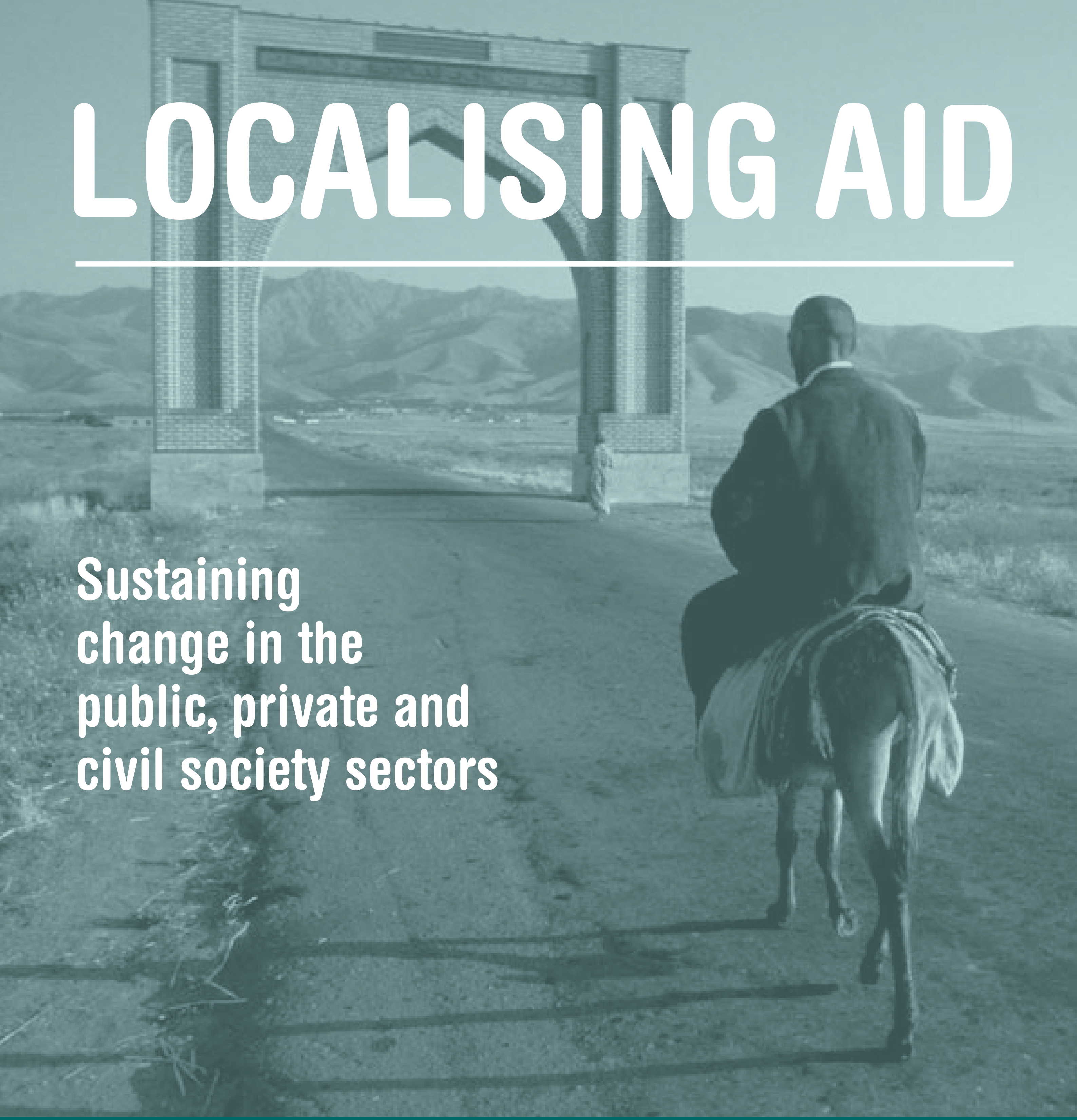

LOCALISING AID

Sustaining change in the public, private and civil society sectors

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March 2013

Centre for Aid & Public Expenditure

FROM THE AMERICAN PEOPLE

ISBN

978 1 909464 14 8

Design: www.stevendickie.com/design

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Acknowledgements

The authors would like to thank David Booth, Fiona Davies, Ryan Flynn, Edward Hedger, Marcus Manuel, Daniel Runde, Gary Russell, Heidi Tavakoli, Fletcher Tembo and Tjip Walker for their helpful comments and suggestions.

They would also like to thank all the experts interviewed during the course of this research, especially in the case study countries.

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Acronyms

AECID	Spanish Agency for International Development Cooperation
AIDS	Acquired Immune Deficiency Syndrome
ARTF	Afghanistan Reconstruction Trust Fund
BRICS	Brazil, Russia, India, China and South Africa
CIPFA	Chartered Institute of Public Finance and Accountancy
CONGCOOP	NGO and Cooperative Coordination
CSF	Civil Society Fund
CSO	Civil Society Organisation
DAC	Development Assistance Committee
DFI	Development Finance Institution
DFID	Department for International Development
DGF	Democratic Governance Facility
DOTS	Development Outcome Tracking System
ECDPM	European Centre for Development Policy Management
EU	European Union
FARA	Fixed Amount Reimbursement Agreement
FINMAP	Financial Management and Accountability Programme
GBS	General Budget Support
GDP	Gross Domestic Product
GIZ	German International Cooperation
GNI	Gross National Income
HIPC	Heavily Indebted Poor Country
HIV	Human Immunodeficiency Virus
IFC	International Finance Corporation
IMF	International Monetary Fund
LA	Localising Aid
LenCD	Learning Network on Capacity Development
M&E	Monitoring and Evaluation
MDBS	Multi-donor Budget Support
MDG	Millennium Development Goal
MoH	Ministry of Health
MoHSW	Ministry of Health and Social Welfare
MoU	Memorandum of Understanding
MTEF	Medium-term Expenditure Framework
NAO	National Audit Office
NGO	Non-governmental Organisation
OAG	Office of the Auditor General
ODA	Official Development Assistance
ODI	Overseas Development Institute
OECD	Organisation for Economic Co-operation and Development
PAF	Performance Assessment Framework
PEFA	Public Expenditure and Financial Accountability
PEMFA	Public Expenditure Management and Financial Accountability
PEPFAR	President's Emergency Plan For AIDS Relief
PFM	Public Financial Management
PME	Planning, Monitoring and Evaluation
PRBS	Poverty Reduction Budget Support
PRSP	Poverty Reduction Strategy Paper
PUGS	Public Goods and Services
SBS	Sector Budget Support
SESAN	Secretariat for Agriculture and Nutrition
Sida	Swedish International Development Cooperation Agency
SMEs	Small and Medium-sized Enterprises
SOE	State-owned Enterprise
STAR-Ghana	Strengthening Transparency, Accountability and Responsiveness in Ghana
SWAp	Sector-wide Approach
TASO	The AIDS Support Organisation
UK	United Kingdom
UN	United Nations
UNDP	UN Development Programme
US	United States
USAID	US Agency for International Development
WAEMU	West African Economic and Monetary Union
WEF	World Economic Forum
WHO	World Health Organization

Executive summary

This report examines the proposition that by localising their aid – by which we mean transferring it to national rather than international entities – external donors can play a part in strengthening three sectors of society: the public sector (state); the private sector; and civil society. A previous paper (Glennie et al, 2012) set out the framework for our research, and a forthcoming series of shorter papers will discuss what our research findings may mean for donors facing complex constraints. This paper sets out our research findings and conclusions based on extensive literature analysis supported by three country studies: Guatemala, Liberia and Uganda.

A core element of the Paris Declaration on Aid Effectiveness, and subsequent fora, is that donors should progressively increase their use of host country systems. ODI's "Localising aid" work evolves this approach in four key ways.

First, we defined a new category of aid delivery: 'localised aid' is aid money that is transferred directly to, or through, national entities. This concept is very much in the same spirit as the "using country systems" popularised by the Paris Agenda, but has a number of advantages, including being easier to define and count.

Second, we set the scope of our research to cover three pillars, the three main sectors of society: state, private and civil society. This scope is in line with the spirit of Busan which sought to expand the vision of development practitioners beyond strengthening the state to include a concern for the private and civil society sectors as well.

Third, acknowledging that the Paris agenda has been criticised for focusing on stable low-income countries, we analysed three categories of country to determine the relevance of localising aid: stable low-income, middle-income, and fragile states.

Finally, we decided to focus on system-strengthening and sustainability rather than other possible development objectives, namely improving short-term results and reducing costs.

After a brief introduction, the report is structured around the findings of the three pillars of our research with a few final conclusions which span each of the pillars. Looking first at the state sector (section 2), our literature analysis and country studies suggest that localising aid is associated with improvements in state capacity. We identified two main reasons that localised aid packages were considered to actively help strengthen state systems. First, they incentivise increased technical and political engagement from donor agencies, civil society and domestic accountability bodies. Second, they can buy donors "a seat at the government's table", enabling them to apply pressure for specific systemic changes (among others) via policy dialogue and aid conditions.

The literature is mixed on the impact localising aid can have on state accountability. Our research suggests that, on the one hand pressure from donors that do localise their aid appears to have brought accountability actors, such as parliament and civil society, more into play. It has also encouraged state actors to be more open to vigilance. On the other hand, the deeper involvement in state processes implied by localising aid has led to accountability moving more towards donors than domestic stakeholders.

There are good grounds to believe that in most cases localising aid will mean more information about the activities of major external actors in the hands of the host government, enabling accountability. The crucial accountability link between aid providers and international citizens (i.e. those that fund aid with their taxes) is one that many donors fear will be weakened if aid is localised.

There are three reasons to be cautious about this evidence associating localised aid with state capacity strengthening. First, there is a causality problem to do with the lack of a counterfactual: we do not know whether the improvements in systems which occurred at the same time as aid was localised were caused by such localisation, or otherwise. Second, there are other well-evidenced means to build capacity and strengthen systems, and the evidence that using alternate aid modalities undermines the gains from localised aid is weak. And third, the evidence base is confined to quite a limited group of fairly aid dependent countries. As countries rely less on aid and more on domestic resources, the theory of change behind a decision to localise aid will necessarily alter.

We conclude that while localising aid is not the only way to strengthen state systems, it is a crucial tool in the toolbox. This means that donors who are unable and unwilling to localise aid will be at a significant disadvantage to those that are willing and able. We also conclude that the main reasons for localising aid hold in all country contexts. Empirical evidence from highly corrupt or fragile countries demonstrates that localising aid, managed appropriately, can have strengthening benefits. And localising aid does not mean relinquishing control of donor monies, as is sometimes assumed. There is a spectrum of options that can cater to the risk-aversion of the donor and the analysis of the country context.

We open our analysis of the non-state sectors with a brief introduction (section 3). We define "local" private sector and civil society actors as those which a) plan to do their business indefinitely in the country and b) are required to be registered under companies, charities, NGOs or taxation laws. Donors can localise their aid through a variety of contractual frameworks and can use a variety of means to encourage aid-recipient governments to also prioritise local organisations.

We suggest three categories of benefit from localising aid to the private and civil society sectors. Firstly, to support the national economy in general via Keynesian multiplier effects, greater local employment and reduced distortion of the labour market. Secondly, to support national (and possibly sub-national) governments, via increased government revenues and better public finance and contract management. Lastly, for the strengthening effects on non-state systems and entities themselves - the subject of our enquiry.

The lack of empirical evidence on how aid affects the productivity of local firms presented a methodological challenge for our research into the private sector pillar (section 4). This led us to rely on broader research on the economics of the firm, in addition to our usual evidence base. We start with the propositions that private sector institutional capacity determines how effective firms are in achieving their goals and that strengthening the private sector means strengthening the productivity of firms, and/or the efficiency with which they can deliver outputs. Part of this involves factors that lie within the firm itself (such as the quality of its leadership); part involves the incentives provided by the environment in which the firm operates; while another part depends on the efficiency of the rest of the economy which provides factors of production like capital, labour and materials, as well as the incentives provided by markets for the firm's output.

The mechanism by which localising aid can increase a firm's productivity operates through the market for public goods and services. Aid can both increase the size of this market and strengthen incentives that increase the productivity of suppliers of goods and services which the market demands. An increased share by localised firms would create opportunities for existing firms to grow and for new entrants. We hypothesised that a greater share of aid flowing to localised firms would increase both the size of the local private sector (in number of firms) and the productivity of the local private sector, *providing* that there are incentives for efficiency operating across the market for goods and services financed by localised aid. We found no statistical evidence for this hypothesis, but our fieldwork implied that it might hold.

Our review of the literature indicates that there are a number of key policies whereby government and partners can influence the way the market for public goods and services works: procurement policy; anti-corruption policy; preferences for locally owned firms; and "industrial" policies. We also identified aspects of aid that could be altered to promote the local private sector, including specification of technology requirements; size and complexity of bid packages; requirements for a supplier to qualify prior to submitting a valid bid; and efficiency of the payments system, which affects a contractor's working capital and cash flow.

We end with suggestions for how donors could strengthen the market for public goods and services and promote a stronger local private sector. These include making strengthening the capacity of the local private sector an explicit objective in foreign assistance, including in contracts; taking a whole-of-market approach to facilitating the development of the local private sector; a new approach to managing economic rents and anti-corruption; and better measurement of the impact of aid on the local private sector.

Drawing analogies from the Paris Agenda, individual civil society organisations carry out many of the same institutional operations as state bodies, and we theorise that localising aid to the civil society sector will result in positive strengthening impacts following a similar logic (section 5). As with the state sector, we define a stronger civil society first in terms of its capacity (core organisational functions for delivering development programmes) and second its accountability (responsiveness to, and representation of, their constituent's needs). First we identify the main problems faced by donors seeking to strengthen national civil society. Then we assess whether localising aid might help to resolve them.

With regard to sector wide issues, there are two main challenges. First, the tension between seeking to support local leadership of the development agenda whilst holding the purse strings, which we term “aligning with NGO priorities”. Second, there is the obvious but complex problem of deciding which organisations to support, which is often as much a political decision as a technical one.

As for strengthening individual organisations, there are four main challenges for donors. First, donor demands for quantifiable outcomes, often over very short periods, have increased the scrutiny and performance culture applied to development activities. They have been criticised for imposing models of evaluating change, and reducing attention on longer term development outcomes. Second, the way overheads are managed in a grant or contract can have significant impact on organisational strengthening. Too often donors are not adequately covering overheads in the support they provide to NGOs, which leaves these organisations struggling to strengthen their capacity. Third, short-term funding undermines organisations’ attempts to plan better and leads to constant funding challenges. And fourth, flexibility once the contract has been signed is critical. The dominant experience of NGOs is one of limited flexibilities offered by donors in terms of the timing and nature of project activities.

Our research does not provide conclusive findings on whether localising aid will help solve these problems, and emphasises the context-specificity of these spending decisions. In most donor agencies the administration costs for a small grant are not significantly smaller than for a large grant. This means the use of apex organisations to manage large contracts or grants is likely to persist, both to save money and to target support to local NGOs more effectively. Some agencies, most notably USAID, are seeking to use local apex contractors instead of international ones in a bid to strengthen local civil society. Such an approach may help strengthen the large organisations managing the contracts/grants, but it is not clear whether other organisations, or the sector as a whole, will necessarily benefit. In fact, international organisations may be better placed to strengthen local civil society in some contexts, even if costs are likely to be higher. Our analysis of multi-donor funds also offers mixed evidence, with the challenge of reaching less formal NGOs and following local priorities still very much apparent. We end this section with a discussion of the importance of core support as opposed to project support, which can be important in targeting specific constraints and beneficiary groups but may be less effective at strengthening organisational capacity and ownership.

We conclude that while localising aid is no magic bullet in any of the sectors, it must be considered as a critical element in any aid strategy aimed at strengthening systems. We set out four findings that reach across the pillars and are worthy of further research. First, there are likely to be trade-offs between emphasising short term results and longer-term system-strengthening approaches. While this may seem obvious, it goes against the frequent assumption that aid effectiveness policies are win-win. Second, most of the issues and problems we looked at are political as well as technical, and need to be addressed as such. The failure to contemplate the political barriers to progress may explain why some practitioners have been over-ambitious for the impacts of new aid modalities. Third, the complexity of decision-making on these issues emerged throughout the research, with a realisation that, for all the directives made at an international level, it is the “human factor” of well informed decision makers on the ground that is often crucial. And fourth, there was an across-the-board consensus in the literature and in our interviews that better information sharing, which includes the now-popular principle of transparency, is one of the most critical factors of progress and one on which much still needs to be done.

There are many questions left unanswered, but we hope this report will be helpful to policy makers and practitioners engaged in the challenge of channelling scarce resources to maximum effect. In forthcoming papers building on this work, we will further explore some of these challenges from the perspective of aid donors seeking to strengthen local actors and systems from within political and technical constraints. Some of these challenges are perennial and possibly intractable; others are shifting in this changing era of development.

1 Introduction

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'[...] if aid is truly effective, it will progressively put itself out of business. Effective aid should therefore be designed with this in mind – to strengthen, not displace, domestic energy and capacity; and to build up, not replace, alternative sources of development finance.'

Donald Kaberuka, President of the African Development Bank, at the Second Regional Meeting on Aid Effectiveness, 4 November 2010.

This paper is the second in a series of papers commissioned by the US Agency for International Development (USAID) to assess the impact of localising aid (i.e. ensuring it is transferred to national rather than international entities) on strengthening country systems. The first (Glennie et al., 2012: 'Localising aid: Can using local actors strengthen them', known henceforth as LA1) set out the framework for our research, and a series of further briefings will discuss what our research findings may mean for donors facing complex constraints. This second paper sets out our research findings and our tentative conclusions.

In this introductory section, we:

- Summarise our research assumptions and approach, as set out in LA1 and developed somewhat since;
- Discuss briefly what is meant by a 'systems approach' to development; and
- Describe our research methodology and the structure of the report.

1.1 Summary of research approach

The Overseas Development Institute's (ODI) Localising Aid research project borrows and expands a hypothesis common in current aid effectiveness processes. It is best-known as a key plank of the Paris/Accra/Busan Agenda on Aid Effectiveness: that using host country systems will help strengthen them for the long term and that, conversely, working around these systems can inhibit their development. In LA1, we defined localised aid as aid that is transferred directly to and/or through recipient country partners, whether they are from the state, the private sector or civil society.

A core element of the Paris Agenda and subsequent meetings has been that donors should progressively draw back from ways of working that avoid host country systems, and instead increasingly using these for their aid delivery. In LA1, we evolved this approach in a number of key ways.

1.1.1 A new category: localised aid

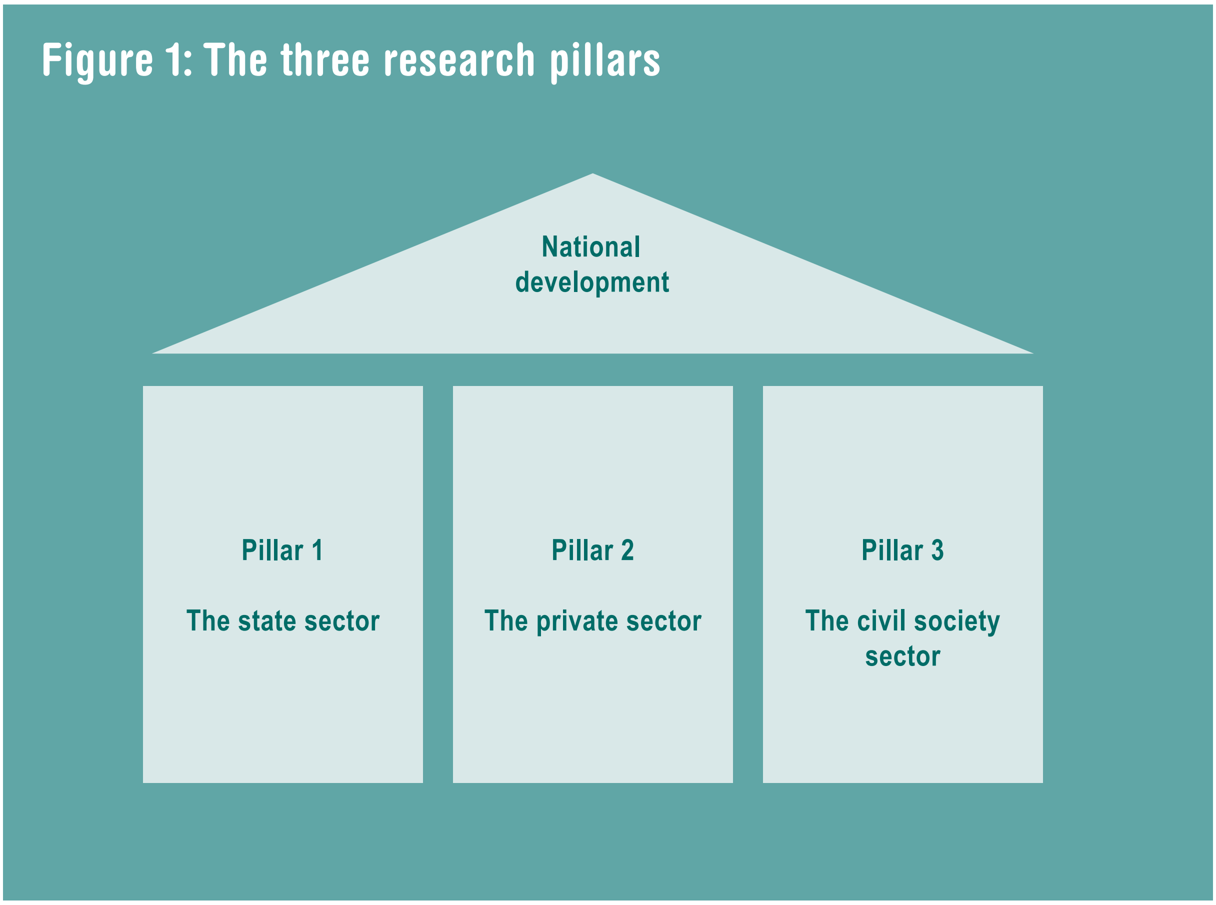
First, we defined a new category, localised aid, to mean aid money that is transferred directly to or through national entities. Localising aid is a concept very much in the same spirit as 'using country systems' as popularised by the Paris Agenda, but it has a number of differences. For example, it is easier to define and count. Whereas a number of judgements are necessary as to what counts as 'using country systems' (evidenced by the complex discussions that have taken place during the three rounds of Paris monitoring), it is easy to define aid as localised or not simply by checking the accounts of the entities that receive it.

While localised aid clearly uses the financial systems of recipient entities, it may not entail fuller use of other systems (such as those for planning, deciding expenditure priorities and evaluation) than some non-localised forms of aid. In the case of support to the state, donors may insist that their money finance particular items in the budget, or on external procedures to audit localised aid; for non-state actors, money may be transferred to local partners to achieve results set out by the donor, that is, it may not fully use the strategic planning functions of the local partners. Our broader research finding –that modalities are only one aspect of more effective aid, and that their importance should not be exaggerated – supports this clarification.

1.1.2 A whole-of-society approach

Second, as noted above, we set the scope of our research to cover three pillars: the state, the private sector and civil society (Figure 1). The 'localised aid' category is more appropriate when looking across these societal sectors than 'using country systems', which is a term more appropriate to the state sector and possibly civil society.

Given the already complex subject matter, our conscious decision to broaden the scope of the work to cover non-state sectors may seem rather ambitious. However, and perhaps ironically, doing



this was one of the ways we sought to bring some clarity to a debate increasingly dominated by jargon and assertion, and desperately in need of some plain speaking. It was also in line with the spirit of Busan, which sought to expand the vision of development practitioners beyond strengthening the state to cover a concern for the vibrancy of the private and civil society sectors as well. This holds for the other strong emphasis in this research, namely, to ground it in an understanding of recipient country specificity (increasingly normal in aid effectiveness debates) and in external partner specificity (which is somewhat more original).

1.1.3 A focus on country context

Third, we acknowledged a further critique of Paris – that it prioritised the needs of its 'main client base'[1] of stable low-income countries, somewhat to the exclusion of a strong analysis of the different needs of different country types. We determined to analyse three categories of country – stable low-income countries, middle-income countries and fragile states – to see how relevant localising aid was to their various needs.

In a new take on the idea of country context, LA1 called for more recognition that the strengths, weaknesses and appetite for risk of different donors should be factors in modality choice. That is, it is necessary to assess not only whether approaches should be different in different recipient contexts (country types), but also whether different donor advantages and disadvantages should be taken into account when assessing how donors should work together to support change. As part of the final stage of the work we will assess whether attitudes to risk and political/institutional barriers in donor agencies hamper the appropriate aid strategies, and what can be done to mitigate this.

1.1.4 A focus on strengthening and sustainability

Fourth, and finally, we decided that, although 'using country systems' had three main categories of objectives, we would focus on only one of them, given the interests of the funders and the research team, and the limited resources available. LA1 (pp.6-10) set out what we called three main groups of motivating factors behind the Paris principles, which we adopted for our own work.

1 Results: a concern that poverty reduction results were limited and slow.

2 Sustainability: increasing recognition of the importance of strengthening local actors and procedures for the sustainability of development results.

3 Reduced costs: Increasing development value per aid dollar by reducing high administrative burdens.

We focused our attention on the second – strengthening systems and entities for the long term. We asserted that the evidence linking choice of aid modality to strengthening systems had still not been well articulated, a finding that our further research has validated somewhat. Categorising motivations in this way has proved useful, and our research has supported our initial hypothesis – that there are frequently tensions between them, as opposed to their coming together as a virtuous circle as Paris implies.

When we began this research project, we were aware that we were entering one of the most complex areas of international development theory and practice. The importance of strengthening country systems, and of using them in order to do so, has become part of today's conventional wisdom. More and more practitioners and theorists would agree with the Learning Network on Capacity Development's (LenCD) simple assertion that 'capacity *is* development'.[2] And yet, at the same time, there is widespread recognition that attempts to strengthen institutional and systemic capacity to date have been fraught with problems, somewhat in contrast with the broadly good news of the past decade in terms of economic growth and social development.

1.2 A systems approach to development

If there is one truism in current development thinking, it is that institutions matter. This has not always been the case. There have been periods in the past 60 years or so in which institutional development has been considered at best secondary to achieving prompt results via the effective delivery of goods and services by whatever means necessary and, more importantly still for some analysts, to getting the policies right. This tended to mean (at least in the 1980s and 1990s) a focus on liberalisation and preventing the state from influencing prices.[3] Neglect of institutions is now considered one of the most damaging aspects of the neoliberal tide (whose one major and not inconsiderable achievement was macroeconomic stability). According to the influential scholars Acemoglu, Johnson and Robinson differences in institutions explain more than 50% of income variation across countries. They suggest that 'improving Nigeria's institutions to the level of Chile could, in the long run, lead to as much as a sevenfold increase in Nigeria's income' (Acemoglu et al., 2001).

So the new consensus on institutions is not to be taken for granted, and represents something of a step forward in development policy. Seen positively, it could be taken as an implicit recognition of the great progress that has been made on service delivery and social development, leading to the need for a deepening of efforts on systems to sustain progress as countries seek an end to aid dependence. A negative spin would say that attempts to build institutions to date have been fairly unsuccessful, especially when compared with progress in other areas of development. The Millennium Development Goal (MDG) culture since the turn of the century may not have helped matters, focusing minds as it has on verifiable deliverables above the depressingly complex world of systemic, institutional and political change – a tension that emerges throughout this report.

Beyond the simple assertion that institutions are important, however, there is little clarity or agreement. *How* important are they? What *kinds* of institution are necessary? Do they need to be in place for development to occur, or are they a consequence or corollary of development? How do endogenous processes of institutional change interact with external influences from the country's partners? How do political factors influence institutional change, particularly in neo-patrimonial polities that differ from the democratic governance of partners? What trade-offs may there be in terms of short- and long-term

1. Phrase used by an Organisation for Economic Co-operation and Development (OECD) interviewee.

2 See www.lencd.org

3 Natsios (2010) sets out three objectives of USAID that could be true of all aid: delivering goods and services (results), institutions and policy change.

Box 1: An issue of principle?

During our research, a fourth category emerged to add to this list of motivations to use country systems and localise aid, namely, the issue of principle. While external partners often emphasise the first three sets of objectives, the issue of principle is one that emerged from discussions with aid-recipient country interviewees. Development should be ethical as well as effective, respecting basic norms of sovereignty and horizontality (a word increasingly common with the rise of South–South cooperation). The decision not to use country systems may be taken as an affront to the country concerned; seeing localising aid as a matter of principle as well as assessing the issue as a functional consideration might lead to yet further pressure on external partners at least to give a full explanation if a decision is made *not* to do so.

beneficiaries of political decisions? And, crucially, how can external agents help strengthen institutions and avoid undermining them?

At a recent conference in Bellagio, the following definition of health system strengthening was developed: 'a complex, iterative, and learning process wherein the interactions between actors, structures, services, and subsystems are optimized over time while striving for health systems goals' (in Best and Saul, 2012). This definition, intended for the health sector, could be used for other sectors as well. We have carried out our research based on the assumption that systems and entities matter for development, that they need to grow progressively more capable and accountable if long-term development is to occur and be sustained. And that the decisions of aid donors working in a country have some importance in this regard, for good or for ill.

Systems strengthening is an activity that improves one or more of the core functions of a given system (adapted from the World Health Organization (WHO) in Best and Saul, 2012). There are many analyses of how donors might be able to engage in such activities. Localising aid is one approach that may have benefits for strengthening systems – this report sets out to examine that possibility.

1.3 Methodology and structure

This report is built primarily on extensive literature reviews for each of the three pillars. Various forms of localised aid have been common in the history of international development, particularly to the state and civil society sectors, but we have focused our attention on experiences since the turn of the century. This is in recognition that a substantially new era of development aid started towards the end of the 1990s, after a post-Cold War hiatus.

