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How to Spend it

The organization of public spending and aid effectiveness

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Abstract

As aid diminishes in importance, donors need a capacity that enables governments to improve the quality of their public spending. In this study I suggest three such organizational innovations: independent ratings of spending systems, Independent Public Service Agencies, and Sovereign Development Funds. These constitute a new donor instrument of influencing the modalities of public spending, alongside the volume of aid. With an additional instrument donors can escape the dilemma of having more objectives than instruments. How aid is spent may become more important than how much of it is spent.

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1 Introduction

The rationale for aid has always been straightforward: it is a transfer of financial resources from the richest societies in the world to the neediest. As more developing countries reach middle-income levels, aid will properly become concentrated on fewer countries. Among the remaining needy countries the quality of economic governance varies widely: some, such as Rwanda, have competent systems for public spending, but others exemplified by the fragile states lack such systems. This gives rise to a donor dilemma. Increasingly, the neediest countries are those with weak economic governance, but in such contexts aid is unlikely to be well-spent. In allocating aid between countries the donor is faced with an uncomfortable trade-off between need and effectiveness.[1] The dilemma can be characterized as an instance of the Tinbergen Rule which sets out the fundamental logic of the attainment of policy objectives by policy instruments. It states that for objectives to be attainable there must be at least as many policy instruments as objectives. If the only donor instrument is the volume of aid then the objectives of responding to need and effective use of donor money cannot both be met. Either money can be well-used in environments which are less needy, or it can be channelled to the most needy where much of it will be misused.

In this study I propose a way out of the donor dilemma. Donors need to develop a second instrument which can improve economic governance. Of course, donors have been trying to do this for decades. But the conventional approaches of capacity-building and policy conditionality have been ineffective. In their place, this study proposes a menu of specific new organizational designs for public spending systems. By offering to channel aid through these systems donors could encourage their adoption. The immediate objective of this menu is to enable donors to ensure that public money can be reasonably well-spent across a wider range of governance conditions than is currently the case. Faced with variations in both need and economic governance, the choice of organizational design would be the instrument used to achieve aid effectiveness, enabling the volume of aid to be determined by the depth of need.

This second donor instrument has potential beyond its immediate objective of escape from the donor dilemma. Over the next decade many countries which are still low-income will be able to tap into non-aid sources of public finance: revenues from natural resource revenues, the taxation of remittances, and commercial borrowing. These sources of public finance will come to dwarf aid. The same instrument that enables donors to spend aid money effectively can also empower governments to spend their own money effectively. Increasingly, if aid is to remain relevant it will be because of how it is spent rather than how much of it is spent.

In Section 2 I set out the donor dilemma. In Section 3 I propose a menu of new organizational designs for improving how public money is spent. Section 4 concludes.

[1] Collier and Dollar (2002) was an attempt to formalize such a trade-off.

2 The donor dilemma

In its simplest form, aid policy has the single instrument of the volume of aid. But in this case there is only room for a single objective: the international agreement around the Millennium Development Goals in 2000 can be seen as an attempt to reduce the objectives of aid to the single, overarching concept of meeting need. So structured, the attainment of the objective costs a certain amount, and the challenge is to co-ordinate donor pledging so as to overcome the free-rider problem inherent in raising this amount from national budgets for a global public good. This provided the intellectual underpinnings to the Gleneagles G8 Summit of 2005.

This framework of a single objective and a single instrument is inadequate to characterize the problem of aid for fragile states. For aid to have a reasonable prospect of being well-used by recipient governments two conditions need to be met. The first is that the intentions of government should be reasonably well-aligned with the interests of citizens. One way in which this condition will be met is if the political system is effectively democratic. The governments generated by such a system have little choice but to follow the interests of their citizens since they otherwise risk losing office. However, many non-democratic governments appear to be reasonably aligned with the interests of their citizens, while many governments that go through the motions of elections are not seriously at risk of losing power regardless of their priorities. Hence, whether this condition is satisfied cannot be determined by a mechanistic rule based on the type of political system, but is an irreducible aspect of donor judgment.

Supposing this condition to have been satisfied, a further condition is that the government controls a public financial system which enables the government to spend public money effectively on its priorities. If public financial management is very weak then, regardless of government intentions, public spending cannot achieve government objectives.

