THE ALLOCATION OF RESOURCES IN DEVELOPMENT POLICY

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Francesca Reinhardt examines whether Official Development Aid is being allocated efficiently. She analyses aid allocation as a dynamic game between donors and recipients, focuses on the importance of access to future resources in development, and concludes by commenting on the importance of intra-household resource allocation.

Introduction

It is a truth universally acknowledged that there is always a shortage of development aid. Three aspects of resource allocation should be taken into consideration to make development policy more efficient. The first issue is how Official Development Aid (ODA), the primary source of funding, should be allocated. The second is how to help with risk management to make current investments last. The third issue is understanding the local distribution structure to determine where resources will actually go and what effect they will have in the targeted community. This essay looks at (1) efficient aid allocation, (2) increasing access to future resources, and (3) intra-household resource allocation and the status of women.

Aid Allocation

While ODA needs to double over the next ten years in order to meet the Millennium Development Goals (MDG), aid proliferation and lack of coordination reduce the efficiency of existing aid. More aid needs to be directed at the poorest and most populous countries at more sustained levels. This is undercut by persistent donor patterns of allocating aid to less developed countries (LDCs) to reinforce political partnerships or dependency, relying on short to midterm budgetary planning, and diverting aid to emergency or high profile development efforts. The EU needs to participate in the drive to consolidate aid allocation to

LDCs, basing allocation on objective efficiency criteria relative to the recipient country's development goals. It also needs to advance strategies to extend development cooperation beyond existing power structures in recipient countries, and channel aid to the neediest and to those best-equipped to effect social and economic change.

Accordingly, the Commission's three operating principals in its 2003 Development report are "Coherence, Coordination, Complementarity." To increase coherence it is working on partnerships with the World Bank and the UN, working more closely with local structures in target countries, and working on poverty focused accords. It is also advocating ODA management reform and budget support for recipient countries to efficiently absorb and administer ODA. Related pilot projects were launched in Morocco, Mozambique, Nicaragua, and Vietnam in 2002. To increase harmonization, the Commission has released strategy papers in conjunction with the UN Development Program, including better contractual and financial procedures. The overall goals it should drive for are: (1) consistency, (2) coordination, (3) efficiency, and (4) participation.

Consistency

In the face of international crises, media spotlights, and political expedients, EU donors need to keep their eyes on the prize: consistent aid flows to consolidate long-term gains in LDCs. The reconstruction of Iraq is a good example of a critical project requiring immediate international support that nonetheless has the effect of diverting funds and curtailing other aid efforts. Hilary Benn, UK Secretary for International Development, defends UK funding decisions, saying

> "Quite a lot of the money for reconstruction has come out of central resources or our own contingency reserve: we have allocated some money from what is known as our 'core for middle-income countries' – those that are less poor."

He adds that

> "By 2005/6, we should be spending £1 billion a year on Africa because this is the part of the world where we need to make faster progress if we are to meet the Millennium Development Goals."[1]

[1] *International Development Review (IDR).* "A passion for development: interview with Hilary Benn." Oliver Romain.

Coordination

In the post-September 11 environment, bilateral aid is exceeding multilateral aid 70-30 (Rogerson 2004.) Multilateral approaches to ODA offer two important advantages. First, they are more likely to filter out vested interests and non-development goals. Secondly, they may avert duplication and conflicts between competing programs and investments. Aid fragmentation is costly, inefficient, and taxes the institutional capacity of LDCs. EU aid allocation needs to address the two linked problems of aid coordination between donors and aid fungibility (the practice of LDCs diverting funds from donor target areas).

Aid coordination may be seen as a global public good. The aid coordination problem can be examined as a dynamic game between aid donors and aid recipients, typically with incomplete information. The rounds may be simultaneous or sequential, however there is limited scope for learning after each round because the budgets change each time and remain private information, and possibly the preferences as well. Coordination failure arises from simultaneous decisions, incomplete information about other donor's budgets even ex-post, and under- or over-sharing in complementary projects. More shared financing and comprehensive data based on donor budgets and intentions would help limit the information failure that leads to coordination failure.

