform the delivery of economic assistance. These include the 2005 Paris Declaration, the 2008 Accra Agenda for Action, the 2011 Busan Outcome document, the 2014 Mexico Commitment, the 2015 Addis Ababa Action Agenda for the implementation of the Sustainable Development Goals and the 2016 Brussels 2030 Agenda for Sustainable Development. The overall thrust of these agreements is to reform donor-recipient relations using the following principles (European Commission, 2015):

- focus on country ownership
- transparency and mutual accountability
- unconditional assistance
- focus on results
- focus on forging partnerships for development
- predictability of assistance
- focus on inclusive and sustainable development.

In recent years, EU members and the European Commission have made modest progress in bringing aid programmes in conformity with the above principles (European Union, 2016). The European Commission adopted a results framework in 2015 that emphasises developing a results-based chain for assurance that programme activities and inputs are consistent with the objectives to be achieved (European Commission, 2015). Significant progress has been made on country ownership and focus on inclusive development. Modest progress has been made on unconditional assistance and partnership principles. Transparency and mutual accountability goals remain elusive. There have been reversals on aid predictability (European Commission, 2011) by member countries and the results focus still seems on intermediate inputs (Adam et al., 2004); mutual accountability remains a distant dream as country systems are rarely used by donor agencies (European Union, 2016).

Emerging consensus on the new model of conditionality and current practice

Multilateral development agencies are gradually moving away from traditional conditionality that emphasised input-based conditions as a tool for leverage and control ensuring that assistance funds were used for the intended purposes following processes laid out by the donor agencies. These agencies have come to recognise that while the traditional conditionality was intrusive, it also undermined the effectiveness of their assistance by reducing flexibility in programme design to meet local conditions by the recipients. The new view is that the conditionality should be specifically tailored to the special circumstances of each recipient and focus on an agreed framework that will facilitate monitoring progress to achieve jointly shared objectives. The conditionality therefore should be seen as a tool of mutual accountability and due diligence rather than of financial leverage and input controls. The new conditionality also emphasises country ownership as the key to the success of the project/programme and sees sustained dialogue as key to strengthening recipient ownership as well as meeting fiduciary due diligence requirements. The new conditionality also sees outcome-based results focus as a means to enhance development effectiveness. There is also an emphasis on having fewer conditions that are critical to the project's success and have the necessary buy-in of the recipient government. Multilateral agencies also emphasise placing a greater emphasis on general budget support and rewarding reforming countries for prior actions taken.

In practice, multilateral agencies continue to practice input-based conditionality for traditional investment projects. For structural and institutional reforms, much confusion remains among outcome, output and intermediate inputs conditionality. In many cases, multilateral agencies impose conditions on intermediate inputs but construe these as outputs or outcomes. Notwithstanding the results focus in international aid dialogues, it should also be noted that bilateral grant assistance that dominates overall aid flows has not seen much transformation and this assistance primarily flows through project assistance with input-based conditionality.

Outstanding issues and views

This section highlights the key outstanding issues and current views on how to address these challenges. The reader is well advised also to consult World Bank (2005; 2007) for a comprehensive treatment and synthesis of the wide-ranging issues under discussion by the development assistance community.

Box 2. **Selected examples of development assistance that did not work as intended**

While donors and recipients can point out numerous examples of success of development assistance, this box highlights a few illustrative cases that worked as predicted by the theoretical literature on aid effectiveness.

Soft conditions by the donor to ensure project success: The World Bank provided a fast disbursing structural adjustment loan (P066867) of USD 606 million to Mexico with no counterpart financing in 2001 to advance decentralisation reforms. The overall objective of the loan was greater transparency of federal transfers and subjecting local borrowing to market discipline. To advance these objectives, the loan imposed two conditions: 1) federal transfers must be published as part of the federal budget; 2) two credit-rating agencies be established to develop and monitor state and municipal credit ratings. These conditions were immediately complied with by Mexico and the loan was fully disbursed within six months of approval. But the loan overlooked some important facts: 1) the statistical annex to the President's report to the congress – a more widely circulated document than the federal budget – had a long tradition of publishing the details on federal transfers; 2) a credit-rating agency was already doing credit ratings for subnational governments long before the dialogue on the Decentralization SAL began (see World Bank [2003]; ICR Review Report No. ICRR 10974).

Project approval culture with little attention to project success: In 1991 after the fall of the Caucescu regime, Romania sought World Bank emergency assistance for critical imports due to a shortage of tires for commercial vehicles. The World Bank provided fast-track approval of this loan in June 1991. However, under World Bank rules, Romania had to follow a competitive international bidding process to procure the needed commercial tires. As the Romanians were unware of such procurement practices, the World Bank offered a training programme. It took Romania three years to comply with the procurement process and by the time the tires were imported, they were no longer needed as the market had already filled the gap. As a result, five years later, the tires were still sitting in government warehouses while the government frantically searched for a solution to get rid of the surplus tires (see World Bank [1996]).

Repeated nash equilibrium in IMF stabilisation assistance to Pakistan with no learning: Pakistan, from its formation in 1947 to the present day, has been an on-again off-again recipient of IMF stabilisation assistance. The objectives of these programmes were almost identical from the 1950s to the 2010s. Pakistan complies with IMF conditions for about two years and then goes off track. A couple of years later it enters into a new stabilisation programme and the game continues to be repeated *ad infinitum* until the present time with no end in sight to this vicious cycle of debt trap (see McCartney [2012]).

Delayed reforms in anticipation of foreign assistance: In early 1992, Pakistan was isolated internationally due to its nuclear experiments and the government adopted a comprehensive fast-track programme of structural reforms recommended by an independent Economy Commission with wider political support. This programme was to be implemented in the fall of 1992. However, in the early fall the international development assistance community resumed its aid relations to Pakistan. The Pakistani government immediately shelved its deeper structural reform programme and was successful in obtaining external assistance for cosmetic reforms.