The mutual concerns of aid recipients and aid donors were addressed by the Paris Declaration of 2005. As to government objectives, the Declaration committed recipient governments to adopt national development strategies, and committed donors to respect these strategies rather than attempting to impose their own priorities. As to public financial management, the Declaration committed recipient governments *in aggregate* to improve their management and procurement systems, and commensurately committed donors *in aggregate* to channel aid through these domestic systems, conditional upon their quality, rather than bypass them. However, an international declaration in itself is intrinsically unlikely to induce much change in behaviour. No commitments were made either at the level of individual recipient governments or individual donors. Manifestly, it cannot be expected significantly to influence whether in practice governments are aligned with the interests of their citizens. As to the quality of public financial management, to the extent that this is has been measured since 2005, there has been no overall improvement. This is unsurprising: poor public financial management is not just a sign of a lack of 'capacity'. More reasonably, it should be thought of as an equilibrium reflecting pressures from different interests.

The donor dilemma is that the greatest concentrations of need are often in the countries where one or both of the two conditions are not met. In effect, the objective of responding to need has to be supplemented by that of achieving effectiveness. Donors

are faced with two objectives which cannot both be attained by the single instrument of the volume of aid. Donors need a second instrument which is able to achieve the conditions under which money can be effective. Such an instrument may or may not be feasible.

As to the first condition, government alignment with the interests of its people, there is no credible potential for a donor instrument. The improvement in overall governance is primarily an internal struggle within these societies: there are severe limits both to what donors can do, and indeed, to what they should aspire to do. The scope for an effective donor instrument is at best confined to situations in which this condition is already met, but where the second condition is not met. Here, however, there is more scope for donor innovation. While overall governance is largely beyond the remit of donor involvement, good economic governance is not merely a matter of political will; it requires specific institutional mechanisms which enable money to be spent effectively. It is at this more practical level that donors can reasonably become involved.

Budget systems have to work in three key respects. First, they have to pass the macroeconomic test of balancing revenues with expenditures. Second, they have to meet the microeconomic test of integrity in taxation and spending. Third, they have to allocate money in such a way that both social needs and public capital goods are adequately provided. These essential features of budget systems require rules, norms, habits and incentives that shape the behaviour of those who take and implement the myriad of decisions on which outcomes depend. There is no simple mapping from rules and incentives on the one hand to habits and norms on the other. Rules and incentives only translate into functional behaviour if they are appropriate for context. Some of the designs which were historically effective in the imperial countries have proved to be dysfunctional in fragile states. They were transplanted during colonialism and enforced by imperial power. Post-independence, while the rules and incentives ostensibly stayed the same, norms and habits often gradually changed. As a result, the inherited systems are now dysfunctional: beneath a veneer of institutional similarity of budget systems, actual behaviour in fragile states is radically different from that in the OECD.

To establish new and more functional norms and habits within budget systems that break the dysfunctional equilibrium, fragile states need distinctive designs of rules and incentives. Designing effective rules and incentives is a complex and demanding task. By definition, the governments of fragile states are ill-equipped to undertake this task, lacking both the skills and the confidence required. Self-evidently, donors can neither substitute for government nor coerce governments into change. However, they can offer governments pertinent skills, knowledge of experience elsewhere, and, by subjecting themselves to rules, they can thereby make aid part of the incentive system. In principle, international skills and experience could be provided independently of aid agencies. For example, the governments of fragile states could hire it in from consultancy companies or universities. However, donors have one huge advantage: since they provide governments with money, they are necessarily implicated in the budget systems they finance.

Donors have been providing ‘capacity-building’ to the budget systems of fragile states for decades. However, with two important exceptions this has been aimed at training budget staff in skills rather than on more fundamental design of the rules and incentives in manner that is likely to be habit-changing. One exception to the sole emphasis upon

