

Perverse Incentives and their Effects

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<http://www.concept.ntnu.no/english/>

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Public Funding without Liabilities for the Recipients



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Perverse incentive 1.

The rat massacre i Hanoi



Perverse incentive 2.

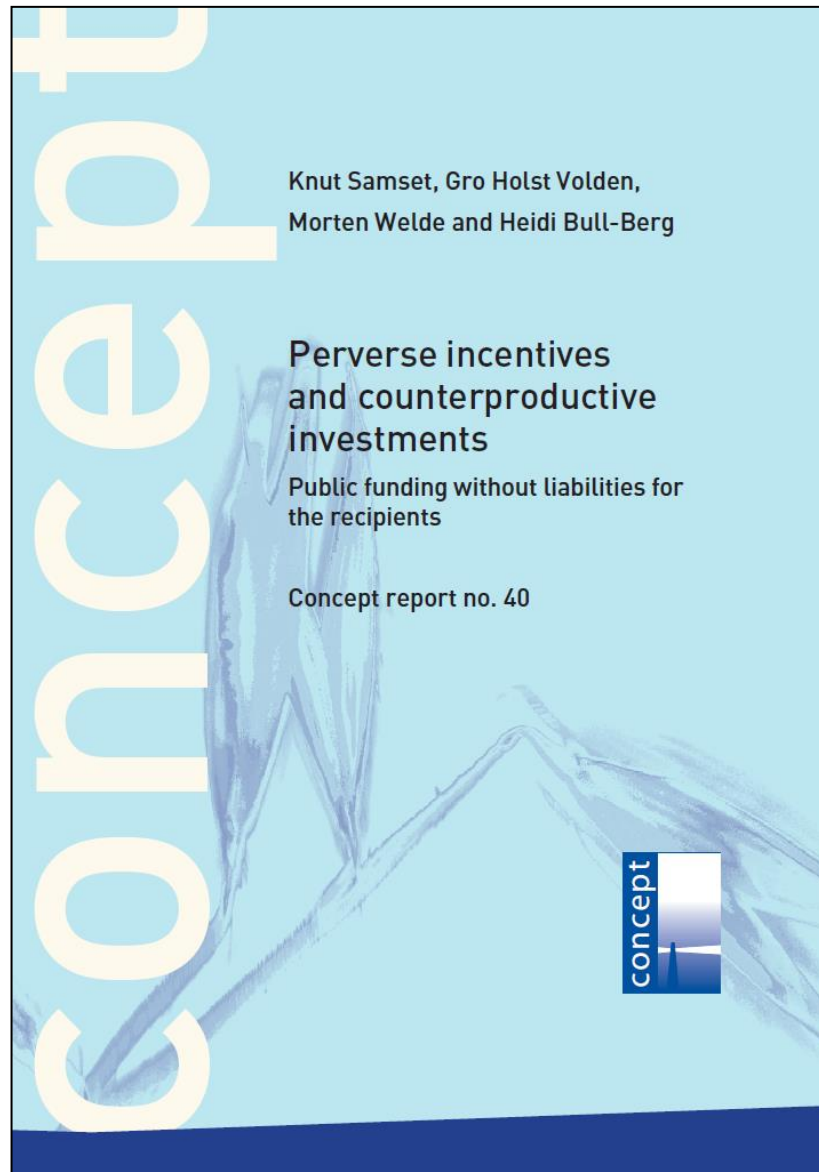
Welfare schemes that discourage poor people to seek employment so that they remain in poverty



Background

Why this study?

- Observation:
 - The State as generous donor on behalf of taxpayers to finance projects that benefit specific target groups, with no liabilities for the recipients.
 - Many such projects are unsuccessful, not least in a strategic perspective.
- Experience with development aid projects indicate serious problems with “perverse incentives”, resulting in unsuccessful projects, waste of public funds, and adverse side effects such as corruption (Ostrom et al., 2001)
- Our study explores the phenomenon in Norwegian state-funded projects. It is a first approach to the problem, based on a small sample of projects.

