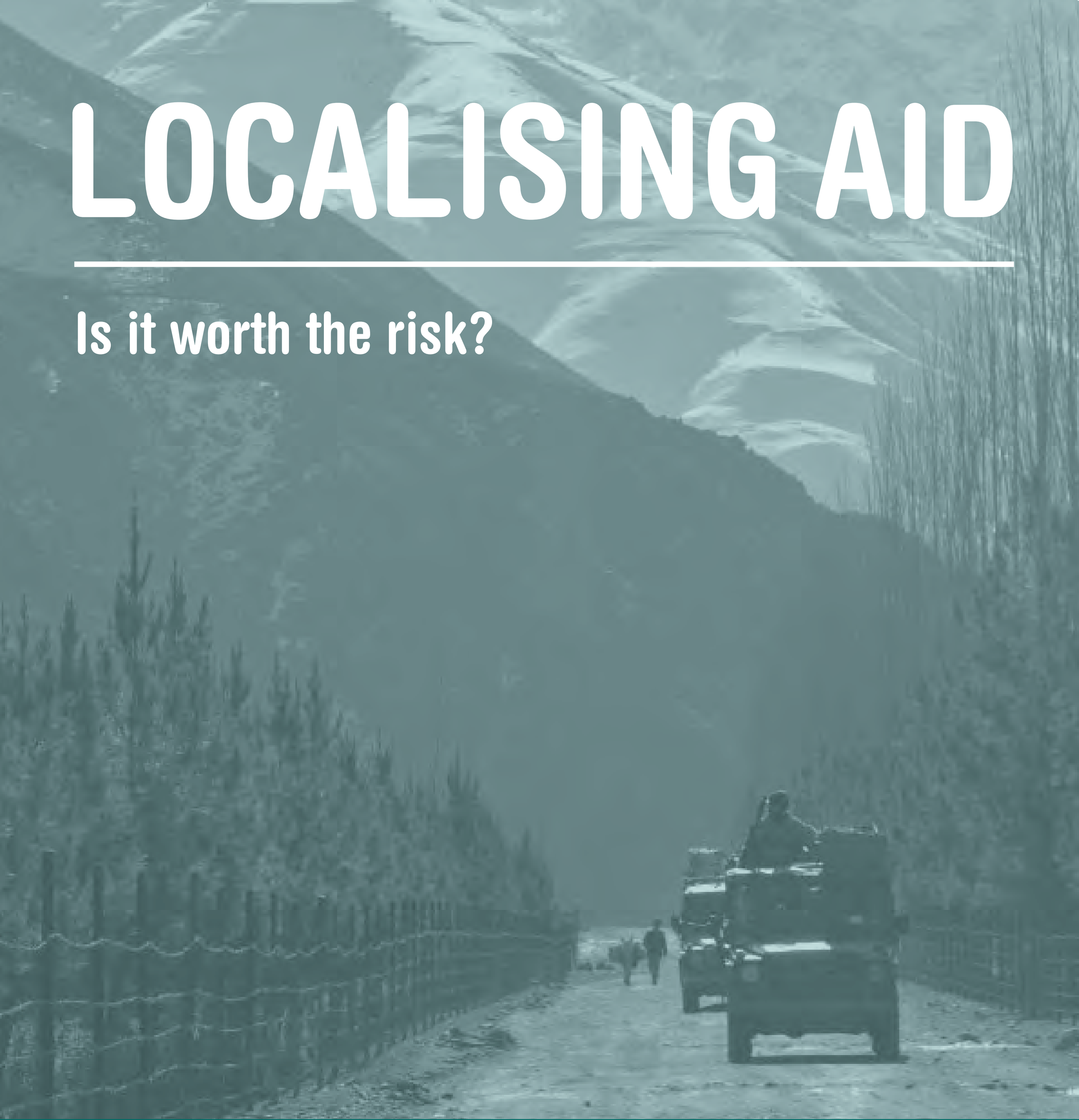

# LOCALISING AID

## Is it worth the risk?


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The views presented in this paper are those of the authors and do not necessarily represent the views of ODI or our partners.

# Contents

# Acronyms

| | |
|---|---|
| **AfDB** | African Development Bank |
| **ARTF** | Afghanistan Reconstruction Trust Fund |
| **CDD** | Community-driven Development |
| **COSO** | Committee of Sponsoring Organizations of the Treadway Commission |
| **CSO** | Civil Society Organisation |
| **DFID** | Department for International Development |
| **ERM** | Enterprise Risk Management |
| **FARA** | Fixed Amount Reimbursement Agreement |
| **GEMAP** | Governance and Economic Management Assistance Program |
| **IDD** | International Development Department |
| **IFI** | International Financial Institution |
| **INCAF** | International Network on Conflict and Fragility |
| **INGO** | International NGO |
| **LA1** | Localising aid: can using local actors strengthen them? |
| **LA2** | Localising aid: sustaining change in the public, private and civil society sectors |
| **LA3** | Localising aid: is it worth the risk? |
| **LA-Govt** | Localised aid to government |
| **MDB** | Multilateral Development Bank |
| **MDTF** | Multi-donor Trust Fund |
| **NGO** | Non-Governmental Organisation |
| **NLA-PP** | Non-localised Aid to Private Providers |
| **NSP** | National Solidarity Program |
| **OECD** | Organisation for Economic Co-operation and Development |
| **PEFA** | Public Expenditure and Financial Accountability |
| **PFM** | Public Financial Management |
| **PRT** | Provincial Reconstruction Team |
| **SIGAR** | Special Inspector General for Afghanistan Reconstruction |
| **UK** | United Kingdom |
| **US** | United States |
| **USAID** | US Agency for International Development |

# Executive summary

One of the greatest obstacles to localising aid (i.e. transferring aid to local rather than international actors) is the perception among donors that it is much riskier than non-localised aid, where the donor appears more able to manage directly the risks of funds being misspent. This report finds that this perception may be incorrect, and that non-localised aid may potentially have higher risks of programme and strategic failure. It sets out an approach for donors who wish to analyse the risks involved in localising aid.

Risk is the potential or probability that a future unwanted event – a risk outcome – will occur. Risk tolerance is the amount of risk an organisation is willing to accept in meeting its objectives. Risk mitigation involves assessing risk factors, anticipating relevant risk outcomes and their potential impacts and taking action to lower the probability that these outcomes will occur. This report considers four main categories of risk: (i) contextual risk that has national, regional or global implications; (ii) programmatic risk, where spending fails to achieve its objectives or contributes to contextual risk; (iii) institutional risk to the donor organisation and its staff; and (iv) fiduciary risk, when funds do not go to their intended purpose.

A donor country may have a mix of altruistic, political, national security and trade objectives for giving aid. There are tradeoffs among these objectives and the timeframes in which they can be achieved. The interplay among broad pro- and anti-aid constituencies influences a donor's tolerance for risk. It is important to note that tolerance for risk is not the same as tolerance for risk outcomes, especially those involving loss of donor funds.

There may also be conflicting priorities between donor and the recipient country governments; the latter might resent outside involvement in its political affairs. The recipient country may also face a set of risks from foreign aid: loss of sovereignty; donor-imposed conditionality; loss of control over public spending priorities; weakened public institutions; aid dependency; and/or unpredictable financial inflows and macroeconomic imbalances. Understanding the recipient's perspective on risk may help a donor provide aid more effectively and improve country ownership of aid, since recipients are likely to prefer options that expose them to less risk.

This report sets out an approach for assessing the risks associated with choices of aid instruments. These risks are specific to the instrument and the recipient country. The methodology involves subjective assessments of as many as 29 risks, their outcomes, probabilities (on a 6-point scale) and risk factors. It also identifies potential mitigation strategies and the probabilities of the risk outcome after mitigation. We applied this methodology to common localised aid and non-localised aid instruments in Afghanistan, a country where good information on the risks of different aid instruments is available.

We found that the risks of localising aid in Afghanistan were not greater, and probably smaller, than not doing so, despite the fact that Afghanistan scores close to the bottom of most international assessments of institutional capacity and accountability. This implies that this finding may also be true in countries with better-functioning institutions. In our Afghanistan example, localised aid carries a slightly higher fiduciary risk but significantly lower programmatic, contextual and institutional risks.