training was the creation of Independent Revenue Authorities. In the OECD revenue collection normally comes under the ministry of finance and the administration is within the civil service. In fragile states as the habits of these civil servants changed revenues for the government declined, triggering both pressure on public spending and unsustainable fiscal deficits. In response, the tax-raising function was hived off from the civil service and a new organization was created. This had three advantages. Recruits for the IRA would be newly hired, so that there was an opportunity to weed out the least effective staff. Employees could be faced with new rewards and penalties distinct from those in the civil service. Finally, because the change was not incremental, there was some prospect that expectations would not be set by past habits. The results have been mixed but generally IRAs have been sufficiently successful at increasing revenues that the experiment has been maintained. However, to date the model has not been extended to other functions of the civil service. The critical nature of revenue was perhaps unique in forcing both governments and the international finance institutions (IFIs) to face up to the inadequacies of the existing model. The other exception has been a new rule adopted by virtually all donors to elevate the existence of an IMF programme (whether supported by IMF money or merely 'Staff Monitored'), as a pre-condition for virtually all donor support. That donors will adhere to this rule was initially credible because a donor that broke it would have avoidably exposed itself to domestic criticism: public bureaucracies are famously risk-averse. Over time, as the practice evolved into being a norm and a habit, it became yet more credible. In turn, in practice the condition for an IMF Programme has been macro-fiscal prudence. As a result, the rule has created a substantial incentive for the maintenance of fiscal prudence. The rule and incentive have gradually changed norms and habits so that governments themselves now usually accept the need for fiscal prudence rather than regarding it as purely externally imposed.

While these distinctive redesigns of rules and incentives have been reasonably successful, neither addresses the process of public spending. Yet without effective public spending systems donors face a fundamental impediment to their core objective of poverty reduction. Not only will the money they provide be less effective, perhaps radically so, but so will other public money. In essence, unless donors develop an effective instrument for improving public spending systems they cannot achieve their core objective. In Section 3 I propose how new rules and incentives could improve public spending systems in fragile states. Collectively, these new rules and instruments constitute a new donor instrument which can be used in conjunction with the traditional instrument of the volume of aid. Armed with two effective instruments, the volume of aid and a choice of modalities of aid delivery, the donors can escape from the dilemma implied by the Tinbergen Rule. In effect, the volume of aid can be linked to the depth of social need, while the most appropriate modalities of aid can be selected to achieve effectiveness. In conditions of good economic governance the appropriate modality will be budget support. In conditions of weaker economic governance the modalities proposed in Section 3 would replace budget support.

3 Reinventing public spending systems

Some needy countries already have adequate systems for public spending. For such countries the appropriate form of aid is budget support and the volume of aid can respond directly to need. Even in such countries some innovations is the system of public spending may be useful, notably to respond to the onset of revenues from natural resources. However, my primary concern is with fragile states, where public spending

systems are usually far from adequate. Among fragile states I focus on a subset: namely those in which the government is at least adequately aligned with the interests of its population, whether through a functioning democracy, or a benign autocracy. I will assume that the government, or at least significant parts of the government, recognizes that it sits atop a public spending system in which dysfunctional practices are well-entrenched. It is therefore willing to discuss with donors new approaches to public spending as long as they are both effective and politically realistic. What, other than capacity-building as usual, should a donor propose? In this section I suggest three new mechanisms. One is designed to change the incentives for reform in the existing public spending system, the other two are new public organizations designed for specific aspects of spending. Although they can be adopted individually, they also form a coherent package.

3.1 Reforming the public spending system: independent ratings

Budget support, which is a favoured modality of most large donors, depends upon the quality of the budget system. Donors have undoubtedly distributed budget support to governments for which it has been ill-suited. Such aid only makes sense if the two hurdles discussed above are jointly satisfied. The political hurdle, that the government should be trying to benefit its citizens, is routinely assessed by donors. But the technical hurdle that the government sits atop a secure process of public spending requires a judgment that they often avoid: money is repeatedly fed into leaky budget processes. Such leakages are not merely wasteful: the money is captured by the very people who are at the core of the governance problem. Donors avoid this judgment because they lack both the necessary access to information and the necessary technical skills. They also have an incentive not to look too closely. Budget support is bureaucracy's nirvana: large amounts of money can be disbursed on schedule with low overheads.

Yet that second hurdle matters: an independent process of scrutiny is needed to rate whether a public spending system is fit for budget support. Currently, no international agency has all the skills and staff necessary for the rating function. The IMF comes closest with its Public Expenditure and Financial Accountability (PEFA) Programme, but this has two critical deficiencies. While it considers system design, it does not investigate how money is spent in practice. That is, it lacks an audit function. The *ad hoc* Public Expenditure Tracking Surveys (PETS) of the World Bank perform such a function and so could be extended, or the international accountancy firms could conduct external audits as part of an augmented PEFA. The other deficiency is that the PEFA does not provide an overall rating system tied to donor behaviour. As discussed above, the principle of a link from IMF assessment to a donor rule of behaviour is long-established: the existence of a Fund Programme is a near-universal condition for development aid. The analogy with an augmented PEFA would be to make a threshold level of the augmented-PEFA ratings a condition for budget support. The evident analogy here is with the credit ratings of governments issued by the rating agencies. From these ratings a particular threshold has been widely adopted which determines whether the bonds of a government can be held in portfolios. As with these credit ratings, the entire range of ratings would be useful rather than just the threshold certification. In particular, for those budget systems which did not meet standards adequate for budget support it would show both governments and donors how far off was the system from the required standard, and hence whether the realistic response was incremental improvement or systemic redesign.