Non-cooperative strategies are likely to continue to be the norm, however. In the case of perfect information in a simultaneous game, the Nash equilibria can be efficient. For example, in a game between a big and small donor with the same preferences for a major and minor sector, there are two equilibria: either the large donor invests entirely in the major sector and the small donor invests entirely in the minor sector; or the big donor funds a project in each sector and the small donor fund a project in the major sector only. Sequential games should in theory create efficient equilibria except that information is rarely complete, especially concerning budgets. The only complete information is the misallocation after each round. A couple of strategies can lead to efficient Bayesian equilibria. First, when the other donor is small, donors concentrate on the major sector and share marginally. Second, when the other donor is big, donors specialize in one sector.

Halonen-Akatwijuka observes that the more similar the preferences are between donors, the more scope there is for coordination failure (2004). If donors have the same preferences in an incomplete information setting, they focus on the same preferred sectors which leads to undersharing in other sectors and sub-optimal results overall. Furthermore, allocating aid in proportion to the donor's preference for the sector does not maximize the donor's utility because the Cobb-Douglas utility function does not apply. That is to say that aid funding is not perfectly divisible, as in the Cobb-Douglas model, and preferred projects may require a minimum threshold of investment to work which might not correspond to their “priority score.” There may also be network externalities between complementary projects which are not taken into consideration in donor preferences.

For instance, increased use of roads to go to market increases the profitability of the market, hence the welfare utility of the LDC and the donor’s utility in terms of aid efficiency and appreciation of development goals (α). However, these gains may require investment in other public goods such as waterways and public sanitation to increase access and ensure that the market does not spread disease. Empirically, donors favour social services over infrastructure and are influenced by the needs of their own bureaucracies and the need to show results to the taxpayer.

Efficiency

Even if ODA is doubled, aid absorption problems could significantly limit its efficiency (Rogerson 2004). Accepted criteria for aid allocation stipulate that allocation should be performance related and target reducing poverty. Other things being equal, more aid should go to countries with better policy and institutional environments, to countries recovering from conflict, and to countries facing external shocks. Two persisting handicaps to aid efficiency are self-interested tied aid requiring LDCs to pay for or privilege DC goods or services, often at net cost and to the detriment of their own economies, and secondly aid as a tool of political patronage. A third handicap is aid fungibility, the potential for LDCs to reallocate or misuse development aid.

A tension exists between poverty criteria and performance criteria, and the conditionality of aid versus constructive engagement with bad governments. The Collier/Dollar aid allocation model suggests that targeting countries based on poverty criteria, while less marginally efficient, reduces more poverty in absolute terms. The so-called “Monterrey Concensus” from the Monterrey Conference on development policy in 2001 concludes that “conditionality doesn’t work.” The tension lies in whether aid is seen as a political message or as a factor in the standard of living (which is nevertheless affected by political conditions). An optimal equilibrium between these criteria would be aid aimed at poverty but accompanied by goals for governance. Aid should be phased in and out to avoid unnecessary shocks to already fragile economies, and to limit the scope of governments to divert it. It also provides a short string by which to coax or threaten LDC regimes into respecting governance goals

The worst-case scenario, although not an uncommon one, is that aid is allocated based on non-development criteria, such as political patronage, commercial interests (e.g. tied aid) or regional stability. This creates more incoherence between aid programs, more inefficiency, and more instability by reinforcing poor governance and creating shocks to LDC economies. The marginal efficiency of aid may be low or negative in a bad environment and may be subverted to reinforce poor governance. However, the Collier/Dollar aid allocation model demonstrates that poverty and per capita income criteria are actually more important than policy criteria as determinants of poverty-efficient aid allocations. Aid conditional on good policies and institutions has higher returns on poverty reduction, but omits many in need. Furthermore, conditional granting and withdrawing of aid rarely increases good governance but creates shocks to LDC economies.