The choice of aid instrument depends on the interrelation of the donor's objectives, timeframe, and tolerance for risk and a particular country context. The recipient will have its own objectives and timeframe for results which may not coincide with those of the donor. Donors with low tolerance for fiduciary risks are less likely to use localised aid instruments. The risk profiles of localised and non-localised aid instruments differ and choosing among them will depend on the weight assigned to each risk by the policymaker.

Donors would be advised to develop explicit tools and capacity for risk management. They should communicate what risks are worth taking in a particular country context, and ensure that decisions on risk taking are communicated upward and reviewed by senior managers. This means creating focal points for risk management, such as the country programme manager. Donor organisations might also consider borrowing risk management tools from the private sector. The report suggests five key policy recommendations for donors to manage risk, detailed below.

### 1. Go beyond project- (transaction-) based **approaches to managing fiduciary risk**

Donors should understand the way corruption connects with patronage networks and local politics, and facilitate policy and institutional changes, while building supportive constituencies among political parties, parliament, judiciary, media and civil society. Without parallel actions to support reducing corruption in all public expenditures, as well as support to eliminating impunity and abuses of power, a country's partners will find it difficult to move beyond ring-fenced donor projects. These leave a donor exposed to high contextual risks, with the possibility that the transaction costs of aid will be high for the donor as well as the recipient – that is, lower value for money – and that slow institutional development will prolong aid dependency. Localising aid can provide incentives to both donor and recipient to improve fiduciary and accountability systems; support to strengthen these systems can be designed to accompany localised aid as a mitigation strategy.

**2. Tailor the choice of aid instrument to the country context**

Sound institutional and political economy analysis to understand the country context is key to managing the risks and opportunities of localising aid. A country may score badly on global indicators of corruption, but may nevertheless have functioning public financial management (PFM) systems, and a few transformational leaders oriented to development, which enable well-designed projects to deliver results much greater than obtainable with non-localised aid. Fungibility of aid with domestic resources suggests localising aid in countries where aid is more fungible (e.g. in middle-income and large low-income countries) and to resort to non-localised aid in countries with severe governance challenges, where the donor has little influence on the government and where aid is not as fungible with domestic resources. However, a donor's ability to hold policy dialogue may be the binding constraint to localising aid through government systems.

**3. Implement special risk mitigation measures in high-risk environments**

These might include contracting out fiduciary services; ring fencing projects and using special procurement rules; dual sign-off on key decisions with government and donor agents, and with budget support instruments; and making expenditures without proper documentation ineligible for reimbursement. Community-driven development (CDD) localised aid instruments, including cash transfers to communities, could be considered in such situations. Fragile states require even deeper contextual analysis of risk trade-offs, since corruption can undermine state legitimacy but also maintain patronage networks that provide stability. Aid can preserve the ability of the state to prevent violence, but pressure to spend at the end of a conflict can be destabilising. Disruption in aid flows can be profoundly destabilising in fragile settings and has led to outbreaks of armed violence in some countries.

**4. Manage trade-offs among donor objectives so as to minimise the risks of doing harm**

Donors tend to bypass governments through non-localised aid when they are under pressure to demonstrate short-term results, to disburse funds and to avoid reputational risks from recipient government behaviour. However, large aid flows that bypass recipient government control can undermine institutions as well as build them, through imposing high transaction costs, fragmentation caused by multiple projects and donors, poaching of government staff, reducing learning by doing and subverting the budget process. Aid dependence can make it more difficult to overcome the collective action problems involved in building an effective state. Such risks of institutional damage in low-governance environments can be minimised by reducing transaction costs and fragmentation through multi-donor pooled funds, using the government budget to coordinate public service provision and agreeing among donors not to poach government staff.

**5. Strike a balance between allowing bureaucratic autonomy and rules-based processes**

A balance should be struck between allowing bureaucratic autonomy and ruled-based processes, depending on how much a donor's staff can be trusted to take the right decisions on risk. One would expect more development innovation in organisations where officials have greater autonomy, which may lead to better development results and value for money. Risk management requires the adjustment of donor organisational culture and human capacity at least as much as formal rules. Risk taking involves shared judgments by competent people who feel secure in their jobs if predicted and mitigated risk outcomes actually eventuate. Risk outcomes are an opportunity to learn, but negligence and failure to communicate risks should be penalised. Overreliance on formal rules and risk management processes is to be avoided; it can lead to bureaucratic box ticking. The consequences of overreliance on rules include underwhelming development impacts, or risk outcomes that the rules did not detect but were obvious in retrospect.

# 1 Introduction

In ‘Localising Aid: Can Using Local Actors Strengthen Them?’ (Glennie et al., 2012) (hereafter referred to as LA1), we set out a simple framework for looking at risks and results, particularly fiduciary risks and the risks of failure to achieve results. The report looked at the trade-offs between different types of risks, particularly of short-term interventions not developing institutions and ending dependence on aid, and of longer-term interventions not having immediate results. The report drew attention to the importance of managing risks by mitigating them, and the current bias in aid agencies towards avoiding risks rather than managing them.

‘Localising Aid: Sustaining Change in the Public, Private and Civil Society Sectors’ (Glennie et al., 2013) (LA2) criticised the argument that some governments are too corrupt or too ineffective to enable donors to localise aid. The empirical evidence indicates that, even in fragile states, appropriately managed localised aid can strengthen institutions, both governmental and non-governmental. It is also important to be clear that localising aid does not mean relinquishing control over donor money, and that a spectrum of options exists for mitigating the fiduciary risks associated with localising aid. LA2 identified the tension, if not inconsistencies, between donors’ primary concerns of seeking value for money, minimising exposure to corruption and delivering results in line with the ‘results agenda’. The report also underlined the relationship between economic rents and corruption, particularly in neo-patrimonial polities. It suggested that donors focus on eliminating the extraction of financial resources by elites, which is detrimental to economic growth and development, while tolerating rents that enable development.

This paper (LA3) develops these ideas further. One of the greatest obstacles to localising aid is the perception among donors that it is much riskier than non-localised aid, which appears more directly manageable without risking the funds going astray. This perception may be incorrect in many situations; moreover, depending on country context, non-localised aid may present higher risks of programme and strategic failure. This report sets out some guidelines and ideas for donors who wish to analyse the risks involved in localising aid. These demonstrate how donors can assess the totality of risk associated with their programmes and the issues relevant to localised and non-localised aid.

The report has three parts. First, it proposes a set of tools for assessing risk and choosing between aid instruments. This builds on LA1’s lead in categorising risk and insisting on a holistic approach that takes account of donor and recipient objectives, tolerance for risks and timeframe for results. Then we apply these tools to a specific country, Afghanistan, and analyse the findings. While fiduciary risks are greater with localised aid, in our Afghanistan analysis they diminish substantially with mitigation measures. Furthermore, other risks are significantly smaller, meaning that, overall, localising aid may be less risky than other options depending on the relative tolerances of a donor for different kinds of risks. The report ends with policy recommendations on how donors seeking to localise aid might improve their approach to risk management.

In applying the proposed risk assessment methodology to one of the world’s most fragile countries, we hope to achieve a further outcome – that is, to demonstrate that localising aid need not be a more risky business than opting for non-localised modalities. In fact, a holistic analysis of aid to Afghanistan implies that localised aid may often be less risky than non-localised aid. If this is the case, then localising aid is certainly an option worth taking very seriously in other countries as well.

# 2 How to identify and assess risk

## 2.1 Key terms

When some aspect of foreign assistance is described as 'risky', there is often confusion between relevant terms. We start our analysis by setting out some of the key terms.

'Risk' is the potential or probability of a future unwanted event occurring. Such an event is known as the 'risk outcome'. 'Risk factors', several of which can interact simultaneously, may cause the risk outcome to occur. 'Risk impacts' are the costs (or benefits) of risk outcomes; some impacts may be damaging to donor and country objectives, others less so. To understand a particular risk it is necessary to specify carefully what the risk outcome actually is, what party it will affect and how likely it is to occur (OECD, 2011). 'Risk tolerance' (often called risk appetite) is the amount of risk, on a broad level, an organisation is willing to accept in meeting its objectives (Rittenberg and Martens, 2012).

