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Stretching Aid More Effectively by Aid Means Testing: A paradigm shift of incentive structure in aid policy¹

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Abstract

To achieve right incentives and obtain essential information in aid financing and allocation, this paper proposes an innovative method of aid means testing (AMT) to target official development assistance at the recipient who needs most help and the donor who delivers efficient aid. AMT is working in a manner of public-private partnership that binds the performance and evaluation together with actors operating in the market to achieve marginal successes. How AMT is feasible, and the prerequisites, limitation and challenges of AMT are also discussed to justify its role in current aid architecture. This paper points out a workable method which provides an explicit calculation and rationale to encourage donors and recipients to invest rather than consume so that aid allocation can be equitable, predictable, effective and sustainable in aid business.

Keywords: Official development assistance, means testing, incentive structure, aid policy, aid policy

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Introduction

Official development assistance (ODA) is initially developed as a means to bridge the gap between the capitalist first world and the undecided third world after the Second World War and throughout the Cold War (IDRC 1996). The amount of aid, over the past fifty years, has dispersed more than 2.3 trillion 2006 dollars (Easterly 2006a). For years, ODA has been criticized as ineffective and not sustainable (CIDA 2002).

It has been a long debate about how the role of ODA helps or hinders the development of the third world. Two competing theories have emerged as conceptual consensus surrounding the effectiveness of foreign aid. The public interest theory argues that ODA plays a key role of filling a financing or investment gap and helps lift developing countries out of poverty trap (Sachs 2005). On the contrary, the public choice theory argues that ODA remains ineffective and further damages recipient countries, reasons being the aid in fact goes to the rulers in the field, the aid project employs manpower from the donor countries, and thus both sides have incentives to misappropriate foreign aid in a manner that serves their own self interest (Bauer 2000; Easterly 2001).

While the fierce debate is still going on, this essay is to identify the overarching problems between the two theories and to seek action against ineffectiveness of ODA. Aid means testing (AMT) will be introduced to align the structure of incentives of both donors and recipients with general development goals, leading to the adoption of effective policies and contributing to the success of foreign aid.

The problem overarching between the public interest and public choice theories

To achieve success for foreign aid, we must tap into the understanding of current problems that both donors and recipients face. The two theories overlook to readjust the incentive structure within current aid architecture that is wrongly designed and attributed to the ineffectiveness of ODA. This failure can be illustrated by four patterns of aid behavior – fragmentation of distribution, selectivity of flows, moral hazard of aid allocation, and information asymmetry of aid architecture.

Fragmentation of aid distribution

To fill up the financial gap, each recipient is obliged to contend with numerous small projects from a proliferation of competing donors. In face of different donors with multiple principles, the incentive is typically weakened to achieve results as denoted in the principle-agent theory (Easterly 2006b). This has explained why ODA splintered into many causes and created the problem of fragmentation of aid distribution across all stakeholders - donors giving aid, countries receiving aid from each donor, and sectors in which each donor operates. For example, the tiny Luxembourg aid budget of \$141 million in 2004 went to 87 different countries, 37 different sectors. The UN agencies are among the worst on country fragmentation (Roodman 2006).

The recipient government suffers from fragmentation and a lack of information sharing in its decision-making and planning processes. Therefore it has thus forfeited the chance to scale up success or gained from specialization, and created huge administrative costs on both donors and recipients from the duplication of donor efforts and their failure to



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coordinate their efforts with each other (Easterly and Pfutze 2008). A medical officer in Tanzania spending 50-70 percent of the time writing reports and missions exemplifies the problem of aid fragmentation among donors to relieve developing countries of administrative requirement (United Nations Millennium Project 2005).

Selectivity of aid flows

Donors are criticized as unresponsive to political changes in recipient countries where ODA flows into the same countries whatever level of corruption in the recipients (Alesina and Dollar 2002). Donors disburse aid based on political motivation and permanent strategic interests of donors, not necessarily based on need (Mosley 1985; Frey and Schneider 1986; Trumbull and Wall 1994; Boone 1996). Evidence shows that higher aid slowed market-policy reforms over the period of 1980-2000 by altering the institutional arrangements from promoting wealth enhancing activities to promoting destructive behavior such as rent-seeking activities (Svensson 2000, Coyne and Leeson 2004, Heckelman and Knack 2008).