The literature available for each pillar was quite different. For the state pillar, the subjects of budget support and using country systems have been extensively analysed in the last decade or so, asking similar questions to ours. Our research, therefore, involved reviewing the most important evaluations and rethinking intervention logics and the relative merits of different approaches. For the private sector pillar, in contrast, few if any researchers have looked at the issue from a localising aid perspective, so our job was to draw together analyses that were often only indirectly relevant to our inquiry, and build hypotheses without necessarily being able to substantiate them – the evidence is not there yet. The third pillar, civil society, had elements of both these approaches. While we found significant academic analysis on which to base our work, our line of inquiry was also quite original.

Building on our literature review, we carried out some analyses of relevant policy and practice of key donors. In order to complement the global analysis, we studied three countries in more detail, via country visits based around interviews with government representatives and individuals within the private sector and civil society. These countries spanned the following country types:

- Liberia (fragile);
- Uganda (stable low income); and
- Guatemala (middle income).

We have also included a broad range of country examples throughout the paper.

In an effort to narrow down our ambitious research scope, we focused our work (somewhat, but not exclusively) on particular **economic sectors.** The two main economic sectors we analyse are health and agriculture, with a sub-focus on infrastructure/construction where appropriate.

The report is structured around the three pillars of our research: whether localising aid helps strengthen state capacity and accountability (Section 2), the private sector (Section 4) and civil society (Section 5). At the end of each section there is a brief conclusion of our findings. Because of some important similarities between the private sector and civil society, Section 3 presents an additional introduction to the non-state sectors. The final section brings the conclusions of these pillars together along with some points relevant to all three pillars and suggestions for future inquiries.

We set ourselves no simple task with this research. In seeking to tackle the question of how aid can strengthen national systems and institutions, we have combined some of the most complicated areas of development policy and theory. Additionally, the contexts in which donors are using localised aid, the nature and variety of the systems it is engaged with and the ways it can interact with these factors to strengthen systems are very complex. Looking beneath this tapestry of characteristics and interactions to understand the contribution localised aid has made is extremely difficult. But we have tried to present complex evidence and theory in such a way that it might prove useful to programme managers and other development practitioners, who are the people left having to piece together difficult decisions. In the absence of rules and concrete answers, this paper seeks to contribute to a thoughtful and evidence-based debate and analysis on which wise decisions may be built.

2 Strengthening state capacity and accountability

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2.1 Introduction

Strengthening is a complex term in a development context because it is hard to define, let alone measure. In our research, we are interested in the state's ability to ensure the delivery of public goods without the support of external actors and for the long-term. This means looking not only at the capacity of the state sector but also its accountability to relevant stakeholders: a capable but unaccountable state will not necessarily deliver public goods effectively in the long term, and vice versa. We therefore enhance our definition of strengthening the state as follows (See LA1, page 7):

- Increasing the capacity of the state to carry out its duties; and
- Increasing the accountability of the state to relevant domestic stakeholders.

'Systems' is also a somewhat confusing term. The OECD (2005) gives the conventional understanding, 'Country systems and procedures typically include, but are not restricted to, national arrangements and procedures for public financial management (PFM), accounting, auditing, procurement, results frameworks and monitoring'. It gives the following examples of country systems, 'public financial management [PFM], procurement, fiduciary safeguards and environmental assessments'.

In aid effectiveness fora, 'systems' is sometimes meant in a quite narrow sense to mean financial and procurement systems, the items the Paris Monitoring Survey specifically refers to (Indicators 2 and 5). During the course of this research, partly by design, we have been impressed by the number of systems that this narrow terminology does not contemplate. Attempts to strengthen PFM and procurement systems are welcome, but should not necessarily be considered more important than those to strengthen planning, audit, human resources, transportation, communication and other systems. We adopt a broad definition of systems encompassing the full range of government and state processes and entities. We also tend to use the term 'entities', not just 'systems', which is strictly tautologous, as entities are part of systems, but helps emphasise that strengthening the organisations and institutions that make up systems can be as important as strengthening the processes that these entities engage with.

We divide state systems and entities into three groups, as implied in LA1:

- Planning, decision making, monitoring and evaluation;
- Financial management; and
- Implementation of projects and service delivery.

The planning, monitoring and evaluation (PME) circle, including internal auditing, is an area well covered in most aid effectiveness analysis, as is the issue of financial management. Less well discussed in aid effectiveness arenas are the systems and entities required to actually implement projects and deliver services, our third group of systems.

2.1.1 What is localising aid to the state sector?

We describe aid as localised to the state sector when it is transferred directly to host country government bank accounts (whether a single central account, or ministry or other accounts). There is a spectrum of options for the localisation of aid, all with a different degree of relinquished control (see Figure 2), with general budget support at one end and payments for goods and services on receipt of proof of purchase at the other (see Section 2.5.2 for more on the issue of fiduciary risk and examples from Guatemala).

Efforts to define anything in this field are both helped and complicated by the pre-existence of well-worn terminology defining three linked but separate concepts, namely, budget support, 'aid to the government sector' [1] and aid that 'uses country systems'. Budget support is 'a transfer of resources from a donor to the partner government's national treasury […] managed in accordance with the recipient's budgetary procedures [without] earmarking the resources for specific uses' (OECD, 2006). *Sector* budget support (SBS) means the 'dialogue between donors and partner governments focuses on sector-specific concerns rather than on overall policy and budget priorities' (ibid.), which would be the case for *general* budget support (GBS).

'Aid to the government sector', on the other hand, is a much broader classification, invented by the Organisation for Economic Co-operation and

1. Also known as 'aid managed by the public sector' in some OECD documents

Development (OECD) for statistical reasons for the Paris Declaration Monitoring Surveys, that is, to provide a denominator for the indicator regarding the proportion of aid using country systems. It is defined as aid:

> '[…] disbursed in the context of an agreement with administrations (ministries, departments, agencies or municipalities) authorised to receive revenue or undertake expenditures on behalf of central government. This includes works, goods or services delegated or subcontracted by these administrations to other entities such as Non-Governmental Organisations (NGOs); semi-autonomous government agencies (e.g. parastatals), or; private companies' (ibid.).

This definition has many grey areas, and the OECD has fielded questions from interested parties regarding how to define it ever since the term was developed. In particular, it could be interpreted to encompass any aid that is for public purposes to which some government entity in the host country has agreed, whether or not the aid finances expenditure decisions that have been made in accordance with country laws governing public expenditure. Such aid could potentially include direct flows to non-government agents that have no contractual relationship with the host government.

In its purest form, full 'use of country systems' means not introducing any external systems for the management of foreign aid. In other words, from planning to budgeting, spending and monitoring, aid goes through national processes with no external interference. There are many parts to the state system, and Mokoro (2008) sets out a diagram to demonstrate this (Figure 3).

Despite being titled 'PFM systems', this is a fairly comprehensive analysis of country systems, although there are some processes it fails to include, such as environmental assessments. Localising aid to the state sector would correspond most closely to what Mokoro means by putting aid 'on treasury'.

Figure 4 shows the relationship between localised aid to the state sector and the other categories of aid we have looked at in this section. Localised aid and aid that 'uses country systems' are both subsets of 'aid to the government sector'. It is possible to engage with a number of country systems without localising aid. For example, donors that decide actually to spend their money via specific projects can engage in planning processes, as well as monitoring processes and even procurement processes. And, conversely, it is possible to localise aid without in fact using many other important aspects of the state system. Some aid both is localised and uses country systems fairly fully; budget support is the best-known but not the only example – aid can both be localised and substantially use country systems but be linked to specific project outcomes and/or expenditures, and therefore not qualify as budget support.

It is worth noting that localised aid and budget support are two categories that are very easy to measure using accounts information; the other two concepts are complicated as they rely on some level of interpretation. This makes localising aid an attractive category for those interested in tracking different types of aid spending.

2.2 Localising aid is associated with improvements in state capacity

According to a recent OECD formulation, 'Decades of development experience show that when donors consistently bypass country systems the sustainability of their efforts are undermined, as is the recipient country's ability to manage their own future. The benefits of disbursing aid through country systems include: building capacity to manage development resources and creating more sustainable development programmes.' [2]

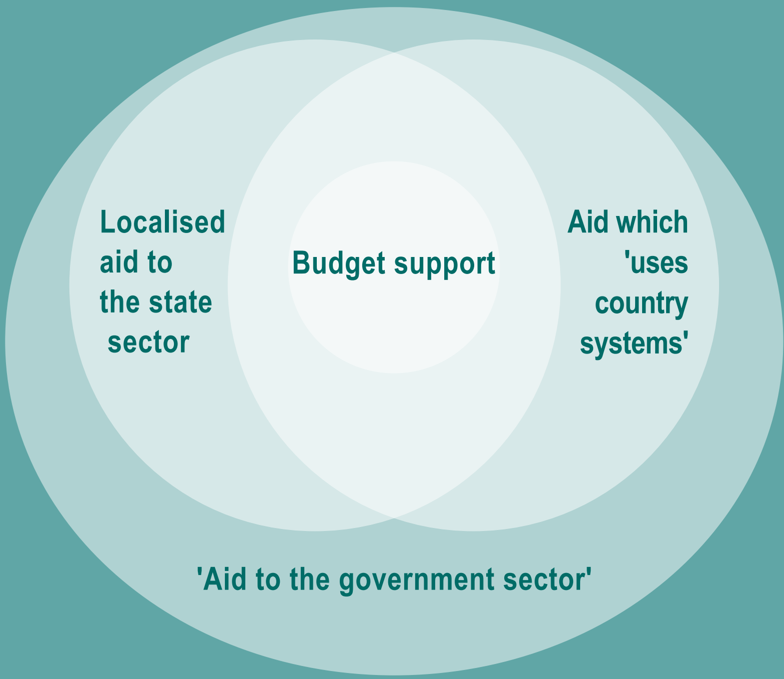
As this quote implies, much of the push towards 'using country systems' came from a common experience and analysis that project-based approaches have undermined efforts to support state capacity (Tavakoli and Smith, 2013). The evidential basis for the move towards using country systems relied heavily on negative experiences of a project approach rather than positive experiences of a programme approach. There is an extensive body of literature demonstrating the harmful consequences of fragmented project aid for state capacity, particularly because of heavy transaction costs (Alexander, 2007; Eurodad, 2007; Manning, 2004; Roodman, 2006; World Bank, 2007). Between 2004 and 2008, aid fragmentation in 80 countries led to an increase

2. www.oecd.org/dac/effectiveness/countrysystems.htm

Figure 2: Simplified diagram of options for localising aid to the state along a spectrum of recipient control

Figure 3: Using partner country PFM systems at different stages of the budget cycle

Figure 4: Defining localised aid to the state sector



Box 2: Loans and grants

One important element sometimes overlooked in the aid effectiveness debate is that all loans are localised, although they do not all use country systems fully. A number of aid-recipient countries (including Guatemala) divide aid into reimbursable (i.e. loans) and non-reimbursable (i.e. grants). While this research is ostensibly about the value of localising 'aid', in reality it is about whether grants should be localised or not. However, a useful aspect of our research has entailed talking with lending institutions to assess their experience of the importance of localising aid for strengthening government systems and entities.

of 'non-significant' partnerships, according to the OECD.[3]

The fact that much of this research has been in the public domain for some time does not diminish its continuing importance in aid modality decisions. Knack and Rahman (2007) claim that, 'In their need to show results, donors maximize performance of their own projects and shirk on the provision of the public sector human and organizational infrastructure essential for the country's overall long-term development'. Meanwhile, according to Dollar and Pritchett (1998), 'At times, donors have hindered the creation of effective public sectors because they saw end runs around local institutions as the easiest way to achieve project success'. Ghani and Lockhart (2008), reflecting on their experience in the Afghanistan Ministry of Finance, were highly critical of project aid, particularly when it bypassed national systems. In a more recent

3. OECD (2009) defines a partnership as 'concentrated and significant' (narrow definition) if a partner either provides more than its global share to a country, and is among the donors providing 90% of development assistance. Under a broader definition, a donor is 'significant' if it is among the donors providing 90% of development assistance, or is providing more than its global share.

review, Pontora et al. (2012) agree that, 'Bypassing the government by utilizing alternative delivery mechanisms does not strengthen state capacity, but rather shifts it, and may actually damage what little pre-existing capacity there is.'

In contrast, following an extensive literature analysis, we are aware of no research in the public domain criticising localised aid modalities in the same way. That is not to say, by any means, that localised aid packages (of which the most analysed is budget support) are considered to have solved the problems of project aid. Indeed, basket funds and SBS programmes are often treated like large projects, for example, with donors using different earmarks and traceability requirements as well as requiring their own procedures to be followed, all of which can have similar effects as the project aid that has been so criticised (Williamson and Dom, 2010).

However, given the complexities and risks involved, donors rightly require more evidence of the *positive good* localising aid can do to strengthen state systems.

No-one expects localising aid to strengthen systems automatically, but rather to serve as part of a package of measures that varies from country to country. As a result, disentangling the specific contribution of localising aid (either on its own or in supporting other measures to have an impact) is extremely difficult. Figure 5 shows the intervention logic for GBS to Zambia, and demonstrates the variety of engagements associated with localising aid (in this case via budget support) intended to streamline donor activities and enhance knowledge and oversight of government systems. At the top is the simple impact of budget support funding on government resources, an issue so obvious it is sometimes overlooked. We take it as self-evident that putting more money in government ministries and secretariats is likely to strengthen their ability in the short term to carry out activities; however, this does not equate to strengthening in the longer term.

Our research finds that packages including the localisation of aid are not only considered by most literature and expert interviewees to be (generally) less harmful than project approaches, but also fairly well associated with actual systems strengthening.[4] Evaluations of the impacts of budget support on PFM systems in particular have been broadly positive (World Bank (2010), Caputo et al (2011), IDD and Associates (2006)). Williamson's (World Bank, 2006) evaluation found that budget support funds in Tanzania and Uganda, when combined with other inputs, 'have proved effective in supporting recipient governments' efforts to strengthen PFM systems and improve PFM outcomes'. A joint evaluation carried out by the National Audit Office (NAO, 2008) found that budget support strengthened PFM systems with strong or moderate positive effects on four of the six countries where the UK Department for International Development (DFID) had provided it for several years, and a weak positive effect in the remaining two countries.[5]

The survey found that DFID country offices providing budget support to partner countries were more likely to perceive improvements in PFM systems and good governance than those in countries not providing budget support.

These findings are backed up across the board.

Among the plethora of intervention logics in the literature for why and how localising aid might strengthen systems (some possibly conceived *ex-post*), we have found two particularly salient ones behind this broadly positive story.[6]

First, localising aid has incentivised increased oversight and technical and political engagement from donor agencies, civil society (national and international), national accountability entities and the executive branch of government. This effect has also helped increase donor knowledge of government systems, which can lead to better capacity-building interventions and joint planning initiatives that emerge from the greater attention paid to systems.

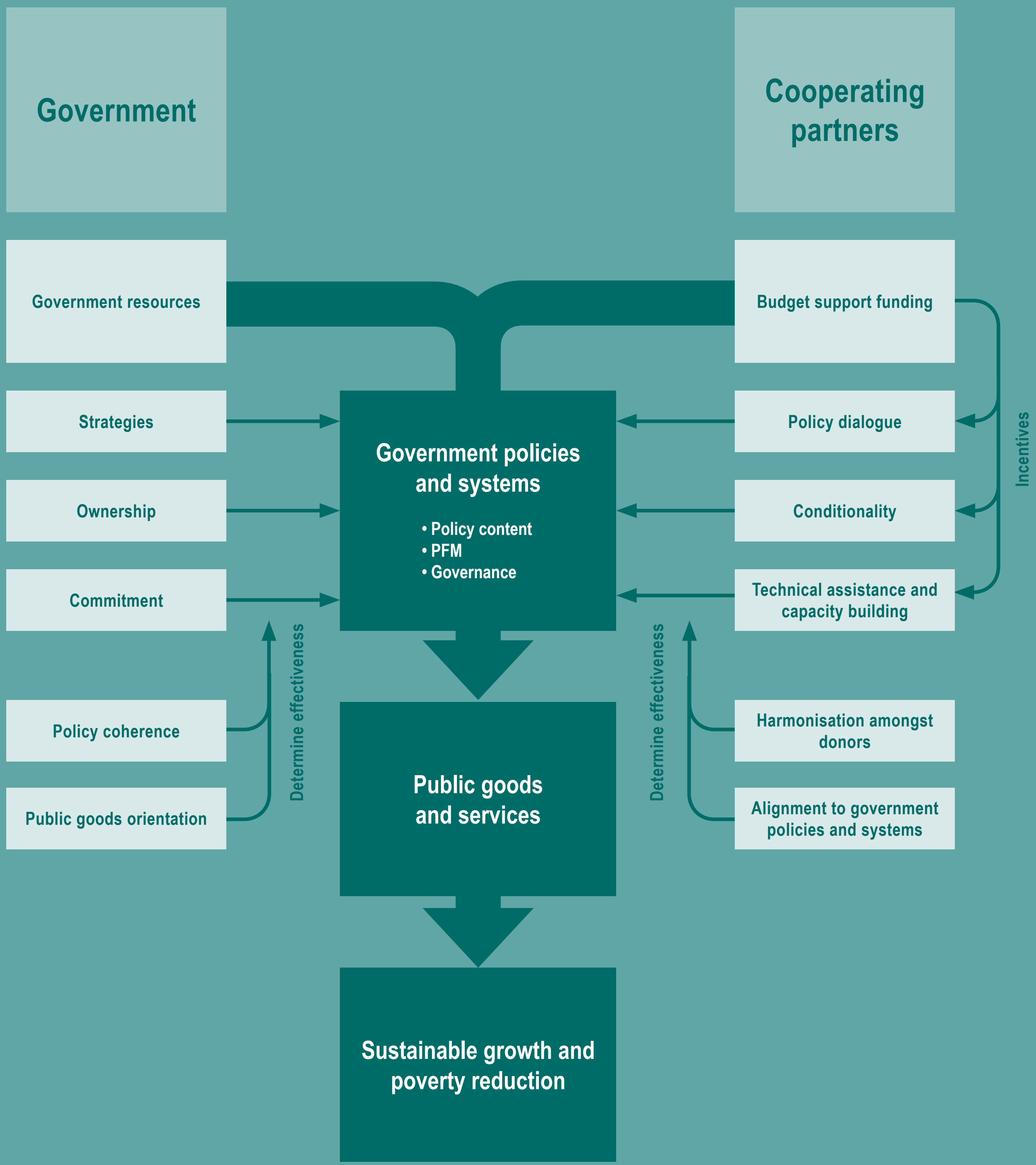
Second, localising aid has bought donors 'a seat at the table' from which to pressure for systemic change. This pressure has sometimes included applying system-strengthening conditions ('conditionalities') to their aid, but less prescriptive forms of policy dialogue have been more effective at pressuring governments to improve systems and have fewer negative effects.

4 In the discussion that follows, we highlight only a sample (inevitably) of a much wider literature.

5 In these instances, the aim of budget support was to increase the capacity of receiving countries by strengthening key partner government PFM systems, including devising medium-term spending plans and budgets, setting up management systems to include spending plans and budgets, safeguarding funds against corruption and ensuring independent oversight by audit institutions.

6 They are similar, though not identical, to the hypotheses for budget support and using country systems.

Figure 5: Intervention logic for GBS to Zambia



2.2.1 Shifting incentives

The first key aspect explaining the generally positive picture in the literature, referring back to Figure 5 (above), appears to be the *increased incentives* of key actors (including donors, governments and accountability organisations) to concern themselves with the effectiveness of important state systems when aid is localised. Such concern by no means translates directly into improvements in capacity, but it makes it more likely that some strengthening will occur.

For instance, we assume that engaging with government in planning, monitoring and reporting is an important part of sensible development interventions – the opposite is failing to do so, and we are aware of no literature or policy papers that extol the benefits of not engaging with these functions. However, there are significant costs in terms of time and human resource involved in coordination and planning together. Incentives on donor agencies and their staff are usually heavily skewed towards demonstrating the difference their own particular interventions have made, so unless there are better incentives for money managers to engage with a particular process, they are less likely to do so. When aid is localised to the state sector, donors take more interest in state systems (be they PME, PFM or implementation systems), as their money depends more directly on these functioning well. This leads to closer engagement and inspection on the one hand, and more and/or more successful capacity-building initiatives on the other. Even those development professionals keen to support systems strengthening are likely to have their attention diverted in the case of, for example, a sudden humanitarian crisis – but such diversion is not an option when donor money is actually at stake, rather than just their goodwill and their knowledge of development theory.

According to one interviewee, 'budget support is about disciplining donors – there are so many incentives for them to work in unhelpful ways and budget support forces them to engage with governments'. As more donor money flows through government coffers, leading to more donor interest, so in turn the executive and bureaucratic branches of the state focus more on these systems, as do the accountability entities of a country, be they official or civil society organisations.

Just as joint funds discipline donors to coordinate activities, so localising aid can force them to show more interest in improving weak government systems. Donors working in a projectised way, on the other hand, will be more focused on achieving a narrow set of project objectives. One donor interviewed in Uganda noted the narrow focus of discussions in agriculture sector working group meetings on achieving the objectives of specific projects rather than addressing the challenges in the sector as a whole; the agriculture sector in Uganda is dominated by project modalities. Another donor staff member, from an agency providing budget support to the health sector, highlighted how he was judged on the basis of the sector's performance, whereas project donors are judged primarily on how well their project addressing a narrow range of health interventions is implemented.

The literature backs this finding. A team studying seven countries (Burkina Faso, Malawi, Mozambique, Nicaragua, Rwanda, Uganda and Vietnam) using a methodology based on the OECD Development Assistance Committee (DAC) criteria of relevance, efficiency, effectiveness, impact and sustainability, and a logical framework approach, found that a GBS package comprising financial input, conditionality, dialogue and technical assistance had helped strengthen the budget process. This was partly because of maintained donor attention which had, among other things, enabled sector ministries to engage directly with negotiations (IDD and associates, 2006). In Burkina Faso, 'the incentives for careful planning and monitoring of PFM reform created by the Budget Support arrangements introduced in 2003 have also been important, as have the ideas and incentives provided by the WAEMU [West African Economic and Monetary Union] Commission' (NAO, 2008).

On the other hand, in South Sudan, the world's newest country, the government has been known to struggle to persuade donor colleagues to come to key government policy and planning meetings, according to one interviewee. Some in the government sees such engagement not as intrusion but as a crucial part of knowledge sharing, and believe that because donors are not putting their money into the system, they are not prioritising these meetings.

In Afghanistan, by contrast, the World Bank was required by its operational rules to pass its money and the multi-donor trust fund through the government budget. This required it to finance contractors to provide temporary fiduciary services while permanent PFM systems were put in place, supported by a World Bank-financed and -monitored grant. Localising aid can, then, have a notable 'knock-on effect' on general financial management, not just aid management.

2.2.2 Pressure and dialogue

One of the major reasons donors give for localising aid is that it 'buys a seat at the government's table'. Having money running through the state coffers means an enhanced oversight role not only on PFM matters but also generally on overall policy matters (Tavakoli and Hedger, 2012). Such a position of influence can be used to pressure for systems strengthening. This is the second intervention logic for localising aid that our research broadly endorses, and is particularly true of budget support, in which general outcomes are measured, meaning donors need to be able to monitor general rather than project-specific progress. It is ironic that, while budget support was originally conceived as a more hands-off means of allowing host governments to receive aid without too much donor interference, it is now sometimes criticised for being even more intrusive, precisely because it gives donors access to more aspects of government processes than previously (this aspect is discussed in the next section on accountability).

There is no doubt that many donors have 'bought a seat at the table' using budget support in a diverse set of countries. In Zambia, for example, donors have achieved leverage over some aspects of governance in danger of deterioration and budget support is having a mildly positive effect on policy processes and overall governance quality, despite a difficult political environment with weak democratic systems (Kemp et al, 2011). In Afghanistan, donors contributing to the *Afghanistan* Reconstruction Trust Fund (ARTF) meet with government on a quarterly basis to discuss policy issues, particularly the Policy Action Matrix, which covered PFM and some sector issues. Lawson et al. (2011) find that, in Mali, 'GBS and SBS have contributed significantly to the establishment of structures for policy dialogue, through the introduction of a harmonised annual review calendar and through the provision of technical assistance support.' These structures have facilitated the implementation and monitoring of national development programmes and 'policies to strengthen public finance management, decentralisation and public sector reform' (ibid.).

The Joint Assessment Framework used by donors that provide budget support to the Ugandan government has four sections consisting of targets and actions. The first three seek to promote government systems strengthening (the fourth relates to donor actions): preconditions for effective and efficient implementation of government policies; reforms aimed at improving value for money in service delivery through removal of barriers in PFM and public service management systems; and sectoral reforms in key service delivery sectors (health, education, transport and water and sanitation).

Conditionality

One particular form of pressure sometimes applied by donors is to attach conditions to their aid. Some analyses (e.g. Glennie, 2008) argue that consistently applied conditionalities have had an effect on policies implemented by aid-dependent countries, as part of broader international pressure, and with a somewhat negative effect on democratic accountability. However, the conventional wisdom strongly calls into question the notion that aid conditions succeed in making governments enact lasting reforms they otherwise would have avoided (Burnside and Dollar, 2000).

In the particular field of system and entity strengthening, while recognising that conditions have sometimes had an impact, the majority of the literature remains wary of them. Since 2000, the most common theories of change of GBS have rested on a rejection of *ex-ante* conditionality, although according to Lawson (2012) donors tend to backslide in practice. According to Williamson and Dom (2010), conditions laid down by donors engaged in SBS have helped ensure key policy and planning documents are in place and sector reviews are held regularly. However, they also find that conditionality frameworks are usually inconsistent and sometimes contradictory.

Lawson's comprehensive study of PFM reform (2012) finds that while general pressure to develop comprehensive PFM reform plans and establish clearly defined monitoring frameworks often appears to have worked in countries receiving budget support, attempts to influence the pace or types of PFM reforms from the outset through budget support conditions have been ineffective and at times counterproductive. In Zambia, progress on the Public Expenditure Management and Financial Accountability (PEMFA) programme was one of the underlying principles of the budget support Memorandum of Understanding (MoU), and PFM indicators were included in the annual performance review to incentivise the government to meet its

Box 3: Oversight and state–society relations in Uganda

In the latest corruption scandal to hit Uganda, it was the Office of the Auditor General (OAG) that detected the misuse of earmarked funds for northern Uganda and not external donor fiduciary safeguard measures. Donors – particularly traditional budget support donors – have invested in strengthening key oversight institutions like the OAG, parliament committees and CSOs as part of their programme of localising aid, the Financial Management and Accountability Programme (FINMAP). For instance, working closely with parliament, budget support donors pressured for an Audit Act that required the OAG to report directly to parliament instead of the finance ministry.

While the OAG is widely acknowledged for its effectiveness, concerns remain about the capacity of, and political support for, institutions downstream. These also need to work well if concerns raised in OAG reports (e.g. on the misuse of funds) are to be acted upon. FINMAP has also helped in improving the effectiveness of parliament committees via capacity building to help remove a backlog of audit reports – parliamentary committees are now evaluating current reports. While non-budget support donors, such as the UN Development Programme (UNDP), are involved in this work, only budget support donors are engaged in all the key oversight institutions. CSOs have a long track record in service delivery in Uganda, and in recent years a Democratic Governance Facility (DGF) has supported initiatives to help them make the government more responsive and accountable to citizens. Evidence suggests that parliament and CSOs are partnering together to improve oversight.

Box 4: Likely impact of localising aid on five key accountability relationships – summary

1 Host government to citizens: somewhat strengthened

- Governments have a greater role in service delivery, prompting greater oversight.
- Donors encourage accountability entities.
- Progress in PFM may be broader than aid accountability and lead to improvements across government.
- Governments are more able to respond to the needs of citizens articulated through the local political system.

2 Host government to provider: somewhat strengthened

- Government provides fuller accounts for monies spent.

3 Provider to own citizens: possibly weakened

- Provider is somewhat less able to link specific results to own spending as financing streams are merged with those of other donors.
- Provider is less able to guarantee non-corrupt or politicised use of all funds if financial controls are weaker.
- Provider is less able to implement the development agenda favoured by its citizens.

4 Provider to host government: somewhat strengthened

- More information is provided to host government, allowing it to plan more effectively and possibly carry out evaluations of external interventions.

5 Provider to host country citizens: no significant change

- Possibly more information in the public domain, allowing citizens to hold providers more effectively to account.

commitments. However, Kemp et al (2011) conclude that, 'the general financial incentive of PRBS [poverty reduction budget support], in tandem with the policy dialogue on the underlying principles and the PAF [Performance Assessment Framework] indicators, were the main catalyst for PFM improvements, *rather than the PEMFA framework's concomitant capacity building or PFM-specific conditionality attached to the PAF*' (emphasis added).

In Ghana, the decision to create the Ministry of Public Sector Reform to monitor promoted actions was a trigger condition for disbursement of funds. However, according to Lawson et al. (2007), the single most important thing in improving multi-donor budget support (MDBS) now is *to move away from conditionality*; they found no evidence that aid conditionalities make reforms more likely and plenty of evidence that they undermine the quality of dialogue – the PAF brought about a confrontational environment between donors and the government. Lawson et al's (2011) analysis of budget support in Mali finds that that 'budget support – sectoral or general – is effective when its primary objective is to finance and monitor the implementation of a given policy. It is much less effective when its primary objective is to change a given policy or to adapt its contents, through the means of conditionality.'

In conclusion, while donors have used localised aid to increase pressure on governments to engage in systemic improvements, with some success, there is little evidence to overturn the traditional critique that conditionality doesn't work and that it probably has a harmful effect on the balance of accountabilities, to which we now turn.