The process of 'risk mitigation' involves assessing risk factors, anticipating relevant risk outcomes and their potential impacts and taking action to lower the probability that these outcomes will occur. Such actions can be taken by the donor, government or other partners. For example, putting donor money through the government's treasury systems has typically been accompanied by measures to strengthen public financial management (PFM), in order to mitigate the risk of funds being misused. Indeed, localisation of aid, particularly through direct budget support, has provided incentives to donors to provide assistance to strengthen a recipient's PFM (AfDB and World Bank, 2011; Fritz and Kolstad, 2008; Netherlands Ministry of Foreign Affairs, 2012). When assessing whether a particular aid instrument is appropriate, the most important risk to consider is the risk of an outcome occurring after mitigation. However, it is still important to assess the risks faced before mitigation in order to decide whether mitigation is in fact possible, to analyse the effort to put into mitigation and to identify the mitigation strategy.

There are likely to be trade-offs among different types of risk. The International Network on Conflict and Fragility (INCAF) identifies three main categories of risk in fragile states (OECD, 2011):

- Contextual risk relates to events outside of an individual programme's scope that affect the country or some other local, regional or global entity. This includes a failure to develop, a humanitarian crisis, political destabilisation or a return to conflict. Contextual risk may render a foreign support programme ineffective or inoperable;
- Programmatic risk relates to risks in programme design, implementation or monitoring such that foreign support fails to achieve its objectives or contributes to contextual risk; and
- Institutional risk relates to the risk faced by the donor organisation and its staff in providing assistance. This includes fiduciary failure, reputational or political damage and incidents affecting staff security.

Given its political importance in donor considerations, and the potential trade-offs between management of fiduciary risk and contextual risk, in this report we treat fiduciary risk as a separate, fourth, category, following Mokoro (2008). Reputational risks can also be treated as a separate category, although almost any risk outcome can affect the reputation of a donor or recipient, we have therefore preferred to unpack such risks. The extent to which a risk event may create reputational damage is likely to depend on the speed and thoroughness of the agency's response, the frequency and magnitude of such events, (does the agency learn from them?), whether the potential benefits justified the risk taken in the first place, and the degree to which the agency communicated the risks it was taking to its authorising environment.[1] In some contexts, the risk of violent conflict may deserve special attention, as conflict can set development into reverse and multiply contextual and programmatic risks.

## 2.2 Weighting risk: A donor political economy perspective

The importance assigned to different risks depends a great deal on the tolerance for particular risks among particular donors in particular situations. Understanding this is essential to preparing recommendations on how to manage risk, including the risks associated with localising aid.

Foreign aid often has objectives that go beyond social and economic development. Governments have instruments other than aid to pursue some of these objectives, but this paper restricts itself to instruments that have an orientation towards development.[2] The objectives of foreign aid are various and include:[3]

1. Humanitarian altruism, assisting those vulnerable people impacted by disaster, war, famine, economic dislocation etc.;

2. Development altruism aimed at eliminating global poverty, including through assisting with economic growth, reduction of inequalities and building the institutions that underpin poverty reduction;

3. Political change through the promotion of donor values such as democratic and accountable governance, human rights and the rights of women and minorities;

4. National security of the donor country, entailing political stability in the recipient country, support from the recipient country to the interests of the donor and absence of violent extremism that might upset the political status quo or flow across borders;

5. Trade that increases the demand for imports from the donor country, promotes exports from the recipient, particularly of natural resources such as petroleum and minerals, creates a favourable climate for investment by the donor country and integrates the country into the donor's trade and investment regime; and

6. Coherence among objectives so the country becomes viable without foreign support other than loans for major investments and for dealing with episodic or externally driven crises such as unusual natural disasters, disequilibria in global markets or foreign security threats.

There are trade-offs among these objectives and the timeframes in which they can be achieved. Focusing on humanitarian results alone may overlook the development of local institutions which are central to building resilience to future disasters, while prioritizing short-term security may compromise political governance in the future. On the other hand, focusing too much on the development of institutions for long-term sustainability may prejudice immediate political and security objectives. There may also be conflicting priorities between the donor and the recipient country, particularly the latter's government which might have its own priorities for development, trade and security and might resent outside involvement in its political affairs. The recipient government might also have different views on the timeframe for achieving results, often reflecting impatience with the donor's internal processes but with more realism on the feasible rate of policy and institutional change.

Different donor domestic constituencies tend to be interested in the different objectives of foreign assistance. Each objective is associated with a number of risk outcomes, typically related to the failure of resources to achieve goals, waste of resources and foreign policy considerations (see Table 1).

A donor's tolerance for risk will depend in part on the relative influence of these constituencies on its decision-making processes and the importance of each objective in a particular recipient country. Donors may be more willing to accept risk when public opinion is supportive of foreign aid (Knack and Eubank, 2009). On the other hand, even small conventional risk events can be scaled out of proportion and exploited by opponents of foreign assistance to justify their position, creating reputational damage. This can lead to internal inquiries that divert time and money, unfavourable publicity and eroded support for the donor. Moreover, with modern media, news of a risk event can be magnified quickly (Institute of Directors, 2012). Risk-averse behaviour by donor staff is likely in an environment where there is fear that a risk outcome will have reputational effects, with some organisations seeking accountability by blaming individual staff for systemic failures. Consequences may be magnified by the political context and the quality of the organisation's risk management.

A donor agency has to balance the tensions among the multiple objectives of foreign assistance, as well as the tension between delivery of short term, visible results and facilitating the decades long development of institutions that enable the country to exit from aid. Governments in donor countries face an electoral cycle that is much shorter than the timeframe for institutional sustainability in the recipient country, where the government may face less competitive politics and may take a longer view. Too much donor visibility, through branding of donor projects

1 Mokoro (2008) shows reputational risks as a category of risk in its own right and many donors take these risks very seriously as in extreme cases they can be existential.

2 Non-aid instruments include diplomacy, military force and trade policy.

3 See, for example, the aid policy statements of major donors, Berthélemy (2006) and Dietrich (2012).

**Table 1: Aid objectives, constituencies and risk outcomes**

| Objective | Constituency for | Constituency against | **Risk outcomes** |
|---|---|---|---|
| Humanitarian | Public, media, non-governmental organisations (NGOs), aid agencies, legislature | Possibly some budget balancers when waste identified | Visible human suffering, inadequate response, waste, corruption |
| Development | Development NGOs, think tanks, development agencies, international financial institutions (IFIs), contractors, foreign policy specialists, some legislators, some military/security, some media | Budget balancers, nationalists, isolationists, defence lobbies, some media | Lack of results, waste, weak governance, corruption, aid dependency, resentment of conditionality |
| Political change | NGOs, legislators, foreign ministries, think tanks, media | Isolationists, 'realists', some security agencies | Human rights abuses, failed elections, authoritarian governments, injustice, impunity, worsened international relations |
| National security | Foreign policy specialists, think tanks, foreign and security ministries, military | Humanitarian NGOs, some think tanks/academia | Insurgency, civil war, cross-border violence, trafficking, anti-donor sentiment, haven for extremists |
| Trade | Private firms and trade civil society organisations (CSOs), pro-private sector legislators | International NGOs (INGOs), humanitarian NGOs, development think tanks, IFIs, trade unions, some legislators | Public concern about subsidies to business, poor development results, renegotiation of deals or expropriation, corruption |
| Coherence | Foreign policy specialists, some legislators | Budget balancers, isolationists, some NGOs and aid agency staff, some military/security actors | Chronic dependence on aid, government accountability shifts from citizen to foreign partner, political instability |

for instance, has the potential to undermine the credibility of the government in the eyes of its people. Support for foreign aid and the risks it entails may be linked to how the donor country population sees the effectiveness of its government in supporting poverty reduction and welfare in its own country (Dietrich, 2012). There is evidence that donors are willing to provide aid to countries with high levels of corruption if they are of high geostrategic importance, such that political and security objectives predominate (Alesina and Weder, 1999; Alesina and Dollar, 2000; Easterley and Pfuze, 2008; Paul, 2006).