Moral hazard of aid allocation (Samaritan's Dilemma)

The structure of aid has facilitated its failure (Bauer 2000). Most of the receiving governments are corrupt in the first place. In 2002, the top 15 recipients of foreign aid which shared a total of 20 billion dollars ranked the worst fourth of all governments in terms of corruption (Easterly 2006b). Since so many aid receiving governments are corrupt, this has further promoted poor incentives to appropriately allocate foreign aid. Recipient governments, therefore, do not have any incentive to achieve positive results and are motivated to constrain the productive capacity of the poor. In this way, the current political regime would not have been threatened by the potential political activism (Easterly 2007).

This is a problem of "*Samaritan's Dilemma*" (Buchanan 1975) and *moral hazard* (Brautigam and Knack 2004). Aid allocation may as well encourage damaging policies because the more misery the impoverishing policies create, the more likely donors are to give aid. The moral hazard makes recipient governments less willing to put in place the right policy framework, institutions, resources, and necessary manpower required for development. By giving aid, the "Samaritan," or the donors, changes the incentives that the recipients face. Citizens in the recipient countries tend to consume ODA and become dependent on the donors. For example, unreasonable high percentage (70%) of Somalia's budget from foreign aid has created a dependency that has made change in recent years more complicated (Coyne 2008). Both donors and recipients may actually engage in less productive behavior to solicit more aid creating a moral hazard problem. Such 'inverse' behavior seems inherited in aid business, leading to several unintended consequences, for example public mistrust to aid agencies that deliver aid services, and recipients' opportunistic selection of projects in which results are more tangible. The misbehavior aforementioned undermines the quality of aid service delivery.

Information asymmetry of aid architecture

Aid information is typical as discontinuous, distributed across stakeholders, and presented in obscure forms. As similar as Hayek (1945) pointed out, the central problem to aid coordination is the use of knowledge in central planning aid architecture. Aid information is dispersed, decentralized and asymmetric on both sides. Central planning fails to tap into



Lai, A.Y. (2012). Stretching Aid More Effectively by Aid Means Testing: A paradigm shift of incentive structure in aid policy. JOAAG, Vol. 7. No. 1

the local knowledge because it has no mechanism of gathering and integrating the fragmented information held across stakeholders.

According to the literature review, the problems resulting from a lack of sufficient information on the effect of foreign aid include creating a dependency on aid, undermining local markets, destroying institutions, increasing conflict, increasing rent-seeking activities, and altering incentives to engage in less productive activities (Maren 1997; Bauer 2000; Svensson 2000; Brautigam and Knack 2004).

The solution to stretch ODA more effectively– Aid Means Testing

Means testing³ is a method adopted by Singapore Ministry of Health to calculate the subsidies for an elderly or a patient who will get step-down care services. Means testing undertakes an investigative process that determines whether or not an individual or family is eligible to receive certain types of benefits from the public finance.

Foreign aid, similar to subsidies, should be utilized as a necessary complement to fill the gap of financing and investment in the process of development. Effective aid must be focused on those who need it most and in areas which yield the most public good through a deliberate examination of local needs, local capacity, and local resources.

To ensure that there is no abuse or obstruction of the aid flow, aid means testing (AMT) is proposed to screen applicants for foreign aid request made by the developing countries where the giving of aid is to be subjected to a means test. The introduction of AMT is meant to allocate ODA and to target at the lower-income countries with responsive and accountable local government or reciprocal local non-governmental partners. AMT is a budgeting and evaluative framework of check and balance, designed to provide right incentive and essential information in a market economy to achieve effective foreign aid and development assistance.

How aid means testing makes a paradigm shift of incentive structure

Aid means testing (AMT) determines how much aid a recipient government or an aid agency should get within the aid architecture according to the need, the resources and the capacity that the country or the agency holds. Here the 'test' is referred to quantifying the indicators of aid effectiveness of each applicant for ODA. Each proposal of aid program should be evaluated and quantified judging from the indicators. That is, every submitted proposal will be means tested, and given a value denoting how effective aid architecture is situated within the recipient governments and aid agencies. A value of one indicates fully effective aid architecture and a value close to zero, a highly ineffective aid setting. The value can be interpreted respectively and provides a measure for how much the total budget will be subsidized with certain amount of ODA. Each specialization of ODA may come up with different key indicators that fit the professional context and adapt to the specialty sector such as economic infrastructure or social infrastructure.

³Means testing takes into consideration of gross income of the patient, his/her spouse and the immediate family members, of number of family members, and of ownership of major assets such as private property. It has been successfully installed in nursing homes and community hospitals to meet social equity and economic efficiency in Singapore.