2.3 Mixed evidence on accountability

While the literature is fairly clear on the positive impact of localising aid modalities on state capacities, it is more mixed with regard to the impact on accountability and our interviews confirm this mixed picture. A 2012 OECD study strongly supports the notion of a systems approach to accountability, finding that accountability works as a 'system around several sectoral and organizational processes (budget processes, decentralization, provision of health and education services, etc.)' and that 'donor support may be more strategic if it is designed for systemic approaches'. In general, however, the OECD's studies of four countries implied that donors had tended to support single actors at the risk of 'unbalancing the system as a whole' instead of building links and supporting coalitions of change (OECD, 2012).

Figure 6 describes the range of accountabilities relevant to an aid relationship, with an arrow indicating the direction of accountability. Host governments are accountable both to their citizens (1) and to aid providers (2); whereas aid providers are accountable to their citizens (3), the host government (4) and the citizens of the host country (5), who may have different interests to those of the government. Citizens are generally represented in practice by elected bodies, independent auditing bodies or civil society organisations (CSOs), or through traditional institutions such as tribes or religious organisations in neo-patrimonial polities.

Lack of accountability of state entities to their citizens is a recognised problem in political science, including in the literature on development. One of the major challenges for external development actors is how to increase, or at least not weaken yet further, this accountability relationship. Institutional arrangements for accountability may be similar to institutions in the donor's own country, or involve an evolution of traditional and hybrid arrangements unique to the recipient country, for example the right of qualified citizens to petition a ruler's *majlis* in small Arab states. The aid relationship has long been criticised for balancing state accountability more towards external actors (accountability relationship 2, above) and away from citizens (accountability relationship 1) (Glennie, 2008; Knack, 2004). The question for this research is not whether aid is problematic – we know it is, especially when it makes up a large proportion of a country's income – but how localising aid might change the already complex balance, represented in Figure 7 (the numbers refer to Figure 6 above).

With regard to the accountabilities of the providers of aid, one of the reasons some donors resist localising their aid to the state sector is the concern that, especially in an age of pressured results measurement, the element of control relinquished when aid is localised may affect the crucial ability of donors to explain to their citizens how their money is being used effectively abroad (accountability relationship 3). However, localising aid should improve the accountability of providers to host governments and citizens (relationships 4 and 5) if it means making more information available

Figure 6: A simple representation of accountabilities in the aid relationship

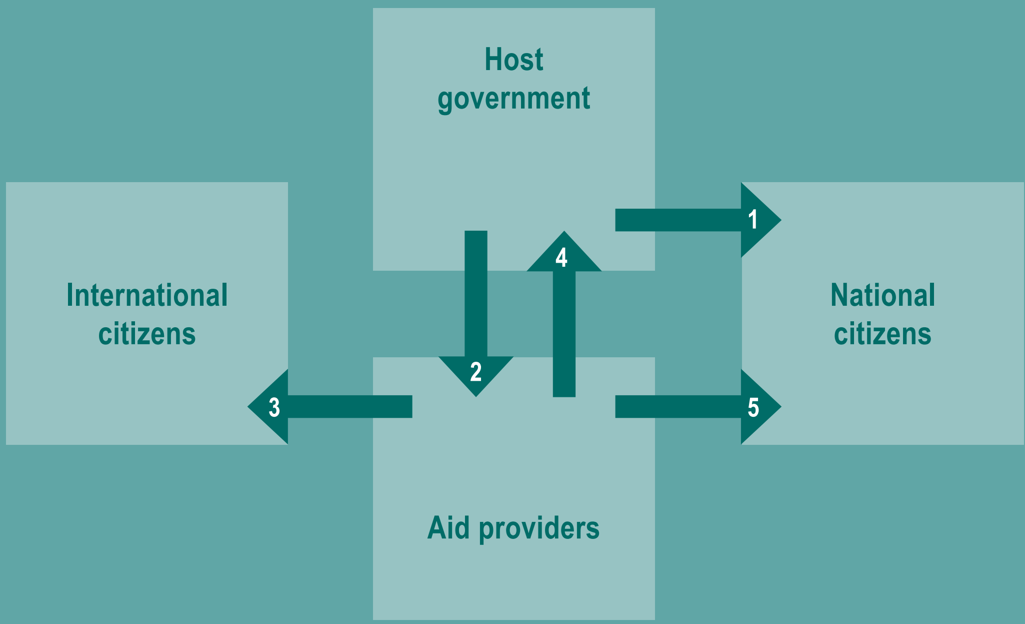


Figure 7: Host government accountability balance

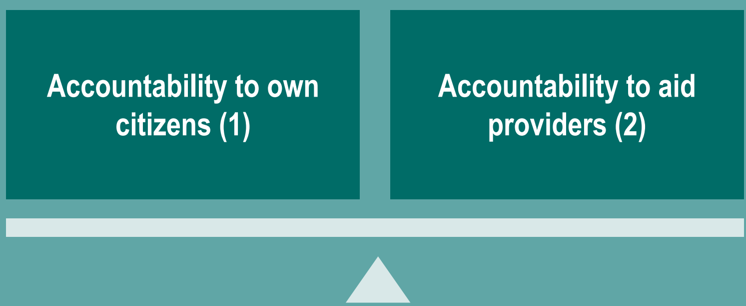
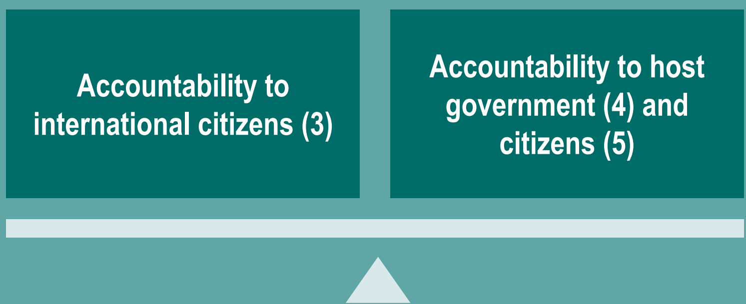


Figure 8: Aid provider accountability balance



to enable joint planning and evaluation – many host governments remain in the dark about major spending decisions in their own countries, even after decades of promises to share information better. Figure 8 describes this balance.

2.3.1 Host government accountability

Localising aid is likely to have a mixed impact on the crucial accountability relationship between state and citizen. On the one hand, pressure from donors that localise their aid appears to have brought accountability actors, such as parliament and civil society, more into play. It has also encouraged state actors to be more open to vigilance, thus strengthening the accountability of host governments to their citizens. According to a study of MDBS in Ghana, there have been improvements in governance and accountability, which the authors (Lawson et al, 2007) argue has owed mostly to a government commitment to deepen reforms and stay on track. Improvements include greater involvement in budget and policy processes by parliament and non-state actors and increased government transparency.

An overview of key papers on the role of CSOs in holding governments accountable (Governance and Social Development Resource Centre, 2009) concludes that a key role of GBS is to strengthen institutions and accountability to citizens. The review envisages CSOs along with parliament as centres of influence to keep governments in check; interestingly, it acknowledges the lack of capacity in parliaments but expects CSOs to fill the gap even though there are clear limitations to their own capacity. Most studies on GBS make references to the role of CSOs in holding governments accountable, but there is a shortage of detailed discussion on how they are expected to play this role. Donors have tended simultaneously to provide support to CSOs when extending aid to development partners. DFID country offices have reported that donors generally tend to provide support to CSOs prior to providing budget support to partner governments and countries that receive budget support from the UK have a greater tendency to receive TA for domestic institutions (NAO, 2008).

So, donor pressure to involve independent accountability bodies and civil society in helping oversee institutions that now manage their money, along with the instinct of such entities to shift attention previously targeted at donor projects to state functions as more money flows through them, strengthens this critical relationship.

Hedger et al. (2010) argue that, ‘SBS has also helped strengthen government accountability, through supporting the establishment of stronger sector policy and review processes’. Financial accountability has generally improved because of the integration of SBS into formal government financial management systems, strengthening the position of ministries of finance in particular.

On the other hand, as expected, the other part of the balance is also somewhat strengthened: a number of analyses express concern that the deeper involvement in state processes implied by localising aid has led accountability to move more towards donors than domestic stakeholders. Glennie (2008) argues that this is likely to be more of a function aid quantity in a country than of which aid modalities are used. The simple fact of having to answer for more aid money in government coffers rebalances government accountability further towards aid providers, as donor concerns shift from how well their particular project is faring to how well the government is managing development activities overall. Clearly, the dynamics would depend to a large extent on the quantity of aid involved. As we have seen, when aid levels are low, donor pressure is limited; conversely, it is less likely to skew the state-citizen accountability relationship.

NAO (2008) recognises indications that donors sometimes undermine CSOs by continuing to occupy the political space CSOs should ideally occupy. There are also claims that localised aid strengthens incumbent governments and makes it harder for political opposition to challenge them thus reducing state-citizen accountability in aid-recipient countries. A series of interviews carried out by Mwenda and Tangri (2005) in Uganda suggests budget support ‘has strong symbolic and political connotations. As it is on and through budget, it becomes closely linked to funding the government in power [symbolising] trust in the government and its policies.’

Hedger et al. (2010) find that SBS can help raise the importance of statutory procurements, financial reporting and audit requirements and improve their timeliness, but that there is some danger this might also externalise these accountability measures. That is, in situations where SBS moves away from established review processes, domestic accountability is not reinforced, as donors may dominate alternative processes. A report looking at donor-government relations in Rwanda talks of the 'perverse outcomes of an aid system which aims at increasing local ownership but which leads to heightened external entanglement in internal policy processes', noting that the 'ensuing encroachment upon national sovereignty, power and control has raised concern in Rwanda' (Hayman, 2007).

The cross-country GBS evaluation by IDD and associates (2006) pointed to improved reporting and transparency leading to better accountability, and posited the possibility of a mutually reinforcing accountability to both donors and citizens. However, it also noted tensions between giving space for domestic policy development and the urge of donors to promote particular policies and demonstrate progress quickly. An analysis of Mali in 2007 argues that:

'As aid-donors' influence over policy has increased, [Mali's] capacity and will to take the lead in managing aid and the aid relationship have decreased. Indeed, if the current political situation seems characterized by a certain degree of inertia, a lack of development strategy, weak capacities and compliance with donors, it can only be understood as the result of the weakening of the state and donor entanglement in national institutions and politics, and several decades of aid dependence' (Bergamschi, 2007).

According to Eurodad (2008), the general trend is for budget support to 'come hand in hand with more intrusion by donors in government policy making through ever more detailed matrices of policy conditions and performance indicators'. On the other hand, there has been a reduction in the number of conditions linked to budget support in some countries, including Mozambique and Ghana (ibid.).

A further tension lies between the institutions of democratic governance in host countries and the politics of elites distributing rents in a neo-patrimonial system. Many host countries are a hybrid of modern and traditional governance as traditional systems evolve to accommodate a changing society (North et al. 2010). At one extreme, democratic institutions can be weak or a facade manipulated by elites (Collier, 2010; Killick, 2004). This poses a problem for donors that might not wish to provide the resources that lubricate a neo-patrimonial system that does not necessarily share their democratic values.

These tensions are the subject of regular comment. Koeberle et al (2006) found that the impact of GBS on accountability in Uganda was mixed – it increased the involvement of parliament in the budget process, and donor insistence increased access to policy processes for these civil society stakeholders, *but* donors often dominate the debate at the expense of other stakeholders, including CSOs.

There is, then, evidence that both sides of the accountability balance are strengthened when aid is localised. This could lead to two different but possibly complementary conclusions. First, that in some technical senses accountability processes in both the host-provider and host-citizen relationships have been strengthened, for example more information is available, and better audited. However, second, that the balance may not tilt towards accountability to the citizen – that is, the localisation of aid is unlikely to resolve concerns about governments being more responsive to donors than to citizens.

2.3.2 Aid provider accountability

The ability of aid recipients to hold donors to account has been recognised as a crucial part of aid effectiveness since the Paris Declaration, but it remains hard to pin down. Analyses of 'mutual accountability' indicators show how far there is to go (UNDCF, 2010). The need for donors to be held to account becomes even clearer when they are conceived as 'part of the system' as opposed to actors external to it, and indeed this is the most sensible conception, given their intimate role in most countries in which they operate, even low aid countries (Harrison, 2001).

There are good grounds to believe that in most cases localising aid will mean more information in the hands of the host government about the activities of major external actors, which should in turn make it easier for them to be held to account for that part of their spending. This was a major concern in Guatemala; perhaps the key reason government interviewees gave for the need to localise aid was the ability of the government not only to plan better but also to evaluate the actions of external actors' interventions in their country.

In all three of our country studies, the issue of information sharing emerged as a key theme. Host governments recognise the reasons why some donors find it hard to localise their aid, but are less forgiving about their continual flouting of best practice in terms of sharing basic information about interventions. Government officials in Uganda acknowledged and appreciated the contribution of off-budget donors in tackling endemic communicable diseases, but there were concerns about coordination levels, information flows of project activities to the government and the vertical focus of some of the large funds. Government officials understood the political realities in donor countries with regards to localising aid but were perplexed by the lack of effort among donors to share information with the government. This can result in duplication of donor efforts and reduces the effectiveness and efficiency of both donor and government resources. Sharing information in a timely fashion can help with integrating aid projects into the planning and budget process. One government official accused an off-budget support donor of keeping everything 'under their armpits'.

Clearly, the major push on aid transparency is in part a response to this frustration. Not only does more information allow local actors to hold government to account, but also it allows host governments, and national and international civil society, to hold donors to account. The Director of Rwanda's Macroeconomic Policy Unit, Kampeta Sayinzoga, has noted that, 'because we do not know the value of project support given to Rwanda, we had to use a guesstimate in Rwanda's macroeconomic framework—a meaningless number' (Development Initiatives Poverty Research, 2009).

However, it is not clear that localising aid will lead to more information being made available about aid in general – there will always be many projects that are not localised, and information is just as important for these. Nor is it clear that this is a sufficient reason to localise aid – making information available should theoretically be a much simpler exercise than localising aid, so it seems odd to stipulate a complex action (localising aid) to solve a simple problem (sharing information).

The crucial accountability link between aid providers and international citizens (i.e. those who fund aid with their taxes) is one many donors fear will be weakened if aid is localised. We found no evidence either way, apart from this stated concern of donor interviewees. It is clear that, when aid is localised, special considerations have to be paid to this accountability relationship, especially if the objectives of the intervention are balanced towards systems strengthening (longer term) as much as project results.

2.4 Three crucial caveats

There is, then, strong evidence that project-style approaches to development undermine efforts to lessen aid dependence, and reasonable evidence that localising aid has had some positive effects in strengthening government systems, largely through shifting provider and host government incentives and better allowing donors to pressure for change. While coordination, planning, oversight and shared understandings are in theory possible without localising aid, in practice it is more likely to take place when aid is localised.

However, we do not think the fairly positive literature on the subject constitutes a body of evidence sufficient to persuade risk-averse donors of the generalised importance of localising aid for the purpose of strengthening state systems. There are three main reasons for this:

- Classic causality problems, there are no counterfactuals and we cannot tell how relevant other factors have been in driving progress;
- The existence of alternative and probably complementary methods of systems strengthening brings into question how important it is for donors to choose the more risky localising aid route; and
- The country-specific nature of these outcomes; while lessons can be learnt from success elsewhere, it is not possible to extrapolate that similar methods will work in different situations.

2.4.1 Causality

The first doubt thrown at the evidence presented in the previous section is simply the ever-present reality in development research that we have no counterfactual. We do not know whether aid localisation caused the improvements in systems that occurred at the same time as aid was localised, or were anyway in train.

For instance, de Renzio et al's (2010) survey findings on the impacts of budget support on PFM seem fairly clear: the share of aid provided as budget support is positively and significantly associated with better PFM quality; the level of donor support for PFM reform is associated with Public Expenditure and Financial Accountability (PEFA) improvements. But de Renzio acknowledges weaknesses in the data that mean causality is not clear (i.e. that there are very limited PFM data that can be used to compare the quality of PFM systems across countries and over time).

Everyone agrees that other factors in the country context, rather than aid modalities, are the main determinants of whether government systems and entities get stronger or not. Lawson et al's (2007) evaluation of MDBS in Ghana found that, despite PFM reforms encouraged by budget support, there has been only a limited improvement in PFM systems, based on PEFA scores from 2006 and Heavily Indebted Poor Country (HIPC) Assessment and Action Plan scores from 2001 and 2004. The evaluation mentions a number of reasons why this might have been the case: weaknesses in the civil service; sequencing problems with an emphasis on long-term systems development; and a limited focus on improving budget formulation procedures. Clearly, the choice of aid modality should not be expected to transform underlying political realities.

Pre-existing government leadership is generally considered a critical factor. Lawson (2012) finds that, while the receipt of budget support helps some countries fund PFM reforms, their willingness to carry out these reforms is the key success factor, quite apart from the aid modality decision. According to IDD and Associates (2006), the effectiveness of partnership GBS-linked technical assistance and capacity building to improve PFM systems has been limited in Uganda, as they have not been linked to a 'coherent reform programme'. This concurs with our interview findings that progress on systems strengthening has been limited to areas where government commitment is strong (e.g. important health and education delivery and oversight issues), but less apparent where such commitment has been lacking (e.g. underlying issues relating to oversight and anti-corruption systems). Dialogue has focused on a very wide range of issues, which has made it hard to generate sufficient emphasis and leverage on individual policy agendas.

A study of SBS in a number of countries (Williamson and Dom, 2010) found that, while SBS has contributed to strengthening the policy, planning, budgeting and reporting cycle, it has had limited impact on overall policy direction and, crucially, domestic leadership influences the degree of follow-up more than the SBS modality. This is fairly conventional development theory nowadays, and should not surprise us, but it does cause us to question how important the choice of aid modality is in countries already on the path to systems strengthening. While there is evidence that localising aid can make a difference, it is far from clear *how much* of a difference it makes. There is probably a tendency for donors to invest in countries already showing the capacity to reform; in fact, it is a clear part of the screening process for budget support in most donor agencies that country governments are already committed to reform.

2.4.2 Complementarity

The second reason the evidence is not as robust as it first appears is that there are other means to build capacity and strengthen systems. Attempts at 'capacity building' have a long history in development, and are the most common means of strengthening local entities, including state entities. As we know, it is not the localisation of aid *per se* that leads to strengthening, but the package of engagement that goes with it. According to one hypothesis, localising aid modalities specifically leads to improved capacity-building interventions in the state sector, as against other modalities, and some evidence backs this up. Williamson and Dom (2010) found that the use of domestic budget execution and financial management systems tended to help identify weaknesses in those systems deepening understanding of recipient PFM systems. The authors note that SBS was more effective in addressing sector-specific gaps such as in financial management at the school level in Uganda and Rwanda than in addressing generic PFM problems at the sector level. Fritz et al. (2011), in a study of eight post-conflict countries, find that:

> '[…] maintaining a predominant share of aid off-budget works against the full effect of [reform] efforts, especially with regards to budget planning but also regarding execution and accountability. Shifting more aid on budget—while possibly still using special accounts, as is done for on-budget aid for public investments in Afghanistan—is therefore an important part of a longer-term support strategy for post-conflict countries.'

A report by the Chartered Institute of Public Finance and Accountancy (CIPFA, 2008) argues that improvements in procurement procedures and PFM systems could not have been achieved through other aid modalities because GBS is more fungible. More importantly, they also argue that the scope of policy discussion with government could not have been reproduced if aid were delivered through other aid mechanisms, including SBS.

Set against this, the OECD's 60-page volume on building capacity in PFM systems devotes only 3 pages to funding modalities, implying their limited relative importance compared with other aspects of a systems-strengthening package. Nor does it call for more budget support, stating that project support is often more appropriate, especially given the most crucial component in a successful funding package: flexibility of funding (OECD, 2011). A 2010 study by UNDP of 20 successful capacity development projects with state institutions does not consider at any stage the importance or otherwise of localising aid. And a review of the efforts of the World Bank to strengthen the state finds that results have been disappointing, despite aid being necessarily localised, suggesting that better use of research, understanding the role of government in the economy and shifts in incentives of bank staff might mark a way forward (de Janvry and Dethier, 2012). Looking at other parts of the state, a Swedish International Development Cooperation Agency (Sida) paper lists nine characteristics of effective aid to support the work of parliaments, none of which refer to the specific modalities of aid (Rocha Menocal and O'Neill, 2012). Even Fritz et al. (2011), while recognising that 'capacity can be short-circuited through substitution (such as donor-funded staff in line positions)' and that 'developing sustainable capacity remains a challenge and needs greater and more sustained attention', do not emphasise the importance or otherwise of localising aid in developing such capacity – most PFM capacity projects are stand-alone and non-localised.

Thus, while there is much literature on the impact of the overall package of budget support on the capacity and accountability of systems, in particular the role of technical assistance, conditionality and dialogue, it is seldom clear how important localised aid has been in this mix. Might progress based on technical assistance and policy dialogue have been possible, or *even more* impressive, with non-localised project aid? Few analyses appear to place localising aid as an important component in strengthening state systems. Some interviewees for this research specifically argued that, if their objective were to strengthen particular government systems, they may well choose not to localise aid, but rather to use project modalities they could control more closely. Conversely, it is possible to localise aid with little capacity building associated with the modality, and in this case donors should not expect strengthening to be an outcome. Wood et al. (2011) find that when donors use country systems, there are strengthening effects appreciated by host governments but they warn against the 'over-fetishisation' of reducing parallel project implementation units that can sometimes be useful. According to Williamson and Dom (2010), when donors use different earmarks and traceability requirements in their basket funds and SBS programmes, as well as requiring their own procedures to be followed, it can have similar effects as the project aid that has been so criticised.

There is certainly no simple equation between localising aid and strengthening systems. In recent evidence to the House of Commons, DFID, a major proponent of budget support, explained how budget support was not considered necessary for capacity building activities:

> 'Generally, our approach with budget support has been to have alongside it programmes that build up all those other institutions. It is not just about financing the system; it is also about strengthening the system. We will keep working on the capacity building, whether or not we are engaging on direct financing of the budget. Arguably, it is one of the most important things we do across the whole programme, this capacity building effort, because that is a key deficit for most of the countries in which we work. *I do not think a reduced level of general budget support is at tension with a stronger effort on capacity building*' (emphasis added).[7]

Is fragmentation really a problem?

One of our questions as we started this research was whether fragmentation (i.e. a range of different aid modalities in operation in a particular country) matters for strengthening state systems. The argument often given against fragmentation of donor support, and one for which there is plenty of evidence that has imbued the Paris process, is that a proliferation of aid not using country systems makes it much harder for a host government to coordinate aid interventions as part of a common plan, and results in greatly increased transaction costs. Thus OECD (2006) claims that, 'The gains from PRBS reducing transactions costs, budget transparency, allocative and operational efficiency are *undermined by continued use of non-PRBS aid modalities* (where large flows of aid are off-budget and un-integrated with national procedures)' (emphasis added).

7 www.publications.parliament.uk/pa/cm201213/cmselect/cmintdev/uc751-i/uc7501.htm

Box 5: Non-localised projects (sometimes embedded) contribute to systems strengthening

Ministry of Health officials in Uganda were keen to highlight the model of a number of donors whose health projects are implemented by staff embedded at the ministry or, even better (as this does not create salary distortions), by the Ministry itself. This approach assists the Ministry to better track progress and outcomes from these projects, to plan more collaboratively with them and to benefit from knowledge and capacity transfers. This issue is illustrated well by a health official who told us, 'The type of reporting done by project donors is not easy to integrate into our plans. When the government is the implementing arm of a project the level of engagement is different to when donors implement project themselves or get third parties to do it.'

However, another project – the Capacity Project – is managed through a project management unit outside of the government's systems, but is nonetheless making an important contribution to developing key elements of the Ministry's systems for addressing health worker challenges. A key element of this work has been the rollout of the Human Resources for Health Information System to district health administrations. As a result, more timely, detailed and comprehensive information is now available in relation to human resource challenges in Uganda's health sector. In order to support the sustainability of these efforts, the project has included dialogue with the key actors in government about their responsibilities to maintain the system, which have been specified in formal MOUs.

Box 6: Localised aid has incentivised reform in Uganda, but not sustainably

Systems and institutions in Uganda appeared to be improving considerably at the turn of the century as budget support got underway. Budget support disciplined donors, encouraging them to engage with and strengthen the capacity of institutions responsible for planning and financial management and oversight. It also provided a justification for requiring increased transparency in budget allocation and utilisation and a greater focus on accountability and results. The increased use of government systems has increased the possibility of detection of faults in PFM systems, including misuse of funds. Localising aid is also considered to have incentivised donors to institutionalise the budget process, strengthen oversight institutions and harmonise the monitoring process. Koeberle et al (2006) found that, prior to the start of GBS, Uganda had all the basic elements of budgetary formulation in place, but its introduction strengthened PFM processes by increasing their prioritisation within government and incentivising donor agencies to pay greater attention. On the negative side, donor focus on following the money trail has resulted in less effort to strengthen other areas important for service delivery, such as planning at the central and district levels. While donor-government dialogue was initially effective and results oriented, via the establishment of the Joint Assistance Framework for Budget Support, which identifies a range of performance indicators against which the effectiveness of government spending is measured, it has deteriorated somewhat since the mid-2000s. The latest PEFA assessment is mixed on budget quality. Meanwhile, repeated corruption scandals (the most recent of which has led to the majority of donors freezing their budget support) point to continuing weaknesses in PFM implementation and oversight. This deterioration implies that early assessments of the sustainable impact of budget support may have been over-hopeful. Changes in systems may not be as closely linked to the choice of aid modality as is sometimes thought.

Hedger et al. (2010) find that,

> 'SBS has clearly contributed to improvements in financial management, especially when associated with multiple donors, in two ways: the first is a reduction of transactions costs associated with the move away from multiple sets of financial management systems to using government systems. The simple fact that spending agencies use government systems more as a result of SBS helps strengthen them.'

While some of our interviewees agreed with this analysis, most thought project aid could be complementary and not necessarily harmful to the positive effects of localising aid.

An internal DFID paper neatly sets out the pros and cons of different modalities, including localising aid.[8] Our interview findings in Uganda support this, suggesting that project and budget support can have complementary roles, both having advantages, weaknesses and suitability for particular contexts. Budget support is a better modality when donors want to achieve national objectives, and project aid is more effective when dealing with crises and speed is of the essence or when providing services in remote regions. Clearly, there is a chicken and egg situation here: supporting projects when state systems are not ready might undermine the long-term development of those systems.

There is one particularly interesting example where the *absence* of donor engagement with country PFM systems appears to be linked directly to progress on PFM. In the late 1990s, donors to Ethiopia shifted aid money away from the government in response to the escalating war with Eritrea. USAID continued to fund a PFM reform project that took a decade to complete (emphasising the kind of time horizons such reforms need to work with) and for which the absence of donors complicating the scenario was crucial (the Bretton Woods institutions were excluded and the bilaterals were assigned specific turfs (Peterson, 2011). Common sense indicates that inviting a range of donors, all with their own financial systems, to engage with host country financial systems, is likely to create significant work for the host country (although some hosts consider it well worth it to reduce overall transactional burden in the longer term). A former Guatemalan education minister told us of her frustration of receiving very little aid to her ministry relative to the size of her budget, but from myriad donors, all with burdensome reporting systems.

It is possible that the general consensus that localised aid should be just one of a range of options may be little more than pragmatism –seven years after donors promised in Paris to reduce fragmentation the reality is an ever-more fragmented aid effort, with new actors (both public and private) joining the already established donors every year, only very few of which are localising their financing to any great extent. In their recent study of development finance flows in Cambodia, Ethiopia and Zambia, Greenhill et al. (2013) show that in these countries the volume of development assistance has grown dramatically since 2000, with a much larger share being accounted for by non-traditional providers. This has led to increased fragmentation, but countries 'see these trends as more positive than negative. The benefits of greater choice were found to outweigh the potential costs of the additional fragmentation' (ibid.).

Attempts to improve aid coordination and allocative efficiency in Uganda through joint budget support operations were only partially successful. Some donors continue to provide funding through off-budget mechanisms. In addition, the lack of discretionary development funding in the medium-term expenditure framework (MTEF), and its unreliability as a medium-term planning tool, has created an incentive for sectors to solicit on-budget projects in order to secure a reliable source of additional funding. It seems that fighting against the increased complexity of aid flows is a losing battle, which means the argument for localising aid to alleviate fragmentation – once common and persuasive – has lost much of its clout.

2.4.3 Country specificity

The final reason why donors might not take the evidence we have presented as sufficient to lead them to localise their aid is that the evidence base is confined to quite a limited group of countries. These are fairly aid-dependent countries, mostly in Africa. There is much less analysis on the importance of localising aid to middle-income countries, which tend to depend less on aid.

The two main reasons for the effectiveness of localising aid in supporting institutional strengthening are first that it changes the incentives of key actors and second that it buys donors influence over host

8 Internal document made available to the authors.

government actions. It is worth exploring how much these intervention logics depend on aid being a substantial part of the government's budget. Taking the second of these first (a seat at the table), it is logical that, if the aid localised is a very large part of the government's budget, far more influence will be bought; if it is a small proportion, the host government will tend to worry far less about the views of the donors behind it.

However, the first reason (incentives) may still hold to some extent in less aid-dependent situations. The critical variable is not aid/gross domestic product (GDP) or aid/government expenditure but localised aid/overall aid – that is, if a large proportion of a particular donor's aid is localised, that donor will be incentivised to concern itself with systemic strengthening even if its aid is a small proportion of overall government funds. However, while *donors* will still be incentivised to follow their money closely, national actors are less likely to see incentives shift. Government and national accountability entities will be no more likely to focus on government systems because some aid is localised, as it will remain a small part of overall government spending.