Those countries that gained certification for their budget systems would have a much stronger case for budget support. Those governments of poor countries that are aligned with the interests of their citizens and administratively equipped to meet those interests should be empowered by aid rather than pestered. Why should donors fund projects or bypass the government through NGOs when money could safely be channeled through the budget? Correspondingly, donors would find budget support easier to grant in these cases because the decision would be politically protected by the authority of an external rating. Those countries that did not meet certified standards could have a grace period to get their systems in order, supported by technical assistance. Presidents would likely pressure their governments into doing what it took to achieve certification. Would this be a backdoor return to policy conditionality? Decidedly not: the purpose is not to tell governments on what to spend their money, but to ensure that their own laws are enforced. Nowhere is looting of the public purse an official policy.

One reason why donors are wary of certification is that with rare exceptions the budget systems of fragile states would not currently meet any reasonable standard. Yet without a budgetary infusion there is a risk of state collapse. The rationale for support here is not 'budget support' but 'life support', to avert the staggering costs of state failure. Life support can make sense, but donors should handle it entirely differently from budget support. The use of the same vehicle, and indeed the same term, for the two situations has both exemplified and deepened donor confusion: if fragile states are eligible for *budget* support, every country is eligible. Once fiscal support in these situations is distinguished as 'life support' the rules of engagement can also be distinguished. Life support should come with sufficient imported administrative capacity immediately to achieve proper standards of public spending, not just of donor money but of all public money (donor spending cannot, in reality, be separately identified). Unlike technical assistance to prepare for budget support, the core objective of imported administrative capacity would not be to build local capacity, but to substitute for its deficiencies, thereby preventing public money from being looted by political crooks. As Paddy Ashdown said of Bosnia, what was needed was not 'doctors without frontiers' so much as accountants without frontiers.

But the major reason why donors are wary of ratings and certification is that they realize that in many fragile states budget systems are not fixable within a reasonable time frame. After the grace period, if the rating was still below the threshold then budget support would be tapered out. Donors are rightly reluctant to subscribe to a policy rule which would appear to imply that the allocation of aid to needy countries would be curtailed. Hence, it is useful to complement the introduction of budget ratings and 'life support' with the introduction of other modalities for aid delivery such as those proposed below.

3.2 Enhancing the delivery of basic social services: independent public service agencies

The standard model of public provision of basic services in fragile states reflects the colonial inheritance. Ministries of education and health perform the three functions of planning, resource allocation, and the direct management of schools and clinics. The nature of the problem currently facing this approach can be illustrated by two examples. In Chad, which is a fairly typical fragile state, the PETS found that only one per cent of the money released by the ministry of finance for rural clinics actually reached the

clinics. The second example is a scandal from Zambia, where governance is considerably above that in fragile states (which is why the scandal came to light). Following the provision of international aid for antiretroviral drugs the chief civil servant in the Ministry of Health established his own private company to import fake drugs from Eastern Europe which, in his capacity as a public official, he purchased. These disturbing examples are symptoms of a more general problem of staff motivation.

Economists commonly reduce motivation to incentives: performance should be monitored and pay linked to performance. But recent evidence from Akerlof and Kranton (2011) argues that this approach has been overemphasized. In many occupations worker motivation is achieved not by financial incentives but by worker internalization of the objectives of the organization. While this is common even in commercial organizations, it is all the more applicable in the public sector. Typically, activities are in the public sector because they are unsuited to high-powered incentives (for example, individual staff performance is difficult to monitor), while being intrinsically satisfying because of their human interest (such as teaching children or healing the sick) or serve a national mission (such as the military). Around the world this is how the civil service is usually run: public servants internalize the mission of the organization. The system is normally self-perpetuating: new recruits adopt the norms of an organization, partly due to purposive training by the organization, partly due to conscious imitation of existing employees, and partly due to sub-conscious imitation dictated at the level of neurons. It is a locally stable equilibrium.