Donors may be under particular pressure to avoid fiduciary risk, sometimes expressed as "zero tolerance" for fraud and corruption. However fiduciary risk cannot be avoided entirely, even in the context of public (or private) expenditures spent entirely within the donor country itself. Avoiding fiduciary risk would involve either not engaging with the recipient country at all, or using instruments which are seen to be low risk, even if they cost more. A more helpful approach could be to insist on zero tolerance for fiduciary risk outcomes involving donor funds, and take cost-effective measures to detect and prevent these risk outcomes. For example, in the Liberian health sector donors are localising aid through government fiduciary systems, but have required additional controls to mitigate these risks. These controls do not eliminate fiduciary risk and, in this case, donors can be reasonably confident that there would be a robust government response to a risk outcome and have the option of invoking their own anti-corruption policies and procedures.

Reputational fallout will depend on how well a donor manages the consequences if funds do go astray. If risk outcomes are likely to occur at a frequency or magnitude that would create reputational risks that are difficult to manage, then the donor has the option of shifting to aid instruments with lower fiduciary risks, even if this involves increases in other programmatic or contextual risks, longer aid dependency and less value for money. Managing these tradeoffs among objectives and the different risk profiles of aid instruments involves political choices by the donor, although technical analysis can help frame these decisions and demonstrate any misperceptions about certain aid modalities.

A donor may also face internal agency issues in risk management when donor agency or partner staff at the implementation level misunderstand the organisation's risk tolerance or have incentives to take part in excessive risk aversion (Paul, 2006). Such incentives could arise from an asymmetrical authorising environment that penalises risk outcomes but undervalues risk opportunities, or risk aversion among staff on short-term contracts without job security who see a risk outcome prejudicing renewal of their contract. It could also arise from weak oversight and/or miscommunication within the organisation, with employees misjudging or ignoring the level of risk acceptable to the organisation or failing to communicate the risks of their decisions.

## 2.3 Risks from the recipient country perspective

The factors that influence a donor's choice of instrument will depend not just on the interests and views of its domestic constituencies but also on the particular country context, particularly the extent to which the recipient government shares the donor's objectives and is committed to development and improved governance. While this report focuses on risk analysis from the perspective of the donor, it is important to be aware that the risks of donor aid as perceived by the recipient country government may be significantly different.

For instance, from a recipient government's perspective, if aid is not localised, legitimate governments can be disempowered and the political dimension of public expenditure decisions may be truncated. The risk of instability and armed violence may increase if important constituencies cannot be placated through the allocation of public funds and if patronage networks cannot function.[4] It is worth noting that these risks may still exist even if aid is localised through the budget, particularly if donors micromanage how money is spent and impose unwanted policy conditionality.[5] As discussed in LA2, the recipient government can also run the risk that accountability to donors will replace accountability to its citizens, although this risk may be higher for non-localised aid than for localised aid linked to domestic budget and expenditure processes.

Such risks may affect a recipient country's acceptance of or response to aid, and may also damage donor–recipient country relations, particularly if the donor country makes little effort to understand or mitigate them. Consideration of the recipient's perspective on risk may therefore assist a donor to provide aid more effectively. It is also relevant to assuring country ownership of aid, since recipients are likely to prefer options that expose them to less risk.

We have grouped risks from the recipient's perspective into four main categories in the table below, mainly for reference. Sovereignty risks relate to donors providing aid in a way that constrains government decision-making or undermines government hegemony. Capacity risks relate to donors providing aid in a way that weakens public institutions, while sustainability risks relate to aid being provided in a way that prioritises short-term interventions or creates continued aid dependence. Economic risks relate to potential macroeconomic imbalances relating to the inflow of donor aid, and the way in which it is spent in-country

Recipient governments are also affected by reputational risks, which can lead to additional fiduciary controls imposed by donors, a shift to less flexible aid modalities, a reduction in aid flows and exposure of government officials to criminal charges.

4 See Khan (2003; 2010) and North et al. (2009; 2013) on the relation between neo-patrimonial politics, corruption and rents.

5 See OECD (2010) on the negative impacts of foreign aid on institutional development.

**Table 2: The risks of aid from a recipient perspective**

| Risk | Risk factors | Risk outcomes |
|---|---|---|
| | Sovereignty | |
| Government not aware of donor-funded activities | Donor does not discuss intended support with government, and/or implements without government involvement | Weakened perceptions of government credibility in the eyes of beneficiaries, as public goods are seen to be delivered by donors not the state. Government does not have full control over the delivery of public goods |
| Donor support is provided conditionally | Donor views provision of financing as a mechanism for requiring government to commit to reforms and/or changes in public policy and public spending | Government perception that sovereignty is being undermined. Public perception that the state is weak. Risk that government may not accept the support, even if for a priority area of funding. Risk that government may accept conditions that it cannot realistically deliver against, given need for funding. Activities then interrupted owing to government failure to meet conditions |
| Allocative distortions in public spending | Either: Donor decides what support should be spent on without discussing with government<br><br>Or: Donor discusses support with government but insists on it being spent in a particular sector, or for a particular activity | Government does not have full control over the allocation of public spending. Likelihood of funding gaps in areas considered a priority by government; expenditure in areas not considered a priority by government; and duplication of activities between donors, or between on-budget and off-budget support. Government has difficulties allocating expenditures to political constituencies leading to potential instability and even armed violence |
| | Capacity | |
| Weakened public institutions | Donor implements support without government involvement, or requires support to be managed by a specially established project implementation unit | Limited core institutional capacity to deliver against its mandate, in terms of both human and financial resources. Institutional capacity not developed. Public institutions lack credibility in the eyes of the public |
| | Sustainability | |
| Donor dependency | The way donor financing is provided does not build sustainable national capacity | Government continually requires donor support, with associated reduction in sovereignty, public perceptions of the weakness of the state, potential distortions in public spending etc. Government becomes more accountable to donors than to its domestic constituencies, which may weaken its credibility and the credibility of state institutions |
| Lack of medium-term predictability | Donor cannot commit support for more than one or two years ahead. Changes in donor policy may lead to abrupt changes in financing at sectoral level | Programmes are designed to deliver short-term results. Activities that require sustained medium-term financing are not prioritised (e.g. capacity building, large-scale infrastructure). Risk of sudden interruption of key programmes providing recurrent financing (e.g. drugs). Benefits of public expenditure to semi-loyal constituencies cut off, leading to instability and possibly armed violence |
| | Economic | |
| Macroeconomic imbalances | Donor spending is concentrated on non-tradable goods, drives up prices domestically, both for wages and for goods and services. Sterilisation of aid flows with bond sales raises interest rates and crowds the private sector out of the domestic credit market | Appreciated real exchange rate, reduced capacity for export-led growth, private investment depressed owing to lack of finance, labour market distortions |

In countries where anti-corruption agencies are politicised or corruption is endemic, there is a risk that individuals will be scapegoated, which leads to avoidance of decision making and other risk-averse behaviour.

## 2.4 A simple framework for assessing risk

In LA2, we defined localised aid as aid money that is transferred directly to or through national state or non-state entities. Localising aid is a concept very much in the same spirit as 'using country systems', but it has a number of differences. While localised aid uses the financial systems of recipient entities, it does not necessarily entail fuller use of other recipient systems (such as those for planning, deciding expenditure priorities and evaluation). In the case of support to the state, donors may insist their money finance particular items in the budget where there may be tension between donor development objectives and government commitment, or 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, but may not fully use the latters' strategic planning functions.

What are the main risks to assess when considering localising aid? Looking at each of the major categories of risk set out in Section 1A, we identify a series of specific risks, grouped as follows:

- Programmatic risks seem the most numerous, and we have created a sub-classification related to how they impact results at each stage of the project cycle – that is, the risks at the design, implementation and operational stages. Design risks include development of a project that is inappropriate to the context, and overestimating the capacities of the implementing agency and suppliers. Implementation risks include a lack of qualified bidders, slow implementation and poor contractor performance. Operational risks consist of inability of counterparts to operate and maintain the project and fund these activities, lack of complementary inputs and the risks that the project is not used or that counterpart institutions are not strengthened.

