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## FINAL PUBLICATION INFORMATION

Who Cares About Development Outcomes? Market Failures and the Role of the Evaluation Function

The definitive version of the text was subsequently published in

Journal of Development Effectiveness, 6(4), 2014-12-22

Published by Taylor and Francis and found at <http://dx.doi.org/10.1080/19439342.2014.966742>

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## **Who Cares About Development Outcomes?**

### **Market Failures and the Role of the Evaluation Function**

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*Development agencies expend large amounts of money and manpower ostensibly to achieve development outcomes which improve living conditions in developing countries. If development agencies cared only about development outcomes and these were easily observable in a timely manner, development agencies would ‘buy’ the best outcomes they could get for their money. And if someone else could get it for them at a lower cost, they would transfer the funds to this other agency. Unfortunately, outcomes are not easily observable, they often take years to appear, and frequently the ‘shopper’ cares more about being seen shopping than about what ends up in the cart. So how do we go about creating a functioning market for development outcomes? What role can the evaluation function play in helping the process of internalizing development outcomes into the development agencies’ objective functions, and thereby aligning incentives with the ultimate goal of improving lives? We present the development business through the lenses of the literature on externalities, principal-agent problems, and decision making under uncertainty. We also present examples of solutions from multilateral and bilateral development institutions.*

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## 1. Introduction

Development agencies usually have the stated objective to improve the welfare of populations in developing countries, as measured by certain development outcomes. Thus, they commit to, say, improving the quality of education, road safety, or agricultural incomes among poor farmers. However, there may be a myriad additional objectives, mostly unstated, driving their activities, such as being seen as doing good (the 'warm glow' benefit), promoting national interests (political and economic), and staying in business (the 'development' business). Thus, giving and being seen as doing so sometimes seem to be at least as important as achieving improved welfare of the intended recipients of assistance, which means 'the shoppers' in the development market place care more about being seen shopping than about what ends up in the cart.

As a result, schools have been built, which see neither students nor teachers, and roads have been built, which lead to nowhere. Even worse, notwithstanding decades of experience, there is a disconcerting lack of knowledge about what works in development, and what does not. For example, the Center for Global Development's (CGD) seminal report 2006 report 'When will we ever learn' established that *'successful programs to improve health, literacy and learning, and household economic conditions are an essential part of global progress. Yet after decades in which development agencies have disbursed billions of dollars for social programs, and developing country governments and nongovernmental organizations (NGOs) have spent hundreds of billions more, it is deeply disappointing to recognize that we know relatively little about the net impact of most of these social programs.'* (CGD, 2006, p.1).<sup>1</sup>

At fault is not our ability to acquire knowledge, but a lack of trying to do so. Appropriate monitoring and evaluation systems and experimental designs would give us the knowledge to link

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<sup>1</sup> As a direct result of this report, the International Initiative for Impact Evaluation, 3ie, was created devoted to 'enhancing development effectiveness through supporting the production and use of evidence from rigorous impact studies' (Gaarder and White, 2009, p.2).

development interventions with outcomes, and evaluate the outcomes after the project finished. However, these systems and designs are missing with surprising regularity. A recent report commissioned by the Evaluation Department in Norad (2014) concluded that *'implementation of a results-focus fails to ensure evaluability, partly because there is little clarity about minimum standards, but also pressures of time on staff, low priority by senior managers and a lack of incentives to prioritise results'* (p. xvii). Most development agencies produce some sort of Implementation Completion and Result reports (ICRs) at the time of project closure; however, these may not be sufficient to reliably link interventions to outcomes. Impact evaluations with robust methodologies can help to establish such links, but they are not routinely done or used. For example, the World Bank's Independent Evaluation Group (IEG) recently found that only 17% percent of recently-evaluated operations cited impact evaluations in the ICR (World Bank, 2014). In many cases where no comparison or control group exists, alternative factors outside of the intervention that may have affected the outcomes are not discussed or considered. So for example, a road infrastructure program may report on decreased travel-time on a certain stretch of road after its rehabilitation, without looking into what happened to fuel prices and traffic density over the same period.<sup>2</sup> The ICR's ability to report satisfactorily on outcomes is to a large extent dependent on the quality of the monitoring and evaluation (M&E) activities built into the projects. The evaluation of learning in World Bank operations (2014) found that only 23% of a sample of recently closed projects was rated 'High' or "Substantial' on M&E Quality by the Independent Evaluation Group (IEG). It also found that while there is a *'consistently positive generalized perception by staff of the Bank's commitment to learning..'* (p.ix), the *'range of*

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<sup>2</sup> If fuel prices go up some people may decide to use public transport, thereby leading to a decrease in congestion and travel time even without any road improvements.

*knowledge sources used for preparing and implementing projects is more limited than it might be' (p. viii).*

However, this seeming lack of attention to M&E should not be taken to indicate a lack of commitment on the part of the staff of development agencies to pursue their stated goals. Most of them are deeply committed to improving lives in developing countries and are willing to take personal risks and put up with difficult circumstances in places covered by dire official travel warnings. Another explanation therefore needs to be found why we know so little about the goods sold and bought in the 'development market place'. This paper suggests that there are three features of the development business itself, which make it susceptible to market imperfections and misaligned incentives.

