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Why do aid agencies exist?

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1. Introduction

In his famous article on "The nature of the firm", Ronald Coase (1937) sought to answer the question why firms exist, why there are many firms and not just one, why people do not work as individual producers but rather in firms. He suggested that transaction costs could explain the boundaries of the firm and that suggestion later on gave rise to an abundant literature on vertical integration. Turning from commercial firms to aid organizations we could ask similar questions: Why do aid agencies exist? Why are there many aid organizations and not just one? Why are there different types of aid organizations (NGO's, bilateral and multilateral grant agencies, development banks)? Alternatively, why is foreign aid not transferred directly from a single donor to a single beneficiary, rather than going through the hands of multiple persons and organizations? In other words, how can we explain the organizational set-up of foreign aid delivery?

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To answer these questions, we first need to determine what aid agencies actually do. At the most general level, foreign aid agencies can be defined by opposition to domestic income redistribution agencies, for instance government agencies that deal with medical and unemployment benefits. While domestic aid agencies redistribute income between donors and recipients who live in the same political constituency, foreign aid agencies target recipients living outside the donor's constituency, usually in developing countries. Split constituencies has major implications for the decision making process. In domestic aid, both donors and recipients have voting rights and can influence the political decision-making process. By contrast, in foreign aid the feedback loop between recipients and decision-makers is broken; only donors have political leverage over the decision-making process. This broken feedback loop explains the origins of the ownership problem that is so frequently mentioned in connection with foreign aid, but rarely if ever in connection with domestic income redistribution. Ownership problems occur when donors can impose decisions on recipients, without the latter having a say in the decision-making process.

At a more functional level, the role of aid agencies can be described in terms of the contents of their activities. One possible perception is that aid agencies deliver goods and services to developing countries, such as food, education, health services, infrastructure, knowledge, etc. The weakness of this point of view resides in the fact that these goods and services can be bought by developing countries on world markets; there is no specific need for aid agencies to deliver them. One could of course point out that developing countries are poor and cannot afford to buy these goods and services on markets. That would imply that the main function of aid agencies is to organise financial transfers. But why would that require such elaborate procurement procedures, the elaboration of development strategies, active aid agency involvement in the minute details of the design and implementation of projects, etc.? Surely, the beneficiary of the transfer could take care of all that. Sending a cheque from the donor country treasury to the recipient country treasury would be sufficient in that case. Obviously, foreign aid agencies are more than just a financial transfer mechanism. They are actively involved in spending decisions, both on the donor and on the recipient side.

I argue in this paper that the main role of aid agencies is to solve the ownership problem that is caused by the broken feedback loop in foreign aid. They do this through mediation between donors' and recipients' interests, or preferences. Though donors remain the main decision maker in foreign aid, mediation is necessary because virtually all aid programmes require some agreement from the recipients too, if only that they authorise the programme to be implemented on their sovereign territory. There is no need for mediation when donor and recipient interests are fully convergent or, in economic terminology, when their preferences are aligned. In that case, they both fully agree on how to spend the financial transfer and there is no need to negotiate a contract. There is full joint ownership. Mediation implies that there is no full ownership by either the donor or the recipient. In most cases, ownership will be partial and shared in accordance with an agreed contract: both donor and recipient obtain a partial fulfilment of their preferences. Like every contract, aid contracts are necessarily incomplete and some of the activities and results will be costly to verify. As a result, moral hazard and adverse selection are inherent in aid delivery. Donors will search for appropriate aid delivery instruments that minimise these risks, for a given cost. This paper aims to explain the role that different types of aid agencies (bilateral and multilateral agencies, NGO's, development banks, etc.) and aid instruments play in mediation between donors and recipients and in the management of the resulting contractual costs and risks.

A voluminous literature has emerged in recent years that focuses on justifications for the existence of multilateral aid organisations, especially the Bretton Woods pair, the IMF and the World Bank (Gilbert & Powell, 1999; Milner 2002; Hawkins et.al., 2003). In general however, research that investigates the role, incentives and biases of donor agencies is rather scarce (Quarles, 1988; Carr, 1998; Ostrom et.al., 2001; Martens et.al., 2002). This stands in stark contrast to the growing volume of research on the (in)effectiveness of aid (for instance Burnside & Dollar, 2000, 2004; Hansen & Tarp, 2000, 2001). Why do all these aid organisations continue to exist and even to flourish if they are not effective in relieving the developing world from the plight of poverty? Clearly, their continued existence indicates that they are useful, though not necessarily for the reduction of poverty in beneficiary countries. Their usefulness may well reside in the production of mediation services for which there is a demand and for which their clients (donors, recipients) are willing to pay. This would imply that an aid agency's performance should not be assessed in terms of improving welfare in beneficiary countries but rather in terms of the efficiency and effectiveness of its mediation.

One drawback of the existing literature is that there are no attempts at cross-institutional perspectives to explain the relative advantages and disadvantages of each type of agency within a single explanatory model. Most attempts are functionalist from an economic perspective. They explain the role of a generic aid organization within a model of economic growth and development: how loans or grants can contribute to economic growth. They do not explain how a particular type of aid agency or aid instrument affects aid performance. The present paper aims to explain the range of diversity of aid organizations within a single approach.

The paper starts from a very simple model of direct redistribution between a donor and a beneficiary, with zero transaction costs and full alignment of preferences, and thus no moral hazard or adverse selection. I demonstrate that there is no need for an aid agency in that case. The model is than expanded to take into account positive transaction costs, non-aligned preferences and asymmetric information. This induces the risks of moral hazard by the agent and adverse selection by the principal, and the principal's need to incur transaction costs to improve information and reduce uncertainty regarding the outcome of the transaction. This is where aid agencies come into play. Various institutional arrangements (types of aid agencies and types of aid instruments) differ in their ability to reduce these risks in particular circumstances, and affect the level of transaction costs but also the benefits that donors and recipients derive from the transaction.