Technocratic solutions ill-suited to local conditions: Indonesia received multi-donor external assistance led by the IMF/World Bank to achieve better financing of subnational governments and improved monitoring of local service delivery performance as part of support for decentralisation reforms in 2000. Following external advice, it revamped its home-designed subnational transfers programme that had served its objectives well and substituted it with a highly complex, yet inefficient and inequitable, system of fiscal transfers. It also imposed complex, laborious data collection and reporting requirements unrelated to local service delivery performance e.g. providing data on the Gini and human development indexes on a quarterly basis. Local governments face high compliance costs yet receive no feedback on these reports from the central government (see Shah [2012]; [2014]). Another example of “ill-suited” advice comes from World Bank decentralisation operations where the World Bank recommended setting up UK-type local audit commissions for local governments to a large number of countries. This experiment imposed high costs in the United Kingdom and was abandoned in 2010, but developing countries that set up similar institutions at substantial costs may not have such an option if they faced a situation similar to the one in the United Kingdom.

Another important example of failures of technocratic solutions favoured by the development assistance community comes from contrasting experience with privatisation reforms in the Czech Republic and Romania. Contrary to World Bank/IMF advice, the Czech Republic adopted a programme of rapid privatisation, leaving the restructuring of the enterprises to the new owners. This programme of mass privatisation with two short waves each conducted over less than a year was remarkably successful and the centrally planned economy was completely transformed into a private market economy in record time. Romania, on the other hand, followed World Bank/IMF advice to restructure state enterprises and make them profitable prior to their sale and its privatisation programme was derailed as public managers organised to oppose privatisation by keeping the enterprises in a loss-making position (see World Bank [1996]; [1997]).

Source: Author based upon referenced documents

Policy-based lending

Several factors contributed to the popularity of policy-based lending by multilateral agencies in the late 1990s (see Williamson [2005]). These included: an urgent need for fast disbursing assistance to deal with the oil and debt crisis; growing recognition of the importance of the policy environment for effectiveness of development assistance; growing realisation of the importance of fungibility of foreign assistance – recipients' ability to put their best projects forward for external financing and to use the financing to finance other pet expenditures, e.g. military expenditures; shrinking demand for multilateral conditionality ridden project assistance. The preferred tool for policy-based lending was programmatic lending, where donors provided general budget support to carry out wide-ranging policy reforms. In many cases, the donor went shopping looking for recent reforms already undertaken to shower their assistance. Such assistance mostly went to higher middle-income countries. Initially there was pervasive political conditionality mostly for legislative and executive actions, e.g. presenting draft legislation to parliament, issuing regulations, etc. As the record of non-compliance with these conditions piled up, lenders embraced a change towards consensual conditions and country selectivity-favouring reforming countries. There was general support for the view that the reforming countries should develop a long-term plan and get donors to buy in to elements of this programme for external financing – the so-called "common pool approach" (Kanbur and Sandler, 1999). However, in practice such a co-ordinated view of country assistance could not be implemented.

While there seems to be a broad based donor consensus on policy-based lending, the conceptual literature presented earlier does not support such a perspective. This is because most of the support goes to general budget support for the government with the expectation that it will implement policy reforms the net fiscal cost of which in most cases is zero or even negative (say tax reforms). Thus such lending violates the cardinal rule of fiscal prudence – the golden rule for borrowing – and enhances the indebtedness of highly indebted countries. Furthermore, country selectivity criteria is of little help to fragile and low-income countries in dire straits that lack the basic institutions of good governance or do not have in-home policy expertise. General budget support for non-democratic regimes could perpetuate non-inclusive elite services or go towards wasteful military and civilian expenditures. Financing prior actions when they were not part of the agreed-upon programme have the potential to reward countries for political reasons and also diverts assistance to higher income countries while depriving assistance to countries in greater need.

Minimum international standards

An emerging donor consensus is to use in the future country systems rather than donor-mandated processes to ensure integrity in the use of donor funds. To this end, donors increasingly rely on public expenditure and financial accountability assessments to form a considered view of country systems. Setting up minimum international standards, however, remains an area of debate. Some worry that a higher standard would exclude some countries deserving of aid while a lower standard may create inertia for some countries not to strive for higher standards. These concerns can be overcome by the design suggestions presented below.

Minimum international standards of fiscal and financial management and accountability are a useful construct. These standards could usefully serve as pre-requisites for receiving external assistance and would possibly circumvent the need for special project implementation units and donor-specific procurement rules and project and financial reporting requirements. These standards, however, need to be carefully constructed for a various class of countries based on their public expenditure and financial accountability assessments and other relevant country-specific circumstances. Certification grants could be a useful tool for encouraging countries to graduate to the next higher classification of minimum standards. This is an area requiring donor attention as not much progress has been made yet in the use of country systems and unharmonised donor systems impose significant costs for the recipients.

Minimum international standards for basic public services along the lines of the Millennium/Sustainable Development Goals could be a useful tool in determining external aid priorities, eligibility for various types of assistance and monitoring progress. These minimum international standards could also vary by country classes (e.g. fragile, low-income, middle-income and upper middle-income, etc.) and affordability issues but a universal class of minimum standards in basic public services would apply to all countries and a rights-based approach may be used to assure universal access to such standards.

Mutual accountability

While there is consensus on the need for mutual accountability, very few practical ideas have emerged to make it happen. A results-based focus is seen as the primary tool for advancing this objective. The results-based focus, however, will bring to light a more informed perspective on project/programme achievements but would have a limited impact on mutual accountability. In the event the aid recipient diverts aid resources to non-assisted functions, there is hardly any remedy available to the donor. Alternately, if there is lack of integrity or waste in the use of funds, the donor has options for future assistance but the consequences of donor actions may not affect the regime but may have a greater impact on the impoverished members of the society if, in fact, they received some benefits from aid flows. On the other side, there are presently not any significant consequences for a lender for a bad loan or bad advice that leaves the recipient in greater debt and more impoverished conditions. While practical options for risk and reward sharing are available, the development assistance community has not shown any interest in examining such options for future adoption.