- First, the actual interactions between development agencies and their counterparts in developing countries relate to negotiations around the inputs and outputs (e.g. schools built; teachers trained), not outcomes (e.g. an improved literacy rate; a decrease in the repetition rate). The parties involved in the exchange are most often not directly benefiting from the provision of the outcome good, which is intended to help 'the poor'. In other words, the 'outcome good' that is the ultimate purpose of the engagement is not part of the transaction. If it ensues, it can be treated as a positive externality, and transactions can and will go ahead entirely oblivious of this part of their ultimate outcomes, as economic theory tells us.
- Second, the interests, incentives and actions of the development agency and the recipient country, respectively, are not perfectly known and observable to the other party. Several additional layers exist in this principal-agent problem: the recipient country's government may or may not act in the best interest of 'the poor', who have incomplete information about the extent to which their representatives do what they

are supposed to. Likewise, principal-agent relationships exist in development agencies between their boards of directors, management, and staff. Principal-agent problems lead to misalignment of incentives, incomplete contracts, and suboptimal outcomes.

- Third, the extent to which inputs and outputs will deliver the outcome good is marred in uncertainty as the theory of change, or the ‘production functions’ through which inputs and outputs result in outcomes, are uncertain, and evidence on effectiveness of particular interventions is scarce and context specific where it exists. In addition, it usually takes years before it can be known whether the interventions actually yielded the intended outcomes, and only if someone has made the effort early-on to put in place an effective system to monitor and evaluate them. Decision making under uncertainty, with unclear assignation of accountability, will lead to inefficient provision of goods, as the literature tells us.

In the remainder of this paper, we will therefore discuss the relevant market imperfection literature, how it relates to the provision of development outcomes, and what solutions exist to make sure development outcomes are provided more often, and with more knowledge and certainty. The second section relates market imperfection concepts to the development business. This is followed by a discussion of existing and possible measures for internalizing development outcomes into decision-making, be it through the creation of a market for outcomes, or by supporting behaviors and processes that are believed to be conducive to outcomes. Throughout the paper, we put great emphasis on the role of the evaluation function in aligning incentives and helping the process of internalizing development outcomes into the ‘development market place’. This is discussed in detail in Section 4.

## 2. Market imperfection theories and development outcomes

What does the economics literature say about market imperfections? Market failure in economic theory refers to a situation when the allocation of goods and services by a free market is not efficient, implying that a better overall allocation could exist. This type of situation is often associated with public goods, externalities, principal-agent problems, information asymmetries, and uncertainty (select historic references: Pigou, A. 1920; Samuelson, P. 1954; Akerlof, G. 1970; Spence, A. 1973; Stiglitz, J. 1976, 1987). The existence of market imperfections is often the reason for government interventions to improve outcomes. And although the dealings between development agencies and governments currently do not display many of the features we are accustomed to seeing in markets, we will in the next sections discuss three market failure concepts which help us in understanding and possibly overcoming the shortcomings highlighted above: externalities, agency theory, and uncertainty.

### 2.1 Externalities

An *externality* is usually defined as a cost or benefit arising from production or consumption activities that affect a party that did not choose to incur that cost or benefit (i.e. someone other than the producer or consumer). For example, Rothengatter (1994) states “an externality is a relevant cost or benefit that individuals fail to consider when making rational decisions.” The definitions bring out the idea that, in addition to the direct and willing parties to transactions, there are also unwilling or unknowing parties, and that this may in part be due to the absence of relevant information. While we are more familiar with negative externalities such as air pollution from cars affecting people's health or carbon emissions from productive activities affecting climate, an externality can just as well be of a positive nature such as the effect of a well-

educated labor force on a company's productivity, or the protection against infectious disease provided to someone living amongst people with up to date vaccinations.

Development outcomes have a number of features that could lead us to viewing them as externalities. First, the parties involved in the exchange are most often not directly benefiting from the provision of the outcome good, which are intended to benefit 'the poor'. In the case of a loan from a development bank or official development aid (ODA) from a bilateral agency, the typical transfer of funds is conditional on a negotiated set of activities (project components) and implementation arrangements, including procurement and fiduciary rules, and lines of responsibility in implementation, with the objective of producing outcomes, such as 'increasing the productivity of irrigated agriculture', 'reducing road transport costs', or 'raising the incomes of communities affected by resource degradation'. Whether or not these outcomes actually ensue will usually not influence in any way the contract terms, interest and principal payments (in the case of loans) or indeed future lending or aid negotiations with the same country and sector. Loans will have to be repaid, whether or not agriculture is more productive, and the next set of activities will be planned with a bilateral donor whether or not incomes of previously targeted communities are now higher than before or not. In other words, outcomes are not part of the transaction in the development business.

How do we internalize the externalities? By creating a market for said 'good' or 'bad' with appropriate regulation. Key to effective regulation is reliable measurement of the externality, putting an economic value on it, and establishing an enforcement mechanism. For example, a well-known response to the negative externality of CO<sub>2</sub> emissions, which lead to climate change, is the creation of a market in which carbon emission permits can be traded. It works by establishing tradable emissions permits, setting a quantitative limit (cap) on these emissions, and then opening a market in which they can be bought and sold. *'After a cap has*

*been set by a government political process, individual companies are free to choose to reduce their emissions or purchase more emissions permits in the market. Exceeding permitted levels of emissions, or failure to report them is often punishable by a further government regulatory mechanism, such as a fine that increases the costs of production. Firms will choose the least-cost way to comply with the pollution regulation, which will lead to reductions where the least expensive solutions exist, while allowing emissions that are more expensive to reduce.'*

(wikipedia).<sup>3, 4</sup> The market for emissions works because they are measurable (tons of CO<sub>2</sub> produced from burning fossil fuel), and governments have created tradable permits and an enforcement mechanism. The market scheme puts a price on emissions, and the externality created by these emissions is thus internalized in production and consumption decisions.