2. Private voluntary aid and preference alignment

Aid – income redistribution between humans – is a phenomenon that is very deeply embedded in human behaviour. Indeed, humanity could not survive without it. For instance, sharing food and other basic resources in families and kin groups is essential for the survival of mankind – as essential as it is for most other animals. What distinguishes mankind from other animals however is our ability to redistribute and share resources within a much wider social setting, outside immediate family and kin groups, even with persons we have never met or will never meet. This paper focuses on foreign aid, worldwide redistribution to far-away places and people.

What motivates people to voluntarily redistribute part of their income to others? Carr et.al. (1998) explain redistribution as a cognitive process in the human mind. When a potential donor encounters individuals who are deprived of essential resources that the donor possesses, it may generate empathy and cognitive dissonance in his mind: the observed situation of the deprived does not correspond to his own perception of how the world should be. This may trigger a response that seeks to modify the situation in such as way as to alleviate this dissonance, in this case via an attempt to redress the relative imbalance in resource allocation. Redistribution can thus be considered as a transaction: the donor transfers resources to the recipient in return for a reduction in dissonance in the donor's mind. Dissonance reduction is a form of 'consumer satisfaction'. It is achieved only if the transfer does indeed change the recipient's situation in line with the donor's expectations. If the donor had wrong expectations about the recipient's response to the gift, and observes a different behavioural response, donor dissonance will not be reduced and may actually increase. An important conclusion is that donors and recipients should have identical – or at least closely aligned – preferences concerning the use of the transfer, in order to have a successful transfer where both donor and recipient utility is increased.

I came across an example of this pure form of aid when my wife and I were walking around on a warm evening in Key West, Florida. A person was sitting on the sidewalk, holding up a begging bowl and a written statement "Why lie? I need a beer". My wife immediately reached into her purse and contributed to the beneficiary's beer consumption. Initially, I was surprised by the frankness of both donor and beneficiary. Thinking it over however, it could see that this was a case of identical preferences: my wife was feeling thirsty and longing for a cold beer and fully shared the beggar's preference to allocate every penny to that purpose. Sharing her money with him reduced her cognitive dissonance about his situation. There was no need for an aid organization as an intermediary: donor and recipient met face-to-face and the momentary exchange of information (the beggar's written statement) was sufficient to transmit a credible message to the donor about the recipient's preferences and the use he was going to make of any additional revenue that evening – and this preference turned out to be perfectly aligned with her own. There was no need for conditionality. Money was transferred from donor to recipient in return for a reduction in the donor's cognitive dissonance and an increase in the recipient's beer consumption. It was a welfare-increasing transaction for both donor and recipient.

Carr et.al. (1998) distinguish between distributional and situational responses to perceived deprivation, depending on whether or not the potential donor perceives the deprivation as being due to environmental factors outside the control of the deprived. Situational interpretations may cause non-alignment of preferences, despite direct face-to-face meetings and exchange of (often tacit) information. If poverty is perceived as the result of the deprived' own choices, it indicates that his behavioural preferences are out of line with those of the potential donor: he could have done otherwise and avoid ending up in this situation. Consequently, an income transfer to the deprived is likely to result in more wrong choices and thus meaningless, at least from the donor's point of view. The donor may still be induced to transfer resources if he has leverage over the use of the transfer, to direct its use in line with his own preferences. Preference misalignment between donor and recipient can be corrected through tied or conditional aid – aid that puts restrictive conditions on the recipient's use of the resources and thereby reduces the discretion or ownership rights of the recipient, leaving at least some discretion to the donor. Conditionality is the price to be paid by the recipient to get access to transfers in case of non-aligned preferences.

Most foreign aid is conditional. Two major types of conditionality can be distinguished. The first type, input conditionality, restricts the recipient's discretion in the spending of the resources and ties it to procurement conditions, be it geographical (procurement of goods and services in the donor country) or procedural (specific procurement and spending procedures agreed with the donor). The most typical form of input conditionality is traditional project aid. "Projects" tie income transfers to a wide range of procedures that increase donor leverage over project inputs and activities: the donor "owns" a large stake in project management. Commercially tied aid is another form of input conditionality. The OECD/DAC (OECD, 2002, table 23) statistics show that the extent of commercially tied aid varies widely among donors, from less than 4 per cent of all Swedish aid to 75 per cent of

Canadian aid. The second type of conditional aid, output conditionality, ties aid to changes in the recipient's behaviour and institutions (specific policy decisions, institutional reforms, etc.). However, the recipient retains most responsibility for management in this case. Burnside & Dollar (2000) demonstrate how aid does not have any noticeable impact on economic growth in the recipient country unless it is instrumental in triggering policy reforms that the country would not do otherwise. In other words: unless it is conditional on a change in the recipient's behaviour. Since the 1980s there has been a shift away from input conditionality towards output or result-based conditionality, mostly in the form of budget support and structural adjustment programmes but also in more traditional project aid (Dollar & Levin, 2004). Clearly, differences in preferences between donors and recipients, and the search for more efficient solutions to manage these differences in a less costly way, play an increasingly important role in aid flows. We should therefore move beyond the simple approach and allow for non-aligned preferences and non-zero transaction costs. Rather than following an approach that focuses on the welfare implications of non-aligned preferences, as for instance in White & Morissey (1997), I concentrate here on the institutional implications.