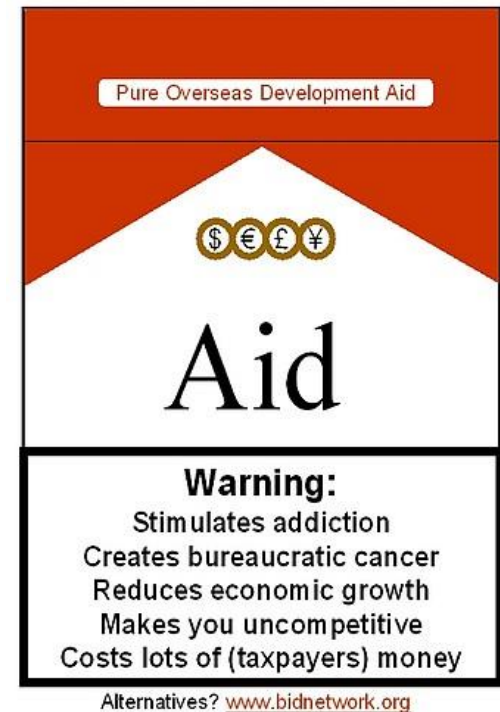
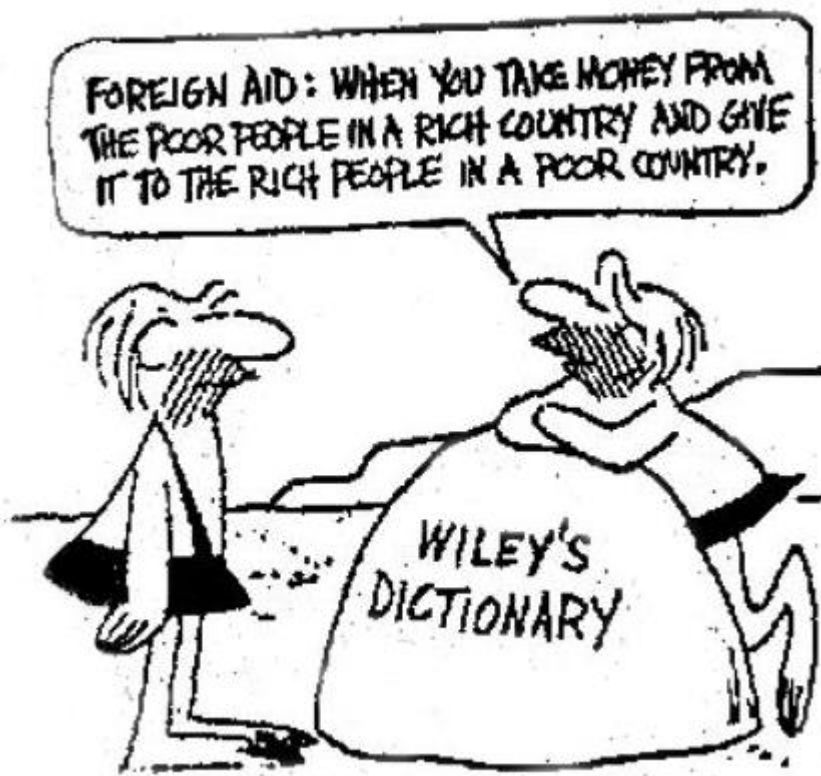