In a similar fashion, we could imagine internalizing development outcomes, such as a decrease in under-five mortality by 10% in a certain region in, say, Tanzania by a certain date. A donor agency would commit to achieving the outcome, and could tender out the delivery of the outcome to implementing agencies to achieve it at least cost. The role of the evaluation function clearly would be crucial: it would measure and/or verify the achievement of the outcome target indicator, and payment would be effected upon achievement of results. The externality of the donor agency's activity – the decrease in under-five mortality – is internalized by making payment – the act of giving – contingent on achieving the outcome. Some variants of such market arrangements already exist and will be discussed further in section 3.1.

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<sup>3</sup> [http://en.wikipedia.org/wiki/Emissions\\_trading](http://en.wikipedia.org/wiki/Emissions_trading), accessed 09/09/2014.

<sup>4</sup> The alternative is the introduction of a carbon tax which fixes the price of carbon, but allows the amount of carbon emissions to vary. Proponents argue that a carbon tax is more easy and simple to enforce on a broad-base scale than cap-and-trade programs.

## 2.2 Principal-agent problems

The *principal-agent problem* can occur when one entity (an 'agent') makes decisions on behalf of another entity (the 'principal'), because of *asymmetric information*. In this case, the principal cannot directly observe that the agent is always acting in her best interests. This situation occurs, for example, when activities that are useful to the principal are costly to the agent, and observing the agent's activities is costly for the principal. If the agent has different preferences than the principal but his/her efforts are perfectly observable and monitorable, the principal will propose a contract which perfectly controls the agent to act in the principal's best interest. The incentive problem disappears. However, in many situations conflicting objectives *and* decentralized information are the two basic ingredients of the principal-agent problem. (historic references: Spence & Zeckhauser 1971, Holmstrom 1979, Shavell 1979, Stiglitz 1974, Mirrlees 1975, Holmstrom 1979, Shavell 1979, Rees 1985a,b).

While applications of agency theory have typically assumed outcomes to be observable with specific preference representations for the principal and agent, there are many situations in which outcomes are not easily observable. In the same way that the shareholders of a firm typically do not know the impact on their future returns of a manager's action, so too is the impact of development professional's actions obfuscated by many other intervening factors. These factors can include the uncertainty around the way the actions will convert into development outcomes, also known as the theory of change<sup>5</sup>, as well as the difficulties in measuring outcomes. Multiple team leaders and implementing agencies over a period of time make attribution more difficult. This makes it next to impossible to write the optimal

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<sup>5</sup> For further insights about theory of change and theory-based evaluations, refer to White (2009).

compensation contract as a function of outcomes, and contracts are instead written on inputs and surrogate measures of outcomes.

To make matters worse, the principal-agent problem is actually multi-layered in the development business. It occurs in the relationship between the development agency and the recipient (or partner) country, and in the relationship between a recipient government and the people it is purported to represent. Even the question of who is the principal and who is the agent is not an easy one: a development agency is principal when it gives money to a recipient in turn for certain interventions, but at the same time the recipient government is principal asking the development agency to help with money and interventions. Then there are the board of directors, management, and team leaders in the development agency, which have principal-agent relations as well. On the partner country side, there is the government, the implementing agencies, and the ultimate 'beneficiaries' which again can create principal-agent problems at various levels (Martens et al., 2001; Murrell, 2001).

The evaluation function is again crucial in establishing the empirical basis for contracts that overcome principal-agent problems. Some variants of contracts intended to incentivize behaviors and processes that are believed to be conducive to outcomes (surrogate measures) will be further discussed in section 3.1.

### 2.3 Decision Making under Uncertainty of Outcomes

While known factors are already reflected in efficient market prices, the main sources of market instability are unknown factors - also known as *market uncertainty*. *Market prices reflect the "known information set", which comprises all information, all knowledge, and all experience available at the time. In addition to the "known information set", there is also information, knowledge, and experience that is unavailable at the time and will be further referred to as the*

*“unknown information set”. Market price is based on available knowledge and market uncertainty conceptually represents the uncertainty of the validity of that knowledge.’ (Slovik, 2010, p.430).*

If development agencies’ survival depended on the developmental return on their investments rather than on the repayment of loans and on capital replenishments as is currently the case, they would shun projects (read ‘assets’) with a higher degree of uncertainty of outcomes. The agencies would have to treat exposure to these assets with a higher degree of caution, which in turn would limit the growth of these assets. In financial markets, institutions with higher exposure to market uncertainty face a higher cost of credit and other penalties, which limit their ability to become overexposed to these assets.

Development agencies currently are not exposed to the good or bad outcomes of their interventions, because recipient countries have to repay loans even when development projects fail to produce the desired outcomes, or politicians replenish grant funds disregarding outcomes, because of the ‘warm glow’ of doing so. Again, outcomes are externalities, which are not taken into account adequately when designing interventions. Instead of development agencies, recipient countries are exposed to the risks of interventions. They have to repay loans, or face criticism over the use of ODA when outcomes do not materialize, or, possibly, make matters worse, actually, rather than improving the lives of people. Such a lop-sided allocation of exposure to risks likely leads to inefficient decisions about development interventions. However, because the development outcomes can be either good or bad, it is not a priori clear whether it would be better to make development agencies more accountable to the outcomes: high risk-high return opportunities to really improve lives could be missed if investors became overly risk averse. Potential implications for development banks will be discussed in the next section.