Table 1: Matrix of policy outcomes: Efficiency of Aid Allocation Criteria Poverty Reduction

Benefit		Unconditional	Conditional
	Targeted	Poverty level criteria: greater effect on poverty reduction, but low marginal efficiency. May be subverted to reinforce poor governance.	Mixed criteria: aimed at poorest but phased in and out according to policy goals. Combines poverty reduction and efficiency at a rate LDC economies can absorb.
Waste	Untargeted	Non-development criteria: more incoherence, inefficiency, and instability. May reinforce poor governance and create shocks to LDC economies.	Policy criteria: greater marginal efficiency but excludes areas under poor governance. Conditional granting and withdrawing of aid rarely increases good governance but creates shocks to LDC economies.
	Waste		*Benefit*

Donor and LDC priorities are often not the same, which leads to the aid fungibility problem. This is a dynamic game in which the LDC tries to learn the donor's preferences and redistribute their own funds away from preferred donor projects towards their own preferred projects. This is not to say that donor preferences are necessarily better for LDC welfare or that LDC preferences are necessarily worse. However the poor are usually politically weak, which means that the utility function of an LDC government may not be a social welfare function. Reallocation by an LDC is a sequential decision; however information is often incomplete due to lack of transparency and administrative capacity.

Halonen-Akatwijuka points out that a game with incomplete information limits the potential to shift aid because the LDC cannot fully anticipate what the donor will do (2004). This leads to a Bayesian equilibrium which favours the donors preferences. However the misallocation due to coordination failure in games with incomplete information is more harmful than the aid fungibility problem. An optimal strategy might be to increase transparency and use some of the methods used in EU Structural Funds and Regional Policy, which effectively monitor recipient spending and institutional capacity alongside aid. Methods include co-financing, where funds have to be matched or part-matched by the recipient, and aid ceilings, which limit aid to a fixed percentage of sector spending. These cooperative strategy tools would naturally have to be assessed on a case-by-case basis for each recipient.

Participation

Coordination between donors is important, as is efficiency, but aid must be "country-led," i.e. responsive and responsible to the LDC in question. Donors must balance working with LDC authorities and working with poor, marginalised, or independent groups that may not be officially represented. Old development practices focused on injecting capital and installing western production and political processes. New development practices should focus on designing cooperative strategies for local production and decision-making processes to increase efficiency and stability. Poverty and productivity are directly affected by coordination failures and non-cooperative strategies. Examples include basic public goods like transport and health care, distribution to women, the poor, and minorities, and efficient allocation of factors of production.

Participation at the government level mitigates the aid fungibility problem, if donors and recipients can agree on preferences. Participation at the local level identifies surrogate public goods providers and the disenfranchised. Immediate poverty reduction is most likely to happen at the local level among the very poorest. This includes the world's 750 million subsistence farmers, 60% of whom are women, whose lives are local community based. Lifting them out of poverty requires capital and technology, as well as international public goods like pro-poor trade agreements. However lasting changes require knowledge of local negotiation models and relative bargaining power and how resources are allocated within households and within the community.

A standard example of participation failure illustrates the point. A USAID project in Ghana introduced freezers to the fish-processing industry, traditionally run by women. Because the new technology gave it status, the industry was taken over by men, although it did not prove sustainable because the freezers were too costly to run. This amounted to a disruption in local labour allocation and a net loss in income, particularly for women, which translated into less spending on childcare and healthcare, which are local female priorities. A more useful aid would have been encouraging a straw-mat industry to provide shade for household workers who pound the staple grains into flour for hours in the sun, which costs them hundreds of calories. Improving the staple grains would also improve overall nutrition.

Access to future assets

A definitive difference between rich and poor is access to future resources and the ability to absorb current shocks. With little training and undeveloped financial markets, the world's poorest are trapped in the short-term conjuncture they find themselves in and live precariously at the mercy of day-to-day shocks, which are significant in the agricultural sector. This makes them naturally risk-averse and resistant to development, and lowers the appeal of cooperative strategies because of the short time horizon and high commitment failure.