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Key concepts

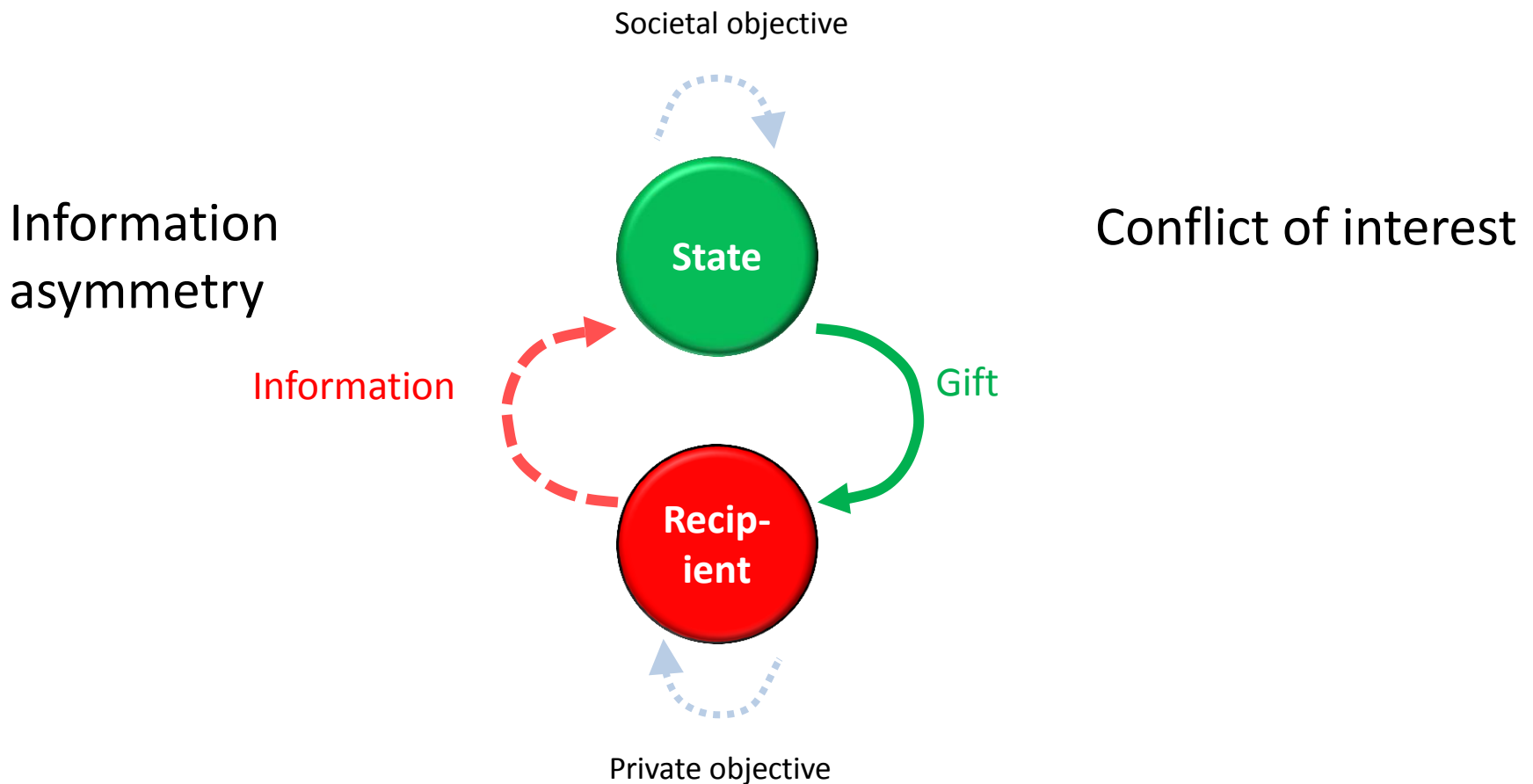
- Incentive
 - Something that motivates action
 - Intentional or unintentional
 - Monetary or non-monetary
- Perverse incentive
 - Refers to the situation where an actor is motivated to make choices that inflict costs or adverse effects on others groups or society as a whole
- Gift
 - A good or service granted by one party to another without an expectation of getting anything in return
- We here define state-funded projects as gifts when they benefit only a limited group or region, with no financial commitments for the recipients.

Development aid – a disservice?



