INTER-COUNTRY EVALUATION OF SMALL FARMER ORGANIZATIONS: HONDURAS

VI - Two Issues

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October 1976

For Office of Development Programs of the Latin America Bureau of A.I.D.

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The history of the AID programs studied in both Honduras and Ecuador shows that the nature of the AID relationship with the institutions it supports inadvertently rewards problematic performance and penalizes good performance. The following two sections explain how this happens, and suggest ways of avoiding this kind of "perverse" outcome.

Pampered Problems

The importance of a policy of AID withdrawal from budget or technical assistance support that is credible to the recipient institution cannot be overstated. The expectation of new AID loans, or of slipping termination deadlines, can be a major obstacle to a resolution of the very problems that are said to require continued AID assistance. The inability of the Ecuadorean credit union federation to achieve self sufficiency is an example from the Ecuador case;[1] and the AID program with the National Development Bank (BNF) is an example from Honduras.

As discussed in the BNF chapter above, the Bank's high loan delinquency was cited by AID as an area for remedial assistance previous to the first AID loan and for two successive loans thereafter--covering a period of seven years.[2] Yet delinquency was about 20% before the first loan; it was about 20% on the first loan and the total portfolio; it was still 20% when the second and third loans were made in 1973 and 1974;[3] and it had risen to 25-30% in 1976, when the Mission was considering yet another loan.[4]

During the period of AID assistance to the BNF, it was never recommended that AID not give further loans or technical assistance to the Bank because of its delinquency problem. The Bank's delinquency, that is, was never considered as a reason not to lend to that institution. If anything, the problem was like a nail on which one could hang one's hat--a corrective program. A similar attitude was taken toward the delinquency problem of the Ecuadorean BNF, when it was a prime candidate for the Land Sale

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[1] Ecuador Report, pp. 174-182.

[2] Pp. 44-47 of BNF chapter above. All further information on the BNF's delinquency is from these pages.

[3] The 1973 loan resulted from the near de-obligation of $744,000 from the Agricultural Credit and Storage Loan (018), which could not be used by its intended beneficiary, FECOAGROH.

[4] Coopers & Lybrand, "Evaluación de la organización, políticas y procedimientos, y controles internos del Banco Nacional de Fomento de Honduras," Contrato AID/la-c-1129 - Honduras, February 1976, p. 34. In August of 1976, the BNF itself reported a delinquency rate of 28%. "Morosos adeudan al BNF 35 millones de lempiras," El Tiempo, 31 August 1976.

Guaranty Program. The delinquency rate was high (25%), it was noted in the loan paper, but the Bank was embarking on an improvement program with technical assistance from the IDB.[5]

In a sense, these banks' delinquency problems were inadvertently rewarded rather than penalized with AID withdrawal or the threat of it. This kind of economically "perverse" incentive system provides little motivation for an institution to deal with its problems. In these settings, then, AID assistance and negotiations for new assistance inadvertently create an environment in which problems tend to flourish rather than die.

Another such pampered problem is the bias toward larger farmers in institutions like development banks and extension services—a recognized problem in the case of the Honduran BNF. As AID sees it, the problem is that the institution often tends to favor the larger farmer, despite AID programs and pressures to

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[5]AID/LA/DR, "Ecuador: Land Sale Guaranty," Capital Assistance Paper AID/DLC/P-854 (24 June 1969), p. 27; Annex IV, Exhibit 4.

serve the small farmer. If the problem persists, more AID assistance is forthcoming to give the institution the resources and the know-how for lending to the small farmer. The large-farmer-bias problem, like delinquency, gets treated with more and more AID assistance.

AID, of course, is not attracted to these institutions because of their problems. More often than not, it wants to put a substantial amount of resources into certain kinds of programs in a country, and looks around for the most likely institutional candidate for the job. (Or, it decides to create a new institution, as it did with FECOAGROH and FACACH in Honduras.) In Honduras, the BNF looked like the only possibility to AID for a significant small farmer credit program. So that institution was chosen as the conduit, and assistance for its problems was included in the loan program.

This may be a reasonable second-best approach for AID in an imperfect environment. But the approach creates an incentive system, without meaning to, that rewards the problems and withholds penalties for their continued existence. AID's affiliation with the institution may make sense in terms of finding an existing conduit to the small farmer and adapting it. But from the institution's point of view, the affiliation with AID turns out to be totally compatible with the problem behavior. The recipient institution does not perceive itself as losing out because of its lack of progress with these problems.

As in many other cases of second-best institutions, the perverse effect of the AID relationship on an institution's problem behavior is heightened when other international lending institutions are involved. They also may select the institution for their programs because it is the only one around. The Honduran BNF, for example, had both AID and IDB support over a period of time.[6] Thus even if the AID program were somehow designed so as to discourage the problem behavior, the existence of, or potential for, substantial support from other donors could cancel out the effects of the AID disincentives.