In many circumstances, the political importance of specific donors, and the overall volume of their aid, may be just as crucial as the aid modality. In Uganda, for instance, it was acknowledged that a donor like the US, which has a wide-reaching relationship with the government – including on security matters – has an influence with the government that is different in nature to that of smaller European donors. This results in access for USAID without it necessarily localising aid to the state.

As countries rely less on aid and more on domestic resources, this dynamic will inevitably continue to change: much more money will be required to buy a seat at the table. Another way of looking at this is that the cost of overcoming the priorities dictated by local politics increases. In the early years of budget support to Uganda, donors were successful in shifting the allocation of resources to priority sectors such as health and education. However, budget support donors now have less leverage over government, as aid now accounts for a smaller proportion of budget financing (see Box 3).

If this is true of Uganda and other low-income countries seeking to reduce aid dependence, it is even truer for those countries that have long since emerged from aid dependence, if they ever were aid dependent. Fritz et al. (2011) found that PFM reform was faster in countries dependent on external aid for assistance. A major donor to Guatemala that engages in large-scale budget support has found it hard to arrange meetings with treasury officials as they appear to consider the relationship insufficiently important to prioritise. Other ways are needed in today's world, according to the donor's country representative, to gain influence over government actions, given that aid is relatively small fry.

A classification developed by Glennie and Prizzon (2012) may help us visualise the gradation of importance that localising aid may have in specific countries. Rather than categorising countries by income, they were categorised by aid receipt as a proportion of GDP. The state systems of high aid countries (which receive over 10% of their GDP in aid) are likely to be more influenced by aid overall, and aid modality decisions in particular, than low aid countries.

2.5 Are some countries too corrupt or too ineffective for localised aid?

According to our analysis, the main reasons for localising aid to strengthen systems hold, in theory, in all country contexts in different balances. In some countries, donor pressure (and even aid conditions) might have some purchase; in others, streamlining aid may prove important; in all, the increased oversight of donors and other entities is likely to have a positive effect on systems. Clearly there are trade-offs. More localising of aid may make it harder for donors to plant their flags on particular projects, and is likely to mean extra time and resources invested in achieving the same results that project aid might have achieved faster and cheaper but without the system-strengthening gains.

However, an argument common among some providers of development assistance is that some countries simply do not have the systems in place to ensure foreign monies are used effectively, or to guarantee they will not be lost to corrupt practices. It is certainly true that corruption and ineffectiveness are common characteristics of many complex organisations, including developing country government institutions and private entities.

But it does not follow that localising aid does not have a role to play even in apparently inauspicious circumstances, for two main reasons.

First, empirical evidence from countries where corruption and/or ineffectiveness in the public sector are major problems, including in fragile states, that localising aid, managed appropriately, can have the strengthening benefits implied by previous chapters. An analysis of where localising aid has helped strengthen systems implies there is value in engaging with systems in all governments, even those commonly thought to be highly corrupt and/or ineffective. In terms of theory, one might even argue that the greater the problems in the system, the *more need* there is to localise some aid to help learn about and mitigate them.

Second, because localising aid does not mean relinquishing control of donor monies, as is sometimes assumed, there is a spectrum of options depending on the risk aversion of the donor and the analysis of the country context.

2.5.1 Theory and empirical evidence

The two main reasons for localising aid to strengthen state systems are around incentives and influence. The main variable that might reduce the impact of localising aid is aid quantity. For example, in low aid countries it may be somewhat less likely that localising aid will have an impact. However, there is no reason in theory to suppose that high levels of corruption or ineffectiveness would weaken these two intervention logics. If the objective is to include systems strengthening in development intervention objectives, then where there are high levels of corruption or ineffectiveness there may be even more reason to localise aid, in order to increase oversight over government operations and dialogue and pressure for improvement.

The empirical evidence appears to support this theory: the benefits of improved systems strengthening associated with localising aid to the state sector appear to have taken place even in some of the most corrupt and fragile contexts in the world, from ring-fenced support via the central account to the national development framework in Afghanistan, to earmarked sector support with additional safeguards in Kenya, to projects sitting within sector-wide approaches (SWAps) supporting state delivery of services in Nigeria.[9] Countries as fragile as Sierra Leone and Liberia have received localised aid, and the g7+ group of fragile states is making the case strongly that aid should be localised to support the rebuilding efforts of member states. Meanwhile, massive and fragmented NGO support in countries such as Haiti has been roundly criticised.

2.5.2 Mitigating risks, maintaining control

Even if localising aid seems just as likely to help systems strengthening in fragile or corrupt contexts, is it too risky a venture with taxpayers' money, as some donors still insist, particularly given ferocious oversight of aid accounts in donor capitals. Our research and analysis suggests otherwise. As we have seen in Figure 2 (in Section 2.1), although GBS is the best-known and best-debated form of localising aid, having gained favour among many donors in recent years, it is only the most extreme and there are many ways to localise aid that preserve a strong element of donor control.

While GBS deliberately relinquishes the right to check on specific spending decisions, the other localising aid options set out in Figure 5 all earmark and track donor monies to some extent. SBS transferred to a government's central account can be tracked only notionally – it is in reality GBS – but SBS going to ministry or other accounts separate from the single central account can reduce the chances of it being lost or misused in the broader government accounting system. The ability to direct localised aid at specific entities within the state architecture is a crucial part of aid programming with localised aid. Within most governments and state entities, there are likely to be more effective/less corrupt parts and less effective/more corrupt parts of the machinery. Obviously, donors will wish to use different modalities with different parts of the state. Some ministries will benefit from sector support; others might need to be held to account for each line of expenditure. Some country governments will be ready for GBS. Very few (perhaps two or three) countries in the world have state systems so far beyond the pale that no form of localised aid would achieve positive results if managed well.

9 Internal DFID paper made available to the authors

Box 7: Corruption will not necessarily lessen as development occurs

Corruption is a complex element in national development. While it is considered a blight on functional and responsive government, there is no good evidence suggesting it significantly retards development and poverty reduction (Chang 2002). Transparency International's Corruption Perception Index ranks wealthier countries like Thailand and Colombia below much poorer countries such as Burkina Faso. Italy ranks below Ghana. China is highly corrupt but developing rapidly. Recent corruption scandals in Europe and the US demonstrate that, even at the very heights of developed status, corruption can continue to be a menace. So it may not be sensible development theory to wait until a government leaps a particular hurdle on corruption levels before localising aid to them. Corruption can often be extractive by an elite that sets back development and perpetuates poverty (Acemoglu and Robinson, 2012), but there is evidence that modest corruption can sometimes be fairly harmless or even enable a pro-development regime to consolidate its political support and neutralise opponents to reforms (Khan 2003, North et al. 2011).

Box 8: A variety of ways to localise aid in Guatemala

In Guatemala, most interviewees recognised that working with government to achieve development objectives could be slow and frustrating, but some donors chose to engage in this way, accepting the trade-offs, because of their intentions to strengthen systems. According to a representative of the European Union (EU), which localises 80% of its aid to the government, 'Slow procedures are really annoying but they are precisely the things addressing concerns about corruption'.

In 2007, the government started to use a single account for loans and is now seeking to extend its use to localised aid in grant form. It is important, according to the finance ministry, for reasons of control, transparency and audit by state organisms. Under the previous system, it was much harder to follow the money. With regard to slow transactions and implementation, the finance ministry claims the problems are with particular ministries. Even donors like the Gates and Slim Foundations are now using the account. The main concern is that central government still does not know about donor activities – examples given were hospitals and roads built by donors and now in need of repair, but about which the government has no information.

The main reason given by Guatemalan government representatives for localising aid was transparency of donor interventions to help with government planning and strategy: 'if it is not on account, we can't track it'. Other reasons are principle ('we have it, you should use it') and strengthening ('donor money through our system helps us hone and improve it'). However, there has been little consistent pressure from the government on donors to change their practices – at least, donors are not feeling any such pressure. The G13 group of donors has had a range of meetings with the government in the past few years on strategy and joint planning, but localising aid has never come up formally.

The EU has two means of localising aid to the state, traditional budget support and 'programme budgets', whose accounts are checked. Its only budget support recipient at the moment is the Secretariat for Agriculture and Nutrition (SESAN). The EU contracts technical assistants to accompany its localised aid, including a programme with the finance ministry promoting the introduction of results-based management and PFM improvements. The objective is explicitly to strengthen state systems so as to improve the chances of long-term change. A main concern of the EU is that the money and capacity reaches localities and does not all stay in the capital. The EU is also increasing funding to NGOs, especially those with a monitoring role over state activities.

40% of the World Bank's portfolio ($150 million) is investment loans –project money spent against invoices; the other 60% is GBS. The World Bank offers free technical assistance with its $200 million of budget support, which is based on prior actions (i.e. there is no conditionality because Guatemala has already qualified, just dialogue and knowledge sharing), but, according to the Bank's representative, 'it is the project loans that are more likely to strengthen systems, as they are better targeted – the budget support is for policy reform'. 'Leakage', according to the Bank, 'has not been a problem' – although the recognition that money is fungible means the monitoring of the government account carried out may not be very meaningful. The main objective of the World Bank is 'to help train a cadre of people in government that understand how to manage projects and money'.

The Spanish Agency for International Development Cooperation (AECID) also gives budget support but notionally tracks payments to specific projects. It assesses outcomes rather than outputs using a results matrix with a four-year time horizon and avoids micro management; future payments are theoretically conditioned on the success of present endeavours. AECID's mission statement and global strategy, even before Paris, is to use government systems. About half of AECID's budget in Guatemala is localised to the government; the other half goes to NGOs. Of the government's half, 50% is budget support and the rest project support. Until recently, AECID used separate accounts, but recent insistence from the Guatemalan government has led AECID to now transfer all monies to a single government account. In the view of AECID's director, parallel implementation units and project support can be positive for strengthening objectives. By localising aid, in his view, 'I am not sure we are strengthening their systems, but we are ensuring that they take responsibility'. It also saves money. The localised aid does not necessarily come with a package of technical assistance, and getting involved with the government on administrative issues is described as 'delicate'. While there have been some leakage problems (the government paid back $1 million that went missing), the main problem is slow implementation of programmes – money not spent on time simply reverts to the AECID account.

While there were no examples we could find of payments for results, UNDP practised ex-post payment for specific purchases. USAID, another major donor, does not localise any of its aid to the state sector, preferring project approaches and citing concerns about corruption and inefficiency. Our interviews confirmed, however, that it is working closely with the government on its main project, agricultural support and nutrition activities in the poor Western Highlands, via information sharing and joint strategising.

Box 9: Localised aid to Uganda has helped uncover corruption

Donors have been supporting the government of Uganda to strengthen its PFM systems since the late 1990s. The latest programme of PFM assistance (FINMAP) localises aid to the government via a basket funded by donors and the government itself. One of FINMAP's most prominent contributions has been its support to the OAG to audit government spending and to parliament to act on its findings. These efforts have helped the OAG secure greater independence*; clear a significant backlog of audit reports; and build its expertise by recruiting highly skilled staff. One indication of the increased capacity and standing of the OAG has been its recent handling of the misuse of funds in the Office of the Prime Minister. The OAG led efforts to uncover the circumstances behind the missing funds and provided parliament and the police with the information required to undertake an extensive investigation. However, given weaknesses in other key governance institutions required to lead the criminal investigations, it is not yet clear whether – as in other recent corruption scandals – senior officials implicated in this corruption scandal will be prosecuted.

* The passing of an Audit Act in 2008 made the Auditor General financially and operationally independent of the executive. Also, a recent constitutional amendment removed the requirement that the OAG be a public office.

Donors are increasingly considering *ex-post* payments for results, and these have the advantage of using country systems fully while not risking donor money. A donor intervention localising aid for financing basic health services in Liberia is USAID's Fixed Amount Reimbursement Agreement (FARA) with the government, an output-based aid approach. FARA is based on a schedule of quarterly costed deliverables and the Ministry of Health and Social Welfare is reimbursed on the basis of reports co-signed by the Ministry and a USAID contractor. This approach also provides incentives for the Ministry to maintain strong fiduciary systems and to execute its programme on time.

A recent internal USAID evaluation (USAID, 2012) finds that FARA is 'an important and potentially effective vehicle for supporting improvements in public sector-managed service delivery even when government capacity is limited' and 'the reimbursable character of the FARA mechanism has reduced fiduciary risk to the [US government] of shifting to partner government systems, while at the same time created strong motivation for country-led improvement in core public sector management functions within the Ministry of Health and Social Welfare, the lead [government] agency responsible for FARA implementation'.[10] Finally, payments to the government for the purchase of specific goods or purchases is a form of localising aid that maintains strong control over how donor money is spent, while keeping in place most of the key elements of the systems strengthening, such as oversight of government accounting and practices and locating responsibility planning and implementation with state entities. The US localises aid in Honduras, a country considered highly corrupt on the Transparency International Corruption Perceptions Index, through its innovative Millennium Challenge Account mechanism. Box 8 gives some examples of how donors localise aid in Guatemala.

While there is general agreement that, over time, national systems should be used to account for and monitor aid expenditures as part of national expenditures, there is no reason why donors concerned with the particular way their money is spent may not hire independent auditors to check, in agreement with the government. While this will be more costly, it would not diminish the strengthening effects of localising aid, according to our analysis it may even enhance them in some cases, if lessons are learnt and techniques shared between the parties.

Finally, and importantly, in countries where corruption and inefficiency are common, other methods of delivering aid may be just as risky. Corruption needs to be dealt with, and localising aid, even given obvious extra risk factors in some contexts for which appropriate safeguards are possible, may well still be the best way to strengthen systems and make sure that in the longer term *all aid* is spent more effectively. IDD and associates (2006) found that 'Corruption is a serious problem in all the study countries, but the country study teams found no clear evidence that budget support funds were, in practice, more affected by corruption than other forms of aid'. The report also highlights the risk of corruption in tied aid and the risk of bidder collusion in aid tenders, neither of which are problems with localised aid.[11] While some may believe that the problems of fungibility and additionality are dealt with by spending in projects parallel to state expenditures. In reality, over time, these are general problems of aid not just localised aid, even if congress and the media do not always see it that way. Donor funds spent building and supplying a school entirely apart from the government still displace the need for the government to spend money on that school.

There is tension here between donor focus on value for money, their concern about corruption and the 'results agenda'. To produce early results and lower corruption risks, donors may bypass government and contract with large firms with a reputation for delivery. However, these arrangements may increase costs, favoured firms may become less efficient through lack of competition and weak contract management and lower local ownership may lead to inappropriate technological and other solutions that can reduce development outcomes. Both waste (or lack of value for money) and corruption lower the development impact of foreign aid and are of concern to taxpayers in donor countries and the parliamentarians they elect. Greater concern in donor legislatures about getting more value for money is recognition that waste of foreign aid is a problem. Beneficiaries in a recipient country have similar concerns about the loss in potential results from illegal diversion of resources by officials in their government and from waste by contractors and consultants implementing aid-financed activities. Surveys in Afghanistan have shown that Afghans often see corruption and waste as synonymous. Localising aid implies managing

10 Internal report made available to the authors.

11 This section draws on Owen Barder's analysis at http://www.owen.org/blog/113

greater risks on delivery of outputs and corruption and realising benefits from better development outcomes and greater value for money.

We have encountered several ways to manage corruption risks. In the health sector in Liberia, the pooled fund puts money through national PFM systems with additional controls from a joint signatory arrangement with a donor representative. The USAID FARA project would reimburse government only on the evidence that its expenditures had been executed satisfactorily. In the ARTF recurrent cost window in Afghanistan, the World Bank administrator appointed a monitoring agent to verify that expenditures were legitimate for reimbursement. In countries characterised by neo-patrimonial governance and weak judicial processes, priority should be given to creating simple and clear procurement, project management, financial accountability and civil service management processes. Innovative ways need to be found to monitor these processes and outcomes by the media, CSOs and beneficiaries (using mobile and social networking technology), as well as the use of traditional instruments for enforcing social behaviour like shame and restitution.

Clearly, assessments have to be made regarding the level of capability, the risk of corruption and the degree of shared objectives (or at least plausible development plan) for each country, and on top of that the balance between investing in longer-term thinking versus achieving shorter-term results needs to be debated. But these decisions should influence *the way* aid is localised, not *whether* localising aid should be a part of the overall donor package.

There will still be trade-offs. One of the most important is the fact that it might be more costly in terms of time and resources to achieve specified objectives. Another is that it will be harder for donors to 'plant their flag' on a project the more their funding resembles GBS. Both of these concerns, and others, are valid, especially in a context in donor countries where publics want to see that their money is making a difference in the relatively short term. But, in our assessment, such concerns should not be conflated with the poorly evidenced assertion that some governments are too corrupt or ineffective for localised aid. Donors refusing to localise aid on grounds of corruption to governments receiving localised aid from other donors would need to argue that other donors audit assessments are significantly weaker than their own, or accept that they simply have a lower tolerance for risk.

2.6 Conclusion: A vital tool in the donor toolbox

To recap, our research points to the following conclusions on the impact of localised aid on state capacity and accountability:

1. Localising aid is associated with progress on strengthening state systems, although it suffers from some of the same problems of other types of aid. Localising aid tends to incentivise donors to take more of an interest in country systems, and host governments to work harder to improve them.

2. The evidence implying the strengthening tendencies of localised aid is not strong enough to generalise across all contexts. Causality and counterfactuals are complex, as localising of aid tends to take place in countries moving in the right direction anyway; non-localised aid can be spent in such a way that systems and entities are strengthened, or that weakening effects are minimised ('do no harm'); and the case for localising aid is weaker in low aid countries. Localising aid is less likely to buy you a seat at the table in less aid-dependent countries. Thus, in countries not dependent on aid, the role of localised aid is quite different to what it was 10 years ago, especially with emerging donors on the scene.

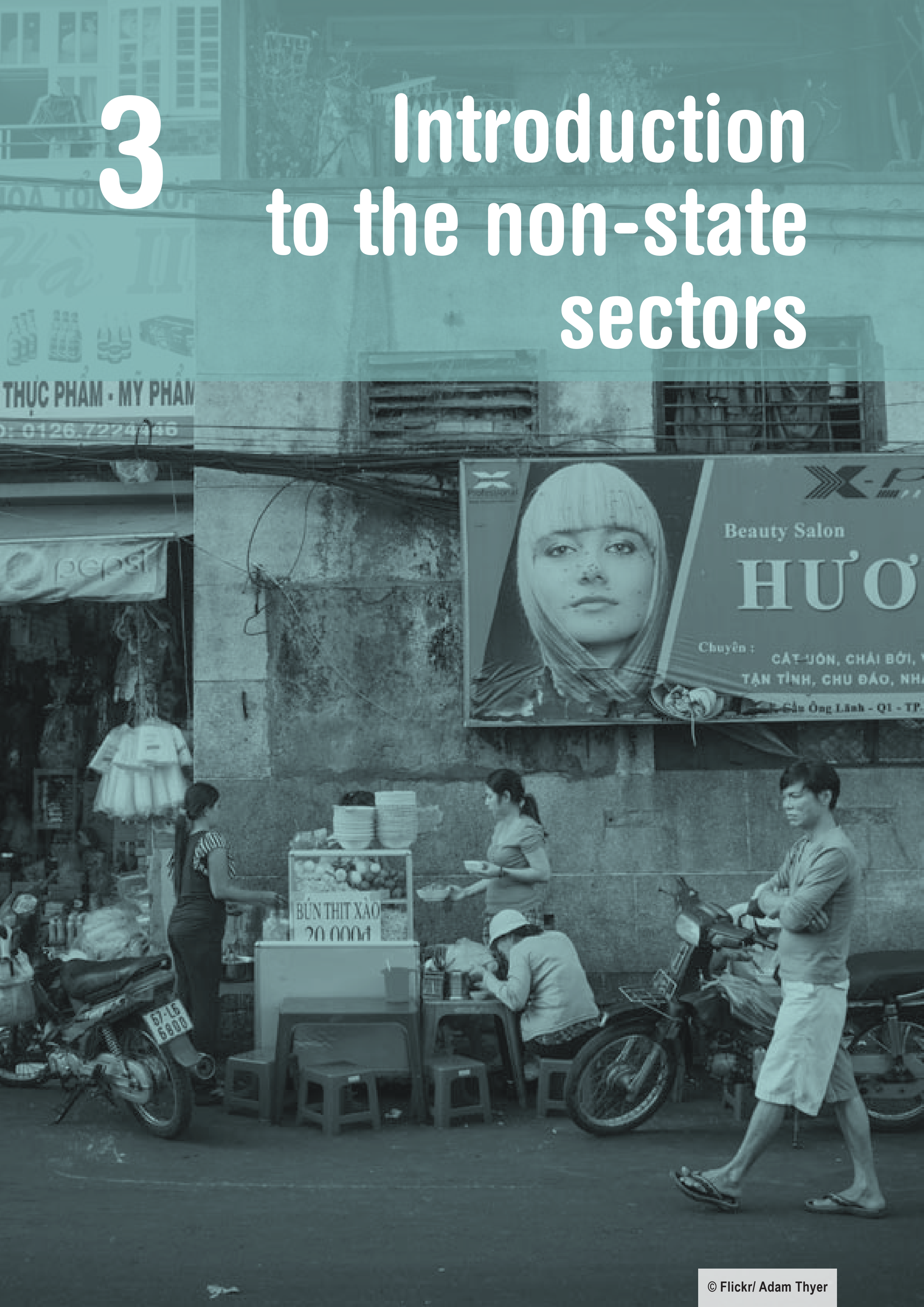
3. Evidence on the impact of localising aid on state accountability is mixed. While some accountability systems are likely to be strengthened, the state's challenge of balancing accountability to both donors and citizens will persist, regardless of aid modality. Donor accountability to their own citizens may be reduced as more control over aid is relinquished.

4. Concerns about corruption and waste, while valid, are insufficient reasons to defer localising aid, which can have positive benefits in all country contexts. Aid to the state can be localised in a range of ways and does not equate to a hands-off approach.

5. While there is some evidence that non-localised aid money undermines the positive impacts of localised aid, there is also plenty of evidence that it could be complementary. In any case, the aspiration to reduce aid fragmentation appears increasingly hard to attain as aid becomes even more complex. Localised aid is an important part of the overall aid allocation to a country, but some donors may not need to localise aid, if others are doing so.

Overall, then, the evidence *is* far from conclusive. However, what is clear from the evidence is that having the facility to localise aid, if and when necessary, is a crucial tool in the toolbox, as there are few contexts where it cannot make a contribution to systems strengthening and it may well be the most important modality for supporting state strengthening where there is sufficient political commitment and capacity to make progress. This means that those donors that are not able and willing to localise aid when appropriate will be at a significant disadvantage to other donors with regard to achieving strengthening objectives. It does not follow that all donors should localise their aid to the same degree. In most countries, a mixture of project and localised aid is not only inevitable but probably also complementary. If that is the case, it is logical that some donors (presumably those with lower risk thresholds) localise more of their aid, whereas others do so less – the important thing is that, as a collective, donors ensure some of their number are engaged in this form of support, because of its significant and complementary benefits.

3 Introduction to the non-state sectors



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Although we divide the private sector and civil society into distinct pillars, given their different nature and roles, the relationship between for-profit and non-profit entities can be blurred. Both are engaged in the market for publicly funded goods and services. In some countries, what would otherwise be private enterprises establish themselves as NGOs so as to be able to access donor grant funds or avoid local taxes. For this reason, this introductory section summarises issues that affect both sectors alike

In contrast with the state sector, the two non-state sectors require some definition, especially because delineating what 'local' means quickly becomes quite technical. We define local private sector and civil society actors as those that i) plan to do their business indefinitely in the country; and ii) are required to register under company, charity, NGO or taxation laws.[1] Of particular interest to this study, of course, are firms and CSOs that have relations with aid providers, often intermediated by the state. Mainly, these will be entities that provide public services that are regulated, financed, controlled or otherwise provided by the state, for example health care, or that are contracted to the state or donors, which implement development programmes and projects. This group of actors also includes associations of business people like chambers of commerce and professional and trade associations, as well as CSO umbrella organizations. Our definition of 'local' would exclude contractors and consultants whose main activities in the country are linked to a particular project, or international entities that do not have a permanent locally registered subsidiary.[2] We further define what we call 'indigenous' non-state sectors in Box 10.

State-owned enterprises (SOEs) have similar characteristics to private firms, including in some cases reasonably hard budget constraints. While we see conflicts of interest in government on both the demand and the supply sides of the market for public goods and services, this may be inevitable in countries with a large SOE sector. According to some analyses, SOEs without much competition tend to be inefficient and absorb public resources that could be used to finance other budget priorities and also crowd out finance from the private sector (World Bank, 1995). Following privatisation and SOE reform in the 1990s, few countries today rely on government departments to construct public facilities, except where the private sector is unwilling and donors are reluctant to finance SOEs when private alternatives are available.

3.1 How can aid be localised to the non-state sectors?

There are variety of ways that donors can localise aid to non-state sectors, and further means to encourage aid-recipient governments to prioritise local firms. We look at each in turn

3.1.1 Contractual and grant frameworks

Different contractual frameworks provide different incentives to the local entity, which will influence its productivity and how its capacity changes; some, such as grants, may be relatively free of conditions. There is a range of options for donors contracting local non-state actors, although all may not exist in all countries. Figure 9 shows the three main routes aid providers can use to localise aid to non-state actors; each arrow indicates a contractual relationship.[3] The aid provider (which could be a bilateral, multilateral or joint donor platform) either contracts local entities directly (Route 1) or contracts an intermediary, either local (Route 2) or foreign (Route 3). We describe Routes 1 and 2 as localised aid. Development finance can be provided on terms that are concessional compared with what would be available from financial markets. In the case of the private sector, it can be provided via (or in close conjunction with) specialised agencies such as multilaterals like the International Finance Corporation (IFC) and the private sector financing arms of the regional development banks.

Intermediaries, which we call 'apex partners' as they are at the top of a pyramid of transactions, lower the transaction costs to the party issuing the contracts, which would otherwise have to deal with

1. In many countries (especially in Africa), there are two regulatory mechanisms for civil society: some kind of Societies and Charities Act and a Company Limited by Guarantee Act.
2. A local subsidiary of a trading firm might, for example, develop capacity in, say, appliance repair, but this would not be relevant unless it was supported by official development assistance (ODA).
3. We use the term "contract" broadly to includes very flexible agreements between the parties, such as grants.

Box 10: The indigenous non-state sectors

Within our definition of 'local' private sector or civil society is a subset of firms and organisations we call indigenous. This consists of those entities that are owned predominantly by resident nationals of the country. They are distinct from the local subsidiaries of foreign firms and organisations, or from entities with owners who live outside the country, who may or may not be citizens of the country. This distinction is relevant for governments that may wish to nurture locally owned enterprises (be they for-profit or non-profit) through policies such as preferences in government contracting. Given that horizontal inequalities (which occur when groups that identify themselves by ethnicity, tribe, language or religion are excluded from the social, political and economic life of the country) can lead to social and even armed conflict, governments may want to implement policies that prevent horizontal inequalities festering into conflict and to implement policies that raise the conditions of minority groups, for example through privileged access to public services such as education, without provoking a backlash among the majority.[*] Such policies have favoured firms owned by excluded groups such as Malays in Malaysia and African Americans and Hispanics in the US.[**]

* For more on horizontal inequalities and policies to address them see Stewart (2010).

** On the effectiveness of affirmative action programmes in the US see Marion (2007).

Box 11: How to manage the contracting procedure

Huysenstruyt (2011) develops a theoretical model of the behaviour of for-profit and non-profit contractors on aid projects and uses this to analyse 457 contracts let by DFID. She concludes that:

1. Non-profits tended not to bid when the decision weight emphasised adherence to the terms of reference selection criteria and dominated auctions where the work required significant labour inputs and comprised a significant public goods component, for example social sectors and renewable energy. For-profits dominated auctions in other fields such as construction, energy, extractive industries, financial services and transport.
2. Adjusting for quality, for-profits tended to bid higher prices for the same work, but the cost differential for non-personnel costs did not differ with non-profits.
3. Contracting with for-profit firms leads to higher post-contract renegotiated payments and the cost of overruns is 30-50% less with non-profits. However, part of this difference can be explained by the complexity of the contract and the precision of the terms of reference.
4. Contracting with a for-profit implies greater government control over project design, but at the expense of quality that cannot be defined contractually and substantial post-award claims. Contracting with non-profits gives government greater non-contractable quality and lower costs, but with loss of control over project design.
5. Costs of post-contract award claims by for-profit firms can be reduced by greater precision over the terms of reference and increasing the reputational costs for overruns and the incentives to reduce costs, for example by factoring past behaviours on post-award claims into bid evaluation, or considering incentive payments and more fixed price contracts.

