

**The Use of New Institutional Economics  
to Increase the Effectiveness of Donor Assistance  
Three Applications**

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## Outline of Presentation

Three illustrations of how an NIE-oriented approach can improve the success of USAID interventions

1. Application 1: Looking before you leap (testing reforms) (with Omar Azfar)
  2. Application 2: Learning from doing (better ways to evaluate interventions) (with Omar Azfar)
  3. Application 3: Harnessing the power of incentives (stimulating local governance reform) (with Patrick Meagher)
- ✓ The IRIS website ([www.iris.umd.edu/forum/default.asp](http://www.iris.umd.edu/forum/default.asp)) contains discussion papers on each application
  - ✓ There are also “field guides” available upon request

## The Spirit of the Work Presented

*One of the most important roles of bilateral donors is as innovators and not just service (or goods) providers (Collier 2003, The USAID “Forums” Project)*

## Implications of the NIE Approach (1)

NIE approach stresses the importance of institutions

✓ Economic activity entails transactions, which take place within an institutional context

- Sub-contract
- Stock exchange
- Tribal chief
- Chinese chamber of Commerce
- Management concession
- Bazaar
- *Keiretsu* (business group)

✓ Institutions create incentives as well as are a prime source or reducer of transaction costs; institutions thus support or hinder economic activity

✓ If donors can help to modify the institutional environment so as to the reduce transaction costs of interacting, they will succeed in increasing economic activity

⇒ *How, to identify the relevant institutions?*

⇒ *How to tailor interventions to the cultural context?*

## Motivation (2)

Donors should harness the power of incentives, rather than fight them

- ✓ All donor interventions affect the incentives of the recipients, USAID staff, and USAID contractors
- ✓ To provide the incentive to work toward a successful intervention we must be able to link effort to outcome which, in turn, requires being able to measure outcomes.
  - ⇒ *How to effectively evaluate an intervention?*
- ✓ Donors operate under a veil of ignorance about the local context but project success depends on knowing how local, affected parties as well as project implementers will respond.
  - ⇒ *How to design interventions which align the recipient's incentives with the donor's objectives?*
  - ⇒ *How to discover what stakeholder behavior reaction will be to a proposed intervention?*

## Application 1: TCAR

We argue that this requires:

- ⇒ Different framework of analysis (“institutions”; information; beliefs)
- ⇒ Different types of field preparatory work
- ⇒ Empirical way to test out interventions

We call the set of diagnostics to facilitate this “different” approach the *Transaction Cost Analysis and Remediation (TCAR) Toolkit*

*TCAR* is a set of empirical techniques that help to...

- ✓ identify sources of transaction costs,
- ✓ their causes,
- ✓ how to remediate them, and
- ✓ how to test solutions for consistency and acceptance