- Contextual risks relate to broader, non-project objectives of aid and may be divided into developmental and strategic risks. Developmental risks include failure to achieve broader outcomes from the aid intervention, such as poverty and growth targets, increased inequality, lack of overall institutional development and declining public revenues and governance. Strategic risks, sometimes referred to as political risks, are linked to declining state credibility, increased violence and trafficking, deteriorating foreign relations for the recipient country and lack of improved coherence and coordination in international assistance.

- Institutional risks for the donor can involve deteriorating relations with the recipient country, loss of credibility with donor domestic constituencies, a shift of resources from longer term development to shorter term humanitarian instruments and inability to operate in the country for reasons such as deteriorating security. Reputational risks also affect the institutional standing of the donor and can be a consequence of risk outcomes from all types of risk. They depend on how the donor identified and managed these risks and responds to risk outcomes.

- Fiduciary risks relate to money and resources going astray during their transfer or the implementation of a donor-funded intervention.

In this report, we propose a methodology for analysing the relative risks of localising aid as opposed to not localising it, using an Afghanistan country case example. We unbundle the four broad categories of risk above by setting out 29 risks relevant to Afghanistan identified from an analysis of the literature, describing the potential risk factors and risk outcomes associated with them in the Afghanistan context and identifying the potential mitigation strategies. We then assign a subjective risk probability to each risk before and after mitigation measures are taken, based on our own knowledge of the Afghanistan country context. We use a six-point scale for risk probability:

- High risk H4 or H5
- Medium risk M2 or M3
- Low to negligible risk L0 or L1

We consider that risk probabilities for a given risk may vary between the two different modalities (localising and not localising aid), and ascribe risk probability scores accordingly. The purpose of the methodology is to identify the areas in which localising aid carries relatively greater risks, and to assess how the risk profile of localised aid might change after the identification and implementation of appropriate risk-specific mitigation strategies.

Risk impact is likely to be common to both aid modalities, but can be judged only on a case-by-case basis after an analysis of donor objectives and risk tolerance, as well as recipient country priorities. We therefore do not attempt to measure risk impact in our Afghanistan country case example. Similarly, we do not attempt to assess reputational risks since most are captured by disaggregating risk and depend to a large extent on how the donor manages risk outcomes, rather than the aid instrument itself. In the Afghanistan example, reputational risks were not just fiduciary but also linked to a failure to achieve results. Different instruments may have higher or lower fiduciary and results delivery risks and these are assessed; their reputational impact will depend on how the donor responds to risk outcomes and the magnitude of these outcomes in relation to the donor's overall country objectives and tolerance for these types of risk. What would be a high-impact risk for some donors may be low impact for others, depending on the constituencies, pressures and objectives summarised in Table 1. For example, if fiduciary risk is a major concern for one donor, the impact of a small loss of funds could be high, even though the project outcomes might be relatively unaffected. In a friendly country of strategic importance to the donor, a donor might choose an instrument with low programmatic or contextual risks and accept a higher level of fiduciary risk, even though the donor would still need to be vigilant regarding fiduciary risk outcomes and demonstrate zero tolerance for them.

The risk assessment methodology proposed in this paper provides a framework for assessing these risks, understanding the trade-offs among risks, objectives and timeframes. It also provides a framework for managing the expectations of the authorities in both the donor and recipient country.

# 3 Applying the framework: The case of Afghanistan


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## 3.1 Explanation of methodology

Because all risk assessments are highly country specific, we have chosen to carry out an exemplary analysis of one country, to illustrate how the methodology proposed here might be applied in a real situation, and how policy inferences could be drawn from its analysis. In a real application of the framework, there would most likely be a group of experts determining the likely risks and risk outcomes, exploring mitigation options and making the assessments of risk. These in turn would be subject to critical review.

We have chosen Afghanistan for a number of reasons. First, it is a country close to the bottom of most international assessments of institutional capacity and accountability. We wanted to demonstrate that the risks of localising aid in such a country, according to our assessment, are not significantly greater, and may even be smaller, than those of not doing so. If that is true of Afghanistan, it is likely also to be true in countries with better-functioning institutions. Second, there is good information on risks and opportunities and more than 10 years of experience of both localising and non-localising aid instruments. Third, risk analysis requires deep knowledge of a country – Afghanistan is country whose aid management and programme implementation issues the author knows well. And fourth, we chose not to use one of the case study countries from LA2 (Liberia, Uganda and Guatemala) to which we have already applied a localising aid analysis, so that we could add a further case study to our analytical work on localising aid. Nonetheless, this analysis remains one person's assessment using the methodology proposed in this report, rather than a definitive account of the Afghanistan experience.

Afghanistan provides a good example of the linkages between foreign aid and political and security objectives set out in Table 1. According to a recent analysis, 'Since 2002, the United States Congress has appropriated nearly $89 billion for reconstruction of Afghanistan; the current continuing resolution and budget requests entail billions more. These funds have been used as part of a multi-pronged effort to build a stable Afghanistan with a government capable of defending and administering its territory—critical factors for the overriding U.S. goal of defeating al-Qaeda, which used a Taliban-controlled Afghanistan to plan and train for the September 11, 2001, attacks against the United States' (SIGAR, 2013: 3).

As the LA2 report shows, there are a many pathways through which aid may be transferred, either localised or not localised and via government, private sector or civil society channels. For the sake of simplicity, this illustrative risk assessment focuses on two of the most common localised and non-localised aid instruments in Afghanistan. The same risk assessment tool could be applied to other aid channels, for example providing aid through an INGO or directly to local NGOs.

1. Aid channelled via an international contractor or partner who then subcontracts local firms and NGOs – that is, non-localised aid to private providers (NLA-PP), an approach adopted by many bilateral donors and some military stabilisation programmes.
2. Aid earmarked for donor-specified purposes that flows through the government budget where the donor has the option of ring fencing the project by insisting that the government follows certain procedures related to fiduciary management, environmental and social impacts (LA-Govt). This approach has been used mainly by the multilateral development banks (MDBs) and the Afghanistan Reconstruction Trust Fund (ARTF).

## 3.2 Country overview

Afghanistan is notable for arrangements to contract out fiduciary arrangements – procurement, financial reporting, audits – while parallel donor-supported activities have built country capacity. These efforts have been successful in strengthening the Ministry of Finance and some line ministries, although they still require donor-financed supplemental capacity. Capacity development has been less common at the subnational levels of governments, where the MDBs have been less involved (Oxfam, 2011; World Bank, 2013). Even though Afghanistan scores near the bottom of international corruption scales, its PFM systems are considered reasonably robust in comparison with other low-income countries, probably because much corruption involves abuses of power (e.g. extortion by police, government officials and local power holders), illegal disposal of state assets like land and diversion of customs revenues before they enter treasury systems. Progress in the development of PFM systems in Afghanistan has been demonstrated by its Public Expenditure and Financial Accountability (PEFA) scores and the decline in expenditures declared ineligible for