### **3. Internalizing development outcomes**

In this section, we will explore possible solutions to the three-pronged problem discussed above: development outcomes are externalities, the development business is beset by principal-agent problems, and decisions have to be made under a high degree of uncertainty. The solutions involve creating markets for outcomes, or creating the right incentives for behaviors and processes that are believed to be conducive to outcomes. We will illustrate this with examples from the evaluation functions in the World Bank Group (WBG), the Inter-American Development Bank (IDB), the Norwegian Agency for Development Cooperation (Norad), the National Council for the Evaluation of Social Development Policy in Mexico (CONEVAL)<sup>6</sup>, and the UK Department for International Development (DFID), when pertinent.

#### **3.1 Developing Solutions: Bringing Outcomes into the Contracts in the Development Business**

Discussions between development agencies and governments in recipient countries most often take the form of negotiations of conditions for the disbursements of funds. The development agency proposes a project design, and requests the counterparts to implement it, specifying inputs and a sequence of their deployment. The intended outcomes of the intervention do not form part of the conditionality. There may be a number of reasons for this decision, including a desire (and mandate) to ensure adherence to safeguards and fiduciary arrangements, and minimize the risk of corruption, and a belief (possibly justified) that it is important to control

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<sup>6</sup> Federal Public Administration decentralized organization, with autonomy and technical capability to generate objective information on the social political situation and the measurement of poverty in Mexico, allowing better decision making in the matter.

and specify the inputs and implementation arrangements because development professionals have the best available knowledge of what set of activities and inputs together will produce results. Nevertheless, this turns outcomes into externalities, and creates a relationship in which the development agency is the principal, while the recipient country's government is the agent. The links between specified inputs and intended outcomes are also highly uncertain, but the risk-reward allocation is lopsided: if the intervention fails, the development agency moves on, while the recipient country still has to repay loans, or live with the stigma of not having made 'good use of donor funds' in the case of grants.

Of course, this characterization is an oversimplification, because projects are designed with varying degrees of cooperation and consultation, with government counterparts actively contributing to designing projects that best fit their country's circumstances. There are also usually additional actors, such as implementation agencies, for example international engineering consultancies in the case of large infrastructure projects. Civil society organizations and the international press also frequently blame donor agencies for failing to produce results. Nevertheless, for the sake of clarity, let us state that the development business today largely ignores outcomes, treats agencies as principals, and country governments as agents, and assigns risks to recipient countries.

The solution for better taking development outcomes into account is making sure that development outcomes form an integral part of the contracts in the development business, and make development agencies accountable for these outcomes. This would turn the usual donor-recipient relationship on its head: the country would contract the development agency to produce development outcomes. In the case of development loans, the country would pay back the loan and interest in full only if the outcomes were achieved. In the case of development grants rather

than loans, let them be counted as official development aid (ODA) only if promised outcomes were achieved, and no ‘warm glow’ shine otherwise.

Arguably, if aid did not ‘aid’ it should not be counted as aid. So for example, the funds intended for reductions in mother and child morbidity and mortality in Norway’s support to a flagship health program in India, the Norway India Partnership Initiative (NIPI), should be counted as ODA only if the reductions actually ensued and were measured. The funds that went into the program would be subtracted from Norway’s statistics of ODA if results were either falling short or were not measurable (incidentally, this was the conclusion in the recent evaluation of said program).<sup>7</sup> Norway’s claim to be one of the most generous donors among high-income countries, with its 1% of GDP annual budget allocation to ODA, would be in jeopardy. The Norwegian aid administration would then obviously come under pressure to care much more about outcomes, and internalize the externality.

Once outcomes are internalized into the development business, market-based contracting becomes possible, just as emissions trading becomes possible with the creation of tradable permits and a constraint on their availability. Similar to emissions trading, which is expected to produce desired emission cuts at lower costs through spurring competition and innovation, market forces in the development business could be used to produce superior outcomes at lower cost. To open up the possibility for a market solution, let the ‘purchaser’ (the partner country in question) of the desired outcome open a tender for turn-key solutions (e.g. improve maternal health by x percent), and let implementing agencies or development institutions bid. The country chooses the best bid, and pays upon independent verification of results. Development agencies would have to develop credible profiles by showing their successes in similar programs in order to win bids. And while it may be counterintuitive at first – why should they bid for being

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<sup>7</sup> Norad, 2013.

contracted to finance development activities? – they would be compelled to bid, because, after all, it is their mandate to engage with recipient countries, and they want to give, even if only for the ‘warm glow’.

When development outcomes are internalized in the development business, risks will also be taken into account more explicitly. Risk-reward relationships are most explicitly modeled in contracts between oil and gas companies and governments in resource-rich countries. The companies invest large sums before knowing the extent to which hydrocarbons found underground can be monetized. Governments, on the other hand, want to make sure that the resources they suspect are within their jurisdiction are developed in the most efficient way possible. Contracts therefore specify the pace of exploration, and have detailed formulae by which the returns on the investment are shared between developers and host country. Sliding scale royalties, for example, allow investors a higher share of rewards early-on to repay their investment outlays, but give host countries a larger share of the resource wealth once the initial investment has paid off. Similarly, varying production shares increase the return for investors when resource finds are small, but limit the upside when they are large (Bartsch, 1998, 2005).