3. Ex-ante and ex-post transaction costs in aid transfers

All transactions, including income transfers between donors and recipients, entail transaction costs (Coase, 1937; North, 1990; Williamson, 1985). There is no single and generally accepted definition of transaction costs in the New Institutional Economics literature (Furubotn & Richter, 1998; Masten & Williamson, 1999). Two main lines of thought can be identified. North (1990) and Coase (1937) define them as the effectively *realized* opportunity costs to organize a transaction: the costs to search for a trading partner, find the right information, measure quantities and qualities of the traded goods and services, negotiate a contract, plus monitoring and enforcement of that contract. Williamson (1975, 1985) starts from the assumptions of imperfect and asymmetric information between transaction partners and opportunism or "self-interest seeking with a guile". In his view, these are the root causes of a key attribute of transactions: uncertainty. Uncertainty can be overcome through contractual arrangements or governance structures that include commitment devices to contract execution, which are costly to negotiate ex-ante and to enforce ex-post of contract signature. Uncertainty is thus considered to be the reason why parties in an exchange invest in finding suitable partners and products, spend time on measuring qualities and quantities, negotiate a contract and invest in enforcement devices. In sum, this is the reason for incurring *realized* transaction costs so as to avoid potentially larger but hopefully *un-realized* transaction costs during or after contract execution. Williamson (1985) then shows how various organisational or governance arrangements entail various degrees of efficiency in the underlying commitment devices for the execution of agreements, and thereby different levels of efficiency of production. Different governance arrangements result in different cost structures with respect to ex-ante (search and negotiation) and ex-post (enforcement) transaction costs.

The Coase-North and Williamson definition of transaction costs can be integrated in a single framework. For a given institutional setting, there is a trade-off: the more we invest in ex-ante realised transaction costs, the lower the potential ex-post costs (Figure 1). Improvements in institutions can be captured by a shift in the trade-off curve. An improvement in institutional architecture must produce lower ex-post uncertainty for a given level of ex-ante transaction cost or, conversely, lower transaction costs for a given level of ex-ante uncertainty.

In the case of (foreign) aid transfers, ex-ante and ex-post transaction costs can be traced back to the various activities in the aid delivery process:

(a) The ex-ante transaction costs for the donor to obtain information about the deprived (who and where they are, what is the source of their problems and what are their needs) and effectively carry out the transfer (money, but also material aid, technical assistance, etc.) ;
(b) The ex-post uncertainty about the recipient's intentions concerning the use he is going to make of the transfer (assessing the extent of preference alignment between donor and recipient).

In terms of Figure 1, the one-to-one aid transfer example that I gave above is situated close to the origin of the diagram, where both transaction costs and residual uncertainty are (nearly) zero. Geographical separation, as well as differences in preferences between donors and recipients, result in positive transaction costs and uncertainty about the outcome. It shifts the aid transfer plainly into the centre of the diagram. This creates an opportunity for institutional entrepreneurs to supply institutional arrangements (aid agencies) that shift the transaction cost trade-off curve to a higher level of efficiency, i.e. lower transaction costs for a given degree of uncertainty. In return, donors and recipients a willing to pay aid agencies for their services.

The concept of transaction costs has been "mainstreamed" in recent years in the development aid literature. It refers to the administrative and management costs of aid flows, which should be reduced through harmonisation of procedures among donors. This looks like an economies-of-scale argument, rather than a reference to uncertainty in transactions. As such, its current use in the development aid literature could be considered close to the original Coase (1937) interpretation. This makes it difficult to see the trade-off between costs and benefits of transaction costs. The present paper does not stick to this simplified interpretation; it applies the combined North-Williamson interpretation.

4. Intermediation by NGO's

The simplest example of direct one-to-one private voluntary redistribution between a single donor and a single recipient rests on the assumptions of both geographical and preference proximity. In reality of course, transaction costs are far from negligible, especially in foreign aid where potential donors and recipients may live thousands of miles apart, are unlikely to ever meet each other, and come from very different cultural, social and economic backgrounds so that preference alignment between donors and recipients is unlikely. Despite these formidable barriers foreign aid has reached unprecedented historical proportions. At the dawn of the 21st century, it has become a full-scale multinational industry with an annual turnover estimated in excess of 50 billion US dollars (OECD, 2002). Direct contact between potential donors and recipients would not be able to achieve such massive transfers. Some sort of organizational set-up is required to facilitate intermediation between donor and recipient and reduce ex-ante transaction costs as well as ex-post uncertainty to an acceptable level.

The archetype of intermediation in foreign aid is the missionary: they mediate between potential donors in their hometown and potential recipients in their mission town. Individual missionaries as well as missionary organisations may generate two types of savings in transaction costs:

- They reduce real transaction costs through economies of scale in search costs: information and appreciation of the plight of the potential recipients, transmission of information to potential donors.
- They reduce ex-post uncertainty by ensuring preference alignment between donor and recipient communities. Missionaries apply the moral and religious values of their community of origin to select recipients in their missionary community.

Individual missionaries and missionary organisations are the forerunners of a more general type of private intermediation in voluntary foreign aid transfers: non-governmental organisations (NGO's). NGOs constitute a first step towards a more complete answer to the intermediation problem between donors and recipients.

What are NGOs? There is a bewildering range of types and varieties of NGOs. Some authors define NGOs as non-profit or voluntary organizations; others emphasize their grass-roots origins as "people's" organizations; still others insist on particular types of legal status or non-governmental aspects (Tvedt, 1998; Anheier & Seibel, 1990). Some indeed are truly voluntary grass-roots non-profit organizations. Others pursue more profit-related objectives in a covered way, pay their staff handsome salaries or have some form of non-official linkages with government organizations. Some may actually be established by government departments and politicians.

For the purpose of this paper I emphasize the non-profit aspect and define NGOs as private organizations, set up by members, that pursue a single or a range of issues without a financial profit motive in mind (though financial constraints are obviously present). Usually, the "issue" is of a normative nature, driven by cognitive dissonance that members experience in a particular domain: "the world is not as we would like it to be and we want to do something about that". As such the activities of an NGO are driven by a "mission" or an "issue". Individuals become members of an NGO because they share a (set of) preference(s) that they would like to convey to the rest of the world. Finding an audience that is receptive to "the issue" and willing to adapt its behaviour in line with the perceived requirements of "the issue" is the primary concern of NGOs. NGOs may be single-issue organizations – "Save the whale" – or seek to promote a wider range of issues covering an entire policy domain such as environmental concerns, democracy, human rights or religious causes.