**Table 3: Relative risks of LA-Govt and NLA-PP in Afghanistan - summary**

| | LA-Govt | | NLA-PP | |
|---|---|---|---|---|
| | Before mitigation | After mitigation | Before mitigation | After mitigation |
| Programmatic risk (design) | | | | |
| 1. Inappropriate project design | L1 | L0 | H5 | M3 |
| 2. Overestimating the capacity of market to deliver project inputs | M2 | L0 | M2 | L0 |
| 3. Overestimating capacity of implementing agency | M3 | L1 | M3 | M2 |
| Programmatic risk (implementation) | | | | |
| 4. Lack of qualified bidders | M2 | L0 | M2 | L0 |
| 5. Slow implementation | H5 | M3 | H4 | M3 |
| 6. Contractor doesn't fulfil contract | M2 | L1 | M2 | L1 |
| 7. Contractor abandons contract | M2 | L1 | M3 | M2 |
| Programmatic risk (operation) | | | | |
| 8. Counterpart agency lacks capacity to operate & maintain project | H5 | M2 | H5 | M3 |
| 9. Beneficiaries don't use project | M2 | L1 | M3 | M3 |
| 10. Government can't finance recurrent costs or recover costs | H5 | M3 | H5 | H4 |
| 11. Lack of complementary inputs, e.g. furniture & books for schools | M2 | L1 | H4 | M2 |
| 12. Project fails to strengthen or weakens institutions | H4 | M3 | H5 | H4 |
| **Programmatic risk averages** | 2.9 (M) | **1.3 (L)** | 3.6 (M) | 2.3 (M) |
| 13. Growth & poverty targets not met | H4 | M2 | H4 | M3 |
| 14. Increasing inequality | M3 | M2 | H5 | H4 |
| 15. Institutions don't get built | H5 | M3 | H5 | H4 |
| 16. Public revenues decline | H5 | M2 | H5 | H4 |

| | LA-Govt | | NLA-PP | |
|---|---|---|---|---|
| | Before mitigation | After mitigation | Before mitigation | After mitigation |
| 17. Governance does not improve or deteriorates | H5 | M2 | H5 | H4 |
| Contextual risk (strategic) | | | | |
| 18. Credibility of the state declines | H4 | M2 | H5 | H4 |
| 19. Insurrection, violence and chaos | H5 | M2 | H5 | H4 |
| 20. Country's external relations deteriorate | M3 | M2 | H4 | M3 |
| 21. Coherence & coordination of international assistance worsens. | H4 | M2 | H5 | H4 |
| **Contextual risk averages** | 4.2 (H) | 2.1 (H) | 4.8 (H) | 3.8 (M) |
| Institutional risk | | | | |
| 22. Relations between donor and country deteriorate. | L1 | L0 | M3 | M2 |
| 23. Loss of credibility with donor's internal constituencies, legislature & public when programme fails to deliver. | M3 | L1 | M3 | M3 |
| 24. Shift of resources from development to humanitarian assistance & security. | M3 | L1 | H4 | M3 |
| 25. Ability to operate in country diminishes as security declines | H5 | M2 | H5 | H4 |
| **Institutional risk averages** | 3.0 (M) | **1.0 (L)** | 3.8 (H) | 3.0 (H) |
| Fiduciary risk | | | | |
| 26. Corruption, fraud & collusion by contractors | H5 | M3 | M3 | M2 |
| 27. Funds diverted by government officials | H4 | L1 | M3 | L1 |
| 28. Corruption or fraud in implementing agencies | H5 | M3 | H4 | M3 |
| 29. Project funds cannot be accounted for | H4 | L1 | M3 | L1 |
| **Fiduciary risk averages** | 4.5 (H) | **2.0 (L)** | 3.3 (M) | **1.8 (L)** |
| **Overall risk averages** | 3.6 (M) | **1.6 (L)** | 3.9 (M) | 2.7 (M) |

financing by the ARTF monitoring agent (ARTF, 2013; World Bank, 2008). [6]

Roughly two-thirds of non-military aid to Afghanistan has been delivered through direct donor implementation outside government budget systems. This has been driven by donor concerns about corruption, the need to secure peace by ensuring the population sees early service delivery and the linking of development aid to security stabilisation, particularly in areas where donor country troops are stationed. Much of this assistance has been delivered through integrated provincial reconstruction teams (PRTs), where donor agency staff are stationed in military garrisons and operate under their own security umbrella. PRT projects are typically agreed with the local provincial and district governors, some of which have had limited local legitimacy at times during the past 10 years, which has inadvertently exacerbated local grievances (Fishstein and Wilder, 2011). These projects implemented outside government systems have not been immune from fraud and corruption or failure to deliver development results. To be fair, many of these bilateral projects have been implemented in areas with low levels of governance and which are prone to instability, and the US has been admirably transparent about the success and failures of its projects in Afghanistan. However, while World Bank management were aware of very few cases of fraud, corruption or collusion at least up until mid-2008, this does not mean that corrupt practices did not take place. [8]

We present our assessment of the relative risks of localised and non-localised aid in Afghanistan in Table 3. [9] A fuller version of this analysis is available on the ODI website.

## 3.3 Main features of analysis

When we look at the risks before mitigation we find different assessments depending on the risk category.

- Under programmatic risks, LA-Govt tends to have higher risks of slow implementation, but NLA-PP tends to have higher risks of getting the design wrong and failing once the project becomes operational. On balance, NLA-PP tends to have a slightly higher programmatic risk.

- Contextual risk probabilities tend to be higher for NLA-PP because of lower engagement with country authorities, less institutional development when local organisations are bypassed and lack of flexibility of NLA-PP to respond to local political priorities.

- Institutional risk is higher for NLA-PP than for LA-Govt, as is reputational risk, essentially because NLA-PP bypasses local institutions, leads to lower country ownership and entails a greater risk that programme goals will not be met.

- Fiduciary risk may to be higher with LA-Govt, especially before mitigation.

According to our analysis, after mitigation, the overall risk associated with NLA-PP is higher than the risks of localising aid by 1.1 points on our risk scale. This is also true for each of the four risk categories except fiduciary risk (corruption, fraud and collusion among contractors, diversion of funds by government officials and slow implementation): mitigation has substantially reduced the difference in fiduciary risk between the two aid instruments. This analysis assumes an equal weight for each risk category. We also assessed the consequences of weights, which might be characteristic of a donor very concerned about reputational risk, that is, fiduciary risk 0.75, institutional 0.1., programmatic 0.1 and contextual 0.05. With these weightings, LA-Govt still has a slight edge over NLA-PP – the overall difference is 0.2 – but the risks of the two instruments are almost equal.

NLA-PP scores consistently badly on contextual and institutional risks; the inference is that, although NLA-PP might protect donor money better and get things done faster, the overall programme is at greater risk of failing to achieve its development or strategic objectives. Such failure comes with a cost in terms of the credibility of the aid provider and its relationship with the recipient country. It may not be an exaggeration to say that localising aid can be an effective instrument to mitigate the development, strategic and institutional risks that come with not localising aid. This analysis suggests that the risks of localising aid in Afghanistan were not greater, and were probably smaller, than those of not localising aid.

This illustrative assessment of risks is designed to demonstrate an approach to evaluating aid instruments in a real context. While the conclusions are necessarily tentative, the analysis indicates that, within the context of Afghanistan:

- The development impact risks of NLA-PP projects seem significantly higher than those of LA-Govt, as do the contextual risks arising from overall programme failure.

- Fiduciary and project delivery risks before mitigation are substantially higher with LA-Govt, but are not significantly different from non-localised aid after mitigation.

- A donor agency that is particularly vulnerable to fiduciary risk events but that cannot substantially affect overall development, security and political outcomes in Afghanistan or has only a small stake in their success (e.g. a small donor without much military presence) might prefer NLA-PP instruments.[10]

These results demonstrate the way in which the risk assessment methodology proposed in this report can be used to inform a donor's decision-making process about the use of aid instruments in a particular country context, relative to the nature and overall objectives of the donor's country engagement.

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6 It should be noted that expenditures ineligible for reimbursement from ARTF have increased in recent years as the environment in Afghanistan has deteriorated.

7 Information on problems in non-localised aid in Afghanistan can be found in the reports of the Special Inspector General for Afghanistan Reconstruction (SIGAR) published at http://www.sigar.mil/. Fishstein and Wilder (2011) state, 'The most destabilizing aspect of the war-aid economy was in fueling massive corruption that served to delegitimize the government. Other destabilizing effects included: generating competition and conflict over aid resources, often along factional, tribal or ethnic lines; creating perverse incentives to maintain an insecure environment [...]; fueling conflicts between communities over locations of roads and hiring of laborers; and causing resentment by reinforcing existing inequalities and further strengthening dominant groups, often allied with political leaders and regional strongmen, at the expense of others.'

8 Hobbs (2005) interviewed road contractors in Africa who claimed 10-15% of bribes were standard in World Bank roads contracts. World Bank procurement procedures were unable to detect these unless full audits of suppliers, contractors and their agents were carried out; this would have been prohibitively costly and unlikely to increase the development impact, unless corruption was at predatory levels. SIGAR (2011) gives an example of some apparently mislaid ARTF funds being sought from a halvadar (a semi-formal money agent in the hawala system).