In the development business, risks are overwhelmingly left with recipient countries. In the worst case, recipient countries are suffering from unintended negative effects of development projects, while their governments pay loan interest and principal for a decade or more. Even when investment projects are delayed for years because of unforeseen complications, country governments pay a commitment fee, because the development agency has tied its funds to a particular project and does not have them available for other projects anymore, although they are still in the agency’s accounts. The risks of intended or unintended outcomes materializing lie with recipient countries.

Turning the principal-agent relationship around, and making development agencies accountable for outcomes changes the assignment of risks. They will henceforth devote greater efforts to understand and mitigate those risks, and invest in better M&E systems. However, ways will have to be found to share risks: leaving them entirely with development agencies could result in overly risk-averse development efforts, and high-risk, high-return activities that could really change lives could remain unexplored. As in the oil and gas business, contracts have to be designed with risk-reward sharing in mind.

### 3.2 Existing Approaches

A plethora of recent initiatives bring outcomes directly into the transaction between development partners (Cash On Delivery, COD; Program for Results, P4R, etc.). They allow setting up contracts that explicitly spell out the desired outcomes against which payments will be made—such as increased primary school completion rates, vaccination coverage, or access to clean water. Nancy Birdsall, President of the CGD, explains that this approach provides incentives for governments to identify problems and design and implement locally appropriate solutions (CGD, 2010). However, these are recent efforts to circumvent the informational and observational challenges, but they keep the usual principal-agent relationship between development agencies and recipient countries untouched: the buyer of the outcome (the principal) is the development institution and the agent providing it is the country. The agent gets paid against achievements of outcomes, which is an innovation over the current situation, where aid or loans are given against deployment of inputs. On the one hand, this may appear empowering the country to find the most appropriate solution to a development problem, because the aid/loan transaction does not anymore specify which inputs are to be used. On the other hand, it is an

acknowledgement that after almost 70 years of development assistance the development agencies have little in terms of knowledge of what works and under what circumstances.

Whether the recipient country becomes the agent responsible for providing specified outcomes, or the development agency, it is clear that incentives align between the country and the development agency to put in place an M&E system to verify the achievement of the desired outcomes. It also needs to be able to give clear insights into how much obtaining certain development outcomes should cost based on previous evaluations in similar circumstances, and hence be able to calibrate *ex ante* the payments for the expected outcomes.

#### **4. The Role of the Evaluation Function**

While the development agencies' mandate is to improve development outcomes, the evaluation functions in these organizations have been established to better demonstrate the effects of aid and to report on them. It is worth distinguishing between the *internal* and the *independent* evaluation functions: the former focuses mainly on strengthening the agencies' internal ability to demonstrate the effects of aid by building evaluation capacity and evaluation frameworks into individual projects. The latter focuses mainly on reporting objectively and *ex post* on the achievement of development outcomes and the agencies' ability to produce these efficiently (what is known as the accountability-focus). Mission statements of some independent evaluation offices put it like this: they aim at 'promoting institutional learning and improving IDB's development effectiveness' (Office of Evaluation and Oversight, OVE, IDB)<sup>8</sup>, providing 'an objective assessment of the results of the Bank Group's work and to identify and disseminate

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<sup>8</sup> <http://www.iadb.org/en/office-of-evaluation-and-oversight/about-the-office-of-evaluation-and-oversight-ove,6655.html>; accessed 09/09/2014

lessons learned from experience’ (Independent Evaluation Group, IEG, WBG)<sup>9</sup>, and evaluating ‘the effectiveness and results according to the plans adopted’; systematizing ‘experiences in order to quality-assure and improve future activities through effective learning processes’; and providing ‘information to funding authorities and the general public’ (Evaluation Department, Norad).<sup>10</sup> While the accountability and learning role of the independent evaluation function is central in these statements of objectives, the motivation for creating such a function may include also legitimizing the organization.

In the traditional development business model where outcomes are treated as externalities, formal evaluation serves the function of remedying the ‘broken feedback loop’ that exists between the beneficiaries of the interventions and the donors. Murrell (2001) suggests this is necessary to overcome moral hazard on behalf of aid suppliers who are seeking business opportunities rather than (or in addition to) development objectives. Nevertheless, in order to fully achieve the internalization of development outcomes in the development business contracts, the feedback loop needs not only to bridge the *spacial* separation between beneficiaries and donors but also the *temporal* separation between causes (activities) and their effects (outcomes).

In the model where outcomes form an explicit part of the contract, the evaluation function should play a key role to reliably verify outcomes. The internal evaluation function would be responsible for ensuring that sufficient capacity is in place, or otherwise for building capacity in monitoring and evaluation. The independent evaluation function could be an important arbitrator of the M&E system and the validity of what it produces. The need for independent verification of results has been strongly emphasized, for example by CGD (Birdsall and Savedoff, 2010).

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<sup>9</sup> <http://ieg.worldbankgroup.org/about-us>, accessed 9/9/2014.

<sup>10</sup> <http://www.norad.no/en/evaluation>, accessed 09/09/2014.