Country ownership and conditionality: Some tensions

An emerging consensus in the development assistance community is the importance of country ownership for project success. This is being proposed as an important criterion for selectivity of assistance. It is argued that if country ownership is confirmed by the donor then a donor may provide such a country assistance for prior actions, unconditional assistance and budget support to finance its reform programme. There are nevertheless risks with such a strategy. The ownership by an elite government may not imply legislative buy-in or citizens' ownership of government programmes. Further, lending assistance may not be appropriate for institutional reforms with net fiscal costs being zero or less. Also, selectivity may lead to greater assistance for countries in lesser need of assistance than for countries in greater need. Selectivity may also be based upon a donor criteria that may implicitly incorporate value judgments, e.g. the World Bank Governance Indicators are based mostly on the perceptions of a handful of foreign experts mostly based on western media reports about other countries rather than in-depth knowledge about the governance environment in specific countries. Such perceptions can be shown to be wrong in many instances and may be in conflict with citizens' perceptions. Similarly, the World Bank's Country Performance and Institutional Assessment indicators are developed by World Bank staff with direct responsibility for assistance to the same countries and therefore hold no assurance of an unbiased perspective.

Current state of partnership for development assistance

Recent discussions on the effectiveness of development assistance has also emphasised multi-donor partnership under the country leadership to finance development. Various reforms are proposed as a way to develop such a partnership. These include the country taking the lead in donor co-ordination, harmonisation of donor requirements and conditionality, donors' use of country systems in place of own requirements, the country developing a development plan in consultation with internal and external stakeholders, and donors making a commitment to finance a slice of the programme on a long-term basis, and the use of conditions simply for mutual accountability and monitoring progress and not as a source of donor leverage and control. Consensus on these principles, however, has not resulted in much progress on the ground. Impediments to progress include both the capability and willingness to bear the transaction costs of such ambitious undertaken by the recipient countries, especially low-income and fragile countries; conflicting agendas and interests of bilateral donors and reluctance to give up control for fear of abuse of funds, financial and fiscal crisis limiting predictability and stability of donor financing, a changing political landscape and policy priorities in donor countries. In general, major progress on this front in the near future seems uncertain. There is also a view that the partnership approach is less workable to deal with fiscal, financial and humanitarian crises or natural disasters, as these require urgent responses through quick consultations of the donor with the central agencies directly responsible to deal with such crises.

Lessons on the conditionality of development assistance

This section draws lessons from conceptual underpinnings and practical experiences with the use of conditionality in development assistance.

*Instrument choice and conditionality must be consistent with reform objectives***.**

Macroeconomic stabilisation goals. The conditions on key macroeconomic indicators that are critical to the achievement of stabilisation goals and are within the control of recipient government policy makers are appropriate both for grant and loan finance. For loan finance, care must be taken to ensure that with stabilisation, the debt is affordable and repayable by the country in the short to intermediate run. Also, while hard conditions on major macro indicators, e.g. debt and deficit limitation, are desirable, the escape clause must be linked to a decline in GDP, a major recession, or civil strife or catastrophe to afford flexibility in the event of a crisis and not to cut off aid to a country when it needs it the most. Another useful alternative to the escape clause is the IMF-type joint programme reviews to take into account unexpected exogenous factors and readjust the programme accordingly as escape clauses cannot take all unexpected factors into account.

Structural reform goals. Results- (output-based) rather than process- and input-based conditionality would be desirable for structural reforms. Grant financing is appropriate but care must be taken in providing loan finance. Loan finance would not be desirable for fiscally poor countries that may not have the potential to repay such loans over a reasonably long-term horizon.

Governance and institutional reform goals. Output conditionality based on a clearly articulated results-based chain is desirable for grant finance. Care must be taken in designing such output conditions to mitigate moral hazard. Certification-based grants where implementation of governance and institutional reforms are treated as pre-requisites for rewarding reforming governments, are appropriate for this purpose. Note that this differs from rewarding countries for prior actions as used by multilateral development agencies. Pre-requisites in a certification programme are part of the agreed-upon phased assistance programme whereas prior actions simply reward governments for having already taken reform steps to the liking of the donor. Certification grants therefore serve as an inducement to reform whereas prior actions in most cases lack any incentives for reform and simply provide windfall gains to the recipient. However, prior actions that are implemented as part of the conditions for approval of a programme would be justified for the first disbursement. Loan finance may not be appropriate for fiscally poor countries. Loan finance as a general budget support for governance reforms is particularly questionable as it violates the golden rule for borrowing and contributes to imprudent fiscal management. Of course, if the governance reform programme has a long-lived investment component, borrowing would be justified for that component only. Ruling elites with a short time horizon may use such borrowing to perpetuate their regimes. Untied aid (unconditional assistance) also would not provide any assurance for the achievement of the reform goals. Unconditional assistance is only appropriate if the donor's objective is simply to augment the fiscal capacity of the recipient to follow its own priorities.

Government ownership in the absence of citizen-centric governance holds no assurance of country ownership.

"Country ownership" is considered critical to a project's success as confirmed by various evaluation reports. Most of this literature, however, equates "country ownership" with "government or ruling regime" ownership. But government ownership in the absence of citizen-centric governance or strong citizen empowerment holds no assurance that broader development effectiveness objectives cherished by donors would be fulfilled even if the project was successful. Therefore, programme design using a results-based chain must pay close attention to the reach (see Figure 3) or winners and losers associated with each programme. This emphasis is a missing link in aid deliberations including the EC Results Framework. In the absence of such attention, the so-called country ownership is a necessary but not a sufficient condition to ensure equity in public services provision and the feasibility and sustainability of the programme.