Another difficulty in putting AID together with problematic institutions is that the institution may experience the "problems" as more functional to its existence than dysfunctional.

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[6] The IBRD turned down the BNF in the late 1960s precisely because of its problems, when it was looking for a conduit for livestock credit (note 5 on p. 2 of BNF chapter).

Delinquency and large-farmer bias are two examples, as discussed in the BNF section. AID names them "problems," but from the institution's point of view, they can be seen as being in complete consonance with organizational needs. Letting some large farmers pay back loans late, or giving them preference over small farmers in the allocation of credit, can ensure political support for the institution. Doing things this way can help the institution's agronomists to make a decent living, and can protect the careers of directors and administrators. To "solve" these kinds of problems is to pull out some of the life stays of such an institution. In this sense, no amount of AID education or training in problem-solving techniques can make these behaviors be felt as problems by the institution, let alone do away with them.

One way AID can help diminish these "functional" problems is to make them into real problems to the institutions, in addition to attacking them directly. For example, it is only when delinquency and large-farmer bias inflict as much cost on a bank as collecting on loans from large and influential farmers, that these problems will start to be treated less complacently. AID can help turn the tide by making it difficult for such institutions to get additional AID capital or other support until significant progress with the problems has been made. AID, in other words, has the power to make the problematic behaviors dysfunctional, rather than functional. As long as there are renewals of assistance to work on these behaviors, however, they continue to be functional. In fact, they become even more functional than without the assistance, for they become associated with support from outside elites as well as local ones—i.e., from the donor institutions.

Though the withholding of additional loans or assistance may succeed in transforming functional behaviors into problems for an AID-supported institution, it can also leave an AID Mission without projects. The institution may also fall back on other loan sources, as mentioned above, which may be more lenient about the behaviors in concern. Withholding of further AID support, then, might not even have the desired effect, even if AID were willing to lose the project in the process. Short of these extremes, AID needs to devise some ways of turning these behaviors into true problems for the recipient institution. If it does not do this, they will continue to work well for the institution and no amount of AID assistance to diminish them will succeed in doing so. Or, they will be resolved at much greater cost and over a much longer time period than is necessary.

One area in which AID can manipulate the incentives to problem behavior is the treatment of termination dates, which affects the institution's expectations about future AID assistance.

Before further assistance is granted or even talked about, the achievement of certain levels of problem-solving could be made mandatory—e.g., a certain delinquency rate, a certain percentage of small farmer loans in the total portfolio, a certain level of financial self sufficiency. These types of goals usually are stated as objectives of an AID program, but not as preconditions for further lending.

The covenants to AID loan agreements will sometimes include a specific directive about desired levels of problem-solving. BNF delinquency was "covenanted" to fall to 10% by 1969, the year after the 018 loan was authorized. But no penalty is attached to failure to live up to the covenant. The BNF failure to diminish its delinquency at all by 1969, let alone to drop it to 10%, was eventually dealt with by AID by postponing the 10% deadline for <u>eight</u> years. And the new schedule became part of a new loan! Such failures, however, should be met with penalties rather than new loans. The point of the penalty is not to be punitive, but to turn around the disincentives of the present system against improvement.

One possible approach to a proper incentive system would be to phase loan disbursements over a period of time. This could be tied to a schedule by which the disbursement would be reduced by a certain percentage when the covenanted objectives were not met--just as construction contracts have penalty systems for not meeting deadlines. In order to induce the desired behavior, and not only punish the undesired behavior, the system should include rewards as well as penalties. Disbursements could be increased, for example, for exceeding the phased targets. This would keep the incentive system from working only in a downward direction and cumulatively undermining the project. Whatever the details of such an arrangement, its importance would lay in the fact that the recipient institution would know in advance, and with exactitude, that the problem behaviors were to result in significant costs.

It may be that AID does not have the programming flexibility to use this kind of system. In that case, other tactics with the same effects should be devised. At the least, second and third large loans should not be discussed with such institutions when they are not making progress in the problem areas. Or, it should be made clear to them that additional lending will be contingent on the meeting of the originally covenanted targets. Otherwise, simply talking about future assistance with a recipient institution reverses the incentive for it to do anything about its problems.

AID's first loan to the BNF provides an example of another way of transforming AID-perceived problems into pressing problems for the assisted institution. The 018 loan funds were lent to the Honduran government, which donated them to the BNF. The BNF, that is, was not required to make interest or amortization payments on the AID funds. Though this arrangement was consistent with the Government's interest in capitalizing the Bank, it took away one of the few incentives in the AID program for the Bank to improve its financial discipline. To receive $8 million of AID funds as a donation rather than a loan, that is, meant that the Bank had no repayment worries. Hence the cost to it of casual collection procedures and high delinquency was no greater than it had been before—when much of its government-donated capital had been eroded by its high delinquent accounts.