They furthermore lack the margin of manoeuvre to self-start projects or self-determine their mode of production as they have few assets and no access to credit. This makes them dependent on and often subordinate to the owners of capital where it exists, and acutely vulnerable to failures and losses. The poor are usually up against market and social norms if they try to break out of this short-term cycle and get access to credit or insurance. Access to future resources and hence a long time horizon is hence a determining cognitive and material factor.

Responding to plummeting coffee prices in 2003, Pablo du Bois of the International Coffee Organisation paints a bleak but plausible picture of the future in Central America. "Once farmers get into debt, they have to abandon their farms and either go to the cities or try to become illegal immigrants to the US, they try to plant something else like coca [cocaine] or they join the guerrilla movements. They are losing their livelihoods, and in these areas there aren't that many legitimate alternatives" (Garratt 2002). Acknowledging the constraints of volatile commodity markets, the Commission is undertaking commodity chain management projects in conjunction with its preferential "everything but arms" trade agreements with LDCs. These projects should encourage three channels to future resources: (1) micro-credit, (2) risk financing, and (3) property rights.

Micro-credit

In the streets of Calcutta, complex baby-lending systems exist among the socially excluded, farming out babies as value-added accessories to street begging. This indicates a well of untapped entrepreneurial skill that could do something more constructive if it had access to capital. The problem with conventional finance in traditional and emerging markets is that creditors have a monopoly and can charge exorbitant rates, but at the same time, are ill-informed about the viability of their loans. The ensuing Nash equilibrium means that only a minority of high-risk, high-return investments can afford the high premiums, whereas low-risk, low-return investments are shut out.

Micro-credit projects are a way of bringing creditors closer to borrowers and closing the information gap that prevents poor people from getting small, low-risk loans. Successful examples include the Grameen Development Bank in Bangladesh, which uses social networks to ensure the viability of loans, and numerous small-scale cooperatives such as the Kuapa Kokoo Ltd coffee cooperative in Ghana that pools members' resources to get critical mass.

Table 2: Matrix of mid-term credit outcomes: The Information Problem Creditor

<table>
<tr><td rowspan="3">Gain</td><td></td><td>High premiums</td><td>Low premiums</td></tr>
<tr><td rowspan="2">Low risk</td><td rowspan="2">High premiums/ low risk: Creditor cannot assess risk, so compensates with high premiums. Borrower's returns on low-risk investment may not cover premiums.</td><td>Low premiums/low risk > high-risk loans: more loans, more investment. Majority low-risk/low-return. Creditor compensates for lower premiums with higher turnover.</td></tr>
<tr><td>Information gap reduced by local micro-credit: Creditor is closed to Borrow, can better assess risks. Borrower has more incentive to repay loans,</td></tr>
<tr><td>Loss</td><td>High risk</td><td>High premium/high risk >low risk loans: fewer loans, less investment. Majority high-risk/high return. Creditor compensates for risk and low turnover with high premiums</td><td>Low premiums/high risk: Creditor cannot assess risk and is vulnerable to Borrower default.</td></tr>
<tr><td></td><td colspan="2">Loss</td><td>Gain</td></tr>
</table>

Borrower: Non-cooperative strategy Transition to cooperative strategy

Risk Financing

Risk financing could be one of the most important public goods in LDCs, particularly in subsistence agriculture. There are two aspects of risk financing that require a coordination effort to provide: sustaining farm businesses in the face of frequent price and environmental shocks, and providing a safety-net for farmers to experiment with new techniques. Market-based solutions, including insurance, are inefficient to deal with high frequency/high severity risks, as are typical in agriculture (Gurenko & Mahul 2004.) Subsidised crop insurance exists in 140 countries, according to the Food and Agriculture Organisation, although most of it fails to reach poor farmers. Transaction costs may make insurance alone inefficient if frequency is high and severity (i.e. reimbursement) is low.