In some of the states of post-colonial Africa this process of internalization broke down. Many of the civil servants in these states are no longer sufficiently motivated by the public objectives of their work to put them before their own personal interests. Unfortunately, dysfunctional behaviour is also likely to be a locally stable equilibrium. New recruits, arriving with the enthusiasm and idealism normal in youth, adapt down to the prevailing norms. For example, Barr et al. (2008), find evidence for such a process in the Ethiopian public health system. Incremental reform is difficult because it faces a co-ordination problem: workers inevitably expect their co-workers to behave today much as they did yesterday, in which case it would be quixotic of them to change their own behaviour. Hence, within a reasonable horizon the existing system cannot be substantially improved. However, since overall provision is far below needs, as long as the finance for those needs is available an alternative approach is to supplement provision through a parallel public delivery system that is more functional. The existing system can be left in place, hence avoiding the political costs of challenging it. What might such a parallel system be like?

While the fragile states of Africa have retained a model of delivery of basic services which characterized the typical European states of the 1950s, meanwhile most European states have found this model increasingly deficient and have moved on. While there are many variants, the common element is to unbundle the functions that in the 1950s model are all performed by a single ministry. Some of these functions are intrinsic to the responsibilities that a state should undertake. For other functions the state can achieve its objectives better by purchasing the function from other providers. Even in the most centralized and efficient of European states this approach is now standard: for example, in France both blood-testing and ambulance services are financed publicly but provided privately. The model proposed here is a variant of this family of approaches.

An Independent Public Service Agency (IPSA) is a design of public service delivery which may be particularly appropriate for fragile state conditions. It need not be merely a temporary measure: it may evolve into a permanent organization much as Independent Revenue Authorities have become permanent in much of Africa. Although all IPSAs have some core features in common, they can take many different forms. For example, at one extreme a single IPSA could have a national mandate for many different types of service, while at the other each district might have several IPSAs, one for each type of service. Such choices should vary country-by-country, according to local capacity. Here I focus on the core principles of an IPSA rather than on such choices.

An IPSA is a public agency: it is an implementing agency of government but is independent of the civil service, analogous to central banks and revenue authorities. While it is an agency of government, its board of directors can include a minority of non-government appointees. These might include the main donor agencies and key components of civil society. The primary purpose of such representation is to provide equal and unrestricted access to information on the decisions and performance of the ISA for government, donors and civil society. As a result, an IPSA is *structurally transparent*.

The government ministries responsible for service provision have representation on the board of the IPSA and set policy guidelines by which the IPSA must operate. For example, they may set minimum standards of provision, and require the IPSA to allocate resources so as to ensure geographic equity. Ministries will also continue to provide state services directly. Since in post-conflict conditions service provision is invariably inadequate, the IPSA should constitute an expansion in provision not a change in the management of existing services. Over time, if the IPSA-provided services proved to be better value that those directly provided by the ministries then it would be a matter for the government to decide whether to reorganize the directly provided services.

An IPSA receives funds from donors and government for the purchase of services from primary providers. Since the IPSA is an implementing agency of government, the money allocated to the IPSA, including that from donors, appears in the government budget as an expenditure. Hence, donor funding of services through the IPSA is somewhat analogous to ring-fenced budget support.

The IPSA enters into contracts with primary service providing agencies but does not provide services directly. This avoids a conflict of interest and focuses the IPSA exclusively on negotiating and monitoring the performance of the primary providers. These providers can be NGOs, local communities, local governments, or private for-profit organizations. Ideally, the IPSA will experiment with multiple channels of provision for the same service to maximize the scope for variation in performance.

Unlike government provision, non-government provision is not a uniform model and there is considerable variation. Two different approaches can both achieve good organizational performance, which in turn is primarily dependent upon whether it is able to motivate its workforce. One approach, typified by mission-run hospitals and schools, achieves good performance by maintaining a high level of organizational commitment on the part of its workers. Given the high intrinsic satisfaction from activities such as healing the sick and teaching children, and the highly visible needs in

post-conflict societies, it is possible to create islands of self-motivation even where in the public sector norms of service have collapsed. The other approach, typified by some for-profit organizations, achieves good performance by solving the difficult problem of linking financial incentives to observable performance. In many aspects of service delivery individual performance is not readily observable and so effective monitoring is difficult. The two approaches are not easily combined and so tend to be alternatives. Norms of self-motivation, or working for the common good, thrive on trust and equity among staff. In contrast, the essence of addressing motivation by means of financial incentives is that trust is replaced by monitoring, and equity is replaced by income differences based on differential performance. Field evidence suggests that where strong financial incentives are introduced into service delivery organizations norms of service and worker cohesion are undermined.