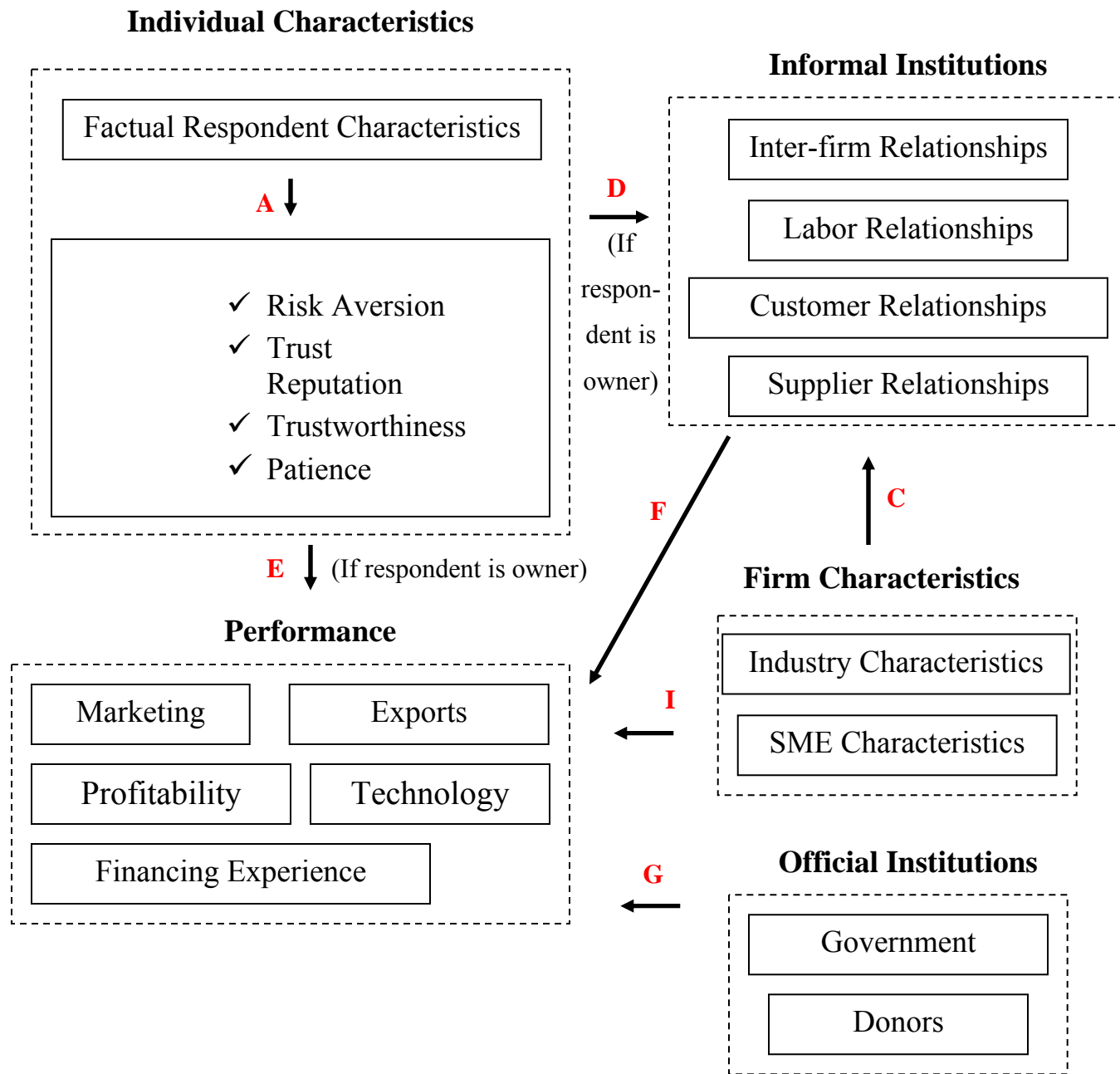
## Application 1: TCAR

TCAR techniques include:

- ✓ Focus groups and structured interviews
- ✓ General attitudes survey assessments (self-declarations), e.g.,
  - “Do your suppliers consider you trustworthy?”
  - “Do you lend money to your friends?”
- ✓ Contingent and elicitation valuation to measure transaction costs, customs, and resistance to change, e.g.,
  - Wage required to be on a consultant roster to help a new SME successfully file an operating permit (contingent valuation)
  - Value (bid) for specific technical assistance (elicitation game)
- ✓ Interactive surveys and “lab” experiments that vary institutional characteristics and context and offer real payoffs (revealed behaviors)
  - Public goods games      ■ Trust games      ■ risk games
- ✓ Analytic narratives—Game-theoretic-based, multi-disciplinary stories amenable to empirical refutation and consistency testing