Lai, A.Y. (2012). Stretching Aid More Effectively by Aid Means Testing: A paradigm shift of incentive structure in aid policy. JOAAG, Vol. 7. No. 1

Among the twelve indicators⁴ of progress mandated in Paris Declaration on Aid Effectiveness, four recipient-related indicators – degree of ownership, performance scale of public financial management and procurement, results-oriented framework and mutual accountability, can be used as indicators for means testing. Prior to adoption and integration into AMT framework for granting ODA, however these four indicators are suggested to be explicitly quantified into various levels of performance using individual country or agency as unit of analysis. In addition, extent of local capacity, utility of local resources and knowledge, degree of transparency, existence of responsive local civil society organizations, coordination with domestic and international non-government organization (NGO), presence of certified public accountant and degree of democracy are important indicators that need to be considered as well.

AMT examines the sources of external assistance and its coordination with the local capacity in the developing countries, and to test if the recipient governments or agencies fall below a certain level. If the aid recipient has been under funded or other projects undertaken simultaneously, the means of the extent foreign assistance are taken into account when the same recipient applies for a new foreign aid. How the means of the recipient is calculated and the amount of means allowed to have varies from case to case, according to the best practice indicators.

How AMT solves the problems in aid architecture

AMT empowers the recipient to take initiative and ownership by proactively evaluating and reporting the information of applicants' conditions. An aid regime is built that effectively disperses the necessary information to economic actors in aid architecture. In addition, the eligibility of the recipient receiving the ODA would be investigated and its subsidiary benefits would be improved. This movement is to solve the problem of information asymmetry of aid architecture. By implementing the means testing, the shift of incentive focus can enhance the specialization of aid priority, and alleviate the degree of fragmentation, saving overhead costs that are spent for managing so many projects from so many donors.

AMT incentivizes the recipient to provide local information and knowledge, and emphasizes democracy and transparency as indicators to maximize budget, it would help reverse the 'adverse' selectivity of aid flows on both sides. The politicians within the aid receiving countries will be incentivized to distribute aid in an effective manner as to achieve the stated goals of the aid programs. Civil society organizations will be approached as the proxy to manage the ODA flow in line with the recipient government. The concept of public-private partnership may help decentralize aid service to the local partner, sharing the ownership and monitoring the performance in aid business. The partnership fills the gap when there is a government failure on the ground.

⁴ Indicators in Paris Declaration are categorized in ownership, alignment, harmonization, result management and mutual accountability. The existing twelve indicators are to be measured nationally and monitored internationally. These indicators are only measured collectively in terms of partner countries or donors. It cannot distinguish good practices from bad practices of individual aid behavior. Nor can incentives be directed in the right way.



Lai, A.Y. (2012). Stretching Aid More Effectively by Aid Means Testing: A paradigm shift of incentive structure in aid policy. JOAAG, Vol. 7. No. 1

AMT holds the recipient accountable and responsive for improvement of aid architecture if the aid receiving country wants to scale up of proportion of subsidization or maximize their program budget, they must follow the agreed measures and indicators of best practices. The review of performance will determine the amount of ODA they will receive for the next step in the program. The consequence of ineffective aid architecture results in disbursement reduction in ODA, and 'co-payment' of the recipient to implement the same program would subsequently increase. This in turn will contain moral hazard in aid business.

Why AMT is feasible in current aid architecture

Given the current aid structure on the ground, aid agencies in most cases abide by what they are authorized and mandated to do. Therefore the aid agencies seldom have opportunity to provide feedback to the donor. Moreover, there is a lack of mechanisms to punish aid receiving agencies if they break their promises. This is where AMT comes in to play a role of check and balance. To constantly improve aid service level, we need to tie accountability and feedback into the incentives on both donors and recipients in an attempt to gather necessary knowledge to achieve stated goals. AMT provides an accurate pricing mechanism to direct the right incentive structure to invest, rather than to consume, with essential information and alter the institutions, or the rules of the game.

AMT is to tap into evaluative indicators of best practice already in place, and to use methods that are simple and already available, and to ensure that they are carried out smoothly. In light of aid effectiveness, the incentives structure of all stakeholders can be aligned in a manner that facilitates successful coordination surrounding ODA.

Unlike the traditional principle in which the donors playing a very dominant role, AMT alternatively manages the shift of incentive to make the recipient more self-reliant and accountable, and makes the optimal use of limited aid resources by empowering the recipient country and non-governmental organizations more to chart their destiny. The rightly placed incentives will not only expose the political elite with benefit of aid flows by having access to more resources, but strengthen their political positions and keep them in power.