Simple model – the state and the recipient*

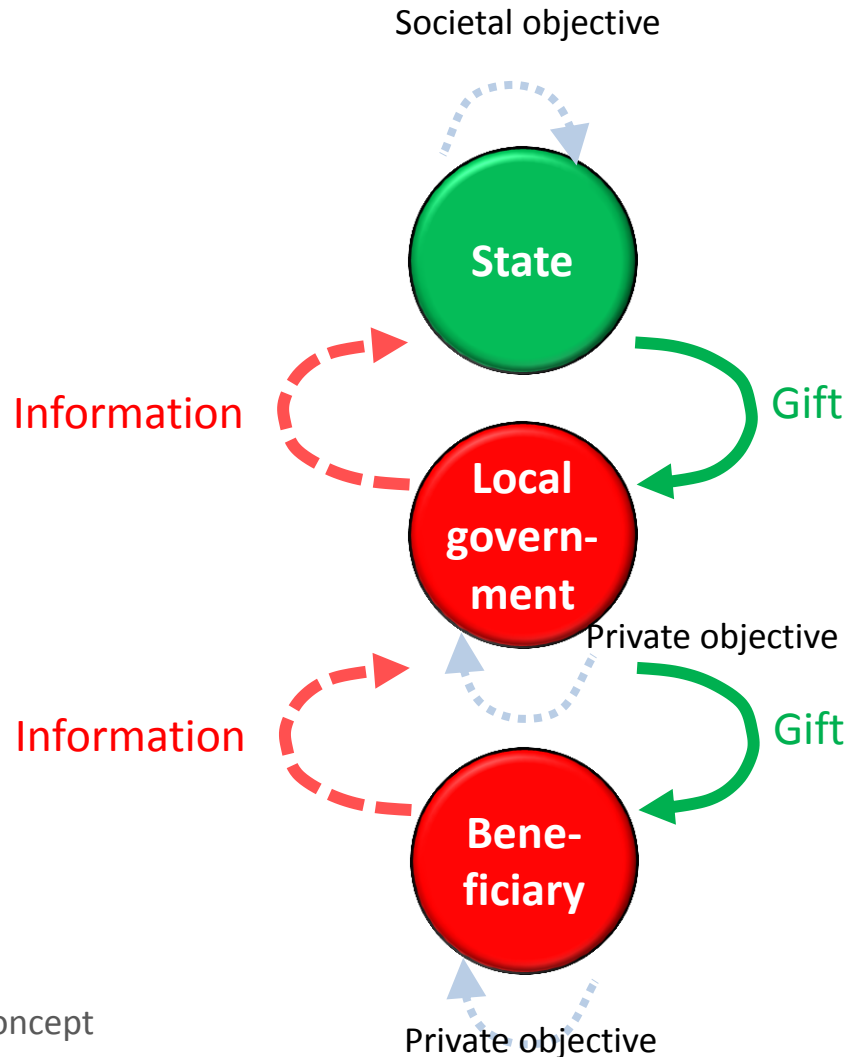
Perverse incentives arise when there is:



Some aspects of perverse incentives

- Lack of effort to improve own situation
- Skewed investment analysis: overestimated benefits and underestimated cost
- Prefers the most expensive option
- Money spent on lobbying activities
- Takes no responsibility for benefits realization and sustainability

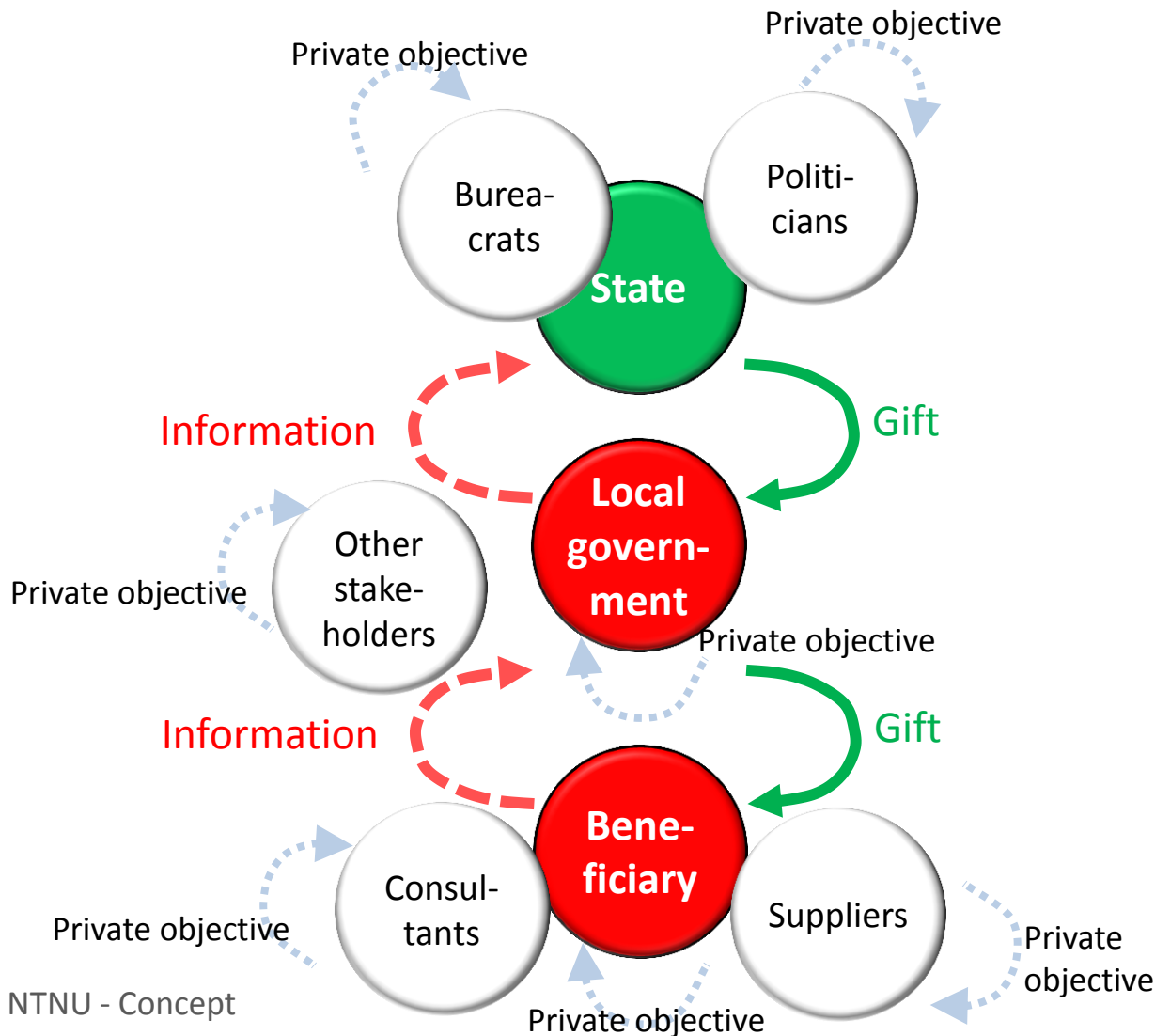
Complex model – perverse incentives at several levels