Figure 9: Contractual arrangements for donors to localising aid to non-state sectors

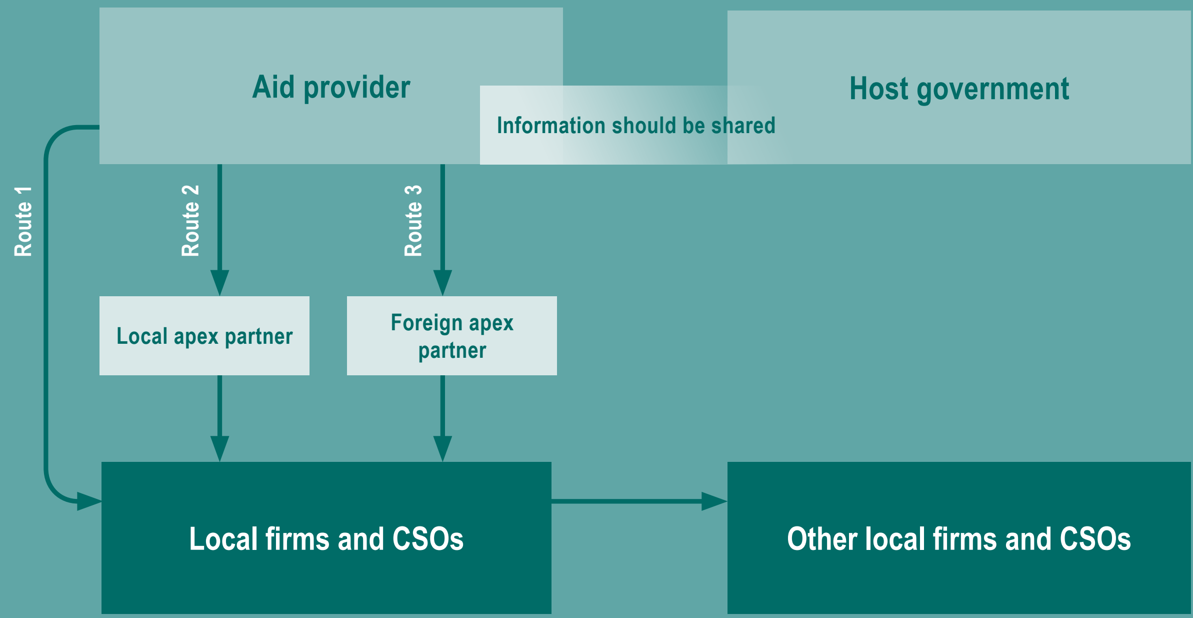
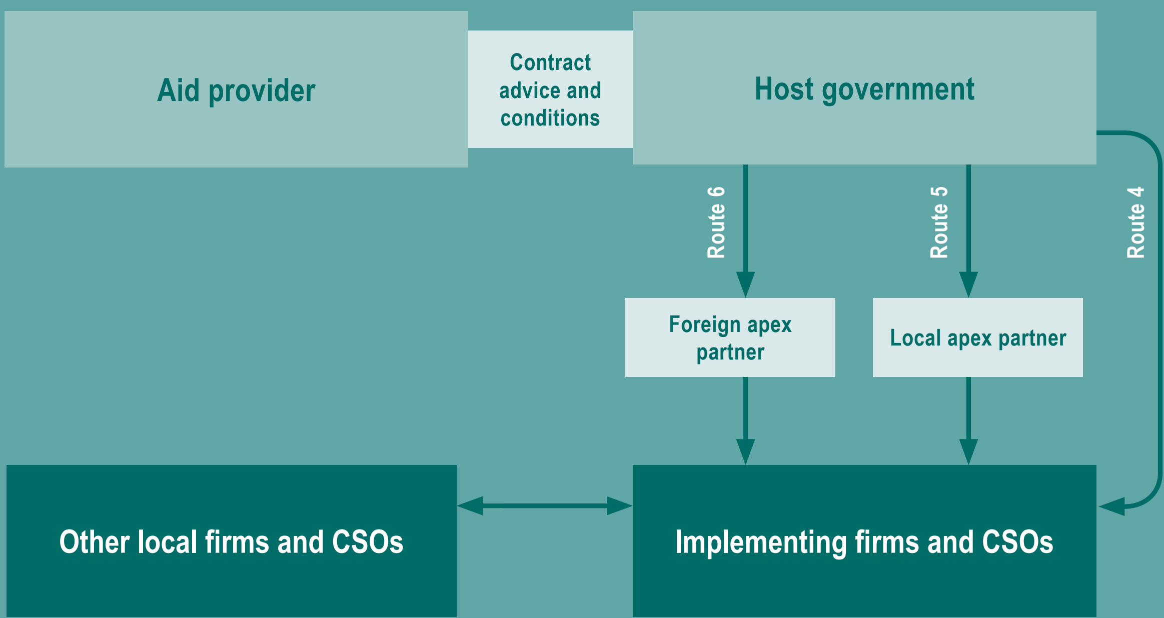


Figure 10: Contractual arrangements for host government to localising aid to non-state sectors



a myriad of small contracts. Such intermediaries tend both to implement some of the work and to manage sub-contracts with a sub-group of local firms and organisations. This sub-group then itself has relationships with many more local entities – the multiplier effect – which are represented by the final rectangle in Figure 10. While the government is not directly involved in this arrangement, sharing information on all activities with the government will ensure better coordination and evaluation.

3.1.2 Non-contractual promotion of localised aid via support to the state

As well as directly implementing contracts and grants, aid providers can also encourage host governments to prioritise local firms and organisations over foreign entities in three ways: contract and payment terms; policy and technical advice; and conditionality. This is stylised in Figure 10, which is similar to Figure 9 except that it is the government carrying out the contracting arrangements, with either aid money (budget support or earmarked funds) or its own resources.

Contract and payment terms
Funds provided by the aid provider could use the government's own budget and PFM processes or systems required by the provider. Provider-imposed systems could be the procurement and payments rules imposed by MDBS, or joint signatory arrangements such as under the Governance and Economic Management Assistance Programme and health pooled fund in Liberia. Donors can also impose additional controls to ensure government systems are implemented with integrity, such as the monitoring agents and eligible/ineligible expenditure controls used in the World Bank-administered trust funds for Afghanistan and Palestine and the cash on delivery approach of the USAID-financed FARA programme for the health sector in Liberia. The public procurement system is the interface between government and the private sector that determines the market conditions through which firms become beneficiaries of foreign assistance.

Policy and technical advice
Donor governments can provide policy and technical advice to governments directly or via intermediaries such as consultants, think-tanks and multilateral organisations. Provided to government, such policy advice might be critical in reforming the business climate, financial sector and other factor markets in favour of strengthening local private and civil society entities and the sector as a whole. Technical advice can enhance the public procurement system to make it more open to localised firms, upgrade government payment systems to ensure its suppliers get paid on time or strengthen regulation of the local financial sector. At the level of the firm, donor-funded advisory assistance can strengthen entrepreneurship and provide information on market opportunities, technological opportunities, better management systems, techniques for quality assurance and how to bid for public contracts. Such advice financed or provided by donors needs to be balanced with the transfer of knowledge and technology that takes place through individual and organisational interactions, such as from foreign firms to their localised subsidiaries and between local CSOs and their international networks.

Conditionality
There is an extensive literature on the effectiveness of policy conditionality, and the record of agreements whereby a government receives money in return for promising to implement future reforms is not one of success, as we have seen in Section 2 above. However, finance linked to policy changes can empower reformers within government to resolve collective action problems and advance the timing of home-grown reforms. Such reforms can be beneficial to the local non-state sectors, for example changes to the public procurement system, tax administration and business climate or creation of an enabling environment for civil society.

This attitude would go aga inst much theory in the past that has pressured governments to adopt 'level playing fields' for foreign firms. In their New Structural Economics, Lin and Monga call for a more active role of government in promoting the development of the local private sector, particularly in coordination. (Lin and Monga, 2010a)

3.2 Why localise aid to the non-state sectors?

We suggest three categories of benefit from localising foreign assistance to the private and civil society sectors (incorporating ideas from Davies, 2011, and Peace Dividend Trust, 2011a).

1. Support to the national economy in general.

2. Support to national (and possibly sub-national governments.

3. Strengthening effects on non-state systems and entities themselves.

It is this third category that is the subject of our research, but we briefly explain the other two areas below.

3.2.1 Benefits for the national economy

It is sensible to assume that the local content of localised aid is greater than the alternatives, and there is some evidence to back up this assumption (Peace Dividend Trust, 2011a). Greater development impacts are likely to include:

1. Stimulation of economic activity owing to Keynesian multiplier effects. This could increase the effect of a dollar spent through a local private or civil society actor by 50% in a post-conflict country (Peace Dividend Trust, 2011b), possibly more in middle-income countries where the import content of local spending is probably lower. With non-localised aid, much of the multiplier effect will take place in donor capitals.

2. Greater local employment, since local actors tend to employ mainly local nationals and are more likely than international firms and organisations to source goods and services from the local market. World Bank (2012) enterprise surveys show that localised firms employ a high proportion of unskilled labour (36% of all production workers in Africa compared with 23% of high-income OECD countries), indicating that localised aid may have a significant impact on employment, even in countries that lack a skilled workforce.

. 3. The fact that using local actors is less likely than other channels to distort the local labour market and thus retard the development of the state's core institutional capacity. UN and other multilateral agencies, bilateral agencies, international NGOs and the international private sector compete against each other to bid up salaries of local staff. The UN is often the market setter in post-conflict situations. A consequence is that government is unable to compete and its capacity can be hollowed out, leading to inadequate performance and long-term dependence on foreign assistance.

3.2.2 Benefits for government coffers

We suggest that localising aid to non-state s ectors is likely to lead to increased government revenues at four levels. First, localised firms and organisations are by definition domiciled in the aid-recipient country and are subject to local corporate income taxes (although NGOs may have some tax exemptions). Second, their staff are made up almost entirely of nationals subject to income taxes. Third, their greater local sourcing generates additional government revenues through goods and services taxes and corporate income taxes. Fourth, local actors are less able than international actors to claim exemptions from import duties and income taxes through exemptions agreed with donors bilaterally or under the global conventions applicable to UN system and diplomatic actors. However, the extent to which these tax revenues can be realised depends on the efficiency of the local tax system and the integrity of those administering it.

Localising aid to the non-state sector via government processes is also likely to strengthen public finance and contract management by state entities. Although this hypothesis would apply to all aid using government systems, there are some additional considerations when local firms and organisations are contracted to government. First, contracts with local actors are likely to be smaller than those with foreign actors; so the government will need to develop processes for awarding, managing and ensuring the accountability of thousands of small contracts. This is qualitatively different to managing a small number of large contracts with foreign firms. Second, in countries where authority is devolved to sub-national units of government, increased use of local actors contracted to government is likely to require strengthening the procurement and contract management capacity of local government, since contracts with foreign firms are more likely to be with central government. As usual, there may be trade-offs, particularly in low-capacity environments such as fragile states, between procurement broken into small contracts that local actors can execute and grow in the process and awarding large contracts to international firms that can be completed faster and (probably) to higher quality.

Box 12: Public accountancy in Liberia – foreign aid can provide incentives for capacity development

The experience of the public accounting profession in Liberia shows how foreign assistance can create incentives for the development of localised private institutions, even if they are not the direct recipients of this aid. Donors require audits for the projects they finance. Domestic audit firms have faced foreign competition from international accounting firms and recognised that they needed to meet international audit standards. In order to do this, they have established a complex system to assure quality and that local capacity is adequate to meet international accounting standards. There is a strong professional association with dedicated headquarters and staff regulating the profession. By law, public accountants need to be licensed by the association through an exam-based accreditation system implemented through the West African association of charted accountants. Regional accounting standards are linked in turn to an international network of accountancy bodies.

To meet these international standards, the Liberian association has forged linkages with local universities to ensure graduates are prepared for accreditation. The association has developed its own training facility and materials to prepare accountancy graduates for regional accreditation. All the accounting firms invest in staff development and training, and have productive links with international firms that provide specialist advice and surge capacity. While international accountancy networks are essentially a loose federation of sovereign local firms, the international firms do bear some reputational risk for the quality and behaviour of their affiliates, which provides additional quality assurance and some protection for local firms carrying out politically contentious audits.

The Liberian accountancy association argues that using international firms to undertake audits for more than 50 years has achieved little in terms of building localised capacity. Foreign auditors, usually from regional countries, have made short visits to carry out audits, returned to their home country and then sent the audit report. Under the regulations that implement the new law on public accountancy, there are requirements that audits must involve a local firm and that this firm is entitled to at least 35% of the fees for the audit. Local firms argue that this protection is necessary for them to invest in human capital and to compete with international and regional firms. Otherwise, the local profession will not develop and grow to meet the increasing demand for accountancy services. Some donors see this as protectionist, and are concerned that the localised profession will not be able to withstand possible political pressures on audits of strategic public enterprises.

3.2.3 Non-state systems and entities

We suggest that localising aid can help strengthen the non-state sector via broadly the same means as it can help strengthen the state sector (i.e. the simple fact of more money being available to local entities, and a better mix of incentives/pressure), although with very different specificities for each sector.

It is self-evident that not involving an international partner means more aid money going to local firms. Furthermore, there is some evidence that the costs of projects implemented by local private sector or civil society are lower than when the work is carried out by international or regional firms, or by local firms under an apex contract between a donor and an international firm. Evidence from the US experience in Afghanistan, where very large contracts were signed with a small number of apex contractors, which in turn employed many subcontractors, indicates significant waste, fraud and corruption (SIGAR, 2012; US Senate, 2011).[4] Also, there have been allegations of waste in some bilateral programmes, particularly when aid is linked to the donor country's strategic interests, or when contracts are very large in relation to the aid provider's capacity to supervise them.

In the civil society sector, the mid-term review of one USAID-funded internationally-administered HIV/AIDS project in Uganda expressed concern at its 38% overheads rate; another HIV/AIDS project, whose primary activities included providing grants to local organisations, was planning to transfer only about 40% of the project's total expenditure in this way. According to a staff member in one Ugandan NGO (a regular bidder for USAID projects), the high costs of many USAID project consortia are in large part down to the high salaries they provide, especially for expatriate staff, which could cover up to three members of local staff at an equivalent level, or 10-15 local project implementers. Consortia projects also deliver a great deal of in-house technical assistance, which is costly.

The quality of some specific outputs from local entities may be lower than with international firms, and the risks that the project may not be completed are probably higher – the classic trade-off between investing in long-term systemic strengthening and shorter-term results emerges once again. The size and complexity of contracts that local actors can execute will depend on the incentives for enterprise development generally in the country and are likely to vary considerably across the spectrum from post-conflict to middle-income country. Even in a middle-income country, there may be some services and large complex contracts that can be carried out only or more effectively by international firms, such as investing financial assets abroad or underground tunnelling through complex geology.

3.2.4 Shifting incentives

Non-state actors that are recipients of localised foreign assistance are likely to develop expertise and capacity and, in the case of firms, become more productive. We have not found evidence from the literature that proves this proposition conclusively, although our fieldwork points in this direction. In Liberia, it seems that desire to win aid-financed audit contracts spurred local public accounting firms to strengthen quality assurance and staff training (see Box 12).

It also seems that the quality demands of multilateral development bank-financed construction contracts have had a strong incentive on local capacity development of foreign-owned but localised construction firms. Firms and organisations that have to compete in a transparent environment and are subject to clear requirements on quality and performance might be expected to carry these skills forward. On the other hand, mastery of arcane donor procurement requirements and dependence on contracts from one source might produce expertise that is not easily transferable to other markets.

There may be other downside risks to be aware of when localising aid to non-state actors, such as:

- Slack contracting procedures by donors or governments that favour particular firms or organisations, may create aid dependency and an inability to survive when aid ceases.
- Over-specification of quality (e.g. to maintain the donor's reputation when aid is branded) might inflate costs and orientate local entities to the market for donor-financed services, rather than the long-term domestic market or other national priorities.

Other sector-specific downsides are discussed in each of the pillar-specific sections, to which we now turn.

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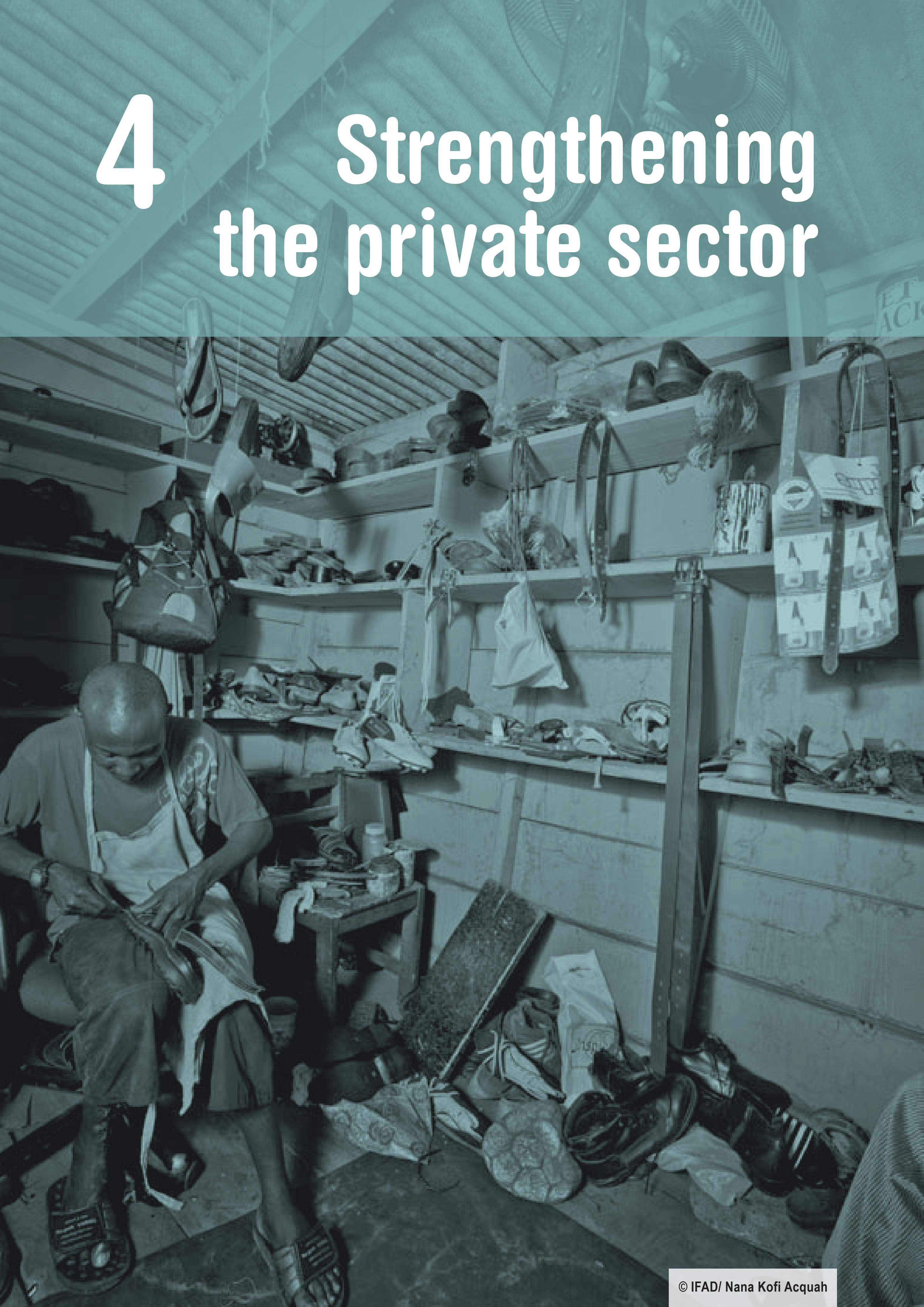
4. Security is undoubtedly an issue in Afghanistan, which may also explain some of the US government project management issues identified in these reports.

4 Strengthening the private sector



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4.1 Introduction

Having looked at some of the issues common to both private and civil society sectors in their interaction with the aid industry, we now look at the private sector in particular. The lack of empirical evidence on how foreign assistance directly affects the capacity of local firms presents a methodological challenge for our research. We have therefore relied on broader research on the economics of the firm, particularly in low-income countries, to assess how localising aid most likely affects local firms, and how international partners could ensure their assistance strengthens the local private sector. Consequently, the research findings in this section are somewhat more theoretical than those for the other two main pillars. This indicates the need for more detailed research and data collection on the effects of foreign assistance on the local private sector and a broadening of programme evaluations to assess their impacts on local firms.

There are conceptual differences and some similarities between the private sector and the civilian arms of the state as to how firm institutional capacity is defined and measured. Goals tend to be different. Although both the private sector and the state set out to deliver outputs, private sector objectives tend to be simpler, such as profit maximisation and market share, whereas government objectives are multiple and more difficult to measure. We start with the proposition that private sector institutional capacity determines how effective firms are in achieving their goals. The economics literature on the firm has tended to use measures of productivity to measure performance. By 'strengthening the private sector', we mean strengthening the productivity of firms, and/or the efficiency with which they can deliver outputs.

We start with a fairly thorough analysis of the key determinants of a firm's performance, both internal and external, reflecting the need to establish the ground we are covering in this quite new topic. Based on this understanding we ask how localising aid can support local firms seeking to enhance their productivity. In the concluding part of this section, we propose five areas in which aid providers can improve their ways of working.

4.2 What determines a firm's performance?

We have reviewed the key elements of the economics literature on the theory of the firm as well as the literature on firm organisation and management, and on the business climate and the firm's collaboration with other firms and networks. Based on this review, we have identified the key influences on firm performance, which will help us analyse the possible impacts of foreign assistance, particularly in low-income countries.

4.2.1 External influences

Factor markets

The classic model of the firm considers key inputs or factors of production such as capital (e.g. plant and machinery), labour and material inputs, including fuels. In a low-income country, one might add services such as security, public infrastructure (e.g. transport, electricity, telecommunications) and secure, serviced land with clear legal title. Frequently, services and land are considered part of the business climate, but these are often so critical to firm performance, particularly when they are lacking, that we have given them special attention. Apart from owners' equity and finance raised informally through family and other networks, capital is financed by financial intermediaries, which could be local banks and other financial institutions, foreign public sector intermediaries such as the development finance institutions (DFIs) and the foreign private sector. Government policies that enhance the supply of the firm's factor inputs or make factor markets more efficient will lead to improved productivity. Examples might include improving the quality of education for workers, or the supply of local bank finance by removing disincentives for bank deposits, for example negative real interest rates, or bank lending, such as barriers to lenders seizing collateral when the borrower defaults.

In our Liberia case study, it was clear that issues in factor markets were detrimental to private sector development. It was difficult for firms to borrow from banks or receive other instruments, such as bid and performance bonds. Banks apparently had large stocks of non-performing loans and tended to lend only to preferred customers. While labour markets were loosely regulated, making hiring and performance management straightforward in the private sector, civil wars for 14 years have seriously disrupted education and had an impact on the skills of the workforce today. Firms operating in the country have to invest in training their workers. The World Bank enterprise survey for 2009 showed that small firms (<20 employees and 90% Liberian owned) reported access to finance, crime and electricity in that order as their main obstacles; medium firms (20-99 employees) mentioned access to land, corruption and tax rates; and large firms (26% foreign owned and 13% state owned) emphasised inadequate electricity, tax administration and an inadequately educated workforce.

Business climate

The business climate consists of the laws and regulations that govern business activity and protect property rights. The World Bank and IFC and the World Economic Forum (WEF) publish annual surveys that compare the business climate across countries. World Bank indicators focus on the regulatory environment and WEF's assess other factors that affect form performance, for example macroeconomic policies, effectiveness of primary and tertiary education systems and access to technology. Despite the differences, the two sets of indicators are closely correlated (World Bank and IFC, 2012).

There is a body of research that shows that firm performance is linked to the quality of the business climate, and this has been incorporated into the policies of the DFIs and multilateral development banks (see IFC, 2011). The World Bank's enterprise surveys contain an extensive database of 120,000 firms in 125 countries, mainly but not entirely in the manufacturing sector, which researchers have used to assess the impact of business climate on firm productivity. Clark (2011) summarises some of this research and assesses the business climate in African countries. Carlin et al. (2007) use these data to assess the relative impact of the main elements of the business climate in specific countries and find that, despite significant variation of their relative importance across regions and income levels, macroeconomic stability, crime and corruption and inadequate electricity supply are common across all non-OECD countries. They also find that transport is a significant constraint in low-income and post-conflict countries and tax and customs administration are also high-ranked constraints in some groups of countries. Labour market restrictions seemed to matter mainly in middle-income countries. Paraphrasing Tolstoy, the authors find that 'even if well-governed countries resemble one another, badly governed countries are badly governed in their own individual way'.

Dethier et al. (2011) review studies based on enterprise survey data and conclude generally that a good business climate promotes economic growth through investment and higher productivity, but that heterogeneity of the local business climate can explain much of the difference in firm performance. McKenzie (2011) notes that there are great differences among SMEs in Africa and information is available only for a small sample of them, so survey data may be inadequate to draw policy conclusions.

Given the capacity of countries to absorb reforms and the time taken to implement them (World Bank, 2011a), it would seem that there is a need to prioritise reforms to the business climate based on their potential impact and the political economy of their implementation. Also, the literature shows that country context clearly matters when it comes to setting priorities for reforms and determining the key bottlenecks that inhibit localised aid from achieving its potential impact on contractor performance. One size does not fit all.

Markets for the firm's products and services

The literature shows that firm engagement in competitive markets leads to higher productivity. Based on an analysis of Chinese firms, Sun and Pan (2011) show that firms engaged in export markets have higher productivity as a result of the effects of market orientation on organisational structure and entrepreneurial behaviour of employees. As part of an international comparative study using survey data, van Reenen (2011) also shows that tougher competition raises productivity through the incentives it creates to raise managerial quality. Crespi et al. (2006) examine how exporting affects the performance of UK firms and find that firms that export learn from their buyers relative to learning from other sources, and that this learning is associated with productivity gains. Competition can also improve the productivity of public enterprises, as a comparative study of British hospitals shows (Bloom et al., 2011).

In low-income and fragile states, domestic markets may be competitive if border management is not strong and rules that inhibit trade are difficult to enforce. On the other hand, there may be strong pressures from incumbent firms and their political patrons to restrict new entrants and to monopolise trade using the powers of government officials and informal power holders and militias. However, an export-oriented strategy can create opportunities for firms to seek profits rather than maximise rents and move business away from a zero sum game (Piffaretti, 2010). Lack of transport infrastructure can retard the development of a national market and substantially increase the prices of imports and raw materials, thus constraining both competition for the domestic market and the viability of exports.[1]

While we could find no studies of the impact of competition for donor- or government-funded contracts on firm performance in middle- or low-income countries, the literature suggests that competitive procurement is likely to strengthen productivity and management capacity. Furthermore, given the evidence that firms that participate in global markets are more productive and better managed, foreign assistance that mimics export markets is likely to have beneficial impacts on private sector capacity. Aspects of export markets a donor might want to see simulated include attention to international quality standards, integration of supply chains and strong incentives for adherence to deadlines. As well as through contract packaging and specifications, these benefits could be achieved through well-designed subcontracting to local firms by foreign-owned prime contractors.

There may be trade-offs with other objectives, such as increasing the size of the local private sector. Too high standards may mean that local, especially indigenous, firms may be unable to compete and thus lose access to the market. There may also be tension with policies to give preference to local firms designed to reduce competition from other firms. However, Khan (2009) shows that development in some countries has depended on private firms being able to benefit from rents generated by the government that allow them to learn and adapt new technology. North et al. (2009) show that centralising and allocating rents may create conditions for reducing conflict and armed violence. However, as both Khan, Acemoglu and Robinson (2012) acknowledge, rents do not always facilitate development, and elites that rely on rent extraction can contribute to institutional failure. These risks may be higher in countries without the bureaucratic traditions of East Asian countries described by Fukuyama (2012) and may create challenges for the government and its partners to manage.

4.2.2 Internal influences

External considerations determine only part of overall firm productivity. As Saliola and Seker (2011) show, there are considerable differences in total factor productivity among countries and industries, which van Reenen (2012) argues can be explained by internal factors, particularly quality of management. We next review the evidence on the impact of these internal factors on firm productivity to determine how localised aid might create productivity-enhancing incentives.

Management

Bloom and van Reenen (2006) and Bloom et al. (2011a) present results of surveys of managers in both industrialised and developing countries that assess 18 dimensions of management performance, which include target setting, monitoring and staff incentives. While most of their analysis is for the manufacturing sector, the surveys also cover other sectors such as health care and schools (see World Management Survey, 2012). They show that management practice scores vary substantially among countries and are linked strongly to level of development. In manufacturing, the top scoring country, the US, had few badly managed firms, whereas Brazil, India and China had a tail of badly managed firms, which the authors linked to the incentives facing managers and firms in these countries. A similar variation in management scores existed in the health and education sectors. In addition, the authors found that incentives management (hiring, firing, pay and promotions) were generally worse in countries with a high Doing Business rigidity of employment index. Management scores also tended to be higher in firms where a high proportion of both managers and non-managers had college degrees.

Ownership

Bloom et al. (2011) found that government ownership was associated with worse management practices in every industry they studied, and this was most pronounced in incentives (human resources) management. They also found that multinational companies (in manufacturing and retail) achieved similarly high management scores in whichever country they were located in, and these were

1. South Sudan, which achieved independence without any all-weather paved roads, is a good example of how lack of infrastructure severely constrains the national market and raises prices in urban centres.

consistently higher than for domestic firms. Indeed, management of multinationals located in low-income countries such as India exceeded the performance of domestic firms located in many high-income countries. In the manufacturing and retail sectors for which data were available, family-owned firms with a family chief executive officer and founder-owned and -managed firms had the lowest management scores, even when compared with government-owned enterprises. On the other hand, Randøy & Goel (2003) found from a sample of Norwegian SMEs that founding family-owned firms had much lower agency costs than foreign or other domestic firms, since the demands for monitoring management performance were lower, and that family-owned firms could use their informal networks to secure financing for new ventures without the drag of agency costs on firm value and profitability. These mechanisms may be relevant in low-income countries, where many firms are family owned and access to formal finance can be difficult.

Technology

Adoption of new or advanced technology is associated with increased productivity. Khan (2009) shows that technical innovation, particularly when implemented through the private sector, is an engine of growth, even in low-income countries. Bloom et al. (2007) associates the increase in US productivity since the mid-1990s with intensive use of information technology and shows that this is also the case for US multinationals located in the UK. They argue that this owes to managerial and organisational characteristics of US firms that encourage efficient use of new technologies. In a survey of private sector development programmes, Naudé (2011) argues that foreign aid has neglected innovation, a driver of economic development, and that private sector development programmes should go beyond entrepreneurship and become a major avenue to promote the adoption of foreign technology by the local private sector.