Risk financing needs to be tailored to the type and incidence of risk experienced by farmers and the minimum capital requirements needed to continue the business. Gurenko and Mahul propose a portfolio strategy combining insurance, savings, and contingent debt according to the severity and frequency of risk. Contingent debt is a pre-agreed emergency loan scaled to the farmer's minimum capital requirements and can be paid off over a long period of time. If it is not offered on the market, governments or cooperative groups could step in. Having a strategy to sustain the business despite adverse shocks is an important step in getting farmers to think cooperatively and long-term.

Property Rights

Property rights are way of transferring the legal and psychological security to the poor to develop their own environment. Establishing legal norms to transfer otherwise unused land to "squatters," who are usually otherwise landless, is an efficient way of allocating resources. It allows the poor to invest in land that would otherwise be ignored and deteriorate through migrant use, and gives them a basis to raise finance to invest in home improvement and business development. In essence, it gives them a longer time horizon to work with.

The Peruvian government has issued over a million land titles to the poorest slum-dwellers, on the advice of Peruvian economist Hernando de Soto, in a bid to control the deterioration of growing cities. A UN report estimates that 2bn landless people could be living in slums by 2030. In the case of slums, the transfer is simpler because any original owners have given up on getting any further value out of their land. Rural land-ownership may be more complicated and land devolution is often a source of conflict. However aid projects should bear in mind that many of the restrictions and red-tape in LDC administrations are the legacy of colonial rule and institutional reform is required to meet current and local needs. Making property rights more accessible should be an important part of institution building.

The Status of Women

Fighting social exclusion is crucial to developing a healthy labour market and stable communities. Improving the status of women is particularly important. Women are usually the primary providers of healthcare, nutrition, and education, especially in subsistence and traditional societies, and often dominate major economic sectors in developing countries such as agriculture and textiles. Depending on the culture, they may be given a particular role in maintaining social cohesion and responsibility for the main family unit. As such, it is essential to raise women's decision-making power and access to resources to correspond to the level of their economic and social contribution.

Intrahousehold Resource Allocation

Allocation of resources in the household affects productivity, human capital, and social stability. Negotiating models and bargaining power are based on cultural norms and gender roles, particularly in traditional societies. Most of the literature now accepts the collective model of the household, composed of differentiated members, as opposed to the unitary or "income pooling" models. There are three major aspects of gender and allocation that need to be addressed: (1) the inefficiency observed in household allocation, (2) gender-based allocation preferences, and (3) gender casting in the work force.

<u>Inefficiency</u>

Household allocation can take the form of a non-cooperative strategy between competing members of the household with different preferences and assets. The result is found to be widespread inefficiency in domestic and agricultural allocation, notably across Africa. Inefficiency is thought to arise from commitment failure, which forces members of the household to work on their own behalf. Fafchamps finds that causes of commitment failure include short time horizon, low assets, unequal stakes in the household, and poor external enforcement (1998).

In theory, whoever controls the least assets should end up contributing the most labour to public goods in the household. Individual members should only participate up to the point that their utility within the household is less than or equal to their utility outside the household. This is called their "threat point." Ultimately the threat point depends on external social norms and the legal structure regarding property rights, divorce, social security, communication and employment networks.

Three possible threat points are (1) non-cooperation within the household, (2) separation from the household, (3) domestic violence. For an individual to negotiate with other members of the household, their threat-points must be credible. Broadly speaking, the first two options are less credible for a female partner with low human capital and little outside intervention, while the third option is more credible for a male partner barring outside intervention. The mistrust between less enfranchised members and dominant members may cause them to seek a Nash equilibrium that allows them to protect their own interests.

As women, children, and young men tend to have less bargaining power, they must rely on the will and capacity of male relatives to allocate their part of the deal to them. The male relatives, however, are limited in what they can promise in the future due to poverty, instability, lack of access to credit, and short time horizon. This leads to commitment failure or the expectation of commitment failure. As a result, the less powerful members of the family opt for a Bayesian equilibrium to ensure their own gains in the future, rather than to ensure the welfare function of the household as a whole.