Conditionality of assistance can be an important tool for positive inducement for commitment and ownership.

World Bank (2005) observes the following regarding conditionality and country ownership: "The main lesson learned from the literature is that conditionality can be useful in helping identify and implement necessary reforms but it is only when there is 'ownership' of the policy that conditionality can succeed, Conditionality helps when it supports governments already strongly committed to reform". (p.i, para 4)

The survey of conceptual literature presented earlier contradicts the above observation. Especially for structural and institutional reforms, conditional assistance is a means to provide a positive inducement for commitment and ownership to reform, failing which there will be financial consequences for the recipient. If the country already had ownership of and commitment to such reforms, it may only need external technical assistance for most governance and institutional reforms and conditionality would be irrelevant and financial assistance in most non-crisis cases probably not necessary.

Conditions and associated indicators should be mission critical, parsimonious, objectively and accurately measurable, timely, meaningful and understandable, firmly grounded in *the results-based chain, administratively simple (cost-effective), comparable, well-documented, facilitate streamlined reporting, well-publicised for public scrutiny, and could be verifiable by ordinary citizens or independent scholars and think tanks.*

To ease administrative burden, to the extent possible indicators chosen should be based on data that are already being collected. Further, the indicators chosen must avoid unintended perverse incentives as often "what gets measured is what gets done". No conditions should be imposed on input allocation, spending levels, programme and process design. However, transparency of the results-based chain should permit citizens and independent experts to monitor the entire chain. Monitoring of performance by the donor must be linked to timely feedback to the recipient on his performance. Compliance failures should have credible and significant consequences both for the recipient government as well as the aid agency. Incentives for staff career progression in the aid agency and government should be linked to the development effectiveness of such assistance. An independent rating agency may be encouraged to rate both the donor and the recipient for development effectiveness of their aid-financed programmes. Administrative costs of external finance should reflect these ratings just as country credit ratings have implications for capital market access and risk premiums by individual countries.

Programme design must attempt to mitigate the unintended negative consequences of conditionality. Uncoordinated cross conditionality should be avoided in the interest of better policy and programme implementation by designating a donor institution with the lead agency role.

We have already noted that external assistance poses many moral hazards for recipients. These include: positive incentives for delaying reforms and getting rewarded for late implementation by fulfilling donor conditions; putting the best project forward to donors for which domestic financing was assured in order to avail the opportunity to have unproductive pet public expenditures financed by donor resources; the opportunity for bureaucratic and political elite to receive private gains, including employment opportunities for relatives and kin in donor institutions; profit from procurement processes and rules; perpetuating the rule of unpopular regimes; improved fiscal position contributing to postponement or abandonment of fundamental reforms. On the aid agency side, moral hazard arises from aid agency contractors choosing project design options that maximise their profits. They may also face positive incentives in reporting results leading to project selection (so-called adverse selection problem) that may not be in the best interests of the principal. Aid agencies themselves may have incentives to maximise aid flows to build their dream bureaucratic empires or to ensure long-term existence through mission creep. There are no easy solutions to mitigate these moral hazards.

Whereas soft conditionality can be easily ignored, hard strictly enforced sanction-based conditions such as fiscal rules on deficit and debt limitations, while desirable, may in some cases have negative long-term consequences for countries requiring fiscal stimulus to overcome recession. These negative externalities, however, can be mitigated by suitable design options, e.g. having a review clause empowering either party to initiate a request for a joint just-in-time programme review or providing an automatic escape clause from debt and deficit limitations that are linked to the decline in the growth rate of GDP as done by the Brazil's Fiscal Responsibility Law, 2000. A review clause may be a better option than an escape clause when data such as GDP becomes available with a significant time lag and preliminary data could be manipulated by a country to trigger an escape clause.

The uncoordinated myriad conditions, at times conflicting, set by different donor agencies adversely affect policy and programme implementation and place a heavy burden on recipient countries. These can be avoided by bringing all concerned institutions and donors under one specific programme umbrella. Such a suggestion is difficult to implement in the current circumstances in view of the presence of a myriad of aid agencies with overlapping and conflicting mandates. If aid agencies can come to an agreement to designate a lead agency role for various tasks to various institutions, then it may be feasible for the designated lead agency to develop a critical set key conditions acceptable to all donors and the recipient.

Use country systems to minimise administrative burdens of recipient performance and compliance monitoring.

Strong trade-offs between effectiveness, ownership and administrative burdens emerge when donor conditions are uncoordinated and are on inputs, processes and activities with donor-specific reporting, accounting and auditing requirements. The existing development assistance regimes are replete with such trade-offs, which undermine recipient ownership, impose huge administrative burdens to meet donor reporting requirements and by shifting focus on inputs and processes undermine results-based accountability and effectiveness of development assistance. These trade-offs are mitigated by output conditionality subject to wider citizen-based monitoring and evaluation and citizen empowerment for oversight on government operations and wider civil society/citizenry support for externally assisted programmes. Donor monitoring should be based on the use of country systems rather than specialised reporting through project implementation units.

Results-based (output) conditionality helps mitigate strategic game theoretic responses from the recipient and donor agency staff and furthers the development effectiveness of external assistance.

Output conditionality promotes responsibility and autonomy with accountability for results. Such an approach empowers citizens to hold the government and aid agencies to account and is helpful in mutual accountability. Such conditionality is also less burdensome administratively.

For results-based mutual accountability to work, human resource management frameworks in aid agencies and government must embody results-based management and evaluation. The reform of executive boards of multilateral institutions may also be critical.