So what role can the evaluation function play in creating incentives promoting behaviors and processes that are believed to be conducive to documenting and improving outcomes?

### Ex-post incentives

Most independent evaluation functions evaluate individual projects, sectoral and thematic interventions, or country, regional, or global programs ex post in order to report objectively on their performance. The extent to which they can do this depends fundamentally on whether individual projects have been made evaluable and have indeed collected trustworthy monitoring and evaluation data. While in multilaterals like the WB and the IDB all projects are required to have Implementation (or Project) Completion and Results Reports (ICRs, PCRs, respectively, in the two institutions) prepared under the auspices of the manager or director in charge, project level results reporting is less standardized and rigorously required in bilateral organizations such as Norad and Danida (Norad, 2014; Lindkvist and Dixon, 2014).

The independent evaluation function in the multilateral organizations (but usually not in bilaterals) validates either a sample (IDB/OVE) or all (WBG/IEG) of these ICRs/PCRs and lends credibility to the self-reporting by management (these are known as ICR Reviews). Each project is evaluated and rated on the relevance of its objectives, the relevance of its design to achieve the stated objectives, the extent of achievement of the objectives (efficacy), the efficiency, the risk to the sustainability of the development outcome, and the bank and borrower performance on a scale from highly satisfactory to highly unsatisfactory. It is worth noting that while all projects are evaluated, the quality and existence of evidence to draw upon in these evaluations varies widely. In the World Bank Group these ratings further feed into the *Corporate Scorecard* which provides a high-level overview of the WBG's performance toward achieving its strategic goals, and is intended by Management to incentivize an improved performance of operations: *'The*

*performance measures are intended to both monitor and incentivize desired behavior. The majority of the indicators will have targets that cascade to relevant business units and for which these units will be accountable. Three-year targets are set for fiscal year 2017, and progress in reaching the targets will be assessed annually...*' (World Bank, 2014). In particular, the Scorecard uses IEG's ratings on percentage of operations with a moderately satisfactory or higher outcome rating as its main development impact rating.

The question often posed is to what extent this rating system, which happens after the projects close, provides an incentive to design projects that are evidence-based and evaluable. Does the knowledge of the fact that a project you are involved in designing will be rated some time in the future provide an incentive today, and is this knowledge sufficient to bridge the temporal separation between causes (activities) and their effects (outcomes)? There are potential limitations to the effectiveness of this incentive. First, given the fact that most projects last at least 5 years before closing, and at least another year to have the project evaluation and validation done, by the time the ratings show up they are at least 6 years old as compared to the time when the project was being designed, which is longer than any Vice-President, Bank Manager or team leader tends to stay in one position. The implication is that it is only by actively ensuring good implementation, as well as by adapting and restructuring already approved operations that are well into implementation that a Manager or team leader can hope to see improvements in the ratings for the sector or region for which (s)he is currently responsible. But it is well known that a sound and thought-through design is more efficient than adjusting mid-course during implementation for something that could as well have been foreseen earlier (prevention versus mitigation...). The second issue relates to the fact that the evaluations are objectives-based, which may create the unwanted incentive of lowering the bar or ambitiousness of the objectives below what one should reasonably expect the project being able to deliver so as to make them

easier to achieve. It is worth noting, however, that the Relevance rating constitutes a check over such behavior – the Efficacy rating may be higher if the objectives are lowered, but the Relevance rating will decline, reining in the overall Outcome rating.

One possible way of circumventing the fact that the performance of the projects is not affecting those who were mainly responsible for designing, reviewing and approving them is to link the ratings to the organization's internal human resources or staff information sites. For example, the WB has an internal site called *Skillfinder*, which allows team leaders access to their colleagues' background, expertise and project experience in order to find relevant experts and skills across the Bank. It would be an easy fix to link IEG's project rating database to this site in order to have the ratings of the projects at hand in which the person was involved. In this case, it should be the Bank Performance rating that should be used to judge staff performance, not the Outcome rating which responds also to factors outside staff control (including the Borrower Performance and unforeseeable events in the country or region). This should of course involve not only team leaders and team members, but also managers and directors. Providing such information on the performance of projects in individuals' work histories would link project performance to future career opportunities and promotions. Knowing this at the outset could create an incentive to team leaders to design projects more carefully for impact and evaluability.

The large-scale evaluations (sector, country etc) typically look at the performance of a whole portfolio of projects over a certain time-period, drawing conclusions about performance, ability to report on performance, and making recommendations (some recent examples include the evaluations of the World Bank Group's investments in the transport and forestry sectors, WB 2013a, 2013b, the evaluation of the World Bank Group assistance to low-income fragile and conflict-affected states, WB 2013c, the evaluation of Norwegian Development Cooperation with Afghanistan and of Norway's International Climate and Forest Initiative, Norad, 2012/3, 2012/5,

2013/5, and the Evaluation of Norwegian support to promote the rights of persons with disabilities, Norad, 2012/1). To a variable extent, recommendations require a *formal management response* and their implementation is tracked. Norad's evaluation department recently started publishing the Management response but there is no official tracking of the follow-up activities, whereas IEG has a formalized system that tracks Management actions against the initially agreed actions over a 4-year period. The extent to which the formal follow-up influences the degree of improvements in a sector or thematic area, and the extent to which this in turn improves development outcomes has yet to be evaluated.