Possible problems with intermediaries:

- May have own private objective
- More concerned with the size of the gift than the effects
- Limited information about needs

Complex model – perverse incentives at several levels



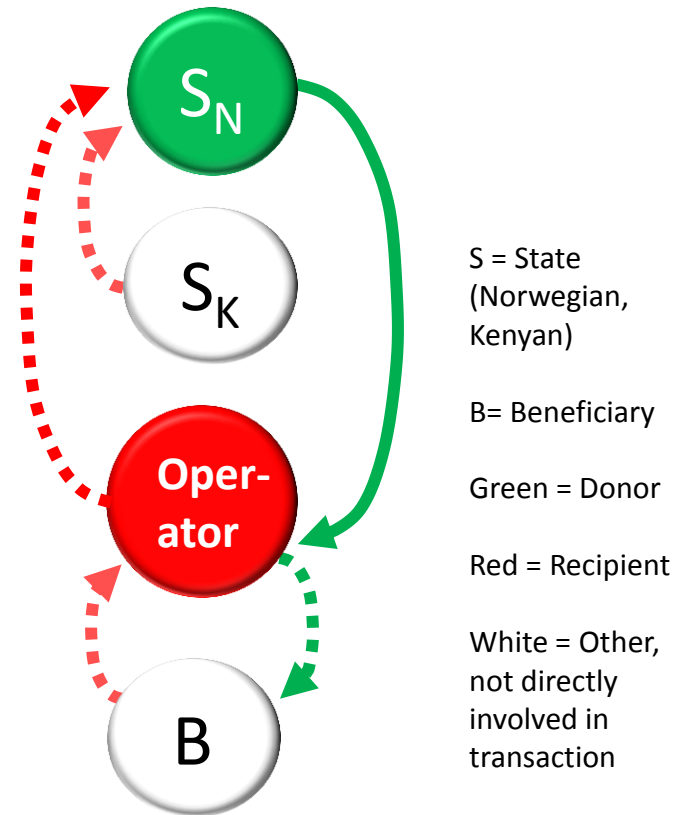
..... what happened to the
Societal objective?

The projects

Name	Type of project	Total cost (mill. NOK)	Year completed	Co-financing
Turkana Fisheries (Kenya)	Development aid	1 500	1990	No
Linesøya	Bridge	250	2011	Minimal
Stad skipstunnel	Shipping tunnel	(1 800)		No
Rock city	Cultural building	50	2013	Some
E16 Lærdalstunnelen	Road tunnel	1 050	2000	No
OL Lillehammer	Sports event	7 500	1994	No
Lofast	Road and sub sea tunnel	1 367	2007	No
St. Olavs Hospital	Hospital	13 000	2014	No
Hvaler-tunnelen	Sub sea road tunnel	200	1989	Some