The narrower an NGO's range of objectives and the more homogenous the preference set of its members, the more focused its actions can be. In terms of Figure 1, that means less uncertainty in the achievement of a given objective, for a given level of transaction costs, compared to an NGO with a wider range of objectives. Broad-spectrum NGO's are more likely to hit inconsistencies and trade-off's between various objectives (Holmstrom & Milgrom, 1991; Tirole, 1994). They will try to control these by investing more in transaction costs, or will simply let the objectives slip into uncertainty for a given level of transaction costs. The extent of slippage may depend on the visibility or measurability of the aid objective.

Private for-profit companies seek to maximize profits, a relatively easily measurable objective (despite some evidence in recent years to the contrary). However, the achievement of an NGO's objective(s) is usually much harder to verify. Therefore, an NGO's best bet to enhance its credibility is to vigorously pursue activities that are perceived to be in line with its objective(s). Activities, not necessarily achievements, constitute the core of an NGO's business. This vigorous drive may also be the NGO's comparative advantage. For a given budget, NGO's maximize activities in line with "the issue" until the budget is exhausted. Commercial companies on the other hand, when faced with a fixed budget, will minimize costs in order to maximize profits. These typical characteristics of NGOs make them well suited for the delivery of foreign aid. They are in a position to provide ex-ante as well as ex-post transaction cost-reducing intermediation between potential donors and beneficiaries.

Though private voluntary aid channelled through NGO's is more transaction cost efficient than direct one-to-one aid transfers, it accounts for less than US$ 7.8 billion or about 15 per cent of total ODA flows, of which about US$ 1.1 billion is provided by governments, not private gifts[2]. In Europe, most NGO aid resources are not mobilized from private donations but from official government aid budgets. First, we need to turn our attention to the largest chunk of the more than 50 billion dollars annual foreign aid flow to developing countries. Most of it is channelled through official foreign aid agencies. How do they come into the picture?

5. Official (bilateral) aid agencies

Selecting for preference alignment between donors and recipients is one way of providing an efficient institutional arrangement for aid delivery. Often however, donors seek to promote objectives for which it is difficult to find like-minded beneficiaries. Preferences may even differ among donors themselves. This requires more strongly leveraged intermediation, strong enough to negotiate an acceptable compromise between the preferences of various parties. At that point, NGO's became inefficient and official bilateral aid agencies come into the picture.

In many ways, the characteristics of official aid are the very opposite of the direct voluntary private aid model that we started from. Official aid is not voluntary; it is paid from enforced taxation. The taxpayer – i.e. the primary donor – may actually disagree with the aid and be unwilling to give it. Official aid is not always triggered by the donor's desire to reduce cognitive dissonance in his mind, though some taxpayers may have a genuine interest in the well-being of the recipient. As a consequence, official aid may come with a lot of conditions attached to it, which the recipient may not like. Aid may be tied to the acceptance of technical assistance and commercial supplies from the donor country; it may be conditional on adopting policy changes and implementing institutional reforms that do not conform to the recipient's own preferences; it may supply goods and services that do not conform to the recipient's own standards, etc. With official aid, we leave the rather idealized world

[2] According to Tvedt (1998), private donations account for less than twenty percent of NGO foreign aid resources in most European countries. In the US however, nearly all NGO development aid funds are private donations. US NGO funds represent nearly US$ 4 billion out of total US$ 7.8 billion of OECD NGO funds.

of preference alignment between donors and recipients, for a world where transfers are used to influence the behaviour of both donors and recipients alike.

5.1. Non-alignment of preferences between donors

There is a voluminous literature of the "Who gives aid to Whom and Why" (WWW) type (for an overview, see Alesina & Dollar, 1999). The WWW literature looks at volumes of aid flows between donors and recipients and tries to link these to indicators of recipient needs (poverty) and commercial, political and other interests of donors (Roodman, 2003). Most of that literature concludes that donors with former colonies allocate their aid predominantly to these countries, with a view to maintain and derive further benefits from this privileged historical relationship. By contrast, donors without a colonial past seem to allocate aid more readily in function of recipient needs, i.e. poverty indicators. However, recent more micro-economic research casts some doubts over these conclusions. Ostrom et.al. (2002) demonstrate that, despite the absence of colonial ties, Swedish aid still pursues to some extent commercial interests. Only, the absence of historical ties implies that these countries care less about where to target their commercial interests. It leaves more flexibility to marry the interests of the genuine aid lobby with those of the commercial lobby.

There is obviously more going on behind the scenes of bilateral aid than the macro-approach of the WWW literature is able to reveal. Several different motives and corresponding interest groups can be identified on the donor side in a stylised way:

- First, part of the electorate in a developed country may genuinely favour the use of tax revenue for wealth transfers to developing countries. Here, the overall motive could be described as poverty alleviation, which is often perceived as an extension of a more general domestic welfare programmes agenda (Lumsdaine, 1993). Other genuine motives are the causes that NGO's pursue: the promotion of human rights, women empowerment and environmental issues, or even such mundane causes as the pursuit of adequate accounting standards or establishing an industry association. In all these instances, the direct beneficiaries of the aid are the like-minded persons and organisations they work with; there is preference alignment between donors and recipients[3].

- Second, aid services suppliers or, in general, suppliers whose products and services could be valuable in developing countries, may want to use aid transfers to enhance their positions on developing country markets (technical assistance, commercial suppliers, but also academic and research institutes, laboratories, construction companies, etc.). Here, the aid is instrumental in bringing about a preference re-alignment in the mind of the recipient – who gets a subsidy to do something he would otherwise not do, or do differently.
- Last but not least, a donor country government may use aid flows to enhance political alliances with the recipient country government, obtain political goodwill and changes (non-alignment in the original preferences) in the decisions and policy stance of that government. Donor governments may also wish to nurture their relationship with particular interest groups in the recipient country (preferences aligned with those of the donor government) who can be influential in political and economic decisions of interest to the donor country.