According to the type of service, the local context, and the personal characteristics of managers, either approach can be more effective. However, while some non-government organizations solve the service delivery problem by one or other of the above approaches, others fail. Some rely upon trust but have unmotivated staff; others rely on financial incentives but monitor aspects of behaviour which are not sufficiently related to performance. Hence, the performance of the organization cannot be inferred from its design but must be observed. This is reflected in the IPSA, which devotes most of its resources to monitoring performance and comparing it. The evidence on comparative performance is provided to the board of the IPSA on a regular basis. The board uses this information to reallocate resources from less-efficient providers to more-efficient providers.

The IPSA can also experiment with distributing vouchers to households rather than money to service providers. This reduces the need for monitoring of performance but introduces other problems. To take a trivial example, in health care the prescription of glucose will produce a short-term improvement in the patient without addressing the causes of the illness. Users can easily misinterpret this effect as indicating that they need repeated treatment rather than different treatment. Hence, in the absence of good ethical standards among practitioners in this instance vouchers could be dysfunctional. More generally, the balance of whether service providers are more effectively monitored by professionals or by users will vary according to type of service and local context and is best determined by experiment.

An IPSA has various advantages. It builds in variation in approaches to service delivery: different providers will be attempting to solve the problem worker motivation in different ways. Since the core function of the IPSA is to evaluate these different approaches it enables gradual improvement in overall efficiency. The increase in efficiency comes about through two different mechanisms. The most obvious is through the awareness of competition acting as a disciplining device on providers. Through this mechanism, the performance of the typical service provider might be expected to improve. However, this is probably not the most important. The more important mechanism is that resources can gradually be reallocated from inefficient providers to efficient providers. Since the variation in efficiency between different providers is likely to be considerable, simply by reallocating money between them the IPSA can raise the efficiency of the average dollar spent on service provision. Note that this does not depend upon any improvement in efficiency in each organization.

Unlike the donor bypass of the state, with an IPSA donor money is routed through a state organization. A condition for a non-government service provider receiving money from the IPSA should be that the services delivered are co-branded by government. While the visibility of donor operations is reduced, that of government is increased. Ordinary citizens are able to see that the government is doing something that is beneficial.

By design, the IPSA generates information on the performance of the organizations that it funds, and hence on its own performance. Since donors are represented on the management board of the IPSA they have full access to this information. Transparency of information for donors is crucial in post-conflict conditions to enable donors to scale up financing beyond the immediate post-conflict period. During the first few years donors give governments the benefit of the doubt, but this rapidly erodes. In its place governments need rapidly to build donor confidence. This cannot be done either by declarations or by comprehensive improvements in governance. Declarations of good practice can be made equally well by those governments that have no intention of adhering to them and so, despite a deceptively courteous reception, cut no ice with donors. Comprehensive improvements in governance simply take too long to achieve to stave of reductions in donor funding. An IPSA provides a quick institutional solution to the problem of building credibility with donors: transparency and design substitute for the lack of trust. As quantitative evidence of performance builds up, the local offices of donor agencies are in a much stronger position to press their headquarters for a larger share of the budget.

The IPSA retains the key benefit of central planning: resource allocation can be co-ordinated rather than being simply the aggregation of individual donor decisions. Further, since the IPSA is designed to generate information, the precondition for central planning to be effective is met. However, while overall resource allocation is centrally determined, the incentive problem is not micro-managed. The IPSA does not attempt to motivate or monitor the workers who deliver services. That task is decentralized to individual service providers to solve as best they can. The IPSA faces the less daunting task of monitoring the overall performance of each delivery organization.