AMT is not designed to penalize the poor living in countries with corrupt governments. However it aims to help the poor either through NGOs or governments' political will to ensure the sustainable development given the right incentive mechanism of check and balance. Through this economic calculation in line with essential information, decision makers can best utilize a price mechanism as a guide to effectively allocate resources. For example, if a recipient country X's AMT rating upgrades among others compared to the previous one, then the country X enjoys a priority in securing resources from the donor community. However, if a recipient country Y downgrades its AMT ratings, then the country Y government needs to review the aid demand and the resource allocation, and work on its weakness in hope that its ratings would improve next time.



Lai, A.Y. (2012). Stretching Aid More Effectively by Aid Means Testing: A paradigm shift of incentive structure in aid policy. JOAAG, Vol. 7. No. 1

Limitation of AMT in current aid architecture

AMT has placed more emphasis on the treatment for the recipient rather than for the donor. It may not immediately rectify the excessive supply-induced demand resulting from donors' ineffective aid behavior such as tied aid, food aid and technical assistance.

To efficiently implement AMT, there are some prerequisites mandatory in place.

1. The recipient must be proactive to take the initiative to submit their proposal for means testing. ODA request is made by the developing countries or NGOs to seek help from the donor countries or aid agencies.
2. Assessment programs before aid commitment and evaluation mechanisms after aid disbursement must be designed and integrated into AMT on condition of agreed measures. Feedback and control mechanism needs to be in line with AMT.
3. Means testing must be transparent. Indicators of AMT need to be clearly defined, quantified and agreed between donors and recipients. Information of local needs, resources, and capacity is therefore important to be available on both sides.
4. A clear understanding of current practice and consensus of criteria of best practice need to be formulated. It needs incentive and information in place, to make it a simple, cost-effective and fair game.

Challenges of implementing AMT

The challenge comes along with the means testing of foreign aid because this innovation would alienate some developing countries which fall outside the range of aid giving from the current comfort zone.

Nevertheless, the means testing should proceed cautiously and several factors need to be considered. Firstly, AMT should be assured that the donor is not taking this opportunity to reduce overall ODA as a means to relieve donors' political pressure. Secondly, the indicators for the means testing must be transparent and fair. Country income should not be the only criterion. Flexibility should be kept in mind when there are special circumstances, such as infectious disease outbreak or natural disaster taking place. Thirdly, a tiered system is preferable rather than an all-or-non system.

With means testing in implementation, there will inevitably exist deserving cases or programs which fall through the cracks. The aid agencies must be able to come in promptly when alerted, to sieve out such deserving cases and free them from unnecessary distress.

Alternatives and justification of AMT

Donor countries adjust their contribution according to the result of AMT, for those recipient countries that cannot meet the requirements, the aid agencies will alternatively save for them in the saving accounts. The saving can be mobilized to them once they have changed the way to meet the criteria of effective aid architecture.

AMT is suggested to be introduced gradually. Instead of shutting out unqualified developing countries from foreign aid, there may be a sliding scale of aid in place. To manage the transformation of aid re-distribution, the less qualified recipients will get a



Lai, A.Y. (2012). Stretching Aid More Effectively by Aid Means Testing: A paradigm shift of incentive structure in aid policy. JOAAG, Vol. 7. No. 1

lower aid under AMT compared to the traditional approach. With this incremental approach, the impact of means testing on the less or non qualified developing countries may not be sharply substantial.

Conclusions

To fix and align foreign aid in the new world order is no easy task, not to mention to make it work effectively. Traditional central planning fails to achieve significant development because neither donors nor recipients hold the entire information necessary to successfully coordinate foreign aid. This is the rationale that we highlight the introduction of Aid Means Testing in aid business.

AMT, as we argue, is meant to posit right incentives for both recipients and donors to manage and integrate the information of their need, resources and the capacity in the proposal submitted for means testing. Based on a price mechanism, AMT is a conceptual framework of check and balance, designed to provide right incentive and essential information in achieving effective foreign aid and development assistance in hope that ODA allocation can be equitable, predictable, and sustainable. Hence, it is imperative for us to re-think the possibility of an innovative approach, i.e. AMT, to place foreign aid in a market economy, driven by a right incentive structure with essential information across public interest and public choice theories of foreign aid.

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Lai, A.Y. (2012). Stretching Aid More Effectively by Aid Means Testing: A paradigm shift of incentive structure in aid policy. JOAAG, Vol. 7. No. 1

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