In spite of heterogeneous, and possible conflicting, preferences bilateral aid is able to mobilise much larger aid flows than private voluntary aid. Indeed, the vast majority of all foreign aid is non-voluntary aid, mobilised through enforced taxation in donor countries (OECD, 2002, table 2). How can we explain the success of this type of aid, despite the fact that it takes us far away from the "ideal" aid model with full preference alignment?

First, the preferences of the three above-described interest groups are not mutually exclusive. A single aid project can benefit all three. For instance, a bilateral aid agency may approve the delivery of water pumps to a village in the recipient country. Such a project satisfies the preferences of all donor interest groups: genuine wealth transfers and empowerment of (water-carrying) women, profits for commercial water pump suppliers and consultants involved in the project, visibility for the donor government, political goodwill from the influential village politician in support of the political interests of the donor country. Second, these interest groups share a common

[3] Though the target of their activities may be to change the behaviour of not-so-like-minded persons

objective: they all want to maximise aid flows in order to achieve their preferences. As a result, there is a strong incentive for these interest groups to collaborate, despite different preferences, and tap the same public funds (tax revenue) to achieve their multiple objectives. Collective action is easier to achieve if they jointly delegate decision-making to a common agent, the official government aid agency. Joint delegation may worsen the typical problems of multiple and conflicting objectives, with poorly defined trade-off's, that negatively affect the organisation's performance (Holmstrom & Milgrom, 1991). On the other hand, while these multiple principals have different objectives and are likely to give incoherent instructions to the agency, the agency may be in a position to make its own proposals, play off different interest groups against each other, forge coalitions in support of the policies that it proposes, induce collective action among members and, in general, achieve objectives that individual members would not be able to achieve on their own (Martimort, 1991). Consequently, one of the major tasks of bilateral donor agencies is to mediate between donor interest groups at home.

5.2. Non-alignment of preference between donors and recipients

Bilateral agencies do not only seek to mobilise the largest possible coalition of donor interest groups at home. They also have to deal with the possible lack of alignment of preferences between donors at home and recipients abroad. Commercial aid services suppliers may actually be interested in the delivery of project inputs only (the sale of goods and services), rather than in the results. Donor politicians who seek visibility and good will abroad may also be interested mainly in visible delivery of inputs, not so much in producing results. There is little risk of moral hazard or ex-post uncertainty is such cases. However, genuine aid lobby groups in donor countries are interested in achieving results down-stream of inputs delivery. In that case, bilateral agencies have at least two means to deal with preference misalignment between donors and recipients, and reign in moral hazard on behalf of the recipient.

A first option for the donor, as suggested in Figure 1, is to substantially increase investment in ex-ante realized transaction costs, and spend more on gathering

and organizations.

information and monitoring recipient behaviour, writing a more elaborate contract with the recipient, getting actively involved in the management of aid projects, etc. It explains why some donor agencies maintain a strong presence in the administration of aid flows, from budgeting and programming, through contracting, implementation, supervision and evaluation (input conditionality). The administrative costs incurred to do so are transaction costs that reduce ex-post uncertainty for the donor, making sure that aid is used in line with his preferences. However, rather than citing non-alignment of preferences, donors mostly justify their involvement in aid implementation by referring to the recipient's lack of skills and expertise required for project implementation. This is not a convincing argument. Even if some projects do require exceptional skills, the recipient could buy these skills on markets. Clearly, it is not the quality of the skills that is the real argument here, but control over conditionality and ex-post uncertainty. Donor-hired implementation agents tend to be more loyal to donor than to recipient interests. It increases transaction costs (the additional costs of subcontracting a task to an expatriate rather than a national expert) but reduces ex-post uncertainty. In terms of Figure 1, it represents a move along the curve towards higher transaction costs in order to reduce uncertainty.

A second option for the donor is to change the disbursement arrangements for the aid and switch from input conditionality to results-based conditionality. In other words, switch from paying up-front of project implementation to paying only down-stream of implementation and in function of the production of the desired results. Up-stream payment is used for most traditional project aid, motivated at least as much by the commercial and political interests of the donor as by the recipient's welfare. Down-stream or conditional aid payment is used when donors are indeed interested in the results of an aid programme (for instance, because of political and economic concerns). This is a typical arrangement in structural adjustment, budget support and policy reform programmes. The problem of moral hazard by the recipient and adverse selection by the donor is not entirely resolved however by this conditional approach, since information asymmetry between donor and recipient is not eliminated. There is a substantial volume of literature on the pros and cons of this approach (see for instance, Killick, 1995; Mosley, 1997; Streeten, 1998; Collier et.al., 1997).

The donor agency's choice of implementation arrangements with the recipient will to a large extent be determined by the composition of the domestic coalition that supports the aid programme. If commercial and domestic political interests dominate, there is unlikely to be much results-based conditionality in aid, though there may be commercial input conditionality (tied to procurement in the donor country). On the other hand, if genuine development lobbies dominate, there may also be little conditionality since these groups often favour recipient ownership rather than externally imposed conditionality and shy away from the often painful adjustments that may be required to put policies back on track. Results-based conditionality will only occur if there are strong external policy concerns in the donor country about recipient government policies. For instance, a deep economic and political crisis may jeopardise the interests of all donor lobby groups, unleash a wave of economic and political refugees, and provide an incentive to create a coalition in favour of more conditional aid programmes. On the other hand, recipient countries may actively play on the diverging interests of different donor lobbies to water down conditionality in aid programmes, for instance by threatening with commercial retaliation.