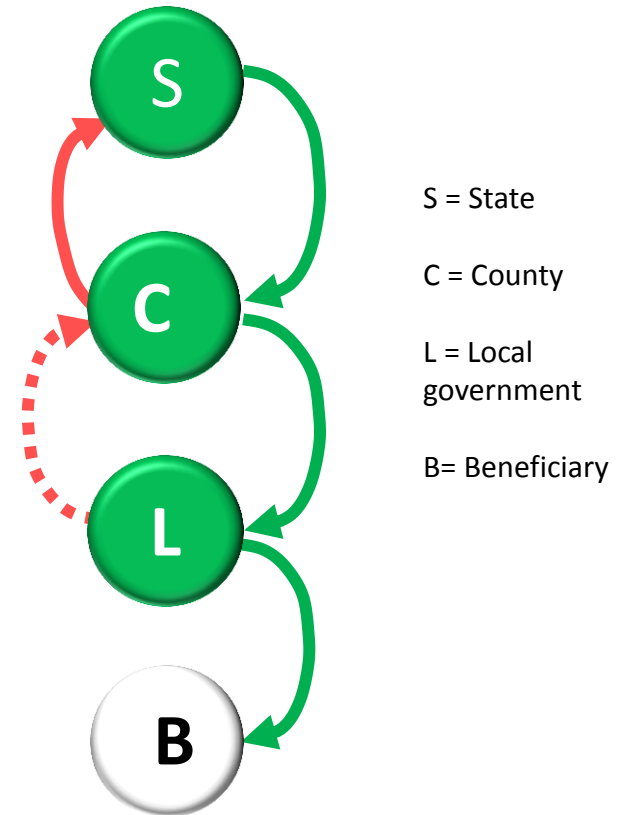
Turkana Fisheries

- Intention: to create employment for nomads in the desert
- Fishing boats, refrigeration plant for fish, road
- Highly unsuccessful project: nomads not fishermen, too hot, too little fish, etc.
- Operators had a vested interest in expanding and extending the project



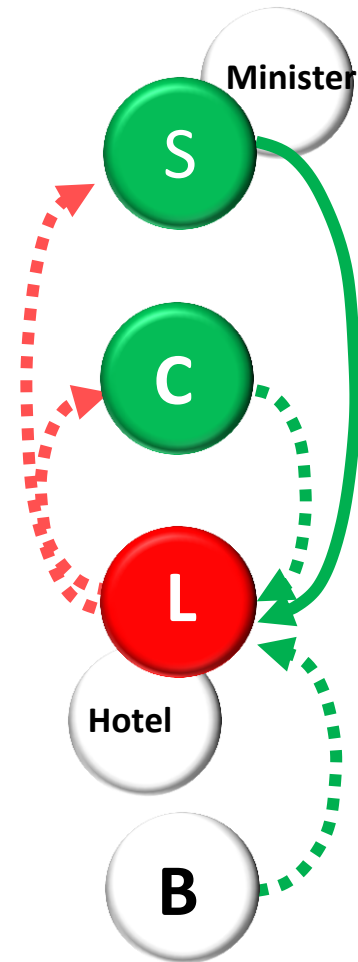
Linesøya bridge

- Connecting the population on an island to the mainland
- Local politicians heavily involved in lobbying
- Visions of economic growth and wider impacts
- Rapidly decreasing population, today 60 inhabitants (elderly), the bridge is hardly used