If AID had insisted on a loan rather than a donation to the Bank, the Honduran government would probably have found other ways to capitalize that institution, because of its great interest in promoting the Bank. These other ways would not have deprived the AID project of one of its few and precious disincentives to the problem behavior.

Requiring financial institutions to pay on their AID loans, in sum, is another tactic that can contribute toward transforming certain problem behaviors into real problems for the institution.

This is so even if a recipient government or institution refuses to accept the AID monies on those terms. For it means that the institution's financial sloppiness has prevented it from getting a large amount of attractive and scarce capital. When this happens, delinquency has turned into much more of a problem.

The Close Adviser

Contributing to the problem of unintended rewards for undesirable behavior is the technical assistance relationship of AID or contract advisers with AID-supported institutions. The history of the AID programs studied in the inter-country evaluation suggests that decisions to continue AID support to an institution are considerably influenced by how well AID or contract advisers get along with that institution. The necessity of that assistance to the institution's future, or in comparison to other potential AID projects, often takes on secondary importance. Turnover in program-monitoring and contract personnel, shifts in policy directives, and changing fads in development lending are other factors that play an important role in such decisions. Sometimes they reinforce the compatibility criterion, sometimes they counterbalance it.

The extension of project termination deadlines and the renewal of project agreements result from the judgment by AID or contract advisers that the institution cannot make it on its own. It is natural that these advisers will sometimes be reluctant to end their involvement in an AID-supported institution. This is not necessarily because of considerations related to their own employment. After such a close and long association with an institution, that is, one tends to always see work that is still to be done. The more intimate one becomes with an organization, the more ideas one has about how to deal with its failings. Involved advisers will always be able to find serious failings which, they will believe, cannot be left unattended. Under such circumstances, it will not be difficult to demonstrate the need for additional AID financing.

At a certain point, the success of the institution and the success of even the most competent of advisers tend to diverge. The project will be successful in institution-building only if it results in the eventual dispensability of AID. But the success of the adviser is based on his being needed by the institution. As an individual, then, the AID or contract adviser can be of considerable value to the institution. But from the point of view of institution-building, the continuation of his AID-financed stay at the institution involves an AID presence that makes certain problems intractable.

Prolonged renewals of AID grant and loan assistance to an institution along with repeated failure to meet targets in problem areas is often indicative, more than anything else, of long-term compatibility between AID or the contractor and the institution. The BNF in Honduras and FECOAC in Ecuador are examples: no progress on delinquency for one, and disappointing progress on financial self sufficiency for the other. Similarly, preliminary or on-time terminations of AID assistance may be more indicative of incompatibility between AID or the contractor and the recipient institution, than of poor performance with respect to the project's objectives. FACACH in Honduras and FENACOOPARR and CREA in Ecuador are examples. (In the case of CREA, incompatibility was between AID and the contractor.) The termination of the AID relationship with FACACH seems to have had more to do with resentments between donor and recipient than with the fact that the Federation had become self sufficient. Preliminary termination of the relationships with FENACOOPARR and CREA were also the product of conflict.

When AID builds an institution that is strong and healthy, that institution will ultimately find AID's presence undesirable, no matter how well liked are the persons representing AID or the contractor. The incompatibility and the desire for AID's riddance will often push an institution to look around for other sources of financing. The desire to attract other kinds of backers, in turn, will pressure the institution to perform in the areas that are still problematic. Though this process may be unpleasant for AID, it needs to be seen as a sign of organizational growth. Long term compatibility between AID and a recipient institution, in sum, should be looked upon with a certain amount of suspicion.

AID should attempt to counterbalance the tendency of advisers to see all too clearly what more there is to be done, or to want a prolonged affiliation for themselves. Because the close adviser will almost always be able to show legitimate need, it will not help for AID to demand more rigorous demonstrations of need from field personnel. One approach might be to regularly assess the benefits to the recipient organization of a break with AID. The assessment should come from someone not associated with the institution. It should ask what the benefits would be to the institution's growth of not supporting it. One could also ask what the benefits would be of providing the institution with an income in a way that would require little or no AID involvement—as in the cases of interest income and credit intermediation by "neutral" parties cited in the FACACH chapter above.

Another approach to this problem may be to build some inflexibility into programs, to map the future a little more. Hard-and-fast termination dates for AID support are one possible alternative. Hidebound phasing-out designs are another. Ironically, I am proposing some inflexibility for a project environment for which one normally proposes a greater degree of flexibility and compassion than is usual. But the stories of this evaluation suggest that compassion can kill the institution one is trying to help—or, at least, stunt its growth. Projects should be designed, in sum, to prevent compatibility with the recipient institution from becoming a decision rule by default.

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