## Application 1: TCAR

- A. Developed under the USAID “Forums” project, let’s illustrate TCAR using the results of a recent application in The Philippines to reduce transaction costs hindering SME relationships and, therefore, SME economic activity (338 SMEs on 4 islands)
- B. The example illustrates how to:
- ✓ Identify obstacles due to institutional gaps or weaknesses
  - ✓ Design institutional mechanisms
  - ✓ Test-fit a proposed intervention into its cultural context
- C. Recall, the source of wealth comes from the division of labor (specialization) but that institutions in the form of relationships are required to tap this.
- D. TCAR examined ways to facilitate SME relationships with firms, organizations and agencies which whom they interact [Figure 1]



## Application 1: TCAR

E. In the assessment steps using the empirical tools above we documented by sector financial, marketing, and technology obstacles facing SMEs—let's now consider two financial obstacles

F. Huge collateral requirements, not interest rates appear to restrain investment

- ✓ Banks say they don't know why more SMEs don't come to them—we did find 94% of bank applications were approved!
- ✓ Yet >50% of bank loans required collateral > 2x loan value whereas  $\frac{3}{4}$  of moneylender loans required *no* collateral
- ✓ Result: inefficient risk bearing and risk spreading

G. Late payment by clients or contractors

- ✓ SME becomes credit provider as well as goods/service provider!
- ✓ SME can't pay its workers, who are the ultimate “bankers”
- ✓ Result: Unemployment, too few suppliers, (informal) bankruptcy

## Application 1: TCAR

### H. Analytic narrative step for excessive collateral obstacle

- ✓ Lack of competition in banking sector
- ✓ Moneylenders use borrower's pre-paid check as "collateral" and a bounced check is a criminal offense
- ✓ Punchline: Where contract enforcement works, system is more efficient

## Application 1: TCAR

### I. Analytic narrative step for late payment obstacle

- ✓ Individual SMEs felt they would lose business if they insisted on some form of guarantee
- ✓ The SME had no easy way to create a reputational consequence for a late-paying firm
- ✓ Business norms and fierce competition raised transaction costs of alternative contracting methods
- ✓ Cultural fatalism and organizational transaction costs led to discounting the possibility of collective action
- ✓ Punchline: *Scope for remediation*. Can an institution be created to overcome cultural obstacles to collective action? What would the mechanism depend on? Where in The Philippines might it work?

## Application 1: TCAR

- J. In institutional remediation step we show how to design two institutional fixes and how to use surveys and experiments to *test* them for acceptance and for consistency with stakeholder behavioral responses
- Delayed payment website run by an association
  - Bank guarantee association

## Application 1: TCAR

### K. Viz. late payment system:

- ✓ 85 percent of SMES as customers would pay on time more often under such a system—with almost 40 percent indicating speeding up by 80 percent (SMEs from Davao were the exception)
- ✓ Almost all respondents indicated they'd be willing to pay a monthly interest rate (or a purchase-price premium) of several percent to avoid being put on such a list: 40 percent were willing to pay above 5 percent per month
- ✓ So, would everyone report late-payment customers to such a system? Only 11 percent said yes!
- ✓ Those showing a higher propensity for collective action were more willing
- ✓ Respondents thought it not worth the effort, due to insufficient participation (Time constraints required CNC survey and remediation pre-test into one instrument, it was not possible to provide the respondents with the result of just how effective the listing mechanism would be)
- ✓ A dedicated remediation pre-test would overcome this and allow a PREP-based test on the best way to formulate the listing mechanism (e.g., who pays, the lister or the user?)

## Application 1: TCAR

### L. Viz. bank guarantee association:

- ✓ 75% of SMEs indicated they'd have no trouble getting a guarantee.
- ✓ >50% said they would not switch suppliers if their suppliers participated in such a program.
- ✓ 82% said they would comply with a required bank guarantee policy if >50% the members of their association complied (Davao SMEs were less likely to comply than those from Cebu or Lucena).
- ✓ We found that in Metro Manila, Cebu, and Lucena, the less trusting, the more likely the respondent would join such an association, *but* the opposite was true for entrepreneurs from Davao.
- ✓ Female entrepreneurs were much more likely to join such an association than males.