For results-based accountability to work, human resource management frameworks in both donor and recipient agencies must embody results-based management and evaluation to ensure that internal organisational incentives are aligned with the organisation’s objectives. There has not been any progress in changing the culture and incentives of staff in aid agencies and in executive agencies of the recipient governments. Staff incentives continue to be in harmony with the aid maximisation culture. The executive boards of the multilateral development institutions have full-time, in-residence members with dual mandates to advance the interests of home countries, i.e. maximising assistance and procurement and career interests of home country stakeholders, as well as providing oversight on the executive. These conflicting mandates undermine executive oversight and limit development effectiveness of external assistance. A part-time, non-resident board comprising government and civil society members would be more effective in its oversight role.

Fragmentation and non-predictability of external development assistance and non-credibility of conditions compromise development effectiveness.

Fragmentation and non-predictability of external development assistance also compromise development effectiveness. Credibility of non-compliance sanctions is unworkable in such an environment as donors compete against each other to benefit their own contractors/suppliers in multilateral assistance. In bilateral aid relations, political considerations undermine the sanctity of fiscal relations. Bilateral assistance often lacks a long-term perspective. This is compounded by recurring fiscal and financial crises in industrial countries. As a result, aid flows have become more unpredictable in recent years. Short time horizons and unpredictability of aid flows work to the detriment of having a long-term perspective on development finance.

Fragmentation of assistance could be overcome by reaching consensus on an overarching policy framework for the country supported by multilateral and bilateral donors and the recipient. This was the original idea behind the IMF's Country Policy Framework and the World Bank's Country Assistance Strategy and Poverty Reduction Strategy papers. These were conceptually sound initiatives but did not yield the expected results due to high transaction costs and only pro-forma commitment by some stakeholders. Renewed efforts at least at the sectoral level by using a lead agency concept may be worth trying to overcome fragmentation of assistance and restore the credibility of non-compliance sanctions.

Aid conditionality should facilitate network governance and partnership for development.

The delivery of external finance can be used as tool for forging international and domestic partnerships for development. On the international front, a single purpose aid agency/organisation could serve as the catalyst for co-ordinating and harmonising the assistance of all donors with the same focus. At the domestic front, it requires that the government act as a purchaser and financier but a competitive provider of public services and all public and non-public providers receive at-par public financing consistent with the population served. This role would be best played by local governments acting as catalysts for developing network governance by bringing together all providers – public, private for-profit, non-profit, good samaritans, self-help groups, hope-based groups and interest-based groups to form a network for local development. Thus it would be desirable for external assistance to flow directly to local governments willing and able to forge such network governance. Aid conditionality could facilitate development of such networks.

Donor conditions can help advance inclusive and sustainable development by encouraging greater transparency, results-based accountability and citizen empowerment through direct democracy and rights-based approaches to basic public services.

While there is a consensus on inclusive and sustainable development in the development assistance community, the goal of inclusive and sustainable development remains an elusive dream. This is because the tax systems in the developing world are proportional at best and public spending lacks a pro-poor bias. External development assistance is only of modest help as donors lack basic information on the reach (winners and losers) and fiscal incidence of their programmes of assistance and the poor do not figure prominently in recipient government political calculus. Recent trends towards greater transparency, results-based accountability and citizen empowerment through direct democracy and rights-based approaches to merit public services can help. Donor conditionality potentially has important role to play here.

A broken information feedback loop is better overcome by higher standards of transparency and results-based management and accountability rather than aid agency self-financed "independent" formal evaluations.

There is a large body of literature making a case for more spending by multilateral and bilateral aid agencies on formal evaluations in the interest of aid effectiveness. Martens (2001) makes an interesting case for higher spending on formal evaluations as a means to enhance the information feedback mechanism. He argues that in donor countries there are two constituencies for aid with conflicting objectives – taxpayers with altruism who genuinely seek to help impoverished human beings elsewhere and suppliers of aid services who are guided by self-interest to maximise their own profits to work as intermediaries. In view of the broken feedback loop and the moral hazard posed by the aid suppliers, Martens argues that taxpayers will be kept in the dark about the beneficiaries and the effectiveness of such assistance. Formal evaluations by aid agencies can help to overcome this problem by introducing an explicit information feedback mechanism on aid effectiveness. Martens, however, recognises that such evaluations by aid agencies are subject to manipulation by aid suppliers as they are the best informed about how aid works. International experience with aid evaluations further suggests that such evaluations are typically dated and not timely for use in improving current operations and are subject to strong moral hazard influences, especially if these are financed by aid agencies, regardless of whether the evaluation office has a significant degree of independence from the management.

An interesting example is presented by the Independent Evaluation Group (IEG), which reports directly to the Executive Board of the World Bank. The staff, however, are assured career mobility within the World Bank. The career interests and ambitions of IEG staff, therefore, place a limit on their independence. Full-time, in-residence executive board members with a focus on advancing home country interests are in a weak position to safeguard the independence and integrity of such evaluations. Further, the IEG evaluates the World Bank's and country's performance based on the objectives giving little weight to their relevance. This "evaluation by objectives" methodology places a premium on defining objectives modestly and overachieving these for a highly successful outcome. In addition, the evaluation separates outcome ratings from sustainability rating. A project may be declared highly successful while it may be unsustainable. This happens for nearly one-third of so-called "successful" projects. This introduces an upward bias in successful project/programme outcomes. A more objective evaluation methodology would use "theory-based evaluations", which establish backward linkages of outcomes to inputs in a results-based chain without worrying about specified objectives. Also, the outcome is all-inclusive of sustainable results.

In view of the moral hazard associated with aid agency financed evaluations, the information feedback loop is better established through greater transparency of aid and aid delivery mechanisms and making full information on the results-based chain made public so that independent scholars, citizens/taxpayers and think tanks can conduct their own evaluations and/or form their own views on aid effectiveness. Therefore, rather than requiring aid agencies to spend more on evaluations, they should be encouraged to disseminate objective data on the project/programme more widely. Further, if the aid agencies embrace results-based management and evaluation as the human resource management paradigm, there would not be any need for in-house "independent" evaluations, as the programme managers would be accountable for results and therefore incentivised to have continuing evaluations to deliver improved programme performance. The resources saved from "in-house independent" or aid agency financed evaluations could be used to further transparency objectives. This would further encourage more arm's-length civil society and think tank evaluations with greater social benefits. Of course, this does not obviate the need for the aid agency's own evaluations to ensure the efficiency, equity and integrity of its operations.