In conclusion, a bilateral aid agency's margin for mediation is constrained by diverging donor and recipient interests. It has two different institutional arrangements at its disposal to manage this situation: a weakly-leveraged but possibly domestically more interesting input conditionality and a more strongly-leveraged results conditionality that may however run into domestic and recipient country opposition tactics. In terms of Figure 1, results-based conditionality is theoretically a more efficient institutional arrangement: it lowers transaction costs for a given degree of ex-post uncertainty or, alternatively, reduces ex-post uncertainty for a give level of transaction costs. However, its effectiveness depends on the underlying political support.

6. Subcontracting by bilateral aid agencies

Official aid agencies usually do not implement projects through their own staff but delegate implementation to for-profit (companies, experts) or non-profit (NGO's) subcontractors. Consequently, official bilateral aid is usually a combination of two institutional set-ups, the official aid agency for policy and financial decision-making and the subcontractor for implementation. Different types of sub-contractors have different performance incentives. NGO's will maximize activity towards achievement of their "cause" or the project objective, for a given contractual budget constraint. Private for-profit companies on the other hand will minimize costs for a given contractual budget constraint, in order to maximize their profits (see Figure 2). As a result of these differences in contractual performance incentives, the choice of type of subcontractor will also affect ex-post uncertainty about the outcomes and transaction costs to establish and monitor these outcomes.

If activities and results are easily observable by the donor agency, for-profit companies have less margin to exploit their asymmetric information advantages. For instance, the outcome of a road construction project is more easily and objectively verifiable than the outcome of an institution building project. To the extent that projects are costly to monitor, moral hazard and adverse selection may occur (Martens et.al., 2002). Increasing transaction costs to monitoring the project is one solution. Another solution is to select for-profit subcontractors on the basis of their track record. Measurability problems are an obstacle to establishing performance track records however.

On the other hand, narrow-focused NGO's are often lacking wider political integration in donor and recipient country societies and may thereby trigger negative political reactions. NGO's and twinning partners may single-mindedly pursue objectives that are not widely appreciated, either in the donor or in the recipient country. To the extent that their activities are financed with private contributions and channelled to private recipients, donor and recipient governments may avoid getting caught up in these issues. However, to the extent that they are publicly financed, some degree of political control over their activities and policies will be required. Many bilateral donor agencies have solved these problems by financing NGO's that are embedded in wider socio-political networks in their home country. For instance, they channel aid through NGO's affiliated with political parties, labour unions, religious groups and other well-established social organizations. These affiliations reduce an NGO's margin for discretionary behaviour and give the donor agency and government a variety of means to exercise political pressure to reign in inappropriate behaviour, if need be. Also, the fact that many NGO's are financially dependent on contracts with the aid agency enables the agency to exercise some degree of control over NGO behaviour.

Apart from formal sub-contracting outside the aid agency there is also sub-contracting inside the agency. In fact, aid agencies, like any other large organisation, are a vast network of sub-contracting of tasks from principals to their agents. The entire aid delivery chain can thus be considered as a chain of subcontractors, between the donor-taxpayer and the final beneficiary in the recipient country. This makes the notion of a homogenous donor unrealistic. There are many persons involved in the delivery chain of foreign aid: private donors, taxpayers, lobby groups, officials in aid agencies, consultants and academics, politicians in donor and recipient countries, etc. It is usually assumed, implicitly or explicitly, that all these individuals and organisations fully share a single objective: the alleviation of poverty among beneficiaries in recipient countries. In reality however, objectives are likely to differ. Individuals pursue careers, incomes, their own preferences; they may but do not necessarily have a genuine interest in alleviating poverty. Politicians pursue political objectives, agencies pursue the perpetuation and expansion of their remit and budget, consultants seek the next contract, etc. How this chain of non-aligned preferences affects aid performance has been analysed in detail by Martens et.al. (2002). The role of aid agencies could be perceived as providing a mechanism that enables collective action to emerge from these different and often contradictory individual motives. The agency establishes explicit contracts and rules as well as implicit norms and standards that affect the behaviour of individuals working with and within the organisation and, consequently, the performance of aid organisations. In that sense, an aid agency could be considered as the chief mediator between the preferences and interests of all persons involved in the aid delivery chain.

7. Multilateral agencies

A large share of bilateral grant aid is actually channelled through multilateral agencies: US$ 18 billion out of US$ 56 billion in bilateral aid (OECD, 2002, table

12). On top of that, multilateral development banks have their own resources (loans) to channel to developing countries. Why do bilateral aid agencies channel part of their budget and delegate decision making to multilateral agencies (Milner, 2002)? How do multilateral agencies fit into the transaction cost and agency theory picture?

Just like bilateral aid, multilateral aid is a case of joint delegation by donor countries with different interests to a single international agency. They supply an institutional setting that responds to a demand from donors as well as recipients. The literature on international and multilateral organisations (Hawkins et.al., 2003) identifies two clusters of factors that determine this demand:

a) A first cluster revolves around achieving collective action in the presence of heterogeneous preferences among donors, or between donors and recipients. Donors may compete to promote their preferred projects in developing countries without diminishing their own benefits or incurring additional costs (though they may induce additional costs for the recipient). However, when the intended output of a project is a public good, collective action among donors is required. For instance, the identification of an economic reform programme, a debt rescheduling agreement or filling the external financing gap of a country, requires collective action, not competition. Moreover, as explained above, bilateral agencies may not be good at implementing programmes that require strong conditionality because of conflicting preferences between donors and recipients, or conflicting preferences in the donor country itself. Delegation to a multilateral agency avoids spill-over of this conflict to donors (who may prefer to maintain a privileged relationship with the recipient) and prevents blame falling on the donor in case a risky programme goes wrong (Rodrik, 1996). A multilateral approach, endorsed by all donors and recipients, may also strengthen the legitimacy and credibility of unpopular programmes (for instance, unpopular economic stabilisation and reform programmes). In all these cases, the multilateral agency acts as an intermediary between the parties. It drives a wedge between the different interest groups and uses it to design a programme that may be supported by all parties.

b) A second (and partly related) cluster revolves around economies of scale and scope, mainly in information gathering and analysis (knowledge production).