Firm size

Large firms tend to be better managed than small firms, since their product market has allocated a greater share to them and they are more able to employ professionals in management and operations and to implement modern management systems (Bloom et al., 2011). World Bank enterprise surveys show that firms in low-income countries tend to be small. This is likely to be especially true for fragile states, apart from foreign firms engaged in extraction of natural resources. Size alone is not necessarily beneficial to productivity if it leads to overconcentration of ownership, lack of competition and rent extraction through political connections.

Networks

Relations between domestic firms and other local and foreign firms are a strategic asset through accessing complementary resources and activities of other firms, enhancing the ability of the firm to influence interdependency with other firms in the production network and to create value through privileged relationships with customers or to appropriate value from other firms (Sousa and Castro, 2004). Acquaah and Eshun (2010) concluded from an analysis of more than 100 organisations in Ghana that managerial social network relations with managers of other firms, government officials and community leaders enhanced organisational performance. However, they cautioned that network relations with political leadership may not provide benefits, given the reciprocity of favours this involves and that the benefits of networking are greater when the firm is small, young, domestically owned and doing business in a competitive market. Håkansson and Snehota (1989) set out how a networked organisation needs managerial changes on how to allocate and structure its internal resources, which require strategies that relate these decisions to the other parties that constitute its operating context.

4.3 How can localised aid strengthen private sector capacity?

4.3.1 Facilitating stronger private sector institutions?[2]

Based on our literature review and fieldwork, we can elaborate the following theory of how foreign aid might strengthen local private sector capacity. Our basic definition of private sector capacity is based on its productivity. An objective of foreign assistance would therefore be to increase firm productivity, which encompasses a number of subsidiary attributes of institutional capacity that might be secondary objectives, such as a firm's competitiveness, its

2. Aid in this context includes funds from donor governments directly to the private sector and funds provided through DFIs like IFC that receive government funding or guarantees. Funds received by the private sector from these organisations include loans on own account or syndicated, equity investments, grants and guarantees.

quality of management in terms of both leadership and operational systems and its adherence to standards of governance with respect to its relations with government, shareholders, employees and financiers. A fundamental constraint is that the firm is sufficiently profitable to be able to remain in business.

Another objective of foreign assistance would be to increase the share of development activities localised firms undertake. An increased share by localised firms would create opportunities for both existing firms to grow and for new entrants. The literature indicates that productivity tends to be correlated with firm size and that greater competition stimulates productivity. Measuring success in meeting this objective would require excluding from the analysis of aid impacts those lumpy mega projects that would be outside the capacity of localised firms in most countries of a similar size and at similar levels of development, for example large infrastructure projects. A related issue an international partner might consider would be whether to include second-level beneficiaries of foreign assistance, for example domestic value added from localised suppliers of goods and services that do not have contracts with government or the donor agency, such as cement, other building materials, engineering services and consultants working on environmental and social issues.

A third objective a government might want to adopt would be to increase the share and productivity of the local private sector owned by or employing particular groups within the country, such as ethnic, tribal and religious minorities. This objective might be particularly relevant to a fragile state or a large country facing localised rebellion.

The mechanism by which localising aid increases firm productivity operates through the market for public goods and services (PUGS market). This market is characterised by a tendency towards monopsony, or at least a limited number of public sector buyers. As well as the central government itself, where ministries and other agencies undertake procurement, there may be other buyers of PUGS, such as subnational governments, SOEs and foreign donors and their agents. Because of the abuse of market power for private gain and the potential for waste and inefficiency, the PUGS market is subject to political or legislative oversight both within the country and in the countries of its partners. Multilateral institutions that inject finance into the PUGS market also influence the ways the market develops and exercise their own fiduciary oversight.

Foreign assistance can both increase the size of the PUGS market and strengthen incentives that increase the productivity of suppliers of goods and services that the market demands. An increased share by localised firms would create opportunities for existing firms to grow and for new entrants. The literature indicates that productivity tends to be correlated with firm size and that greater competition stimulates productivity. Our hypothesis is that a greater share of foreign assistance flowing to localised firms would increase both the size of the local private sector (in terms of number of firms) and the productivity of the local private sector, *providing* there are incentives for efficiency operating across the market for goods and services financed by localised aid. Unfortunately, we could find no statistical evidence to prove or disprove this hypothesis, since data on aid flows that reach localised firms simply do not exist.

However, our fieldwork in Liberia found that demand from aid-financed projects had contributed to a massive expansion in the size of the construction sector since the conflict ended, but many of these firms were small shell companies. The Ministry of Public Works is carrying out a registration process to certify those firms capable of implementing different types of public contract. Another good example from the construction sector is of the impact of the World Bank financed Output and Performance-based Road Contracts construction and maintenance contract for a major highway, which has a duration of at least 10 years. This was a factor in Chinese-owned local companies being established and their investment in training Liberians, who comprise most of the work force, as equipment operators, surveyors, etc. We also saw how prospective aid-financed business (and expansion of the economy in general) had led to a returning Americo-Liberian establishing a new accounting firm. The public accounting sector had in general responded well to incentives for quality and integrity in auditing in donor-funded activities implemented by government, through investment in staff training, joining a regional/global network for accreditation of public accountants and establishing linkages with foreign auditors.

4.3.2 Incentives in the market for public goods and services

The review of the literature indicates that there are a number of key policies whereby government and its partners can influence the way the market for public goods and services works, including:

Box 13: Main sectors of the private sector linked to aid financing

1. Sectors that might receive state investment support, for example agro-processing, manufacturing, construction and exporters.
2. Sectors of critical importance to particular groups of countries, for example construction in the case of post-conflict countries.
3. Sectors where public–private partnerships might implement what otherwise would be entirely public investment, for example in the transport sector.
4. Sectors that might be induced to invest in areas normally subject to state investment, for example firms engaged in natural resource extraction, which might build facilities such as roads or power generation with designs that could be adjusted to meet public demand.

Box 14: Marion (2007) on encouraging smaller firms to compete

Marion (2007) assessed the impact of the 5% contract price preference given to minority-owned businesses in road construction in California and concluded that, while procurement costs increased by 3.5%, the efficiency loss from transferring contracts from large to small firms was only 0.3% of overall procurement costs, but the efficiency loss increased to 6.5% when the lower participation of large firms in the procurement process was taken into account. Larger firms tended to bid more aggressively when there were minority preferences, lowering their bid prices by 1.4% on average, whereas smaller firms bid less aggressively, increasing their prices by the same amount. However, even in the US there seems to be insufficient data on how bid preference programmes affect minority businesses and whether preferences set too low encourage firms to stay small, or whether higher survival rates from preferences lead to greater competition. Creating preferences for localised firms to participate in procurement for contracts financed by localised aid is an instrument for developing the capacity of the local private sector. Marion suggests that the economic costs of this may not be high and that such programmes need to be designed with care to minimise any short-term efficiency losses.

- Procurement policy;
- Anti-corruption policy;
- Preferences for indigenous and locally owned firms; and
- ‘Industrial’ policies, where the government and its partners might want to use public procurement to shape the development of the private sector. These policies could also apply to the private sector generally, so as to influence firms not engaged directly in public procurement (see Lin and Monga, 2010a and 2010b).

At the level of transactions – project or programme financing and the packages of goods and services for which bids are solicited – the literature points to five actions and processes that can have an impact on the development of the local private sector. These are:

1. **Specification of technology requirements** Governments and partners can stimulate technical innovation by stretching local firms to adapt modern technology. They can also set technical standards so high as to exclude localised firms from bidding. Technical specifications can also be designed so as to restrict bidding and raise bid prices. In the worst cases, technical specifications can steer contracts to particular suppliers, either because the government agent believes this technology is best or as a consequence of corruption.

2. **Size and complexity of bid package**
   Large complex bid packages may be beyond the technical, managerial and financial capacity of localised firms but may reduce the administrative burden on government (or donor) staff who would otherwise have to manage hundreds or thousands of contracts. However, there are ways for governments to aggregate and manage many small contracts, as the successful 'national programmes' in Afghanistan demonstrate (see McKechnie, 2011). The complexity of the procurement process and the demands for information in bids should be commensurate with the size of the contract, the risks involved and the capacity of the firms expected to bid. It is inefficient to impose costs on firms preparing bids that are high in relation to the size of the contract and the probability that the firm will be successful. Some bid packages, especially for large infrastructure, may be inherently large and need to be contracted to foreign firms. These provide contract management challenges for the government and require the development of important capacity. Well-designed bid packages for large infrastructure can also contain incentives to employ nationals and to subcontract to localised firms. This can generate significant increases in capacity, if done well. Done badly, it can lead to little development in local capacity, as the Liberian experience in health service delivery and until recently in public accountancy demonstrates.

3. **Requirements for a supplier to qualify for submitting a valid bid**
   Excessive pre- or post-qualification requirements for bidders can restrict the number of localised firms able to bid. Too lax qualification increases the risks of projects not being completed, or shady firms taking the initial payment and abandoning the contract. Bidder qualifications need to be seen as part of a strategy for developing particular sectors, such as construction. Liberia has a process in place to qualify localised firms for particular types of construction and to eliminate shell companies from public procurement.

4. **Effectiveness of procurement policy implementation**
   Disseminating public procurement rules throughout government and developing a cadre of procurement professionals is a challenge in most low-income countries. MDBs and the ILO offer training in public procurement, although this may be aimed more at generating understanding of the donor's rules than of the procurement rules in the country. The speed and transparency with which public procurement is managed in the country can ensure all qualified firms can be considered and contracts awarded without delays that impose costs on localised firms.

5. **Effectiveness of project management**
   This includes assuring quality of the goods and services being delivered and resolution of disputes over contractor and government obligations and the interpretation of the contract. In recent years, public procurement has shifted to specialists who are masters of procurement processes, but who lack information on the technical requirements of the contract. It may be time to bring back the 'engineer', who combines knowledge of procurement with the technical details of the project, especially the ability to assure quality and provide constructive advice to the contractor.[3] Significant corruption can occur during project implementation, particularly in requests for deviations from the contract or for additional work not anticipated at project design. An independent engineer is one way to mitigate this risk, to protect the government client from unjustified claims and to ensure the government is well prepared if there are claims that go to arbitration. The system for paying the contractor affects its working capital and cash flow.

4.4 Enhancing the impact of localised aid

Our research indicates a number of ways in which a country's international partners can provide aid that builds the capacity of the local private sector.

4.4.1 An explicit objective in foreign assistance

Most foreign assistance has been indifferent to private sector development, except when this is the prime objective of development assistance. Even investment financing from DFIs has tended to focus narrowly on profitability and other financial indicators, inadequate measures of private sector capacity and performance, and has sought to measure the broader development impacts of their support, rather than have an impact on the private sector itself.[4] Assistance that is concerned about developing national capacity should also be concerned about the development of the local private sector. International partner governments need to take a 'whole of government approach' to strengthening the local private sector that includes humanitarian and security agencies as well as those providing development assistance. These non-development actors may have lax approaches to procurement, quality assurance and accountability that undermine the development of the PUGS market.

Incentives created by the process for awarding and managing contracts are likely to have a significant effect on the productivity and capacity of the local private sector. Weak incentives could promote rent-seeking rather than profit-seeking firms. Lack of competition for contract awards could create favoured firms and restrict the emergence of new entrants. Objectives such as creation of local business through government contracts can be managed objectively, as the US experience in minority preferences shows. There are risks that contracts might not be well implemented, but excessive risk aversion by those providing localised aid needs to be set against the risk that private sector capacity might be developed much more slowly and that benefits from developing the local private sector might be lost. There would seem value in reassessing procurement processes to determine whether greater development benefits from developing contractor capacity can be achieved at an acceptable risk of cost overruns and delayed project completion.

For private sector firms, competition tends to raise productivity through increasing management performance (van Reenen, 2010), and this would seem to indicate that the greater the competition for contracts, the greater the productivity gains. Shaikh and Casabianca (2008) argue that contracts with private contractors to deliver US aid projects give the government greater control over results, ensure greater transparency and accountability, allow more competition and are equally cost effective with non-profits. However, they do not present quantitative evidence in support of these claims, which partly contradict the UK findings of Husentruyt (2011). Agapos and Dunlap (1970) set out a theory of how prices for government contracts are determined and conclude that the government should not reveal its estimated price for the contract. This principle was recently adopted by the World Bank (2011), which acknowledged the risks of collusion among bidders if there were too much transparency, including regarding cost estimates for the project. Asker and Cantillon (2010) apply game theory to examine procurement decisions when quality as well as price matters. They conclude that direct bargaining between government and firms disadvantages the government and that other modalities that lead to greater competition, for example using scoring systems to evaluate quality, contribute to more cost-effective outcomes.

4.4.2 A whole-of-market approach

Donor efforts at supporting the local private sector have tended to be narrowly focused on areas of interest to the donor, with less attention to a strategic approach that considers what actions have the greatest impact on local firms. A review of the websites of donors and multilateral development banks shows the international community has paid a great deal of attention to areas such as procurement rules, financial accountability, rules-based approaches to anti-corruption business climate reforms and fostering entrepreneurship. Much less effort has gone into the actual *implementation of procurement and financial accountability rules.* International partners that helped governments write these rules have shown extreme reluctance to apply them to their own financing, hardly a demonstration of confidence in the effectiveness of their work.

Even less effort has gone into helping governments strengthen *project management*, ranging from preparing technical specifications through setting bidder qualification standards, managing contract variations, quality assurance of goods and services like construction, to contract dispute resolution that avoids dysfunctional local judicial systems. Experience in *financial sector reforms and lines of credit to the local banking sector* has been mixed, and there has been a lack of imagination in trying to solve problems related to bid and performance guarantees and working capital requirements that localised firms often face. Pragmatic advice on *labour market reforms* that balance efficiency objectives

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3. The World Bank's Department of Institutional Integrity highlighted deficiencies in project management in India's health sector that led to poor quality supplies and work, owing at least in part to corruption in procurement and during project implementation A recent report by the same department on procurement in the roads sector raises the issue of whether there is a need for the traditional independent project engineer to oversee project management (World Bank, 2011).
4. For example, see the IFC Development Outcome Tracking System (DOTS) for measuring project impacts (IFC, 2012a; 2012b; 2012c).

of business with concerns about social justice and the distribution of value added between capital and labour has also been rare, not surprisingly given that such distributional issues are inherently political. *Technology promotion* is another neglected area, yet economic growth and poverty reduction depend on the adaptation and adoption of modern technology (see Khan, 2009). Technological change in the PUGS market could involve technical specifications that pressure local firms to adopt new technology and the use of new information technologies to increase market information and transparency and to counter corruption.[5]

Infrastructure investment can lower the costs of SMEs and enable them to compete with larger and foreign firms in the PUGS market that have the network relationships or financial capacity to obtain access to services in short supply, like electricity, or to move goods through inefficient ports. Finally, there are *private sector civil society organisations* like professional and trade associations that are beneficial to the local private sector and can have a significant role in assuring professional competency and ethics. These may be worthy of additional attention from the international community, particularly in facilitating partnerships with their regional and international counterparts.

4.4.3 Managing economic rents and corruption

All governments create and distribute economic rents to some extent, and rents and corruption tolerated by government are common in the neo-patrimonial political systems that characterise low- and middle-income countries. The PUGS market is typically part of the system of allocation of economic rents and benefits of corruption to favoured groups and individuals. As Khan (2003) argues, rents have been a factor in countries that have been successful in economic development, and the association between high economic growth and low levels of corruption is not statistically robust. Khan suggests that, in a dynamic state undergoing economic and social transformation, growth-enhancing rents are favoured over growth-reducing rents through industrial and regulatory policy and that capture of service delivery systems by and open-ended transfers to privileged groups are avoided.

Positive rents that can enhance markets include information rents (Stiglitz, 1996), Schumpeterian rents that drive technological innovation and learning rents. Negative rents arise from monopolies and protection of market incumbents that have ceased to innovate, or whose productivity growth has reached a plateau. Managing the dynamics of rents to strike a balance between building the capacity of local firms and the tendency for firms without strong competition to become rent-collecting parasites on the state is a challenge for government and its international partners. An example of this is the proposed regulation to the Liberian public accounting law that requires 35% of the fees for a joint venture between a local and a foreign accounting firm to flow to the local partner. This may be necessary to enable local firms to invest in staff development and to gain knowledge in the short to medium term, but in the longer term may stifle innovation and generate easy profits for their owners.

4.4.4 Promoting competition and open access to the PUGS market

This is an option for donors wishing to lower economic rents and get more value for money. It means avoiding bids being awarded to a small number of firms through better design of bid packages to encourage more participation in bidding. It also means taking more risk through firms being unable to fulfil requirements of the contract such as timely completion and adherence to quality. This risk can be offset by lower contract prices and better value for money.

Competition through participating in competitive bidding, investing in plants financed through contracts that are large by local standards, access to externally funded training, learning from international apex partners (if they mentor their subcontractors) and tighter management of quality might be expected to have results. One might also envisage other firms with only private sector clients being under even greater pressure to improve productivity. Increased local private sector participation in development activities may also increase adoption of new technology, investment in human capital and

5. For example, surveys of enterprises in low-income countries in South Asia and Sub-Saharan Africa show that less than half of firms use email (World Bank, 2012). While this may owe to infrastructure issues, pushing firms through the public procurement system to adopt modern information technology could have additional benefits, including electronic bidding that increases transparency through the ability to make contracts publicly available through the electronic media.

Box 15: The pros and cons of prequalification

Carter and Dunne (1992) look at small and large firm issues during the prequalification phase when firms are selected to be invited to submit bids. Preparing bids is expensive for firms, and prequalification is intended to ensure an adequate number of qualified firms actually bid. Small firms may be handicapped because their record of quality, completion and cost is not well known and they may be perceived as lacking the financial strength to complete the work. Managers of small firms prefer to compete through negotiation rather than by submitting documentation, but larger firms perceive a bias towards smaller firms in Europe. The authors conclude that small firms may be disadvantaged during pre-qualification, particularly if they are bidding outside their region and competing against the public sector or SOEs for public contracts. Implications of this for localised aid could be to avoid prequalification wherever possible, particularly in countries where negotiations between managers and government officials might lead to corruption, and use other criteria in the bid documents to steer some contracts towards local small firms and new entrants, for example domestic preferences, using firm turnover as a criteria in selection. Based on its reviews of fraud and corruption allegations in the roads sector, the World Bank (2011) has recommended abolishing prequalification of contractors.

Attanasi and Johnson (1975) assess the impact of prequalification of highway contract bidders and arrangements to license contractors for certain kinds of work. Prequalification in particular is often used in low-income countries to restrict competition to those firms with the technical and financial capacity and experience to undertake the project. The authors show that prequalification is a barrier to entry that creates inefficiencies such as higher contract prices, slow adoption of new technologies and lower levels of industry capacity, which are magnified when construction is constrained by weather to only part of the year. This suggests that those administering localised aid need to consider alternative instruments to managing the risk of inadequate contractor performance that balance the risks that the development of private contractor capacity might be retarded.

workforce development, and mobilise additional financial resources (Nelson, 2010). This is not necessarily a given, depending on local firms' linkages with foreign firms and access to technology, the incentives facing the localised firm and the firm's access to finance, which implies that maintaining a clear role for foreign firms is important.

4.4.5 Better measurement

Our research revealed a lack of empirical studies to inform policies regarding channelling localised aid to the private sector. Much of the data needs to be generated from actually localising aid to private firms established within the recipient country via the various possible financial and contracting arrangements. The impact of each of these on the localised firm can differ, since the incentives to the firm may be different if it is contracted to government or to another intermediary or foreign donor agency. This suggests two approaches to improving knowledge on the impact of localising aid to the private sector. First, include questions in some of the existing firm-level surveys on the impacts of localised aid on firms that are participating in aid-funded activities and a control group of firms that is not. Second, modify project evaluation methodologies to include measuring impacts on private firms responsible for delivering project outputs. This second approach follows logically from our earlier proposal to make strengthening localised firms a development objective in projects that involve them.

4.5 Conclusion: an important contribution

Our research points to the following conclusions on the strengthening impact of localised aid on the private sector. We are well aware of the limitations of our research methodology due to the somewhat original line of investigation. We therefore present these conclusions as tentative.

1. Localising aid is likely to increase the size of the market for publicly financed goods and services, which will in turn increase the gross output of local firms.
2. The extent to which localising aid will increase the productivity and organisational capacity of local firms depends on *how* aid is localised, in particular the incentives for higher productivity it creates. These incentives depend to a large extent on the quality and implementation of the public procurement rules in the countries, or the procurement rules used by the donor if foreign assistance is only partially localised, and how these procurement rules are implemented, for example specification of technology, size of bid packages.
3. Increasing the effectiveness of the state in areas such as implementation of its procurement rules, project management, payments system, customs efficiency and managing anti-corruption and economic rents will enhance the impact of localised aid on the private sector.
4. The extent of the impact of localising aid on the local firm's productivity will also depend on the quality of other factors that affect performance of all localised firms, whether or not they are engaged in the PUGS market. These factors range from factor markets, financial sector and critical infrastructure, to the overall climate for business in the country. International partners seeking to localise aid should take a *whole-of-market* approach to the PUGS market so as to give attention to complementary policies that can multiply the impact of localised aid.
5. Localising aid implies a shift in the share of contract payments from international firms to localised firms. In some countries, this shift may take place very slowly without special policies that temporarily favour local firms; in others, such policies include smaller bid packages that are unlikely to be profitable for international firms that have not localised. Governments might also want to give a preference to localised firms during bid evaluation, for example adjusting the prices of localised firms downwards by an amount for the purposes of evaluation.[6] Some governments may wish to use public procurement as an instrument to achieve other policy objectives, such as giving preferences to local firms while they adopt new technology, to strengthen coordination among local firms and to favour indigenous firms owned by marginalised groups. International partners would need to support such policies and seek to ensure that such policies create rents that have positive developmental results and do not reinforce an extractive elite.
6. International partners localising aid should make strengthening the local private sector an explicit objective and adjust their policies and modalities to achieve this. M&E of the programmes they finance should include explicit indicators of the capacity of the firms (and NGOs) that implement the projects, particularly given lack of data on the impact of aid on the development of the local private sector. Those implementing global surveys of private enterprises and private sector management should consider adjusting these surveys to collect information on the share of a firm's sales to activities financed by the government and foreign assistance directly. This information would enable more comprehensive analysis of the impact of aid on localised firms to inform policy. In countries where a major shift to localised aid is contemplated, it would be useful to carry out baseline surveys to assess the impact of the policy.

6. The World Bank procurement 'guidelines' allow for a preference of 15% on goods and 7.5% for construction in bid evaluation (World Bank, 2011a, Appendix 2, 'Domestic Preferences').

5 Strengthening civil society

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5.1 Introduction

It is even more challenging to define the parameters of civil society than of the private sector; civil society incorporates a great variety of entities and an organising framework is subject to much debate. Definitions of civil society include the very broadest, focusing on all degrees of organisation between the state on the one hand, and private individuals on the other, and a variety of narrower definitions that distinguish between factors such as the cause being pursued (e.g. health, free speech), operational boundaries (e.g. not for profit, some profit element) and location (e.g. developed or developing world, community level) (Vakil, 1997). Given limited resources, our study focused on the section of civil society with which international development actors most commonly engage: CSOs. These are entities whose function is to mobilise citizens, or to speak on their behalf, in pursuit of some social, political or economic cause. We are most interested in CSOs primarily pursuing development activities and operating on a not-for-profit basis (popularly known as NGOs, a term we use interchangeably with CSOs). These have been the focus of our research, but our work is also relevant for other bodies such as trade unions, business associations and cultural organisations. Apart from being the area of most immediate relevance to many donors, there is also plenty of useful literature on these actors.

As well as exploring whether localising aid can help strengthen individual CSOs, we are interested in whether it can have strengthening effects on the civil society sector as a whole, a concern of many donors. Building on the analysis in the state pillar of the research, we define a stronger civil society in terms of first its capacity (core organisational functions for delivering development programmes) and second its accountability (responsiveness to and representation of constituents' needs). We look at these concepts in more detail in the following sections.

Drawing analogies from Paris

The Paris agenda is concerned primarily with strengthening state and government systems, but we have extrapolated from the theory and empirical evidence that support the Paris principles to devise similar principles that might apply to civil society entities. This might be described as our general theory of change. Individual CSOs carry out many of the same institutional operations (e.g. financial management, procurement, monitoring and evaluation) as state bodies in managing aid and other resources; these functions are likely to be strengthened when they become the focus of coordinated efforts to promote their use and scrutiny, and weakened when they are neglected and subverted. Building on the reasons for localising aid to the state sector and our preliminary literature analysis, we therefore theorise that localising aid to the civil society sector will result in positive strengthening impacts following our two main logics, namely, shifting *incentives* for key actors and donor *pressure* to improve in key areas. This thinking sits neatly within our definition of localising aid: the shift of resources from international organisations to national organisations.

In the next section we set out the main challenges facing aid providers seeking to build up both the NGO sector and the individual organisations within it. Then we assess whether and to what extent localising aid might help overcome these challenges.

5.2 Donor challenges

The first major challenge donors face when seeking to strengthen the CSO sector is the renowned conundrum of seeking to support local leadership of the development agenda while still holding the purse strings, which we denominate 'balancing accountabilities'. And second is the simple problem of deciding which organisations to support, which is often as much a political decision as a technical one.

5.2.1 Balancing accountabilities: donor influence

A series of evolutions in the history of development have created a turbulent environment for NGOs, ever since their early role as pioneers of development assistance during the colonial period, posing fundamental challenges to their effectiveness, legitimacy and sustainability. Development assistance provided by NGOs was relatively limited until the late 1970s, when aid donors began to work with them more actively, driven by a growing disenchantment as to the effectiveness and accountability of the state in terms of leading the development process. During the era of structural adjustment, NGOs became prominent in delivering services and supporting community development, with international NGOs expanding their role and raising ever-greater sums. Then, in the 1990s (with poverty reduction strategy papers (PRSPs)) and early 2000s (with the aid effectiveness agenda), donors began to re-emphasise the role of the state in development; the role of NGOs in empowering citizens and holding governments accountable became more critical. Social and political trends within developing countries have also been hugely influential in the evolution of NGOs (Bank and Hulme, 2012).

Common to all these distinct periods, however, is the fact that NGO effectiveness hinges on the ability to link with and represent communities, poor and marginalised people and citizens in general. This is perhaps the most important asset NGOs have and therefore an important aspect of any donor agenda to strengthen the sector. As with the state sector, questions of accountability refer as much to the importance of 'doing no harm' as they do to actually enhancing accountability. We hypothesise that, when aid donors enter the equation, issues of accountability become muddied, with CSOs facing two ways, required to be accountable both to funders and to those they seek to represent. The main factors of accountability we looked at in our research are:

- The strength of accountability processes to constituents;
- The strength of the organisation's governance structures; and
- The strength of the organisation's own commitment to its stated mission and objectives.

Donors have had a significant impact on the agendas of NGOs as they have attempted to funnel NGO activities, using funding, to meet their changing priorities. Recent research highlights how rapidly increasing funding for issues such as HIV/AIDS (Morfit, 2011) and microfinance (Stiles, 2002) has skewed the activities of CSOs heavily towards these areas and away from activities in important areas such as agriculture, governance and empowerment. NGOs reorient their mission statements to maintain their relevance for donors they rely on for most of their funding (Devine, 2003).

During the 1980s and 1990s, when neoliberalism was at its height, donors promoted NGOs as alternatives to the state in carrying out functions such as service delivery (Bebbington, 1997; Edwards and Hulme, 1996; Fyvie and Agger, 1999). However, although this ideological agenda pushed NGOs to prominence, it also circumscribed their activities in areas such as those related to economic development, where market-based approaches came to dominate and donors became increasingly reluctant to support NGOs to challenge such policy agendas through their programmes and advocacy activities (Bebbington, 2005; Stiles, 2002).

It has also been suggested that the emergence of the poverty reduction, MDG and aid effectiveness agendas in the late 1990s and early 2000s led to the promotion of technical and prescriptive interventions led by the state. This has discouraged donors from funding NGOs to engage in more political approaches that attempt to address the underlying structural causes of poverty and to challenge their government's policy agendas (Bank and Hulme, 2012; Bebbington, 2005; Edwards, 2008; Igoe, 2003; Wallace, 2006). The NGOs we interviewed were almost unanimous in raising frustrations about the degree to which they had to adjust their work to meet donor requirements; they recommended that donors do just the opposite – that is, operate in ways that respond to local priorities.

NGOs face serious challenges in ensuring donor support builds both their capacity to function effectively and their accountability to their constituencies. Research suggests that NGOs that maintain a clear organisational vision are more effective and sustainable than those whose focus changes frequently in response to various pressures (Edwards, 1999). In addition, where NGOs are reorienting their activities in response to donor priorities, they are likely to be in danger of weakening their capability to be directed by the priorities of their constituencies and the development challenges they face (Bank and Hulme, 2012; Bazan et al., 2008; Elbers and Arts, 2011). An NGO staff member in Uganda illustrated this last point:

> '[…] you want to implement what is relevant to the community, based on what you have seen or researched about […] you submit a proposal with three core objectives, and then the funder adds a fourth, so you implement what you don't want […] as a result of the donors being predetermined in what they fund, organisations end up being less responsive [to the community].'

5.2.2 Identifying which NGOs to support

The fact that NGOs can develop and practice their accountability in many different and often subtle ways poses major challenges for donors seeking to assess their representativeness and legitimacy. Research suggests donors are not always successful in supporting NGOs that link effectively with poor and marginalised citizens. There are various models of NGOs in operation. Membership organisations are probably the most representative, given that there are formal structures and processes through which their constituencies shape the organisation. But this does not mean NGOs operating in other ways (e.g. national advocacy organisations) cannot be representative, only that they face more significant challenges developing their legitimacy, usually by operating transparently, accountably and in partnership with citizens (Atack, 1999). Donors have struggled to ensure that NGOs they support are not captured by elites (Mohan, 2002; Swidler and Watkins, 2009), function through representative structures (Igoe, 2003), are effective in mobilising communities (Bano, 2007) and build on existing community structures rather than undermining or ignoring them (Lewis, 2004; Nabulsi, 2005).