## Application 1: TCAR

- M. Results show that acceptance depends on sector, on island-specific tailoring of the initiatives, due to differences in trust and trustworthiness (better in big cities), risk aversion, and willingness to engage in collective action.
- N. The results permit donors to tailor institutional solutions and implementation cultural context, increasing likelihood of success

## Application 2: PREP

*A better way to evaluate a donor intervention*

### A. Statement of Problem:

- It is hard for a donor to know which reforms work (or where) even *after* they have been implemented
- It is hard for a donor to know how to adjust an intervention to fit—or take advantage of—a particular country context
- Project evaluation, such as it is, is often carried out *after the fact* and cannot rigorously determine impact because the necessary “controls” are missing

### B. Consequences:

- USAID is under-funded because skeptics who argue USAID is ineffective can't be persuasively countered
- USAID available resources may be allocated to relatively ineffective projects
- Difficulty in linking incentives (of recipients, USAID staff, and contractors alike) to performance

## Application 2: PREP

### *Nature of the solution*

C. NIE Solution: Align implementer incentives to the objectives of the donor will improve outcomes

D. This raises two questions:

- How to structure the incentives (broad/narrow; large/small; financial/in kind)?
- How to implement them (embedding in technical assistance; monitoring; measurement)?

E. To persuasively show that a project is successful (or not)

- The evaluation procedures (incentives) must be established and known in advance (prospectively)
- The intervention (treatment) must use a randomized implementation, i.e., include a control group and randomly vary the structure of incentives accordingly

*In short: Implement the project in some areas and not others and then compare improvements in the control and treatment groups in order to identify the impacts.*

F. Added benefit: Encourages donor innovation (Collier: best use of funds)

G. Punch line: Projects must be *designed* for evaluation

## Application 2: PREP

### *Training example*

- A. This approach may be used for a broad range of assistance activities:
- Decentralization (e.g., Application 3, below)
  - Tax compliance methods
  - Primary education reform
- B. Detailed example: Do incentives for BDS trainers in The Philippines improve their performance and, if so, what kind?
1. Incentive issues:
    - a. Extra financial payments to trainers should improve their performance.
    - b. Measurement using 20-question tests (“final exam”) will not provide broad knowledge relative to 80-question tests.

## Application 2: PREP

### *Training example*

#### 2. Treatment protocol:

- Select 27 trainers based on qualifications and pre-test
- Divide trainers into 6 different groups based on the number of questions their students will answer in a “final exam” and if trainer gets financial incentive
- Ask students several questions on which to base evaluations (essay questions, satisfaction ratings, whether training helped their business, willingness to pay for future trainings)
- Run comparisons between groups

#### 3. Results:

- Trainers with incentives received higher satisfaction ratings and their students scored higher in the multiple choice “final exam”
- Students with trainer whose incentive was based on a 20-question final had a less broad knowledge of the subject taught than those whose trainer’s incentive was based on 80 questions

## **Application 3: Inter-jurisdictional competition**

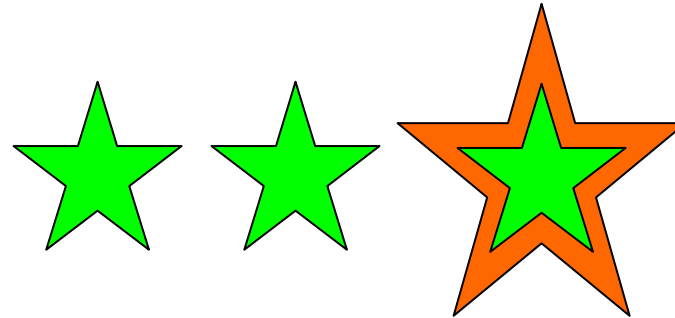
### *Strengthening local governance in Morocco*