Note

1. This section draws heavily upon Huther and Shah (1996).

Annex A.
IMF, World Bank and EU/EC experience with conditionality

This annex draws on European Commission, IMF and World Bank reports and wider academic literature to distill lessons from past experiences with aid conditionality.

IMF conditionality

The IMF provides short- to medium-term lending to countries to restore or maintain balance-of-payment viability and macroeconomic stability to create an enabling environment for sustained high-quality growth and in low-income countries for reducing poverty. Such lending assistance is subjected to a wide range of conditions on macroeconomic and structural policies by the borrower as well as various tools to monitor progress in implementation of the agreed programme and achievement of the programme's objectives. The IMF considers such conditionality critical "to ensure that the country will be able to repay the Fund so that the resources can be made available to other members in need" (IMF, 2016: 1) The IMF also considers such conditionality essential in promoting national ownership of strong and effective policies.

The conditions cover macroeconomic (monetary, fiscal, debt, inflation and growth) policies and targets. Structural conditions relate to reforms in fiscal and financial management, monetary management, central banking, public sector revenue management and accountability, public enterprise and pricing reforms, labour market reforms, civil service and pension reforms, fiscal federalism reforms, regulatory reform, fiscal transparency and economic data reforms, etc. (see IMF [2010]).

Some loan conditions require conditions on prior actions – or pre-requisites of IMF financing. These are justified to ensure that the country meets some basic requirements that are considered critical to the success of the IMF programme, e.g. approval of a formal budget consistent with the programme's fiscal framework or removal of price controls or agricultural subsidies. IMF loans are typically disbursed in tranches with release of each tranche subjected to a satisfactory formal review of progress on loan conditions.

Prior actions

Quantitative performance criteria (QPCs). These are typically quantitative targets or limits on growth, macro-fiscal, monetary, inflation, debt and balance-of-payments balances, international reserves, and net worth. Non-compliance with these targets requires formal waiver by the IMF Executive Board for the programme to be continued.

Indicative or qualitative targets. These conditions are imposed in instance data limitations prevent specifying the QPCs.

Structural benchmarks. These are qualitative measures to monitor progress with structural reforms.

Evolution of IMF thinking on loan conditions

IMF policies on loan conditions have evolved over time. Until the early 1980s loan conditions focused on macroeconomic policies and IMF staff had a free hand carrying out the diagnostics and developing conditions that a borrower must accept. In the ensuing two decades, the demand for traditional IMF lending softened and the IMF had a growing role in structural reforms to support economic stability in low-income and post-conflict countries. This period saw an explosive growth in IMF structural conditions, with an average of 17 conditions per programme per year. A 2007 review conducted by the IMF's internal evaluation group, the Independent Evaluation Office (IEO), confirmed that most of these conditions had little structural depth and weak compliance, with only half of them met on time. Further, the IEO determined that compliance with these conditions had little bearing on a programme's success. Country ownership was critical for compliance and continuity of the reform. Loan compliance and effectiveness was observed to be higher in the areas of core IMF competencies such as tax policy, revenue administration and expenditure management but lower in other areas such as privatisation and wider public sector reforms. The IEO recommended a cap on structural conditionality of five per year, discontinuation of structural benchmarks and restricting conditionality to the core areas of IMF expertise. It further recommended that the IMF should develop a monitoring and evaluation framework linking conditions to reform and goals and programme documents should establish how the proposed conditionality is critical to achieving a programme's goals.

The international financial crisis of 2008 led to an explosive demand for the IMF's stabilisation programme and circumvented the need for mission creep, especially in areas of overlap with the World Bank. This helped the IMF to streamline its conditionality in 2009 and focus more on areas of its own competency. Parsimony in emphasising criticality as well as rigorous justification of conditionality was also emphasised. Structural performance criteria requiring formal waivers were abolished. This led to a significant reduction of overall conditions. In addition, new programmes to provide urgent assistance based on *ex ante* conditionality (pre-qualification performance criteria) were introduced. The requirement that all conditionalities under an IMF-supported programme must be "macro-critical" – "that is either critical to the achievement of macroeconomic program goals or necessary for the implementation of specific provisions under the IMF's Articles of Agreement" (IMF, 2016: 1) was reinforced. Subsequent internal review of conditionality (IMF, 2012) addressed concerns about lack of attention to individual country circumstances and needs and income redistribution consequences and of IMF programmes. In response, the IMF amended operational guidance to staff to strengthen the focus on "macro-social" (income redistribution, macro stability, employment and growth issues) aspects of IMF programmes, improving partnerships with other institutions, discontinuing monitoring with other donor conditionality, and better leveraging programme monitoring and technical assistance to advance programme effectiveness. The revised guidelines also emphasised the review-based approach to monetary policy conditionality in countries with inflation-targeting frameworks or evolving monetary policy regimes (IMF, 2014). Newer guidelines establish the principle that primary responsibility for the design of the programme lies with member country authorities. It stated that in helping the authorities to design an IMF-supported programme, staff: 1) seek the views of country authorities early and make every effort to accommodate their preferences and policy choices; 2) follow programme preparation and review processes that can facilitate reflection on the links between programme goals, strategies and conditionality. Staff are also advised to assist member countries in broadening domestic support for IMF-supported policies. Programme notes should establish explicit assessment of potential implementation difficulties, existing technical capacity and capacity building to be undertaken as part of the programme, and collaboration with multilateral and regional development finance institutions (IMF, 2014).