One of the ways donors can address these challenges is to ensure they are as informed as possible about the civil society context they are engaging with and the implications of their funding decisions before making such decisions. This would usually involve a purposeful and in-depth exploration of the local context through a formal process of consultation and research as part of the process of allocating funding. None of the six donors we spoke to in Uganda – which include most of the biggest donors working on governance issues – seemed to have undertaken focused and extensive research or outreach to feed into the design their civil society programmes. Instead, they seemed to be relying predominantly on the experience of previous projects (which, given high staff turnover, is not always that extensive), some limited consultations and the informal knowledge of staff (especially of the many local staff most donors now employ).

An NGO staff member with first-hand knowledge of the process a donor went through in deciding which of the two main general umbrella organisations of NGOs in Uganda to support reported that the decision was handled as a technical issue, with little reference to the consequences in terms of which types of NGOs their funding would ultimately empower. In another example, a recent review of the work of a multi donor civil society programme (Strengthening Transparency, Accountability and Responsiveness in Ghana (STAR-Ghana)) stated:

> 'STAR's initial political economy analysis does not assess civil society in the same depth as government. The absence of such an assessment increases the likelihood that STAR could have an adverse as well as positive impact on civil society. STAR is widely reported to be the dominant funder of civil society. Its creation, evolution and closure can be expected to have major impact on civil society' (STAR, 2012).

Some interviewees in Guatemala raised the issue of external actors supporting NGOs that, in the view of the interviewees, were disruptive to the orderly progress of politics, that is, encouraging strikes and road blockades. The role of donors in this context is subject to debate. But what cannot be escaped is the fact that donor money is helping shape Guatemalan politics – some of the smaller NGOs would simply not survive without it, often mediated through an international NGO.[1]

5.2.3 Strengthening partner CSOs

Having looked at two key sector-wide challenges, we now turn to the challenges donors face in seeking to strengthen (or refrain from damaging) individual CSO capacity. There are many elements of organisational capacity relevant to the civil society sector. We use a five-year study of capacity development by the European Centre for Development Policy Management (ECDPM) that has captured some attention in the development sector; this provides a useful framework, identifying one core organisational function in particular that most closely relates to our needs, namely, the capability to 'carry out technical service delivery and logistical tasks' (ECDPM, 2008). This further incorporates the following sub-capabilities very much related to the way we earlier subdivided state capacity:

- Strategic planning and management;
- Financial management; and
- Service delivery (and other activities).

Here we identify four key factors for organisation strengthening in donor funding relationships with local civil society: monitoring and reporting; overheads; length of funding; and flexibility.

1. According to one Spanish interviewee, 'Our Spanish NGOs have created dependency in their national partners'.

Monitoring and reporting

Since the mid-1990s, donors have increasingly demanded that their developing country partners are able to demonstrate the achievement of concrete and quantifiable outcomes from their work, often over very short time periods (Edwards and Hulme, 1996), probably in response to pressure in their own countries, in which most of their resources originate. This trend has been driven not only by the increasing accountability demands donors have been facing, but also by new approaches to management and accountability emerging in the public and private sectors in donor countries (Wallace et al., 2006) and the increased role for NGOs in supporting service delivery and poverty goals.

This trend has expressed itself in the increased and almost universal use of tools such as logical frameworks, project cycle assessment techniques and indicator-based reporting systems. These attempt to facilitate detailed planning for, delivery of and reporting on concrete and often quantifiable results from development programmes. Such approaches have increased the scrutiny and performance culture applied to development activities, especially in contexts where capacity and resources to put in place such systems is weak.

However, at the same time, these approaches have been the focus of criticism from development professionals who raise concerns about the extent to which their model of change has become the norm – that is, a controlled process that can be planned for linearly, achieved through taking distinct steps and captured in measurable form. It is claimed that these approaches have dominated more participatory and flexible approaches and reduced attention to less tangible, more complex and longer-term development outcomes that are often more transformative in nature (Wallace et al., 2006).

One area of development outcomes that seems to have suffered from these evolutions in oversight and reporting demands are those relating to organisational capacity building. Such outcomes are often hard to measure and can take significant time periods to emerge; in the current donor environment, it has therefore been more difficult to ensure that development programmes delivered to and through CSOs and focused primarily on other goals also maintain a focus on these goals (Edwards and Hulme, 1996; Kabeer et al., 2012). Included among the types of organisational functions that such trends are reported to have discouraged NGOs from developing are those related to building coherence and resilience (Sterland, 2003), experimentation and innovation (Fyvie and Agger, 1999; Arts and Elbers, 2011), strategic planning (Arts and Elbers 2011) and empowerment and accountability to the constituencies they represent and work with (Edwards and Hulme, 1996; Igoe, 2003; Mohan, 2002; Wallace et al., 2006).

In the case of the accountability of NGOs to their constituencies, Ebrahim (2003) has carried out important research on the specific pathways through which these effects emerge. He illustrates how donors often emphasise a focus on NGOs using tools that promote upward accountability to donors (e.g. reporting and disclosure requirements) over ones that help promote downward accountability to the constituents of NGOs (e.g. participatory planning and monitoring). He suggests that one of the factors contributing to this dynamic is the fact that systems relating to downward accountability are often more expensive and time consuming to develop.

It is also well documented that the donor push for NGOs to plan for, achieve and report on more concrete and quantifiable results has discouraged their efforts to promote more complex and transformative change in the societies in which they work. Donor support to social movements in Latin America has been on the wane since the 1990s (Bazan et al., 2008; Bebbington, 1997; 2005); similar trends have been documented in Bangladesh since the emergence of large-scale donor support (Stiles, 2002) and elsewhere (Arts and Elbers, 2011). Where donor practices create such a dynamic, they are likely to undermine the capability of the affected NGOs to be accountable to their constituencies by responding to the full range of social, political and economic factors that hinder their progress. In many cases, responding to these challenges will have been among the founding goals of these NGOs. Our field interviews suggested that, in some respects, these challenges are becoming more significant as international aid comes under increased scrutiny following the economic slowdown in Western economies experienced since 2008.

HIV/AIDS funding in Uganda (over 80% of which comes from the US government's President's Emergency Plan For AIDS Relief (PEPFAR) initiative) is characterised by a very intensive focus on delivery partners providing regular reporting on the numbers of people the various services provided reach. Such reporting requires significant resources and time, from donors, project management agencies and delivery organisations, possibly to the exclusion of focusing on other activities. A number of NGOs suggested to us that the focus on reaching service delivery targets meant limited attention and effort were focused on organisational strengthening; even when organisational strengthening is addressed, it is focused predominantly on meeting reporting requirements and only to a limited extent on other capacities that will be relevant to the organisation's effectiveness and sustainability beyond the project's activities.

An evaluation of a major HIV/AIDS project funded by USAID during the period 2002-2007 – the Uganda Programme for Holistic and Human Development – says that, 'As a result of the focus on numbers, capacity development efforts were oriented to enhance capacities in that direction. As a result there were diminished efforts and resources placed on systems and institutional strengthening as a process.' And, 'The level of detail required by the monitoring process, as well as the time constraints to collect this data, placed considerable pressure on district and local partner institutions, and on occasion it seemed that there was more emphasis placed on the collection of numbers than the actual activity itself' (ibid.).

In addition, the comments of an NGO staff member we interviewed on these issues provide an important insight into what is at stake in effectively addressing them: 'It seems like many donors are content to implement projects that allow people to smile for five years, but what we need are projects that help create local organisations that can support people to deal with all the challenges they face throughout their lifetime.'

It was not just in relation to HIV/AIDS that we encountered insights into how approaches to results affect organisational-strengthening outcomes. A research and advocacy NGO told us that donors funding a number of its projects are becoming increasingly demanding in terms of results reporting and timescales. To meet their requirements, this NGO had to be able to report concrete outcomes on a regular basis, including sometimes *weekly* reports on activities. While recognising this approach was helping focus attention on project goals and delivery, this NGO also made it clear that it was also creating challenges in working with some weaker and more grassroots-oriented partners, with whom progress was harder to achieve. In one project, these pressures had contributed to a decision to stop working with such a partner; in another, it had resisted such pressures by emphasising progress stories from the other partners in the project to satisfy the donor. This case illustrates the trade-offs involved between achieving project impacts and possible disincentives to working with weaker, more grassroots-oriented organisations that may arise as a result of the demand for results. Obviously, a balance between these goals is needed and should be explicit in the decision making of donors and NGOs.

Of course, donors funding these projects face significant pressure to achieve progress on very pressing development issues. However, it does seem clear that, if one of their goals is also to leave behind local organisations that can operate effectively and take initiative in responding to these challenges after their aid has gone, then they need to do much more to explicitly focus attention on such organisational-strengthening goals. This will require them to incorporate organisational-strengthening results indicators (albeit possibly with a longer timeframe in mind) into their contractually binding results frameworks and to take such outcomes as seriously as those related to service delivery.

Using partner systems

There is quite an extensive literature on the impact donor approaches to project oversight, and particularly on results reporting, can have on organisational-strengthening objectives. However, this literature has not extensively addressed whether using NGO systems for managing and reporting on projects helps strengthen NGOs, as our application of aid effectiveness theory to the civil society sector would imply. This issue appears to be more of a concern for service delivery NGOs than for those focused predominantly on advocacy and research activities, perhaps because the latter's activities vary quite widely and each set of activities requires distinct management and reporting that can more easily borrow from donor approaches. However, service delivery NGOs, such as those operating in the health sector, will often deliver services of a relatively standard nature. In such cases, where multiple donors are supporting the same type of activities but require different reporting formats, major problems can be created for the NGO in strengthening its core systems for management and results.

This point is illustrated in a recent report assessing the monitoring and evaluation systems of one large NGO delivering HIV/AIDS services in Uganda, The AIDS Support Organisation (TASO): 'The changing environment in HIV/AIDS service provision and donor funding has seen TASO implementing several projects funded by different donors and with diverse [M&E] systems. Currently, TASO runs an average of eight projects per year, each of which had an independent M&E system running concurrently to achieve the overall goal of TASO' (Kizito, 2012). In Liberia, we saw that the skill that some local NGOs most wanted was to be able to prepare better proposals for donor funding – a useful skill if it encourages discipline in planning, monitoring and financial management, but a less useful one if it encourages over-specialisation in the requirements of particular donors.

Overheads

One of the major benefits of core funding is that, by supporting an organisation in its entirety, it provides support across all of its planned activities and functions. By contrast, by supporting a specific subset of an organisation's activities, project funding will not automatically cover all of the costs (directly and indirectly) relevant to these activities and the degree to which it does so will be determined in large part by the policy of donors in relation to these types of costs – often referred to as 'overheads'. The limited research literature that addresses these types of challenges suggests that all too often donors are not adequately covering overheads in the support they provide to NGOs, which leaves these organisations struggling to use donor assistance to strengthen their capacity (Arts and Elbers, 2011; DI, 2008; Howell, 2011; Sterland, 2003; Wallace, 2006).

Our field interviews in Uganda strongly confirmed the significance of this challenge relating to project funding: NGOs almost unanimously emphasised the major significance of donor policies on overheads for organisational strengthening.[2] Perhaps the most vivid insight we heard was from a donor in Uganda who mentioned two NGOs that had ended up losing money because the limit the donor placed on overheads meant they had to cover these from other resources. Another NGO complained that a donor had provided insufficient staff funding, meaning non-project staff had to make up the numbers, limiting their time spent on other activities. One area of overhead support of particular concern was the funding of physical hardware, such as computers, vehicles and premises vital to basic organisational functioning and sustainability, but which many donors are reluctant to fund because such items are not likely to be dedicated purely to the project being funded.

It was clear from our interviews that the approach donors take to supporting overheads varies greatly, even defining the term differently (DI, 2008), and that many do provide sufficient overhead support. One donor in Uganda seemed to have a very flexible overheads policy, which allowed it to be more responsive to the needs of individual organisations. However, this donor worried that its policy was likely to become less flexible and generous as a result of growing pressure from headquarters to identify the specific results its funding was achieving.

Although it is hard to make firm policy conclusions on the back of this analysis, it does seem clear that the issue of overheads is one donors need to pay increasing attention to if their assistance is to achieve better strengthening outcomes. In particular, it seems important that rules from headquarters do not preclude country programmes from approaching overheads in a way that responds to the needs and challenges facing NGOs in the particular contexts and sectors in which they are working. Such a threat could be mitigated somewhat if donors promoted more regular and open dialogue about these challenges with NGO partners on the ground.

Length of funding

A strong theme emerging from the literature and fieldwork is the relevance of the length of projects for the strengthening of organisational capacity. For example, Arts and Elbers' (2011) in-depth study of the experiences of 51 NGOs in Ghana and India highlights how NGOs struggle to develop and pursue long-term visions for their work and integrate learning into their practices when the funding they receive is predominantly short in term. In addition, they need to divert extensive resources towards constant fundraising, which reduces resources available for other priorities.

One Ugandan NGO highlighted how a three-year project, not even particularly long term, had allowed it the opportunity to make effective use of a consultant who was hired to support implementation to deliver informal training of its staff on data issues outside of the formal project activities. Another NGO in Uganda highlighted how a five-year project it was involved in

2. By 'overheads', NGOs were referring to the general costs involved in supporting them to implement their projects. Unfortunately, we were not able to define this term any more precisely through our interviews, which makes specific conclusions about the most critical elements of overheads or the way they are handled quite difficult.

had given it the opportunity to plan on a longer-term basis for follow-up work and the next phase of the organisation's development. Experience of projects of a year or less was that they did not provide organisations with an opportunity to take forward successfully piloted approaches.

Flexibility

Another important theme that is especially relevant to the ability of NGOs to engage in a demand-led and responsive way with the communities and citizens they work with is the flexibility donors display in their funding relationships. This issue is prominent in the Arts and Elbers (2011) study, framed around the inherent difficulty in foreseeing all the challenges that will arise in a project and how needs and the context evolve, which requires project activities to remain flexible if NGOs are to be perceived as responding effectively to the needs and challenges facing poor communities. This study seems to suggest that limited flexibility on the part of donors is the rule, likely driven by rigid use of log-frames to guide project implementation (Wallace, 2006).

The dominant experience of NGOs we interviewed was also one of somewhat limited flexibilities offered by donors in terms of the timing and nature of project activities; where donors did offer flexibility the importance of such an approach was clear. One NGO in Uganda told us that one of its project funders had allowed numerous changes to the log-frame of activities that had been agreed at the start of the project. The NGO's perception of why this flexibility had been offered was that the funder understood that the NGO was in the best position to understand the local context relevant to the work it was doing and therefore to guide the project effectively. It also believed that the positive personal relationships it had built up with the staff of their funder were significant. Another NGO in Uganda told us of its appreciation of a donor including a mid-term review after two years of a four-year partnership, which provided an opportunity to assess the suitability of the project activities and make adjustments based on challenges that had become apparent. Its experience was that few donors provided this type of flexibility.

Of course, as with all the issues we are addressing in this research, donors have their own perspectives, which often differ from those of NGOs. One donor criticised by a range of interviewees for its especially inflexible manner responded that NGOs were not making maximum use of the flexibilities in contracts; changes were generally not requested according to due process, at a suitable time in the project's implementation and based on a clear vision for how the next phase of the project would benefit from these adjustments. A constant theme in interviews was the ability of NGOs to make maximum use of the official and unofficial flexibilities that funding rules allow in order to address their organisational-strengthening needs. This point was emphatically illustrated by an NGO in Uganda, which used a number of tactics to free up funds and time for organisational-strengthening activities. One NGO managed to convince a donor to fund a generator, even though this was not fully consistent with the donor's rules. The NGO suggested that its success in winning this flexibility from the donor was down to it making a strong case about how power cuts were undermining project reporting, and also the trust built up in personal relationships between the staff of the NGO and the donor in question.

5.3 Options for localising aid and possible impacts

NGOs are very diverse, ranging from large to small organisations, with a host of different political perspectives, technical expertise and bases for their legitimacy. A central problem for most major donors is their inability to maintain direct contractual relationships with NGOs towards the smaller end of the spectrum: in most donor agencies the administration costs for a small grant are not significantly smaller than for a large grant. This means that the Route 1 means of localising aid in Figure 9 (on page 47) is unlikely to be a significant option for attempts to broaden support beyond the largest local NGOs. Exceptions to this rule include small civil society funds such as those managed by British embassies around the world, which make small one-off grants to local or international civil society. It seems inevitable that the use of apex partners, or intermediaries, will continue; the issue is who these contractors are. For this research, we are interested in exploring the differences between national (Route 2) and international (Route 3) apex partners, and how important they are for strengthening the sector as a whole. Some NGOs interviewed in Uganda were nostalgic about an era when direct funding by donors was more common, although we found no strong evidence to suggest that this was ever a dominant model in Uganda or elsewhere.

According to Tembo et al. (2007), reasons given for using intermediaries, apart from the need to reduce donor transaction costs, include more effective targeting of support to local NGOs and their agendas and better coordination of donor support. Encouraging a consortium to bid with one lead NGO is a slightly more democratic variation of the traditional use of a single intermediary. But questions have been raised about how effective the use of intermediaries has been in strengthening local civil society, particularly with regard to the dominance of international NGOs as intermediaries (Scanteam, 2008) and the difficulties in targeting grassroots NGOs that may struggle to meet technical funding requirements (Lavergne and Wood, 2009; Tembo, 2007). The degree to which they are selected using demand-led procedures focused on their accountability and legitimacy to local NGOs has also been questioned (Tembo, 2007). The limited literature in this area points towards the need to understand better what types of intermediaries are most suitable for different contexts (Howell, 2011; Tembo and Nkonkolimba, 2012).

Attempts to localise aid by one particular major bilateral donor with significant experience working with the civil society sector – USAID, also the funder of this research – are worth exploring. USAID'S experiences are shared by many other bilateral donors. Over the past two decades, USAID has increasingly outsourced the management and oversight of its programmes to private contractors, in large part because of reductions in its staffing (Natsios, 2010). Over the same period, it has become increasingly reluctant to provide funding through national governments. As a result, much of USAID funding is now managed by a range of mostly US NGOs and other private organisations, which commonly work together in multi-organisation consortia to provide grants and support in-country. In Uganda, the vast majority of USAID's projects in the health sector are managed by US or internationally-based organisations. Of the 25 projects with budgets greater than $5 million in the health sector, only four are managed by indigenous organisations; the local offices of international organisations manage another five.

Although local NGOs are able to bid for USAID project management contracts, in most countries only the very largest and most established NGOs bother to do so. This is because it is difficult even for large local organisations to compete with those headquartered in the US, which are better resourced, meet donor requirements more easily and have better knowledge of USAID's funding practices. Their better political connections are also helpful. In some countries with a highly developed NGO sector, like Colombia, local NGOs are now increasingly able to compete with international organisations, mitigating their weaknesses by hiring in experts in proposal writing with specific knowledge of donor requirements.

To counter this problem, the USAID mission in Guatemala chose to open a recent very large contract only to Guatemalan organisations, to the surprise of many US firms and NGOs that had been preparing to bid for the contract. This is in contrast with other major donors, which have no such policy to promote local NGOs. Two main reasons were given for the decision to localise this aid – the denominator and numerator of the value for money equation: cost and effectiveness. The argument on cost seems fairly clear. According to USAID, it is 'both cheaper and more effective to work with local organisations'; US grantees are 'much more expensive'. An international bid would both have been more expensive on running costs and have seen a large proportion of the cash spent abroad rather than in the Guatemalan economy. However, there may be marginally more administrative work for USAID project managers now they are working with Anacafe and Agexport, two Guatemalan organisations – not because they are national but because they are new to a number of systems, compared with US contractors that know them backwards. Anacafe has hired an ex-USAID staffer to help with M&E.

But the argument that local organisations are more effective needs to be examined more carefully; while it may well be true in this particular case, as a generalisation it may not be backed up by evidence. According to Anacafe, 'we know the needs of our people better than international organisations'. USAID, meanwhile, views local organisation as 'more ambitious', with better local knowledge and direct relationships with local organisations. But we spoke to international organisations in Guatemala and elsewhere that work almost entirely with and through local organisations and see their primary task as strengthening them. According to one international NGO interviewee, 'that is all we do'. How well an apex contractor is positioned to strengthen sub-grantees may depend as much on many other factors as on whether the contractor is national or not, although this is likely to be a major factor. For instance, some foreign organisations may have strong links with local churches, which can be a crucial part of service delivery and advocacy systems. Many international organisations have been working for decades in host

Box 16: localising aid to support nutrition in Guatemala

Anacafe is an organisation sustained by contributions from coffee cultivators, large and small, throughout Guatemala, giving advice and assistance to its members. There are 22 departments in the country, and in 20 there is coffee; there are 90,000 coffee producers, mostly (60%) small farms. In 2012, USAID invited bids for a $42 million grant (over five years) to support income generation and development in the poorest parts of Guatemala in conjunction with its international Feed the Future programme. A number of the large US organisations accustomed to winning these bids were originally very interested in the Feed the Future bid and came down to Guatemala to prepare. However, USAID announced it would be a locals-only bidding process. Anacafe won the bid, splitting the grant with another major local organisation, Agexport.

Many local organisations came to the pre-bid conference, and some smaller NGOs applied for the rural value chains work, but in reality few bids were anyway near the quality of Anacafe and Agexport's. The fact that bids had to be in English further favoured the larger organisations. The apex partners were bound to be large NGOs with capacity (Anacafe brought in expert help to advise on the bid). Anacafe has worked with USAID since 1989 (though not as a direct grantee) and has built up a relationship of trust: it has never had problems with its audits.

Sub-grantees include federations of cooperatives and producer associations in other economic sectors such as tourism. They will receive $7.9 million and, according to Anacafe, 'after five years should be ready to manage large direct grants'. According to the grant conditions, no more than 40% of sub-grant money can go to US sub-grantees – Anacafe is subbing to MercyCorps and Save the Children. There are 16 new partners, mostly local, approved by USAID but with no close oversight; it is the prime grantees that make the decisions and manage the accounts.

There are 16 indicators of change obligated by Feed the Future, with another 42 for this particular project, some of which refer to the organisational strengthening of the NGOs involved. Insiders acknowledged, unsurprisingly, a 'results systems' tension and the universal difficulty in measuring progress on the latter. Anacafe is looking for complementary funding to increase its contribution over the next few years – the focus of the USAID grant is the Western Highlands, the poorest part of Guatemala. Anacafe is also working with municipalities and mayors, sometimes contractually, asking them to invest their own money and time in the project.

Accountability

There have been no significant difficulties in responding to USAID requirements on the project. In fact, Anacafe is grateful to have been made to look beyond coffee production issues to broader development issues such as income generation and education – seeing its members in the round, not just as coffee producers. Where it previously focused on technical assistance, this grant ($19 million over five years) will help Anacafe invest in organisational infrastructure. Education will be a key part of this work in fertility, administration, nutrition, etc. So, with regard to the balance of accountabilities, Anacafe sees no conflict. Apart from USAID money, Anacafe is 60% member funded and 40% funded from payments for services rendered; this project will have no significant impact on Anacafe's accountability to members – it works in only 2 of Guatemala's 32 departments.

The Guatemalan government's SESAN is very much in the loop, as we verified in interviews. The government will still need to respond to the needs of the very poorest (Anacafe's target beneficiaries are all at least landowners), but it is recognised as working much more slowly than Anacafe, and a perception of corruption and poor administration has put USAID off working directly with the government at this stage.

Box 17: Two types of multi-donor facilities to support Ugandan civil society

A new DGF is pooling the governance funding of seven bilateral donors plus the EU in Uganda and working to deliver a more coordinated and strategic response to a wide range of governance challenges. It has a budget of €72 million over five years to 2016 and will fund a wide range activities, including capacity building. The CSF was founded in 2007 and has a budget of about $20 million a year funded by six bilateral donors. It is intended primarily to fund work on HIV/AIDS and orphans and vulnerable children, with a growing focus on organisational strengthening.

Is the aid localised?

Both funds are intended to fund only national NGOs. The DGF is managed by donors and transfers monies direct to local NGOs. It also provides certain funds for core funding, which should give opportunities to some NGOs to plan on a longer-term basis, deepen their expertise in core work areas and develop responses in closer partnership with their constituencies (see next section). The CSF, on the other hand, is currently managed by two international organisations: Deloittes, which is responsible for financial management, and Chemonics, which handles technical assistance and M&E; this management structure is funded by USAID. While the CSF was originally intended to be locally constituted and governed, no local organisation wanted to take on the role, in part because they would have been excluded from receiving CSF funding. Instead, USAID provided funding for its management by a consortium of international NGOs (originally led by CARE International) and private contractors. The CSF provides predominantly short-term project grants, which have had limited impact on organisational strengthening, although NGOs have used their voice in the CSF's governance structure to push for a stronger focus on organisational strengthening, which now constitutes 13% of total funding.

Tension 1:
International versus national agenda setting

Perhaps the biggest concern expressed about the DGF is the apparent limited involvement and power of Ugandans in its decision making and functioning, perhaps best illustrated by the fact that its programme log-frame was developed almost exclusively by donors. The main day-to-day decision-making body allows only donors to have a say; the three Ugandans on the Board probably have only limited influence, according to interviewees. We were not made aware of any major study or consultation that fed into the design of the DGF's programme and donor staff agreed the process for developing its strategy and log-frame was handled behind closed doors.

The CSF's governance structure, on the other hand, does provide a significant role for local NGOs and government representatives, who are strongly represented on the Steering Group and Partnership Group and have been able actively to influence the CSF's evolution and some key decisions. However, despite the CSF's relatively localised governance, its activities and the way they have been delivered are still strongly driven by donor priorities and approaches. This is largely because USAID funds its management, meaning USAID's funding constraints are passed on to the CSF. These include strict financial controls, which have limited the focus on smaller and more informal NGOs (DFID, 2009) and certain political emphases, such as a limited focus on condoms as part of HIV/AIDS prevention. The CSF's 2009 evaluation (ibid.) revealed a perception by NGOs that its management costs are high, reducing the level of funding available to final beneficiaries.* Efforts to locally constitute the CSF continue, and a number of options are being actively discussed at present, with progress held up by recent corruption scandals implicating a state institution. The clear intention of both the DGF and the CSF to promote local agendas appears still to be in tension with donor priorities, restrictions and ways of working that may suit donor needs more than those of local organisations.

The issue of overheads was also raised in a 2009 review of the work of the CSF, which stated that 'applicants are not allowed in some rounds to budget for organisational overheads beyond services and programme activities, such as recurrent costs or salaries. This is not efficient, if the purpose of the CSF is to strengthen civil society responses' (DFID, 2009). According to the same analysis, a short-term approach to funding has hindered the work of the CSF, which has had limited success in promoting long-term planning as its projects are only one to two years in duration (ibid.).

Tension 2: Large versus small
These funds appear not to have effectively addressed the common concern that aid favours larger NGOs better positioned to handle this level of funding (Scanteam, 2007). Both the DGF and the CSF have responded to this concern by encouraging consortia of NGOs to emerge with lead NGOs supporting smaller ones. Such a model may help promote greater NGO collaboration, but it is unclear whether it would strengthen smaller NGOs and the constituencies they represent, or whether their political and financial positions may be weakened if not adequately represented by the larger NGOs leading consortia. The vast majority of the CSF's funding goes to national organisations, with about 60% (in 2010) going to eight of the larger national NGOs, although smaller NGOs are becoming more prominent recipients as funding conditions are gradually tailored to meet their needs.

* Between 2007/08 and 2009/10, 13.8% of the CSF's expenditure was on its management; although not obviously significant, given that two-thirds of its funding has gone to eight or nine strongly functioning national NGOs, this may well be a much more significant figure than it first seems (CSF, 2010).Between 2007/08 and 2009/10, 13.8% of the CSF's expenditure was on its management; although not obviously significant, given that two-thirds of its funding has gone to eight or nine strongly functioning national NGOs, this may well be a much more significant figure than it first seems (CSF, 2010).

Box 18: The role of international NGOs in Colombia

Colombia is a highly divided country after years of civil conflict, with suspicion about the motives and backgrounds of different CSOs rife. In such a context, even though civil society is highly capable, international organisations continue to play a vital role, for two main reasons.

Perceived as non-political
While all organisations have ideologies, international actors in Colombia and other conflict zones are often able to provide services, including advocacy services, other local organisations would struggle to provide, because they are often perceived as 'above the fray'. Their international contacts and protection, either explicit or implicit, from their embassies, enable them to work in areas that might be dangerous for national organisations.

Sharing international knowledge and alternative ways of working
The presence of international organisations in the Colombian context allows for the sharing of experiences of these organisations in other parts of the world with local NGOs. It also means sharing of best practice in the NGO sector in terms of strategic planning, financial management and other core organisational activities. This is somewhat analogous to the kind of technology transfer in the private sector one would expect from the presence of international firms.

Box 19 Core and project support to CSOs

Donor modalities to support NGOs can be split broadly in two: project and core funding.

- Project funding can be defined as assistance that supports an organisation to implement a distinct set of activities, often set out by a donor agency.
- Core assistance is the provision of support to implement an organisation's general strategy and activities – it is analogous to budget support to the state sector as specific expenditures that cannot be tracked by outcomes can be assessed.

countries – their knowledge of local organisations and politics may well be as good as or better than national applicants for grant money. It very much depends. Box 16 (page 73) looks in more detail at the case of Anacafe and how it has dealt with some of the problems identified in the previous section.