In terms of farming, it is observed that women and young men work harder on their own plots than on the head of the household's plots, although their own plots are less productive. Cultivating several smaller plots is again less productive than cultivating the same land as a whole. When men and women are divided into separate or complementary sectors, such as fishing and vegetable cultivation, they do not necessarily coordinate these sectors, but prefer to ensure their own returns. Furthermore, when a traditionally female sector becomes highly profitable, it tends to be taken over by men which erases the specialisation advantages accrued by the women in that sector (Quisumbing & Maluccio 1999.)

Allocation preferences

Cross-country studies suggest that women are more likely to spend money on nutrition, health, and education then man. Quisumbing and Maluccio found that women's preferences in Indonesia, Bangladesh, South Africa, Ethiopia consistently favoured children, whereas increases in men's income was likely to increase alcohol and tobacco consumption (1999). Part of the explanation may be that in societies where women have few other assets, they have an interest in ensuring that their children can look after them and stand up for them later in life. Furthermore, skills, education, and levels of health acquired by women have a much stronger transmission effect on children, as women are the primary caregivers.

Gender casting

Division of labour in pre-industrial societies is often done by gender and age casting. This has the advantage of simplicity, sustainability and specialisation. The disadvantage is that skills are not always well allocated, although this matters less in a less differentiated economy. The wide variety of roles attributed separately to men and women suggests that some may be efficient, while others are simply habitual. Giving women jobs close to the home when they are likely to be pregnant or have small children may be efficient. In contrast, some tribes in the Gambia find it degrading for men to do river work, although it is nonetheless physically demanding.

Norms regarding training, labour roles, and remuneration may also be a means of reinforcing the inferior bargaining power of women in the household. Market “cartelisation” is a means by which employers (typically men) collude to exclude or marginalize a sector of the labour force (in this case women.) This is not a self-enforcing equilibrium because each employer could profit from secretly employing this sector for lower pay, so it requires social or legal pressure, sometimes extreme, to enforce it. This has been observed, in particular, in the enforcement of cast restrictions in India.

Policy implications

Aid projects should work towards providing the legal and social protections to give women more bargaining power in the household and more options should they choose to leave it. Possibilities suited to local norms include legislating for women to keep part of their dowry should they divorce, which gives them a credible threat point without them actually having to leave the household. Reducing the power of male relatives and increasing the assets of other members should engender more cooperative strategies, reduce inefficiency, and make distribution more equal.

Investing in female work sectors such as textiles, vegetables, and rice paddies (according to culture,) increases spending on children, housing, and nutrition, as long as it does not reach a threshold where the men wish to take over. Investing in training and education for women has a high transmission incidence on children. Investing in employment projects that shift the boundaries of gender casting slightly could improve the status of women in the workforce and improve allocation of skills.

Conclusion

The shortage of available development aid makes the efficiency of allocation important. Three levels of distribution are particularly significant: (1) the criteria and consistency of ODA between countries; (2) the access to resources over time in LDC markets; and (3) the bargaining power and spending preferences of different social sectors. This essay arrives at a few suggestions for priorities at each level. All of them necessarily come with the caveat that policies should be taken on a case by case basis.

ODA should be treated as an economic factor rather than a political tool, and be phased in and out to avoid shocks to LDC economies. Allocation should be systematic and multilateral to increase transparency, coordination, and objectivity. A reliable database of aid targets and allocation could increase co-ordination, while monitoring and co-financing methods could reduce misuse by bad governments. Targeting poor and populace countries regardless of governance criteria is less marginally efficient but increases poverty reduction in absolute terms.

Increasing access to resources for the poor is key to making investments last and encouraging a culture of development. Three important mechanisms are (1) micro-credit banks and networks; (2) subsidised risk-financing; and (3) accessible property rights, particularly in urban slums. Donors also have to look at how resources will be distributed at the local level. For example, investing in traditional female economic sectors will often translate into increased spending on health and childcare. Similarly, healthcare and training for women is often transmitted to children. Finally, increasing the legal rights or economic leverage of traditional dependents can make household units more co-operative and thereby more efficient.

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