The Board of the IPSA faces the task of motivating the staff of the IPSA. Why might this be any easier than the task of motivating civil servants in the service delivery ministries or those in a Project Implementation Unit? In part it is easier than motivating civil servants because, being a new organization outside the civil service the IPSA can start with higher pay structures that are credibly linked to rewards and penalties. Recruits have some reason to expect that the behaviour of their colleagues will not be the same as civil service behaviour. Perhaps more importantly, the remit of the IPSA is more narrowly defined than the remit of a ministry. It is not trying to do everything from policy design to on-the-ground delivery of services. It is allocating money between providers and evaluating their performance. It is also subject to day-to-day scrutiny by donors and civil society who as members of the management board receive a continuous flow of information about the performance of managers. Motivation through internalization of objectives should be easier than in a Project Implementation Unit because an IPSA is permanent, and it has a national mission rather than being a temporary foreign entity.

An IPSA does not need to start with a 'big bang'. It can start small, with one or two donors co-operating with a particular government ministry to finance an expansion in the delivery of a particular service. It should be viewed as an experiment in the architecture of public service delivery. As an experiment it should be evaluated, but, by design, such evaluation is automatic. If it succeeds it can be scaled up virtually without limit. Ultimately, the government might decide that the IPSA, or a series of IPSAs, is the most cost-effective and politically effective way of delivering services for the society. If it fails then it can readily be closed: donors are used to running projects which terminate. Nor is failure likely to have high costs. Unfortunately, there is currently no successful model of large scale service delivery in post-conflict conditions, so that the opportunity cost of failure is likely to be modest.

In summary, in many low-income countries governments have been attempting to deliver basic services using an inherited colonial model that has little prospect of success in the context of their own societies. Given the acute needs of their citizens, it is time for governments to experiment with other designs. The key desiderata are that a new system should be capable of being rapidly scaled up, while leading to something that is politically sustainable. An IPSA is not as good as the 1950s European model when that model is deployed in ideal conditions. However, it is likely to be more successful than the centralized ministerial approach in the conditions that actually prevail in many societies.

3.3 Enhancing public investment: sovereign development funds

One characteristic of most low-income countries is inadequate public infrastructure: the legacy of decades of underinvestment. As part of the sustainable ascent from poverty these deficiencies will need to be rectified. The accumulation of adequate public infrastructure faces two hurdles. The most obvious hurdle is financial: money must be found and then ring-fenced for investment. But money alone is not enough. For example, the government of Nigeria has cumulatively spent some US$ 16bn attempting to rectify shortages of electric power, yet without significant results. For money to produce results the process of public investment must be sound.

Most low-income states now have opportunities for financing a major increase in public investment. Partly this comes from donor money: although most aid budgets are under pressure, there is also a trend towards reallocating aid towards fragile states, exemplified by DFID, the World Bank and the European Commission. Further, within the aid budgets assigned to fragile states, there is a reaction to the previous donor fashion of prioritizing social spending, towards favouring infrastructure. However, aid-for-investment is fungible: governments can choose to reduce their own investment efforts. A clear indication of such behaviour is that by the 1990s in many fragile states the entire 'development budget'—that component of the budget that financed public investment—was aid-financed. Donors can reasonably expect that the governments of fragile states contribute some domestically-generated revenue towards the cost of new infrastructure but for this to be a reality there has to be some corresponding political decision structure: a commitment technology.

In addition to donor funding, many low-income countries are now benefiting from substantial increases in revenues from natural resource extraction. Sometimes, as with

the Chinese, this is directly linked to the provision of infrastructure, but more properly revenues can be used to augment public financing of infrastructure. There is an evident economic and ethical rationale for using a substantial proportion of the revenues from the depletion of public natural capital for the accumulation of other forms of public capital (Collier 2010). Disturbingly, to date this has not been the global pattern because resource rents have been associated with political dysfunction (Ross 2011). Controlling for the level of income and other salient characteristics resource rents have significantly and substantially reduced the public capital stock (Bhattacharyya and Collier 2011). The type of politics which produces pressures to over-spend resource rents on consumption is well-understood, notably the 'voracity effect' (Tornell and Lane 1999). To avoid this syndrome of political pressures governments again need commitment technologies. Currently, the governments of several resource-rich countries are establishing such commitment technologies through variants on Sovereign Wealth Funds (SWF), examples being Nigeria and Ghana. These are constitutional devices which earmark a certain proportion of resource revenues for the Fund. In turn, money in the Fund can only be used for the accumulation of assets, whether foreign financial assets or domestic public investment. Since in a capital-scarce country it is unwarranted to accumulate long-term foreign investments, the core objective should evidently be to finance domestic infrastructure. Hence, to distinguish these vehicles from the conventional model of a SWF, in which the only permitted assets are foreign, it might be more appropriate to think of them as Sovereign Development Funds (Collier 2011).