Whether the existence of these various levels of ex-post evaluation serve as an ex-ante incentive/threat that indirectly influences how projects are designed, implemented and evaluated is another area for further research.

#### Ex-ante incentives

Projects that do not adequately capture and evaluate their contribution to development outcomes fall short in a number of areas: they are not able to report on their performance, they miss the opportunity to learn how to improve their own and future projects' performance, they potentially waste tax-payers money, and they may miss the opportunity to improve the welfare of people. The best way to avoid such shortcomings is to make sure that projects are evaluable before they are approved and funded. *Evaluability* is defined by the IDB as the “*ability of an intervention to demonstrate in measurable terms the results it intends to deliver*”. This implies having ‘*operations that feature the characteristics needed for results to be measured, as well as the understanding of the main factors affecting the process by which they are generated.*’ (IDB,

2010, p.2). The IDB has formalized this in nine dimensions,<sup>11</sup> addressing both the proper identification and linkages between the conceptual elements of an intervention (such as the evidence-based identification of the problem and its causes, SMART objectives, the theory of change and its evidence-base, and the identification of assumptions and risk), and the identification of indicators and baselines and the systems and resources for data collection. As a result of a recommendation by the IDB's Office of Evaluation and Oversight (OVE), the organization introduced in 2010 evaluability as a *critierion for project approval*. OVE has in turn been instructed to perform evaluability assessments on a yearly basis. (IDB, 2010; OVE 2010). IDB is the only Multilateral Development Bank that has 'a formal system to measure the "evaluability" of projects at entry' (Gray, 2014, p. 3).

A comparable approach to incentivizing and enforcing evaluability now in place at the IDB has been implemented in Mexico. There, the federal social sector agencies are required by law to have an annual evaluation program agreed-upon with the National Council for the Evaluation of Social Development Policy (CONEVAL), the Ministry of Finance and the public comptroller's office as a *prerequisite for inclusion in the national budget* (Gaarder and Briceño, 2010).

Since 2009, there was a similar drive to strengthen the evidence base upon which policy and program decisions are made within the UK's Department for International Development,

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<sup>11</sup> Substantial dimensions: **Diagnosis:** Evidence-based identification of the problem and its roots causes. **Objectives:** Identification of what project expect to achieve. Objectives must be S.M.A.R.T. (Specific, Measurable, Agreed upon, Realistic, Temporal). **Logic:** why this particular intervention and why not others? Causal chain: components ⇒ create conditions ⇒ produce outputs ⇒ achieve outcomes, **Risks:** Quality of analysis in the identification of assumptions & risks. Risk Evaluation, Follow-up and Mitigation. Formal dimensions: **Outcome indicators:** measures of expected results during and/or at end of project, **Output Indicators:** measure of expected products executed as part of the operation, Indicators must be mutually exclusive, valid, adequate, and reliable, **Baselines for outcomes:** Ex-ante assessments of conditions expected to change as a result of project, **Baselines for outputs:** Ex-ante assessments of the goods and services present prior to the project, **Monitoring and Evaluation:** Identification of systems and resources for data collection.

DFID. It has since been working to create an internal culture of evaluation and evidence. All development cooperation investments in DFID undergo a thorough planning and approval process, called the “business case approach”. The Business Case has five interdependent cases (or “stages”): *‘**Strategic Case** – sets out the context and the need, including for DFID intervention. Sets out the Impact and Outcome we expect to achieve. **Appraisal Case** – explores how DFID will address the need set out in the Strategic Case, appraises options, and identifies which best delivers value for money. **Commercial Case** – ensures that the option is commercially viable and delivers value for money through procurement; **Financial Case** – establishes that the option is affordable and that the principles of sound financial management for public funds are followed; **Management Case** – sets in place the arrangements necessary for the successful delivery of the intervention including procedures for monitoring and evaluation.’* (DFID, 2011, p.1, 2).

Strengthening the evaluability of proposed interventions and the use of evidence in decision making are the key aims of the Business Case. Evidence plays a critical role in justifying the need for the intervention and in demonstrating why the intervention will work. The assessment of the evidence base as outlined in the appraisal case influences the approach to monitoring and evaluation (evidence base can be strong, medium or limited). If the evidence base is strong, and the program is based on very clear evidence of impact, the evaluation effort can often be limited to looking at process, i.e. exploring whether the program is being effectively delivered. *‘**Limited evidence or no evidence** is where either no studies or impact evaluations exist, or the evidence is from poorly conducted studies on which no reliance can be placed, or where the results are conflicting so no firm conclusions can be drawn. This does not mean a programme with no existing evidence should never be undertaken. Rather it should be seen for what it is: an innovation (even if it is an innovation people have been doing for some time, without any evidence that it works). As a minimum, the proposal will need to include a rigorous monitoring*

*and evaluation strategy or impact evaluation plan, but it may also be necessary to set out what other reasons there are for embarking on a programme where the evidence is weak.’ (DFID, 2011, p12).*