Revised guidance on designing conditionality

IMF guidelines (IMF, 2014; 2016) provide the following guidance to staff on designing conditionality:

- programme-related conditions generally must be either critical to the achievement of programme goals, to monitoring implementation of the programme or necessary to the implementation of specific provisions under the Articles of Agreement or relevant for policies development
- the criticality criterion applies to all measures – whether they are in the IMF's areas of expertise or not, or whether or not they are covered by another agency's conditionality
- staff should apply the principles of parsimony and criticality to all programme-related conditions
- cross-conditionality, under which the use of the IMF's resources would be directly subjected to the rules or decisions of other organisations, is prohibited
- conditions should be clearly and precisely stated
- the scope of programme reviews must be clearly specified
- structural benchmarks should be critical to the achievement of programme objectives
- staff may opt to follow a review-based approach to assessment of monetary policy in countries adopting flexible and forward-looking monetary policy frameworks that emphasise policy interest rates and inflation targets
- outcomes chosen as the basis of fund conditionality must be reasonably under the control of authorities
- staff may also use floating tranches where tranche release is contingent on implementation of specific measures when achieved
- conditions outside IMF core areas require stronger justification.

The overall thrust of the new guidelines is to have greater parsimony in conditions and greater flexibility in programme implementation, provided there is assurance of achievement of programme objectives.

World Bank conditionality

Prior to the 1980s World Bank lending assistance was focused on physical and social infrastructure projects with conditionality on procurement, implementation monitoring and auditing. The effectiveness of these loans was measured by project outcomes and by pre- and post-project rates of return. The compliance record with these conditions was good and a large majority of these projects had successful outcomes. The project rates of return, however, appeared less useful as they showed a consistent over-optimism in *ex ante* rates of return. However, in the World Bank's judgement, these projects could not address the broader policy and institutional malaise that hindered development. In the early 1980s, the World Bank brought a greater emphasis to policy and institutional reform through policy-based lending programmes. Policy-based lending brought a new kind of conditionality in lending that emphasised broader policy reforms through legislative and executive actions. These conditions varied in terms of specificity, clarity, monitorability, enforceability and difficulty in implementation. Conditions also varied by the economic and political clout of the borrowing countries. Large upper middle-income borrowers typically faced softer conditions whereas small low-income countries were subjected to a degree of detail that could be misconstrued as micromanagement by an external aid agency. The conditions typically embodied the so-called "Washington Consensus" on policy reform and emphasised trade liberalisation, privatisation, public enterprise reforms, and fiscal policy and tax administration reforms.

In 1997, the Operations Evaluation Department of the World Bank conducted a comprehensive review of two decades of fiscal reform under structural and sectoral adjustment lending programmes. This review concluded that the record of borrower compliance with excellent yet World Bank-supported adjustment lending had only a limited fiscal success because fiscal issues were treated in a fragmented manner and conditionality was vague. Conditionality on the budget deficit or public savings was too general, inconsistent over time and between loans for the same country or subject to different interpretations. Deficit reduction in successful countries was achieved mainly though revenue enhancements, not by structural reforms or expenditure restraints. Non-trade tax reform supported by the World Bank was generally selective and difficult to monitor and evaluate whereas the record on trade tax reform was better. The countries with expenditure conditionality only did marginally better than countries without such conditionality in improving expenditure patterns. The vagueness of the fiscal conditions made implementation and monitoring difficult or impossible in about two-thirds of lending operations. Conditions were soft, calling for legislation to be drafted rather than implemented (in 47% of cases) and stressing studies rather than implementation (16% of cases) and conditionality was poorly timed in about one-third of all operations (World Bank, 1997: 2). The study also observed that during the period 1980-96, 72% of World Bank lending went to countries with a poor track record on compliance with World Bank conditionality, indicating that non-compliance did not matter for future assistance.

The record of success on non-fiscal reforms such as privatisation and public enterprise reforms was even weaker. Sustainability was a major issue in nearly one-third of all operations and reform programmes were either abandoned or even reversed upon completion of the programme.

The OED review concluded that fiscal conditionality in adjustment operations need to be made more specific and precise, supported by specific and monitorable performance indicators, and focused on fiscal macroeconomic and service delivery performance outcomes in addition to the means and the process of reform. Conditionality should stress implementation of new laws as much as enactment and implementation of study recommendations more than the preparation of studies (World Bank, 1997: 5).

In the 1999 *Annual Review of Development Effectiveness*, the OED further argued that conditionality was an important instrument to foster country ownership and commitment to the assisted programmes. Subsequently, in more recent years, various annual reports on development effectiveness by the Independent Evaluation Group (IEG, formerly the OED) has opined that World Bank-supported programmes are well-grounded in country ownership. OED/IEG studies over the period 1981-2014 have shown an improvement in successful outcomes of World Bank policy-based lending from about

60% to about 75% in recent years. But OED/IEG evaluation criteria do not embody sustainability. On average during the same period, about one-third of the projects were not sustained, resulting in an effective success rate of only 50%.

World Bank internal research on aid effectiveness also supports this viewpoint. World Bank (1998) suggests that reform programmes are more likely to be successful in a good policy environment with strong commitment by authorities for reform. It suggested that policy-based lending should focus on countries with good policies and strong champions of reform in the government.

Subsequent World Bank internal management reviews of adjustment lending (World Bank, 2005) that changed economic circumstances in recipient countries called for a move from adjustment lending to programmatic lending to give a sharper focus on governance and institutional reforms. Programme lending through development policy and sectoral development loans would provide opportunities to develop comprehensive medium- to long-term reforms. Loan conditions for such programmes are intended to emphasise country ownership and sustained commitments to reform and strict compliance with loan conditions would be de-emphasised provided the client is on track in achieving mutually agreed reform objectives.