5.3.1 Multi-donor funds

An alternative to using an already established organisation to manage funds is to set up new funding facilities, generally pooling donor funds, thus theoretically enabling smaller grants while reducing overall transaction costs. In some countries, these joint donor efforts to strengthen the civil society sector are becoming more common, for this and other reasons, including donor recognition of the importance of responding to development challenges in a more coordinated and strategic way. Recognition that bilateral donors do not usually always have the relevant capacities in-house to support NGO development effectively has led to joint approaches, which often try to involve local actors in the management and oversight of NGO funding. These mechanisms could either be conceived as new intermediary organisations with no implementation role or as the reorganisation of an aid provider. Changes to previous funding models and the establishment of new relationships at the country level have been required to respond to these priorities. Tembo (2007) has raised concerns over the possibility of multi-donor facilities multiplying donor demands on NGOs, thereby weakening downward accountability to their constituents. Our case studies appear to bear this out.

In Uganda, we looked at two multi-donor facilities: the Civil Society Fund (CSF) and the Democratic Governance Facility (DCF). The emergence of the multi-donor CSF was fundamental to efforts in Uganda to invest in central systems, as it not only provided support for M&E strengthening but also led to the harmonisation of donor reporting requirements. Box 17 looks at them in more detail.

5.3.2 The advantages of international NGOs and firms

We have seen that localising aid to the civil society sector by using local apex contractors or by constructing multi-donor funds does not necessarily get over some of the problems facing donors seeking to strengthen the sector. As with the state sector, we conclude that it is an important option to have, but that it should not be considered a magic bullet. Furthermore, evidence suggests that international apex partners may still have a number of comparative advantages to support both sector-strengthening and development objectives in general, which do not rely on their stronger capacity or contacts, as Box 18 on Colombia illustrates. Arts and Elbers' study suggests that international NGOs that fund NGO partners in-country offer greater flexibility than official donors in their funding relationships.

Perceived as non-political
While all organisations have ideologies, international actors in Colombia and other conflict zones are often able to provide services, including advocacy services, other local organisations would struggle to provide, because they are often perceived as 'above the fray'. Their international contacts and protection, either explicit or implicit, from their embassies, enable them to work in areas that might be dangerous for national organisations.

Sharing international knowledge and alternative ways of working
The presence of international organisations in the Colombian context allows for the sharing of experiences of these organisations in other parts of the world with local NGOs. It also means sharing of best practice in the NGO sector in terms of strategic planning, financial management and other core organisational activities. This is somewhat analogous to the kind of technology transfer in the private sector one would expect from the presence of international firms.

Interviews in our case study countries highlighted the expertise international organisations were able to share in terms of financial management, M&E, research and other areas. Many have been working for decades in host countries and their knowledge of local organisations and politics may well be as good as or better than that of national applicants for grant money. However, our fieldwork also highlighted some of the tensions around the role of international organisations, which are often perceived as unfairly powerful competitors that can sometimes overstep their role, not to mention their high overheads.

This analysis points to the importance of donors having a clear understanding of gaps in local capacity and ensuring the role of international organisations is tailored to filling these, while allowing local organisations to increasingly lead development efforts. It also highlights the importance

Box 20: Project versus core funding – quotes from the field

Project funding
'When some donors send project support, they only fund project officers and finance officers, excluding the top management [...] donors need to recognise that the person implementing the project has to be guided by the leadership of the organisation.'

'The biggest problem of project support is that it is not flexible [...] You are tied, yet most NGOs are always faced with emerging issues in the implementation of projects, but are only limited to what was agreed on with the donor. The problem with that is that you then look irrelevant.'

'Project funding is often not significant enough for our organisation to do such activities like carry out financial audits, board meetings, staff training and strengthen internal governance mechanisms. Yet they expect us to be strong organisations.'

'There has been little money from projects for physical resources such as computers and other hardware, which are vital to our functioning.'

Core funding
'The core funding we received allowed us to deliver on our core priorities and then look beyond these to choose project funders carefully and work with those that best fit its priorities and approach.'

'The core funding we received allowed us to engage in a flexible and responsive partnership with our partners; we learnt how to do genuine needs assessments for these first time.'

'Core support allows us to build synergies between different projects and to ensure that they better contribute to the programme and the overall goal of the organisation.'

'Core support has enabled the organisation to build the capacity of our staff in skills like M&E, to build physical infrastructure and spend time sharing experiences with other organisations.'

Box 21 The funding priorities of Guatemalan NGOs

NGO and Cooperative Coordination (CONGCOOP), the cooperative of NGOs in Guatemala, represents 18 NGOs that are in large part dependent on international NGOs for funding, which are in turn part bilateral and part publically funded. German International Cooperation (GIZ) is the only bilateral directly supporting the work CONGCOOP. The EU used to support CONGCOOP directly, but now prefers to work via a European NGO, an arrangement that better suits the EU's administrative requirements, but also suits CONGCOOP, relieving it of burdensome form filling.

Most of its members receive money for projects lasting three to five years and want to move from projects to programmes to core support, always subject to sound controls, which would help them plan more coherently into the longer term and deepen their own lines of work and priorities. CONGCOOP itself has a four-year accord with Christian Aid and Oxfam, which monitor their annual progress as an organisation, not specific projects. According to CONGCOOP's director, the most effective organisational strengthening has occurred when internationals have come to work embedded with the organisation for long periods of time – seminars are not so effective. Civil society needs support in auditing; strategic planning; transparency; and linking better with the state to formulate public policy. According to CONGCOOP's director, donors are really poorly coordinated and should specialise better on themes and regions.

of donors not setting unreasonably high reporting and financial management standards that preclude local actors from taking more of a leadership role. Such approaches, however, appear to have been the exception rather than the rule. Rather than leading consortia as apex partners, international NGOs could increasingly become parts of such consortia. The AECID model of financing a Spanish NGO hand in hand with a national NGO may be one for the future, although it is a clear example of tied aid, especially as many Spanish NGOs are struggling financially.

5.3.3 Core and project funding

Finally, we ask whether providing core rather than project support may be a more important factor than the nationality of the apex partner for supporting CSO strengthening. Categorising aid to NGOs as either project or core support is quite broad and does not capture the full variety of approaches, but it is useful for our analysis (see Box 19).

A shift from project to core support is analogous to a move in the state sector from localised but projectised support in Figure 2 to budget support. Most aid finance to civil society is in the form of project funding.

The costs and benefits of core versus project funding have been debated actively over the past decade. Project approaches can be important in targeting very specific constraints and beneficiary groups and in closely tracking the use of resources, especially where the context does not allow for broader interventions. However, by avoiding (usually) broader organisational challenges, they can be less effective in terms of their strengthening impact and create transaction costs for recipients. They are also associated with quite close donor control and weaker ownership by recipients. Lack of core funding tends to pose challenges in attracting and retaining quality staff, investing in research and staff development and devoting time and resources to learning (Arts and Elbers, 2011; Bebbington, 2005) and incentivises projects to neglect core organisational functions and longer-term organisational strengthening (Arts and Elbers, 2011; Howell, 2011; Sterland, 2003; Wallace, 2006). In contrast, while core support to an organisation to address development challenges can involve more risk for donors, it can also avoid many of the pitfalls of project support outlined above (Lawson et al., 2003).

Our in-country interviews broadly confirmed our literature survey. An NGO interviewed in Uganda highlighted how the lack of general organisational support created challenges for it in maintaining its organisational focus and identity as it scrambled for diverse projects related to its work, which also take significant resources to pursue. In contrast, the core funding received by another NGO allowed it to deliver on its core priorities and then look beyond these to choose project funders carefully and work with those that best fit its priorities and approach. Box 20 shares more quotations from interviews on this subject.

Core funding may also be important for NGOs in terms of how responsive and demand-led their work with local partners is. Two NGOs interviewed in Uganda highlighted how the core funding they received allowed them to engage in a close and open dialogue with their partners on their needs and to deliver more bespoke support, including on organisational development issues other funders neglected. These practices would have been less likely to emerge with more narrow and subscribed projects that were more tightly controlled by donors.

Despite the fairly strong evidence that core funding is crucial to strengthening civil society, most NGOs interviewed for this research confirmed that core funding had historically been a marginal type of support for them and donors were becoming even more reluctant to fund NGOs in this way. It seems that for most NGOs core support is likely to remain a small part of their funding in the immediate future. Somewhat unfairly, it seems as though it is the preserve predominantly of international NGOs, with funding decisions made by headquarters, or established local NGOs that are in a position to serve the main political interests of donors (e.g. around corruption or HIV/AIDS). It may be that the growing demand from donors to focus on specific results will make them even more wary of providing core funding – that was certainly the concern of some NGOs we spoke to. Given the next section focuses on three characteristics of project funding that can be managed better to enhance its organisation-strengthening effects. While the core versus project divide emerged its important in our research, there are other important aspects to the funding relationship; the blunt core versus project separation hides a wide variety of practices that may well have .diverse organisational-strengthening impacts.

5.4 Conclusion: localising aid may be useful, but it is unlikely to be transformative

We hypothesised that local NGOs acting as apex partners would be better able to strengthen local civil society but have not seen convincing evidence that this is a sound generalisation. Neither the joint donor approach nor moves to local intermediaries will necessarily help strengthen local civil society or get away from donor preferences being paramount in funding decisions. At times, international organisations may still be the most appropriate contractors. What is undoubtedly the case is that donors should consider localising aid more often in this sector, not least for reasons of cost. That means donors need to ensure they have the means to support local organisations, and are ready for the trade-offs and the extra work this might imply. In order to rebalance funding possibilities in favour of local CSOs, donors could possibly start with a default option of supporting local organisations and, when this is not done, explain clearly why not – similar to the Busan commitment on using country systems. It seems clear that, if donors want to strengthen the capacity and accountability of NGO sectors in developing countries successfully, they should be more open to being driven by local priorities and to apply their own priorities more flexibly.

Our research points to the following conclusions on the strengthening impact of localised aid on the civil society sector:

1 CSO functions are likely to be strengthened when they become the focus of coordinated efforts to promote their use and scrutiny, and weakened when they are neglected and subverted. The choice of which NGOs to support remains as much a political issue as a technical one, whether they be international or national entities. Generally, donors need to invest more time in understanding the civil society sector as a whole, in order to inform a strategic, long-term and system-wide approach, rather than focusing too much on their individual projects.

2 While there are likely to be cost savings from using local apex partners, it is not certain that project effectiveness will improve – this depends on a range of factors beyond the local or otherwise nature of the contractor. International intermediaries can play an important role in improving the technical capacities of partners they fund and are often able to carry out activities that local actors find hard, particularly in highly politicised situations. But they face questions about how they share resources with beneficiaries and how localised their governance and practices are. International CSOs and firms can continue to play a crucial role in coalitions, though not necessarily as apex partners.

3 The strengthening effects of localising aid to CSOs depend on a number of characteristics, some of which are under donor control. These include the influence of donor priorities on CSO activities and policies; the degree to which donors are able to target support to CSOs with the legitimacy and ability to represent citizens; the accountability and reporting demands CSOs face from donors; the length and flexibility of the project; how overheads are addressed; and whether organisational strengthening is part of the results matrix. They also depend on how successfully recipients make use of the flexibilities available in the project. Local (especially grassroots) CSOs may struggle to meet multiple donor demands and technical funding requirements, especially given the dominance of international NGOs in the domestic space.

4 Core funding can help strengthen the capacity of NGOs, as it frees resources for NGOs to pursue their own programmes. Project modalities lend themselves more easily to dominance by donor management and accountability practices, which can discourage a focus on less tangible outcomes such as organisational strengthening. Dependency on project support may create challenges as core costs are not covered and long-term agendas are bypassed, although dependency on core support can also be problematic.

5 Donors working outside of government are not doing enough to share information, plan effectively and to operate in a way that is complementary with state-led programmes. They are also failing to incentivise their partners to support systems development (particularly in health).

6 Conclusions

‘If you want to go fast, go alone; if you want to go far, go together.’ — African proverb

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6.1 Summary

In this report, we have analysed the impact localising aid might have on strengthening the state, the private sector, and civil society. We have found a mixed picture. While localising aid is no magic bullet in any of the sectors, it must be considered as a critical element in any aid strategy aimed at strengthening systems.

6.1.1 State

For the state, we found sound evidence that localising aid can be an important tool in many contexts, but nothing to convince us that it is generally a more appropriate tool than other modalities. Different modalities have different roles in the complex business of supporting state capacity and accountability, and the key may be achieving a sensible balance of modalities.

1. Localising aid is associated with progress on strengthening state systems, although it suffers from some of the same problems of other types of aid.
2. The evidence implying the strengthening tendencies of localised aid is not strong enough to generalise across all contexts.
3. While some accountability systems are likely to be strengthened, the state's challenge of balancing accountability to both donors and citizens will persist, regardless of aid modality.
4. Concerns about corruption and waste, while valid, are insufficient reasons to defer localising aid, which can have positive benefits in all country contexts.
5. While there is some evidence that non-localised aid money undermines the positive impacts of localised aid, there is also plenty of evidence that it can be complementary.

6.1.2 Private sector

With the private sector, localising aid can increase the performance of local firms and the productivity of the sector as a whole. We propose a range of ways in which aid providers can work with governments to strengthen the private sector, most (but not all) of which are related to localising aid. The evidence is supportive of a move to localise a higher proportion of aid to the private sector.

1. Localising aid is likely to increase the size of the market for publicly financed goods and services, which will in turn increase the gross output of local firms.
2. The extent to which localising aid will increase the productivity and organisational capacity of local firms depends on *how* aid is localised, in particular the incentives for higher productivity it creates.
3. Increasing the effectiveness of the state in areas such as implementation of its procurement rules, project management, payments system, customs efficiency and managing anti-corruption and economic rents will enhance the impact of localised aid on the private sector.
4. The extent of the impact of localising aid on the local firm's productivity will also depend on the quality of other factors that affect performance of all localised firms.
5. In some countries, the shift in the share of contract payments from international to local may take place very slowly without special policies that temporarily favour local firms; in others, such policies include smaller bid packages that are unlikely to be profitable for international firms.
6. International partners localising aid should make strengthening the local private sector an explicit objective and adjust their policies and modalities to achieve this.

6.1.3 Civil society

With civil society, we found that while localising aid to apex partners is likely to strengthen those particular entities, it is not clear that organisations further down the pyramid will necessarily be strengthened by such arrangements. Indeed, internationals will sometimes have advantages and should be used appropriately. Again, a range of other issues, such as the importance of core rather than project support, may turn out to be more important than localising aid *per se*.

1 Donors need to invest more time in understanding the civil society sector as a whole, in order to inform a strategic, long-term and system-wide approach, rather than focusing too much on their individual projects.

2 While there are likely to be cost savings from using local apex partners, it is not certain that project effectiveness will improve.

3 The strengthening effects of localising aid to CSOs depend on a number of characteristics, some of which are under donor control.

4 Core funding can help strengthen the capacity of NGOs, as it frees resources for NGOs to pursue their own programmes.

5 Donors working outside of government are not doing enough to share information, plan effectively and to operate in a way that is complementary with state-led programmes.

In a report with findings as balanced as this, it is likely that different elements will be emphasised by different readers. Advocates of localising aid might emphasise our finding that in all country contexts localising aid should be a key tool available to programme managers seeking to strengthen local systems. On the other hand, they might be disappointed that our support for localising aid is somewhat equivocal.

Our own analysis of our findings is that they are commensurate with a new era of aid and development. There was a time when supporters of specific aid modalities would line up against advocates of other approaches to battle out the evidence.

In today's aid world, armed with a further decade of evidence, we can recognise the usefulness of manifold approaches, each with pros and cons and available for use in the appropriate circumstance. Perhaps too much emphasis has been placed in past aid effectiveness discussions on finding the perfect aid modality; all aid modalities can be used well or poorly. However, the inability or reluctance to localise aid should be viewed as a significant weakness in an aid programme portfolio.

6.2 Concluding reflections

During our research we identified a number of issues common to all three pillars and relevant for policy makers and programme managers. In the second part of this concluding section we briefly summarise those findings.

6.2.1 Acknowledge trade-offs between short- and long-term change

Balancing short-term results and longer-term systemic shifts is the complex business of decision makers in the public and private spheres in all countries, and development is no different. It is not controversial to those in development practice to acknowledge that there may be trade-offs between emphasising short-term results and longer-term systems-strengthening approaches. Nevertheless, the aid effectiveness consensus that emerged from Paris has not emphasised this tension; the very term 'aid effectiveness' implies that some aid is effective and some not, rather than recognising that some aid may be more effective at achieving short-term results at the expense of systems strengthening, and vice versa.

While win-wins undoubtedly exist (transparency being the most obvious), there are also likely to be trade-offs between quick wins and longer-term strengthening. Often pressure for short-term results comes from aid providers who find themselves under pressure from donor capitals and the 'results agenda', rather than from aid recipients, who may better understand the longer term nature of structural change. Short-term fixes may have an impact on the market for public goods and services; such distortions should be minimised and mitigated, even as short-term outcomes are prioritised, especially in the case of life-saving interventions.

The arrival of new development actors such as the BRICS (Brazil, Russia, India, China and South Africa) will further complicate this balance. China is famous, and has been lauded, for achieving short-term infrastructural impacts with little regard for local systems. Meanwhile, other emerging powers, particularly from Latin America, emphasise the politics and institutions required for development.

Natsios (2010) states the 'central principle of development theory is that those development programs that are most precisely and easily measured are the least transformational, and those programs that are most transformational are the least measurable'. One donor in Guatemala reminded us of the adage, 'If you can't measure it, it doesn't exist', although we would prefer the alternative and more practically useful, 'If you can't measure it, you can't *manage* it'. Localising aid with the intention of strengthening systems is very likely to pose challenges in terms of results reporting and measurement.

6.2.2 Give political and technical analysis equal weight

Again and again, we have come across issues and problems that are best described as political rather than technical. The role of the state in public service delivery, for example, is a highly political issue in all countries, including developing ones. A donor decision to prioritise non-state delivery (whether for-profit or non-profit) cannot therefore be made only on technical grounds.

The National Coffee Association of Guatemala (Anacafe) provides an interesting example of the intractable interconnection between the technical and the political. Apart from being technically impressive, Anacafe is an important player in Guatemalan politics, it is large and linked to important people in business and politics. These connections can clearly be used for the benefit of a project's objectives; on the other hand, senior representatives of Anacafe have campaigned against government plans for minor land reforms. USAID's decision to support Anacafe is therefore not only a technical choice to support the partner most able to successfully carry out a project, but also an intervention that strengthens the hand of a particular part of the Guatemalan political firmament, on an issue of supreme importance to the Guatemalan economy.

Another example is the role localised aid might play in supporting a particular government, rather than just the state. There is plenty of evidence across a range of countries that localising aid at particular times has helped the incumbent government stay in power. Non-localised aid can also have this effect, when it mitigates problems caused by ineffective governments. The point here is that these delicate political matters are of huge importance for the long-term development of a country and cannot be separated from aid modality decisions.

6.2.3 Accept limited knowledge in a complex world

Throughout the research, the complexity of decision making on these issues came out, with a realisation that, for all the directives made at an international level, it is the 'human factor' of well informed decision makers on the ground that is often most crucial to the right path being followed. Our findings on localised aid have not yielded any simple conclusions – we argue that it is likely to be useful in all contexts but that when and how to apply it depends on many factors, political as well as technical. Understanding those factors is the key to choosing the right aid modality.

Sometimes donors may make the wrong call or lack the expertise required to influence systems, whatever the modality they employ. According to an analysis of budget support in Burkina Faso, 'Development Agencies have not always been able to bring to the table an adequate knowledge and experience of PFM reform, most particularly with regard to the sequencing of budgeting reforms, involving programme budgeting and medium term expenditure frameworks' (Lawson, 2012). It is sometimes too readily assumed that capacity is weak only on the host-country side.

6.2.4 Share information regardless of aid modality

The across-the-board consensus in the literature and in our interviews is that better information sharing, which includes the now-popular principle of transparency, is one of the most critical factors for system strengthening, and still one on which much progress can be made. Localising aid may help, but this a separate topic from aid modality discussions – the host government and its citizens should have access to information about all aid, regardless of its modality. About 50% of aid to Guatemala is still a 'known-unknown' according to our interview with the planning ministry. Even the most basic reporting by donors on their activities in fragile states is inadequate, according to OECD analysis (OECD, 2010).

Future research could usefully study these four issues. Linking particularly to the issues of trade-offs and politics, such research could build on the ideas for a "whole-of-society" approach as set out in LA1, and assist aid providers in deciding how to split their limited funds across all three sectors, all important to the development of developing countries.

In forthcoming briefings we will further explore these challenges from the perspective of the aid donor seeking to strengthen local actors and systems from within political and technical constraints, some perennial and some changing with a changing era of development.

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Annex: Summary of selected literature reviewed in Section 2

Localising aid: can using local actors strengthen them? (2012)
Glennie, J. with Ali, A. King, M. McKechnie, A and Rabinowitz, G
Summarises key aspects of the present state of the aid-effectiveness debate and sets out tentative lines of new enquiry for a second paper on whether channelling aid to and through local actors/ systems/institutions could have significant benefits for capacity and accountability.

Argues for an approach that treats building the private and civil society sectors as importantly as state sector strengthening in what it calls a "whole-of-society" approach. Critiques over-claiming for what aid modality tweaking can achieve.

Evaluation of Public Financial Management Reform (2012)
Lawson, A
This evaluation looked at two main questions: (1) where and why do PFM reforms deliver results and (2) where and how does donor support to PFM reform efforts contribute most effectively to results? The case study countries were Burkina Faso, Ghana and Malawi (2001 - 2010)

Donor pressure to develop comprehensive PFM reform plans and establish clearly defined monitoring frameworks had a positive impact in countries receiving budget support. However attempts to influence the pace or types of PFM reforms through budget support conditionality at the onset have been ineffective and at times counterproductive.

Why it Worked: Critical Success Factors of a Financial Reform Project in Africa (2011)
Peterson, S.
This paper reviews the factors that led to the successful implementation of the Government of Ethiopia's reform programme - the Decentralisation Support Activity Project.

There are six critical factors to PFM reform: task, context, patrons, role, staff and decisions. The role of the government is critical ingredient to the success of reforms but project design and reduced defragmentation is also important.

Between high expectations and reality: An evaluation of budget support in Zambia (2011)
Kemp, A. Faust, J. and Leiderer, S
The objective of this evaluation was to determine whether or not budget support in Zambia realised the intended objectives. This first component of the overall evaluation relies mainly on data from four sources: interviews, existing reports and publications, information on financial flows and macro and micro data and indicators.

Budget support had a positive impact in improving PFM in Zambia but not much of an impact on macroeconomic environment. PFM reforms have particular importance on policy dialogue.

Sector Budget Support in Practice. Synthesis Report ODI and Mokoro (2010)
Williamson, T. and Dom, C.
This is the synthesis report for a study on Sector

Budget Support (SBS) in Practice for the Strategic Partnership with Africa. The methodology used in this study included assessing the effects of SBS in the context of the major other influences on sector systems and service delivery.

SBS has supported the expansion of service delivery but has not effectively addressed its quality. SBS has also supported greater efficiency in the use of public resources and contributed to improving financial management.

Sector Budget Support in Practice Case Study Education Sector in Uganda'. ODI and Mokoro (2010)
Hedger, E. Williamson, T. Muzoora, T. and Stroh, J.
This case study examines Sector Budget Support (SBS) to the education sector in Uganda using a methodology (ODI and Mokoro, 2008) which draws from evaluation frameworks of General Budget Support. The assessment framework has four levels: (1) breaking down SBS into financial and non-financial inputs; (2) identifies the immediate effect of SBS inputs on the overall nature of external assistance to the sector; (3) examines the outputs influenced by SBS; and (4) examines the likely influence of SBS on outcomes in the sector.

There are three interesting conclusions: (1) SBS has enabled the expansion of service delivery by providing additional resources; (2) SBS has not effectively addressed the quality of service delivery'; (3) But thirdly the study found that SBS has contributed positively to improvements in the policy, planning, budgeting and reporting cycle.

Budget support and policy/political dialogue Donor practices in handling (political) crises (2010)
Molenaers, N. Cepinskas, L and Jacobs, B
The study analysed donor policies on budget support and how they mitigate political risk at the recipient side. The study reviewed policy reports, relevant literature and carried out interviews.

The credibility of sanctions has increased because of donors harmonizing their aid and positions in dealings with partner governments. Without government commitment to reform, it is unlikely increased harmonisation will result in substantial change. External actors cannot buy change but they can support it.

Evaluation of Donor Support to Public Financial Management (PFM) Reform in Developing Countries - Analytical study of quantitative cross-country evidence (2010)
De Renzio, P. Andrews, M and Mills, Z
The study aimed to answer two questions: where and why do PFM reform efforts succeed? And where and how does external support to PFM reform efforts contribute most effectively to their success? The methodology included reviewing of existing literature on PFM, interviews and using HPIC and PEFA data in determining factors that led to cross-country differences and variations over time.

Economic and social factors explain more than half of the existing differences in the quality of the PFM systems, while aid related factors only explain a quarter of the variation. State fragility is negatively associated with the quality of PFM systems. The study also found a significant and positive association between donor PFM support and average PEFA scores.

Aid and Trust in Country Systems (2009)
Knack and Eubank
The paper provides a systematic theoretical framework for understanding the incentive problem donor's face in using country systems. An assumption is made that to strengthen government systems transactions costs must be reduced by channelling more aid through government systems.

The authors conclude that donors trust in a recipient's aid management system is determined by three criteria: trustworthiness of those systems as measured by PFM quality and corruption ratings; trust in aid effectiveness in general; confidence it will reap sufficient benefits from investing in country systems.

Helpdesk: Budget support and CSO's (2009)
GSDRC
This paper is an overview of key papers on the role of CSOs in holding governments accountable.

Most studies on GBS make references to the role of CSOs in holding governments accountable but there isn't a detailed discussion of how they are expected to play this role. Support to CSO's is regarded as crucial to improving partner government accountability to citizens and ensuring the effectiveness of PRSP's. The paper also found evidence that donors sometimes undermine CSOs by continuing to occupy the political space that ideally should occupy.

Stocktake on Donor Approaches to Managing Risk when Using Country Systems (2008) Cant et al
The study looked at the risk and benefits associated with using country systems to deliver aid. The report reviews the policy guidelines of nine donors and details the similarities and differences between these donors in: their policies and guidelines for the use of country systems, and the benefits they recognise from using country systems; and their approaches to each aspect of risk management (identifying risks, initial risk assessment and subsequent monitoring, and strategies for addressing risks).

The study found that most donors have a clear policy of using country systems where possible but have not clearly set out the criteria for using country systems.

Putting aid on budget Good practice note: Using country budget systems (2008)
Mokoro
The study summarises the literature on why aid should be on budget.

Using country systems is relevant for all aid modalities, not just budget support but bringing project support on budget is a particular challenge.

Providing Budget support to developing countries (2008)
National Audit Office
The methodology of the study included the following: reviewing and analysing relevant literature and other documents; analysing inputs, outputs and wider country performance data by country; survey of DFID country teams; and fieldwork visits to four countries.

The joint evaluation found that budget support strengthened PFM systems with strong or moderate positive effects on 4 of the 6 countries where DFID has provided budget support for several years. In the remaining 2 countries there was only a weak positive effect. The predictability of DFID's support has fluctuated over the years but since 2001/02 it has disbursed 96% of its budget according to plan.

Donor fragmentation and bureaucratic quality in aid recipients (2007)
Knack, S and Rahman, A
This paper analyses the impact of donor fragmentation on the quality of government bearacracy in developing countries. The paper uses an econometric model to measure the impact of fragmented aid on the institutions of recipient countries.

The presence of many small donors, without one dominant donor erodes the administrative capacity of recipient governments. However this effect is not tantamount to aid being ineffective.

Joint Evaluation of Multi-Donor Budget Support to Ghana (2007)
Lawson, A. Boadi, G. Ghartey, A. Ghartey, A. Killick, T. Kizilbash Agha, Z. and Williamson, T. Joint Evaluation of Multi-Donor Budget Support to Ghana Based on OECD-DAC methodology.
The methodology is based on the General Budget Support Evaluation Framework developed under the auspices of the OECD Development Assistance Committee's evaluation network.

The authors argue that General Budget Support enabled benefits that could not have been achieved through other aid modalities. More importantly, the scope of policy discussion with government could not have been reproduced if aid was delivered through other aid mechanisms including sector budget support.

DAC Guidelines and Reference Series Harmonising Donor Practices for Effective Aid delivery (2006) Volume 2
OECD
This is an OECD good practice guideline when delivering aid through budget support and SWAP's.

Guidance on delivering aid through budget support include the following: refraining from targeting support once resources are in government treasury; reflecting partner country priorities; focussing on results; following good practices in PFM diagnostic and assessment work.

Joint Evaluation of General Budget Support synthesis report (2006)
IDD and Associates.
The methodology was based on the OECD DAC criteria relevance, efficiency, effectiveness, impact and sustainability and a logical framework approach to spelling out successive levels of inputs, immediate effects, outputs, outcomes and impacts. The countries studied were: Burkina Faso, Malawi, Mozambique, Nicaragua, Rwanda, Uganda

and Vietnam.

The budget process was strengthened in countries with a track record of receiving GBS. This has enabled sector ministries to engage directly with negotiations and therefore less opportunity to circumvent it through their relationships with donors. The paper recognises that the impact of GBS has been modest and should not be expected to transform underlying political realities.

Aid, Policies, and Growth (2000)
Burnside, C. and Dollar, D
This paper uses data on foreign aid to examine the relationships among foreign aid, economic policies and growth of per capita GDP. Using an empirical model they aimed to answer two questions: Is the effect of aid on growth conditional on economic policies? And secondly do donor governments and agencies allocate more aid to countries with good policies?

On average aid has had little impact on growth, although it had more of an impact in countries with good policies; no tendency for bilateral aid to favour good policy countries but evidence to suggest that multilateral aid does. Finally there is a trend towards good policies in many developing countries, improving the climate for effective aid.