National action by individual donor countries could develop redundant capabilities, for instance duplication of projects in similar domains or collecting information from countries that is afterwards put in the public domain. Multilateral approaches can reduce national costs and enhance the credibility of that information (Rodrik, 1996). Note however that multilaterals do not necessarily put all the collected information in the public domain. They may use some of that to build up a comparative information advantage over their member states, which they can exploit to selectively promote their own policy proposals. They may specialise in specific issues for which they are the primary source of world wide information (the IMF on fiscal, monetary and balance of payments information; the World Bank on reform policies; the WHO on health policy issues; the FAO in agricultural and food issues; etc.). This informational advantage makes their policy analysis and proposal more credible, and makes it more difficult for individual member states to formulate alternative proposals. They may use these to perpetuate temporary assignments, boost their financial resources and domains of competence, increase their leverage over a wide range of development policy issues.

The above two clusters of demand for the mediation services of multilateral aid agencies benefit the donors; it looks as if there is not much in it for recipient countries (though economies of scale may also benefit the recipients). There must be benefits for the recipient countries too, if not they would not want to participate in these institutions. A first obvious benefit for recipient countries is that multilateral institutions at least partially restore the broken feedback loop that is so typical of bilateral aid. They give recipient countries a voice in decision making. How much voice they get depends on voting systems in the multilateral agency. Multilateral development banks (MDB's) allocate voting rights according to shares in the capital of the bank. Recipient countries usually have very small shares only. Multilateral grant agencies (MGA's) or other non-bank agencies usually operate along the one-country-one-vote system. They treat all countries on an equal footing. I will explain below how MGA's can exploit this to their advantage.

A second benefit that recipient countries can derive from multilateral institutions is access to cheap loans, which is typical for MDB's. I will discuss that benefit in the next section[4].

Multilateral aid agencies can be distinguished according to their source of financing:

- Multilateral development banks (MDB's) that operate on the basis of loans[5], mobilised on international capital markets. Examples include the World Bank and the regional development banks like the European Bank for Reconstruction and Development and the African, Asian and Inter-American Development Banks, amongst others.
- Multilateral aid agencies that operate with grants, financed with fiscal revenue from donor countries: the United Nations Development Programme, various specialised agencies of the United Nations involved in thematic development programmes (WHO, FAO, ILO, UNICEF, UNHCR, UNEP, etc.), and also the European Commission's external aid programmes.

I discuss the strengths and weakness of each of these types below.

7.1. Multilateral development banks

MDB's are a case of joint delegation of tasks from several principals (the member states) to a single agent (the bank). The MDB's is given relative financial autonomy: its funds are mobilised on international capital markets, not from taxpayers' money. This gives them more room for discretionary decision making. It induces a financial multiplier effect[6]: MDB's can mobilise more financial resources than member states fiscal constraints would allow.

[4] Bilateral development banks can also provide cheap loans, but they are unable to supply collective action mechanisms.

[5] Most multilateral development banks also have so-called "soft windows" whereby grant financing is mixed with loans in order to subsidize interest rates below market rates. This mixes the characteristics of both types of multilateral organizations.

[6] The combination of a gearing ratio (ratio of lending to capital) above 1 and a ratio of effectively paid-in capital below 1 results in a strong multiplier effect: for each dollar invested by donors in the capital of an MDB, many dollars can be lend by the MDB to recipient countries.

MDB's are successful to the extent that they are able to drive a wedge between the interests of donors and borrowers. Borrowing countries get financially advantageous interest rate conditions, far below the international financial market rates that developing countries would normally have to pay, at the cost of policy conditionalities (Rodrik, 1997). Treating all borrowers on an equal financial footing (they pay the same interest rate, independent of country risk ratings), gives them no reason to form coalitions against the MDB. Moreover, they offer donor countries a politically less contentious channel for collective action on sensitive problems, at a low fiscal cost, in return for reduced involvement in decision making. On top of that, they manage to marry the often conflicting objectives of donor and recipient countries, at a price to both: relative independence of the MDB. MDB's have managed to circumvent some of the problems and exploit the advantages associated with joint delegation.

Some MDB's combine this financial advantage with an informational advantage. They gather world wide or at least region-wide information and use their economies of scale in this process to strengthen their informational advantage over donors and recipients alike. Informational advantages are useful in presenting policies and make it harder for outsiders to verify the validity of the analysis and policy proposals, especially when some information is not made publicly available or at least hard to get. It also enables these MDB's to get involved in normative work and standard-setting. These may include international regulatory standards as well as setting aid policy standards. Economies of scale in information gathering also put MDB's in an advantageous position for international aid co-ordination. For instance, the World Bank's unique situation as a world-wide MDB gives it a comparative advantage in overall information gathering and analysis, which can be exploited to its own advantage. Together with the IMF[7], it is mostly in the lead position in the design of economic policy reform programmes in developing countries, partly because of this.

7.2. Grant-based multilateral aid agencies (MGA's)

[7] The IMF is not a typical MDB but shares many behavioural characteristics with MDB's.

MGA's have two major disadvantages compared to MDB's. First, they use taxpayers' money from donor countries, which makes it harder to keep donors' national political and economic interests at arms length. Membership contributions are usually based on GDP, so that the industrial countries share the largest budgetary burden.   Obviously, donor representatives will want to keep a close eye on how that money is spent and further their own interests through that spending process. Second, most UN agencies operate as co-operative clubs, with both donors and beneficiary countries represented in decision-making bodies that follow the one-country-one-vote rule. This gives recipient developing countries an overwhelming majority in decision-making and creates an obvious disequilibrium between financial contributions and voting power.