9 This Annex shows mitigation actions that are applied to the overall risk outcome. However, it would also be possible to adopt the approach used by others such as DfID which differentiates actions to mitigate the probability of a risk outcome occurring and to separately mitigate the impact of the risk outcome.

10 It is worth noting that the US, the largest contributor to Afghanistan, is now the largest donor to ARTF, which finances LA-Govt instruments.

# 4 Policy implications for donors

We have analysed one country in detail using a framework for assessing multiple risks. Donors wishing to localise more of their aid will be confronted with different risk profiles, sometimes with greater fiduciary and implementation risks but also greater opportunities for development impact and value for money. The relative programme, contextual, donor institutional and fiduciary risks will vary on a country-by-country basis. While we cannot provide definitive rules for choosing particular aid instruments in a given situation, we can provide some guidelines.

The choice of aid instrument depends on the interrelation of the donor's objectives in the particular country context, conditions within the country, the donor tolerance for risk in this country, the weights the donor assigns implicitly or explicitly to the importance of each risk, and the timeframe for meeting objectives. The recipient too will have its own objectives and timeframe for results which may not coincide with those of the donor.

Country context matters for setting risk tolerance; a donor might be willing to take high risks in countries of strategic importance where the stakes are high, but more risk averse where potential risk outcomes don't justify the costs to reputational capital. If corruption is pervasive and the risk cannot be lowered to a level acceptable to the donor with mitigation, the donor might want to avoid government channels and be cautious about localising aid to national organisations that might be pressured into diverting funds. [11]

Donors having authorities that have low tolerance for fiduciary risks are less likely to use localised aid instruments. If the donor is under pressure to demonstrate value for money then localised aid instruments might be preferred. When the risk profile is slanted towards producing results, the picture is more complicated, and may depend on whether these are short term political or security gains, medium term programme level results, or self-sufficient institutions that enable a country to stand on its own feet. The risk profiles of localised and non-localised aid instruments differ and the choice among them will depend on the weight assigned to each risk by the policymaker, and these weights in turn will depend on country context and the speed with which results need to be achieved.  Where tolerance for risk is low, the donor might wish to share risks with other donors through pooling funds in a multi-donor trust fund or similar arrangement, and transfer them to a multilateral or private agent.

None of this is easy. Donors interested in choosing between aid instruments on the basis of their respective risk profiles relative to the overall objectives of their country engagement would be advised to develop explicit tools and capacity for risk management. At a minimum, this involves managing risk and communications about risk tolerance proactively – that is, what risks are worth taking in relation to potential development gains in a particular country context – and ensuring that decisions on risk taking are communicated upward and reviewed by senior managers. It means creating focal points for risk management, such as the country programme manager. Donor organisations might consider borrowing risk management tools from the private sector, where these are appropriate, including formal enterprise risk management (ERM) tools such as those developed by the Committee of Sponsoring Organizations of the Treadway Commission COSO (COSO, 2004).[12]

However, in practice assessing risks and the choice between localised and non-localised aid may not be as difficult as it may appear. Our assessment of the Afghanistan example implies that at least for this case,, after mitigation LA-Govt is no more risky than NLA-PP; similar assessments could be done for other aid modalities or country contexts. In our Afghanistan example, fiduciary risk may be slightly higher but contextual and institutional risks are lower. Localising aid can provide incentives to both donors and recipients to improve fiduciary and accountability systems; support to strengthen these systems can be designed to accompany localised aid as a mitigation strategy. Localising aid could be able to mitigate the contextual or strategic risks associated with non-localised aid, as well as to reduce risks of waste and chronic aid dependency.

The process of transitioning to a different risk profile is likely to require a number of inter-linked actions. We end this report by suggesting suggest five key policy implications from our analysis for donors seeking to manage the risks of localising aid, which may also be applicable to other fields of development programme management.

11 World Bank (2011) essentially proposes a shift from localised to non-localised aid in situations where governance has deteriorated to very low levels.

12 For example, the World Bank, which uses localised aid instruments almost entirely, has followed this path.

## 4.1 Go beyond transaction-based approaches to managing fiduciary risk

Corruption is related to the country context, and donors should understand the way it connects with patronage networks and local politics in order to facilitate policy and institutional changes that minimise incentives, while building constituencies among political parties, parliament, judiciary, media and civil society to prevent it (OECD, 2007b; North et al., 2013). Some corruption is likely even with vigilance, and comprehensive forensic audits to routinely determine corruption in contractors, suppliers and agents would be prohibitively costly (Hobbs, 2005). Corruption is a problem in government contracting even in industrialised countries (PricewaterhouseCoopers, 2009).

While non-localised instruments are often chosen to reduce corruption risk, there is evidence that these, like other donor government contracting, also face significant fiduciary risks (SIGAR, various). Despite the conventional wisdom that the fiduciary risks of localised aid are higher than for non-localised aid, we have found no compelling evidence to support this. Extrapolating from studies on the risks of direct budget support compared with project support (de Catheu, 2013; IDD, 2006; Fritz and Kolstad, 2008; Netherlands Ministry of Foreign Affairs, 2012), we would postulate that the difference in fiduciary risk between aid modalities may not be significant after risk mitigation (particularly with PFM reforms) and depends also on country context. Furthermore, corruption involving fraudulent diversion of funds from the government treasury may not be significantly easier to achieve than other forms of corruption, such as plundering state-owned enterprises and banks, abuse of power, illegal acquisition of public assets, enabling organised crime or diverting revenues before they enter the budget system. [13]

General budget support is one of the best-known forms of aid localisation: a multi-donor study (OECD, 2007a) concludes that, 'there was no clear evidence that budget support funds were, in practice, more affected by corruption than other forms of aid'. The same study calls for decisions about budget support to be informed by country-level assessments of the balance of potential risks and benefits. It goes on to say that few risks are unique to a particular modality and different instruments can be used in combination to mitigate risk. Without parallel actions to support corruption reduction in all public expenditures, as well as support to eliminating impunity and abuses of power, a country's partners will find it difficult to move beyond ring-fenced donor projects. These leave a donor exposed to high contextual risks, with the possibility that the transaction costs of aid will be high for the donor as well as that recipient – that is, lower value for money – and that slow institutional development will prolong aid dependency. This illustrates the value of strengthening PFM and facilitating reforms that strengthen rule of law, in this context a government obeying its own rules, and the accountability of government to its people.

## 4.2 Tailor the choice of aid instrument to the country context

Understanding the country context is key to managing the risks and the opportunities that localising aid might create. This requires sound institutional and political economy analysis, particularly to understand how the recipient country sees the risks of a donor's interventions and the recipient's tolerance for these. One could also argue that the recipient needs to understand the donor's policies and tolerance for risk, which, given donors' multiple objectives, may sometimes appear confusing. A country may score badly on global indicators of corruption, but may nevertheless have functioning PFM systems that enable well-designed projects to deliver results much greater than are obtainable with non-localised aid. While the government overall may not be well oriented

13 There are many examples of scandals involving fraud and corruption that do not involve diversion of funds within the government treasury system, for example the privatisation of state assets in the former Soviet Union, scandals involving the Kenyan central bank and Kabul Bank, extortion by police and army at checkpoints in many countries, corruption of officials by narcotics traffickers in Afghanistan, Colombia, Guinea Bissau, Mexico and Central America and organised crime in southern Italy. It is worth noting that the Governance and Economic Management Assistance Program (GEMAP) programme in Liberia focused on protecting revenues rather than expenditures (USAID, 2011).