In a similar fashion that the internal evaluation function is in charge of overseeing and ensuring that project reviews take place upon project completion, and the independent evaluation function is there to assure the objectivity and soundness of the assessments, so too can they divide up the roles of ensuring evaluability at entry. This ex ante review has two aspects: first, it overcomes the time-inconsistency of incentives discussed earlier, when relevant staff is not held accountable for the outcomes several years down the line; and second, it increases the chances of knowing the development outcome of the project at the end of it. Whether it also increases the likelihood of the projects achieving their development outcomes is a question that remains to be further evaluated. An early analysis by OVE of the evaluability efforts at the IDB found significant improvements in the evaluability frameworks of sovereign-guaranteed projects, while for the non-sovereign the evaluability issues were not properly captured. While it is too early to assess the performance of the operations approved under the new evaluability framework, the frequency of discussions of evaluability issues has increased in quality assurance meetings. One of the main challenges found is the teams’ willingness to report not only on success but also on failure (IDB, 2013). A recent review of the experience of embedding evaluation in DFID (DFID 2014) finds that while the approach has contributed to a significant increase in the quantity of evaluations commissioned by DFID, ensuring sufficient quality has been identified as an increasing challenge. And while there is greater appreciation of evaluation in DFID, the quality of management responses to evaluation findings is variable and there is a need for improving the use of these in decision-making. These findings are a timely reminder that while incentives work – in the above cases making evaluability assessments compulsory in the organizations have led to

an increased focus on and quantity of evaluations – the extent to which the structures and processes are appropriate to achieve the aims of embedding evaluation within the organization need to be taken into account. As noted in the DFID review *‘the constraints to fitness for purpose are primarily capacity and the need to ensure the relevance and quality of evaluations’* (DFID, 2014, p. iv).

The alternative (or often precursor) to validating the project evaluability assessments carried out by the organization is for the independent evaluation function to carry out an evaluation of the evaluability of projects. It was the sobering findings of such an evaluation at the IDB that resulted in the recommendation to introduce evaluability as a criterion for project approval. Norad’s evaluation department also recently contracted an evaluation of the evaluability of Norwegian aid which concluded that a number of systemic factors hindered the evaluability of projects (Norad, 2014; Lloyd et al., 2014, Lindkvist and Dixon, 2014). The recommendations include introducing a clear strategy for evaluability as a prerequisite for approval of funding. Management response and action plan have not yet been published.

## **5. Conclusions**

We have highlighted that it is the development agencies’ mandate to improve development outcomes, but that the actual interactions between them and governments in recipient countries typically relate to negotiations around the inputs and outputs (e.g. how many schools will be built, how much training of teachers will be delivered). The 'welfare good' that is the ultimate purpose of the engagement –such as better math grades, school progression or a better educated labor force – is not part of the transaction. We have also cited literature showing that the development profession has actually surprisingly little knowledge about what works in development. The paper draws upon

three market failure concepts in order to help us understand and explore solutions to these shortcomings: externalities, principal-agent problems, and uncertainty.

The paper suggests that in order to improve development outcomes and our knowledge about the links between inputs and outcomes, it is necessary to make sure that development outcomes form an integral part of the contracts in the development business, and make development agencies (more) accountable for these outcomes. The proposal is to turn the usual donor-recipient relationship on its head. In the case of development loans, the country would pay back the loan and interest in full only if the outcomes were achieved, and in the case of development grants, the official development aid (ODA) would only be counted as such if promised outcomes were achieved.

Once outcomes are internalized into the development business in this way, we suggest that market-based contracting becomes possible, which could produce superior outcomes at lower cost. The ‘purchaser’ (the partner country in question) of the desired outcome would open a tender for turn-key solutions (e.g. improve maternal health by x percent), and let development agencies bid. They would have to develop credible profiles by showing their successes in similar programs in order to win bids, and thereby would have a strong incentive to build strong M&E systems to be able to do so.

When development outcomes are internalized in the development business and development agencies are made more accountable for results, risks will also be taken into account more explicitly and shared more appropriately. In the traditional development business, risks are overwhelmingly left with recipient countries. In the worst case, recipient countries are suffering from unintended negative effects of development projects, while their governments pay loan interest and principal for a decade or more. With development agencies also accountable for

outcomes they will devote greater efforts to understand and mitigate those risks, and invest in better M&E systems.

What role can the evaluation functions play in aligning incentives and helping the process of internalizing development outcomes into the development market? In the traditional development business model where outcomes are treated as externalities, formal evaluation serves the function of remedying the ‘broken feedback loop’ that exists between the beneficiaries of the interventions and the donors. However, the evaluation function can also play a key role in supporting the creation of a market for development outcomes. The internal evaluation function would be responsible for ensuring that sufficient capacity is in place, or otherwise for building capacity in monitoring and evaluation, while the independent evaluation function would be an important arbitrator of the M&E system and the validity of what it produces and in helping identify and provide evidence on promising solutions and their costs.

We further suggest that the evaluation function can help create incentives and requirements that are likely to be conducive to development outcomes. Currently, in many cases mechanisms for evaluation rely on ex post ratings of the achievement of objectives. Those responsible for a project’s quality often have moved on in their careers before outcomes are known, and the evaluations therefore have little impact on their incentives. Nevertheless, ex-post evaluations provide a rich source of information and learning, which is available for the design of new strategies and operations. Recent promising initiatives try to tackle the time-inconsistency in the incentives by assessing the evaluability of projects at entry, when staff can be held accountable for the quality of their current project and there is still time to address identified weaknesses.

What will ultimately determine whether we achieve the alignment of incentives around obtaining improved development outcomes is whether this is truly the main objective of the

actors involved, or whether a number of the unstated objectives have the political upper hand.

Another way of putting the question is this: do the agencies involved in trading in development (the ‘shoppers’) care more about being seen shopping than about what ends up in their cart?

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