A comprehensive review of World Bank conditionality (World Bank, 2005) argued for newer approaches to lending instruments and conditionality. It suggested that the conditionality should be considered part of a cycle that includes policy dialogue and capacity building requiring participation by key stakeholders. Policy advice should be country-specific and should emphasise principles and lessons from experiences to guide country policy makers to develop their own design and donor support and processes should be harmonised to support home-grown programmes (World Bank, 2005: 12) through general budget support contributions.

There have been numerous external studies reviewing World Bank conditionality. These studies are, in general, critical of World Bank conditionality for: 1) being too intrusive and micromanaging; 2) undermining democratic governance; 3) imposing a one-size-fits-all approach to improving development outcomes; 4) failing to bring about the desired reforms (see Stiglitz [1999]; Drazen [2002]; Easterly [2005]; Koeberle et al. [2005]). These studies argue that compliance with World Bank conditions have little relevance for the effectiveness of its assistance. Furthermore, a few studies demonstrate that non-compliance with World Bank conditions have little consequences for the borrower in terms of continued assistance. This is because in most cases loans are always disbursed regardless of the compliance record (Klick et al., 1998; Dreher, 2004; Mosley et al., 2004) and in the unlikely event they are cancelled, additional new lending is provided to continue the programme with the borrower (Dijkstra, 2002).

In conclusion, both World Bank lending instruments and associated loan conditions have undergone profound changes over the last 50 years. There has been greater flexibility in lending instruments and associated conditions in recent years. The lending emphasis has shifted from the "Bank knows best" to joint learning and a greater focus on the enabling environment for better economic and social outcomes. There is a greater emphasis now on local ownership. However, there are still residual concerns with the mutual accountability framework as donor agency staff are incentivised to approve and disburse loans with little accountability in the event of failure. The system of frequent rotating appointments shields individual World Bank staff from accountability for failure while taking credit for loan approval and disbursement. The burden of failure rests solely on the recipient's shoulders, with no adverse consequences for the World Bank as the

World Bank being the prime creditor would almost always be repaid. This contrasts with private bank lending where loan failures have consequences for both the lender and the borrower. These perverse incentives are at the heart of the problem of limiting development effectiveness.

EU conditionality

The EU is the largest donor of development assistance. There are three major channels of EU assistance: member states' contributions to bilateral and multilateral assistance, the European Commission (EC), and the European Investment Bank (EIB). Bilateral assistance by member states is the most dominant form of such assistance. However, the Commission plays a central role in the design and development of EU development assistance and provides a leadership role in improving aid effectiveness (Kitt, 2010).

EU/EC policies on conditionality have evolved over time. Traditional conditionality with unilateral input or process-based donor conditions with little harmonisation across member states and the European Commission dominated the EU aid regime in the late 20th century. The EU also imposes political conditionality relating to democratisation and human rights in recipient countries. Non-compliance with these conditions led to inconsistent sanction responses across countries (see Del Biondo [2011]). EU aid programmes suffered from excessive concerns with input-related tasks and insufficient attention to project quality with almost no attention to results (see Seabright [2001]).

However, with the dawn of the 21st century, the EU has actively pursued to improve aid effectiveness by playing an active role in important international agreements that aim to reform the delivery of economic assistance. These include the 2005 Paris Declaration, the 2008 Accra Agenda for Action, the 2011 Busan Outcome document, the 2014 Mexico Commitment, the 2015 Addis Ababa Action Agenda for the implementation of the Sustainable Development Goals (SDGs) and the 2016 Brussels 2030 Agenda for Sustainable Development. The overall thrust of these agreements is to reform donor-recipient relations using the following principles (European Commission, 2015).

- **Focus on country ownership.** The programme of assistance and associated conditions are to be jointly developed by the donor and the recipient. These programmes are to provide support for the recipient's reform agenda. The donor will co-ordinate financial and technical assistance with the recipient and other donors.
- **Transparency and mutual accountability.** Donors will use country public financial management and procurement systems and desist from requiring separate systems for aid management, monitoring and accounting. Project implementation units are to be discouraged.
- **Unconditional assistance.** Donors will strive to eliminate conditionality of their assistance. Instead there will be a greater focus on general budget support or programme or sectoral assistance. To the extent that conditionality is to be applied, it should be parsimonious and mutually developed and agreed-upon and must not be imposed by the donor (European Commission, 2009).
- **Focus on results.** Both the donor and recipient accountability will be on results to be achieved with greater flexibility to the recipient in designing and implementing programmes to suit local circumstances provided they achieve the desired results.

- **Focus on forging partnerships for development.** Donors and recipients will co-ordinate/harmonise their actions and develop a division of labour to accomplish development goals. They will also seek to involve "beyond government" stakeholders in public service delivery partnerships.
- **Predictability of assistance.** Donors will make long-term commitments to assist financing of recipient-developed development plans and ensure continued rear over year assistance provided the programme was on track in achieving the agreed objectives.
- **Focus on inclusive and sustainable development.** The donors and aid recipient will strive to achieve inclusive and sustainable development by expanding access of public services to marginalised individuals and groups in society. Further development assistance will advance environmental protection, including combating climate change goals to improve quality of life outcomes.

In recent years, EU members and the European Commission have made modest progress to bring aid programmes in conformity with the above principles (European Union, 2016). In 2015, the European Commission adopted a results framework that emphasises developing a results-based chain for assurance that programme activities and inputs are consistent with the objectives to be achieved (European Commission, 2015). Significant progress has been made on country ownership and focus on inclusive development. Modest progress has been made on unconditional assistance and partnership principles. Transparency and mutual accountability goals remain elusive. There have been reversals on aid predictability (European Commission, 2011). Donors and member countries' so-called 'focus on results' still seems to be on intermediate inputs (Adam et al., 2004) and mutual accountability remain a distant dream as country systems are rarely used by donor agencies (European Union, 2016).

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