In principle, the political commitment technology of an SDF could be used for the donor finance of investment as well as for government revenues from natural resource depletion. Indeed, by making the two sources complementary through a matching-rule, donors can increase the incentives to resist the resource curse. However, the critical reason why donor finance should flow into SDFs is not macro but micro: donors have expertise in investment processes.

The process of public investment can be decomposed into four stages: project design, project appraisal and hence selection, implementation, and finally *ex post* evaluation. The quality of these processes has recently been assessed for 90 countries by the IMF and used to generate an index: the Public Investment Management Index (PIMI). Bhattacharyya and Collier (2011) find that controlling for the level of per capita income the PIMI is significantly worse in the presence of natural resource rents. Hence, reduced expenditure on the public capital stock is compounded by a poor investment process. Resource-rich fragile states need reinforcement of their processes of public investment just as they need reinforcement of their investment decisions.

If donors contribute financially to SDFs they can also contribute technically and politically. Technically, they can bring the standard international methods of project design, selection, implementation and evaluation. It is far better that these be integrated into a purpose-designed government agency than in free-standing *ad hoc* 'project implementation units' which have been the customary donor approach. Further, as with IPSAs, by creating a public agency outside the regular civil service with a narrowly-specified function, there is a better chance of achieving adequate standards than through the incremental reform of an entire civil service that is far below the necessary level. Politically, if the government wishes to reinforce its commitment technology, the donors can make adherence to these standard technical processes a condition of continued funding.

For many low-income countries the challenge of using natural resource revenues is far more important for development than the use of aid. Were donors to offer to channel aid through an SDF, it would encourage appropriate rules for investment to be established. Were donors to subject themselves to rules which maintained their support for an SDF over perhaps a decade, the formal rules which directly define the SDF might become internalized by its staff and the political elite, evolving into norms and habits which entrenched prudent decisions.

4 Conclusion

Aid is in danger of becoming prematurely irrelevant. On present donor practices, in those low-income countries that have reasonable economic governance it will become marginal, while in those that have inadequate economic governance it will be impotent.

For many of the governments that will continue to be aid recipients aid will be a rapidly decreasing component of their available resources. For these countries, sustained development will depend not upon how their governments manage aid but upon how they manage their own revenues. Aid can only continue to be relevant in these societies if it becomes a vehicle for enabling governments to strengthen their management of these domestic revenues. But benign donor influence is unlikely to come from a continuation of past donor practices. *A fortiori*, conditionality will be ineffective in this context: donors will simply lack sufficient financial leverage. Capacity building, while more politically comfortable, has repeatedly proved ineffective, as exemplified by the lack of improvement in the PEFA assessments of public spending systems.

The context in which aid will remain financially important is the fragile states. Donors will therefore increasingly concentrate on fragile states. However, in these environments on present aid delivery systems to fragile states aid will have only limited effect because public spending systems are manifestly inadequate. While donor conditionality has greater leverage in these contexts, it is often beyond the power of politicians to rectify the problem. Although highly dysfunctional, public spending systems cannot be reformed incrementally because the dysfunction is a locally stable equilibrium.

In both contexts aid effectiveness depends upon donors developing the same capability. They need a capacity that enables governments to improve the quality of their public spending. In this study I have suggested three organizational innovations in public spending. Since donors are intrinsically involved in how public money is spent they have the scope to promote the adoption of such innovations. One, the introduction of independent ratings of spending systems, would generate pressures for higher standards of financial integrity and budget cohesion. The second, Independent Public Service Agencies, could enable governments to scale up basic social services with demonstrably well-spent donor finance. The third, SDFs, could enable governments both to ring-fence both the macroeconomic decision of how much revenue to devote to investment, and the many microeconomic decisions of the investment process. Collectively, such innovations constitute a new donor instrument of influencing the modalities of public spending, alongside the conventional instrument of the volume of aid. With an additional instrument donors can escape the dilemma arising from facing more objectives than instruments. More fundamentally, the organizational structures through

which aid is spent can become models for how the government spends its own resources: *how* aid is spent may become more important than *how much* of it is spent.

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