1. Donors: UNIDO and Government of Italy (and possibly The World Bank)
2. Background and objectives
  - a. Overcome sclerosis in business investment outside main cities by improving local governance
  - b. Political system new and in need of exercise (within context of strengthening democracy within the Muslim world)
  - c. Increase SME demand in Morocco for investment promotion services
  - d. Provide market intelligence and trade facilitation to European exporters

## Application 3: Inter-jurisdictional competition

### *The Components*

1. “BIE Star” *rating system* (level and commitment) for investment-related regulations, procedures, and governance at the municipal level



2. A *competition* among communes to carry out a set of defined (by-participant), voluntary reform tasks to improve BIE Star ratings
3. *Technical assistance* for communes striving to improve their investment regimes.
4. *Benefits* for communes that improve and for their firms

## **Application 3: Inter-jurisdictional competition**

### *The Competition (1)*

#### 1. Players:

- a. Regions (2)
- b. Provinces (2 per region)
- c. Communes (about 70 per province)

#### 2. Rules of the game:

- a. Participate in *ex ante* baseline measurement exercise
- b. Implement tasks (see below) over a 12-month period
- c. Participate in *ex post* baseline measurement exercise

## **Application 3: Inter-jurisdictional competition**

### *The Competition (2)*

#### 3. Tasks:

a. Land, Site Development

b. Business Operational Requirements

c. Regulatory environment

d. Administrative effectiveness (planning, service provision)

e. Communal resource mobilization and use

f. Administrative transparency and accountability

g. Management and oversight of officials

## Application 3: Inter-jurisdictional competition

### *The Competition (3)*

#### 4. Rewards:

- a. Completing a task yields points reflecting task's importance to UNIDO
- b. Commune wins (financing, technical assistance to firms, training and study tours, national and international marketing) either by
  - Scoring higher *improvements* (not *levels*) than other communes
  - Placing (number depends on UNIDO budget)
  - Consolation prize (exceeding a threshold on at least one task)
- c. Province wins if it scores more (average) points than the other provinces
- d. Electors of winning communes wins (certificate from King, write-up in national papers, trips abroad, increased personal recognition in community)

## **Application 3: Inter-jurisdictional competition**

### *The Competition (4)*

#### 5. Strategies:

- a. Make local political bargains to allow changes to local laws, regulations, procurement, public sector employment, zoning, etc.
- b. Engage in collective action with private sector
- c. Engage civil society
- d. Engage in collective action with neighboring communes
- e. Petition higher authorities to effect reforms or provide resources

## Application 3: Inter-jurisdictional competition

### *The Competition (5)*

#### 6. PREP:

<i>Province:</i>	1		2				
<i>Treatment Group:</i>	1	2	3	4	5	6	<i>Row total</i>
Benefit ('000): <sup>(b)</sup> Limit	40	60	80	100	120	140	540
Per player	4	3	2.6	10	6	4.6	n.a.
Want to participate:							
Accepted	10	20	30	10	20	30	120
Rejected	3	6	10	3	6	10	38
<i>Don't want to participate</i> <sup>(a)</sup>	3	5	9	3	5	9	34
Communes in game	16	31	49	16	31	49	192
Total communes		96			96		192

Notes: (a) These are only guesses. (b) Benefits are denominated in thousands of Euros.

## **Application 3: Inter-jurisdictional competition**

*NIE illustrations contained in application*

7. In achieving these objectives, the pilot illustrates:
  - a. Builds on social capital and encourages voluntary cooperation
  - b. Better aid targeting through demand-driven, results-based allocations
  - c. Greater leveraging and cost-effectiveness of donor funds
  - d. Greater use of local know-how
  - e. Increases *legitimacy* of reforms
  - f. Donor harnesses incentives rather than fights them
  - g. Minimal need for donor monitoring of reform activity
  - h. Information does not equal communication
  - i. Power of peer pressure and local reputation