14 Examples of countries where there may be subnational government with stronger capacity than at the national level include Democratic Republic of Congo, India and Nigeria.15 And the risk-reward calculus in localising aid in a weak governance country of strategic importance may still be lower than the alternatives (see Rosenberg, 2013).

to development, there may be some ministers (or subnational leaders)[14] with the capacity to be transformational and to implement a development vision within their jurisdiction, and who will protect their resources from predators and effectively utilise localised aid with acceptable risk. Some countries may have potentially high non-developmental benefits from aid, be important to the donor's strategic interests and justify a higher risk tolerance than, say, a small country remote from the donor country interest.[15]

The parallels between LA-Govt and budget support (despite them being different instruments) suggest an approach to the decision of whether or not to localise aid. In countries where aid is fungible with domestic revenues, the choice of aid instrument may affect neither allocation of aid to particular purposes nor accountability. Fungibility of aid is less in countries that are not heavily dependent on aid and donors may have more influence on government expenditure policies and accountability. As mentioned before, budget support increases the incentives for donors to strengthen recipient PFM systems, but this requires commitment by local stakeholders. The challenge for donors is to draw the line between countries considered too corrupt and those where corruption is 'acceptable'.[16]

Other governance factors – adherence to international human rights standards, civil and political freedom and the government's commitment to development – will also be decisive. Whether LA strengthens domestic accountability will depend on the strength of government in relation to the groups that seek to hold it to account. On-budget localised aid, like budget support, increases government ownership over aid resources and can increase external accountability too. Whether it increases domestic accountability and leads to less misuse of funds depends on the political economy landscape, the strength of the domestic accountability system and the political economy of the aid relationship (Fritz and Kolstad, 2008). The policy implication of this for donors would be to localise aid in countries where aid is fungible with domestic resources (e.g. in middle-income and large low-income countries) and to resort to non-localised aid in countries with severe governance challenges where the donor has little influence on the government, and where aid is not fungible with domestic resources. However, the lessons from budget support in fragile states suggest that a donor's ability to hold policy dialogue may be the binding constraint to localising aid through government systems (AfDB and World Bank, 2011). Non-localised aid may mean donors put less effort into facilitating better PFM, so the effectiveness of overall government spending and development outcomes are lower, even though there may be better risk outcomes from the donor's project.

## 4.3 Implement special risk mitigation measures in high-risk environments

These might include contracting out fiduciary services; ring fencing projects and using special procurement rules; dual sign-off on key decisions with government and donor agents, and with budget support instruments; and making expenditures without proper documentation ineligible for reimbursement.[17] Community-driven development (CDD) localised aid instruments, including cash transfers to communities, should be considered in such situations. Such approaches can mobilise social monitoring of projects and generate results at low cost. Elite capture of resources for personal use is a risk that can be mitigated by programme design and central government financial controls (Platteau and Gaspert, 2003), and CDD programmes in Indonesia and Afghanistan demonstrate how this can be done (di Vinadio, 2010).[18]

15 And the risk-reward calculus in localising aid in a weak governance country of strategic importance may still be lower than the alternatives (see Rosenberg, 2013).

16 While donors may be unable to eliminate most corruption in the short term, and may therefore need to tolerate some, at least temporarily, this does not mean they should be indifferent to diversion of the funds they contribute to the country, although, as Hobbs (2005) mentions, there is an implicit benefit-cost calculus to their efforts to detect and address misuse of their funds, as in law enforcement generally.

17 Examples of these risk management mechanisms include the MDBs requiring governments to use MDB procurement rules and special financial reporting, at least for contracts above a specified threshold, GEMAP in Liberia (USAID, 2011), the Liberia health pooled fund (Hughes et al., 2012), the health pooled fund and USAID's Fixed Amount Reimbursement Agreement (FARA) programme in Liberia and ARTF (www.worldbank.org/artf). The New Deal on Effective Engagement in Fragile States (g7+, 2011) contains provisions for such enhanced risk management systems by recipient countries and greater use of country systems by donors.

18 In its audit of the National Solidarity Program (NSP), SIGAR states, 'Donor funds provided to NSP are subject to numerous oversight and internal controls implemented by the Word bank, the Afghan government, and members of rural Afghan communities. We found that these controls provided reasonable assurance that NSP funds would be used as intended' (SIGAR, 2011).

Fragile states require even deeper contextual analysis of risk trade-offs. Corruption can undermine state legitimacy but also maintain patronage networks that provide stability. Aid can preserve the ability of the state to prevent violence, but pressure to spend at the end of a conflict can be destabilising. Calibrating aid flows with reforms that go beyond a narrow focus on corruption and that involve PFM, social accountability, widening enforcement of anti-corruption beyond a single agency and bottom-up approaches with local accountability and transparency not only discourage corruption but also promote more inclusive programmes and policies (OECD, 2009a; 2009b). Disruption in aid flows can be profoundly destabilising in fragile settings and has led to outbreaks of armed violence if constituencies within the country see the benefits of participation in national institutions decrease (Bates, 2008; Nelsen et al., 2011; Rubin, 2002). This is an extreme case of the tensions that exist between managing fiduciary risks and the risks of programme failure (OECD, 2011).

## 4.4 Manage trade-offs among donor objectives so as to minimise the risks of doing harm

Donors tend to bypass governments through non-localised aid (or localised aid to unregulated actors delivering public services that may not be sustainable without donor funding) when they are under pressure to demonstrate short-term results, to disburse funds and to avoid reputational risks from corruption and other recipient government behaviour.[21] In small- to medium-size low-income countries, this can lead to large aid flows that bypass recipient control. Aid dependence can undermine institutions as well as build them, through imposing high transaction costs, fragmentation caused by multiple projects and donors, poaching of government staff, reducing learning by doing and subverting the budget process (OECD, 2010). In addition, high levels of aid can create incentives that make it more difficult to overcome the collective action problems involved in building a responsive state and a more effective foreign aid system (Brautigam and Knack, 2004). Such risks of institutional damage in low-governance environments can be minimised by reducing transaction costs and fragmentation through multi-donor pooled funds,[22] coordinating public service provision with the government budget [23] and agreeing among donors not to poach government staff.[24] The CDD instruments mentioned above can help resolve collective action problems at the local level and start to build institutions from the ground upward.[25]

Communicating risk-reward trade-offs to stakeholders may help. The private sector is clear that achieving strategic and delivering returns entails at least some risk (Shah and Sykes, 2012). Donors should engage with their domestic constituencies on plans to achieve results that are transformational, enable countries to move beyond aid, achieve value for money and yet involve some risk, including fiduciary risk.

## 4.5 Strike a balance between allowing bureaucratic autonomy and rules-based processes

This balance will depend on the human capacity within the donor organisation, that is, how much staff can be trusted to take the right decisions on risk. One would expect more development innovation and risk taking in organisations where officials have greater autonomy, which would lead to better development results and value for money.[26]

Risk management requires the adjustment of donor organisational culture and human capacity at least as much as formal rules.[27] Risk taking involves shared judgments by competent people who feel secure in their jobs if predicted and mitigated risk outcomes actually eventuate. Risk outcomes are an opportunity to learn, but negligence and failure to communicate risks should be penalised.

Overreliance on formal rules and risk management processes is to be avoided; it can lead to bureaucratic

19 Dietrich (2012) shows that, in poorly governed recipient countries, donors bypass recipient governments and deliver more aid through non-state actors, all else being equal. In recipient countries with higher governance quality, donors engage the government and give more aid through the government-to-government channel.

20 However, author interviews with donors revealed concerns among donors about the performance of multi-donor trust funds (MDTFs) in two African countries experiencing governance crises and lack of accountability for the fund's administrators.

box ticking. These can result in either risk aversion or reckless decisions on the grounds that all the right boxes have been checked. Formal rules can also promote the growth of the ‘counter-bureaucracy’ – those who check whether the rules were followed, which can retard organisational effectiveness (Natsios, 2010). Consequences of overreliance on rules include underwhelming development impacts, or risk outcomes that the rules did not detect but were obvious in retrospect.

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21 Before the present coalition government in Zimbabwe, which was subject to international sanctions, DFID provided supplies to the health sector shown in the budget through third-party procurement.

22 In the South Asia Region, which included Afghanistan, the World Bank had a unilateral policy not to recruit from government staff.

23 The NSP in Afghanistan is an example of promoting political engagement around development projects at the local level (Beath et al., 2012; 2013; Fishstein and Wilder, 2011).

24 These ideas are based upon Fukuyama (2013).

25 ERM, mentioned above, recognises that organisational culture and staff capacity, as well as formal rules, are part of the risk management system.

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