However, in many cases donor countries have various means at their disposal to reverse this disequilibrium. Obligatory membership contributions feed only into the regular budget. A considerable part of donor contributions for specific research projects and aid programmes is kept extra-budgetary and at the discretion of donors. This discretionary financing channel enables them to influence decision making. Also, most agencies take care not to approve a budget that runs counter to the interests of its major donors. This is particularly important in the realm of so-called "normative" activities of various specialised UN agencies, such as WHO, FAO and ILO. They are involved in setting world-wide standards and regulations in their domain of competence. Donor countries can use these financial levers to forge coalitions and ensure that standard-setting is not done against their interests.

This careful balancing act between financial and voting power, and between normative and development aid activities, opens a window of opportunity for the multilateral agency to exploit its position, launch proposals and forge coalitions in favour of these proposals. It allows the agency to work itself in a key position as an agenda setter and policy maker and justify its existence as an enabling environment for collective action among its member states. This explains why donors and their bilateral aid agencies are willing to channel part of their foreign aid through multilateral specialised agencies. Multilateral agencies are uniquely placed to promote collective action in their domain of competence. It is in a donor country's interest to be a member of these organisations so as to be able to voice its interests in international policy making. Foreign aid can be used as a lever to enhance its policy influence and reduce uncertainty, perhaps not so much in the execution of development projects but more so in normative decision making. It helps a donor country to redress its disadvantage in voting power over normative issues and other policy decisions in general.

In a way, MGA's constitute a two-sided institutional arrangement: a financial institution and a normative institution. The normative institution has high ex-post uncertainty for the donors because they are usually in a minority. The financial institution has low uncertainty because of the financial leverage it gives to the donors, in return for a high transaction cost (grant contributions). Combining the two strikes an acceptable political balance to both donors and recipients.

8. Conclusions

This paper argues that the *raison d'être* of aid agencies is to mediate between diverging preferences between donors and recipients, not to transfer financial resources to recipients nor to supply them with know-how. Aid agencies offer not only economies of scale but, more importantly, a transaction-cost efficient mechanism to reduce ex-post uncertainties in the use of aid. Various types of aid instruments (project aid versus budget support) and types of agencies (ranging from NGO's to bilateral and multilateral banks and grant-based agencies) offer different types of comparative advantages, depending on the performance incentives that are embedded in their set-up and their ability to thrive on specific asymmetric information situations. A more optimal aid allocation across types of agencies and instruments should take into account the pros and cons of variations in the institutional set-up. Individual aid agencies can not profile and position themselves independently of each other; they need to take into account the evolving policies and roles of others too.

So far, there has so far been very little debate in the aid community on the merits of various types of agencies and aid instruments. This is partially due to the fact that the aid community has apparently rallied in recent years around the single objective of poverty reduction, with the implicit assumption that all donors, recipients, agencies and actors in the aid delivery process are motivated only by that same objective. This paper has tried to demonstrate that this is not only unrealistic but also unhelpful to understand the incentive that play a role in the aid delivery process and the comparative advantages of different types of aid agencies.

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Figure 1: The trade-off between transaction costs and uncertainty

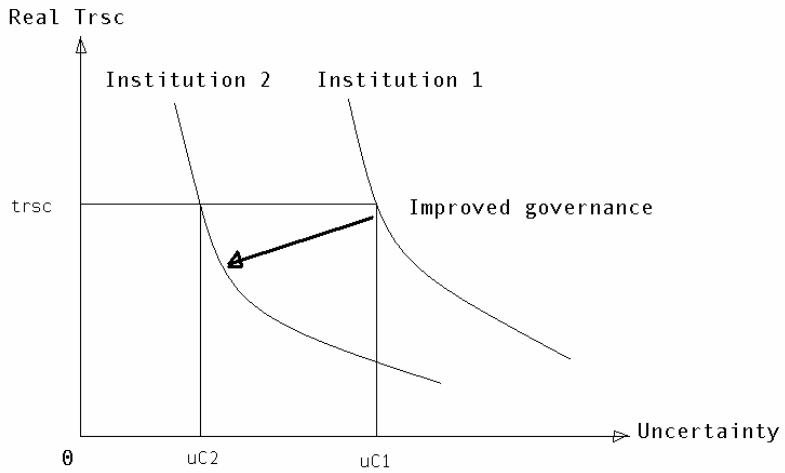

Figure 2A: The behaviour of a for-profit company

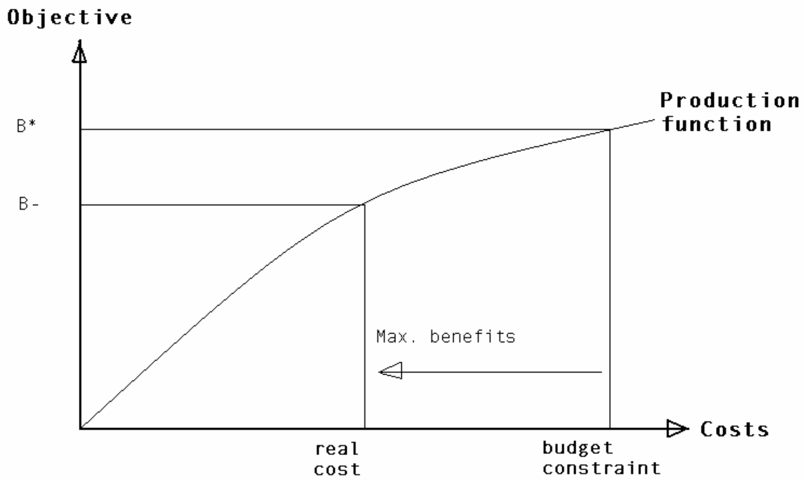

Figure 2B: The behaviour of a non-profit NGO