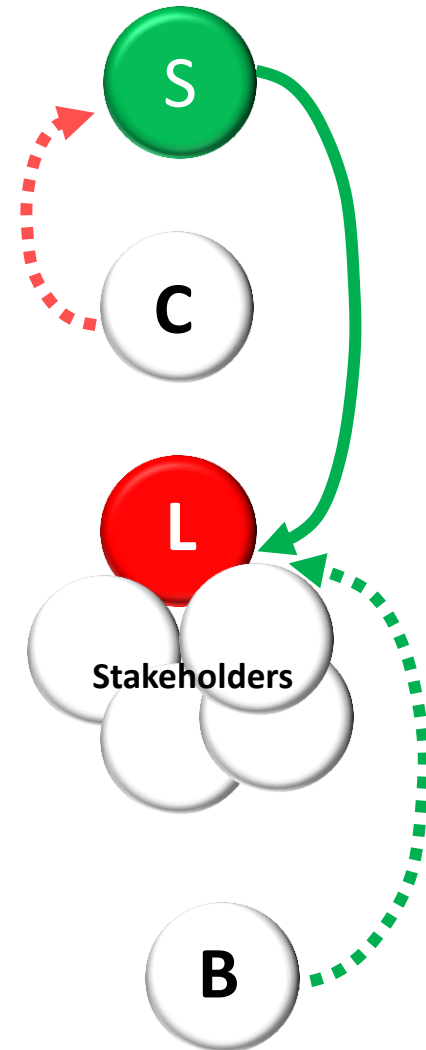
Rock City

- Namsos, Nord-Trøndelag
- The intention was to build a national center for rock, including a museum for local rock
- Unclear objectives, unclear how to finance operation
- The center is operated as a center for local rock only, but expects the state to pay
- Few visitors. Financial havoc
- The local population must take the bill



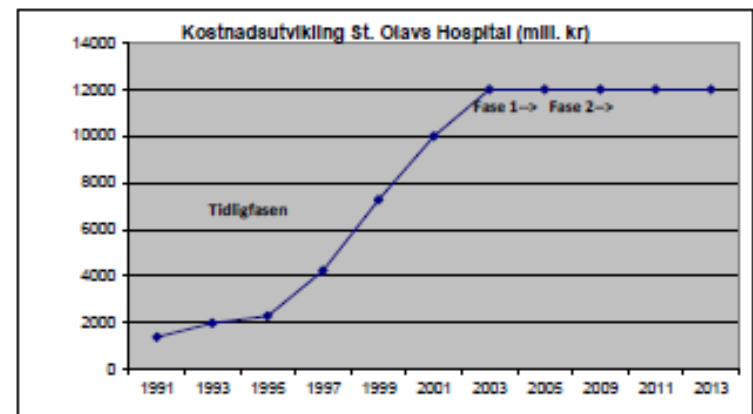
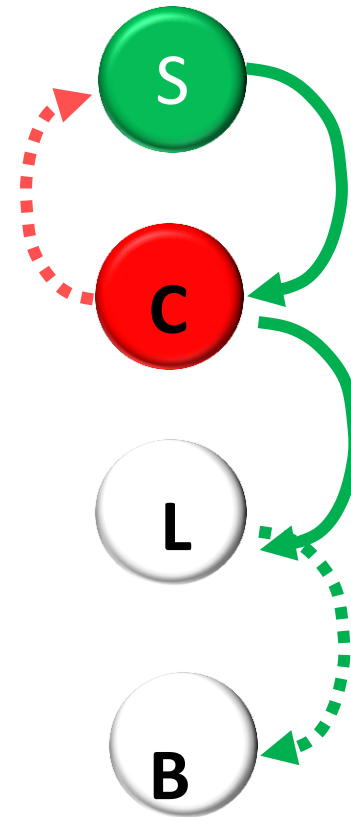
Olympic Games Lillehammer, 1994

- Visions of major economic spinoffs and regional growth
- First cost estimate was 1 bill. NOK
- Many free-riders, assumed that the state would cover all costs
- Became a great success as a sports event
- Some regional benefits (small)
- Huge cost overrun, final cost was 7 bill. NOK






























St. Olavs Hospital

- Run down regional university hospital
- The County suggested a new, larger hospital. Unrealistic initial cost estimates.
- Dramatic increase of estimate after «go» from the state
- Change of financing scheme half way removed cost risk for the state
- Resulting in major cuts in operating budget
- Today a great hospital, but struggling with high operating costs



Findings

- Project success requires
 - Delivery as planned and cost control (operational success)
 - Useful to recipients (tactical success)
 - Contributes to a desired societal development (strategic success)

Name	Operational success	Tactical success	Strategic success
Turkana Fisheries (Kenya)			
Linesøya			
Stad skipstunnel			
Rock city			
E16 Lærdalstunnelen			
OL Lillehammer			
Lofast			
St. Olavs Hospital			
 Hvaler-tunnelen			

Findings

- Bottom-up processes dominate the early project phases.
- Local authorities and politicians often involved in lobbying...
- ...and central politicians make promises to their own constituencies
- Often conflicts of interest, even at local level, but no clear pattern
- The government does not question the local cost estimates.
- Decision to finance is often based on overestimated benefits and unrealistic cost estimates.
- Probably intended in several cases, due to poor planning and lack of experience in others.
- Absence of liabilities result in cost-driving requirements

Findings (continued)

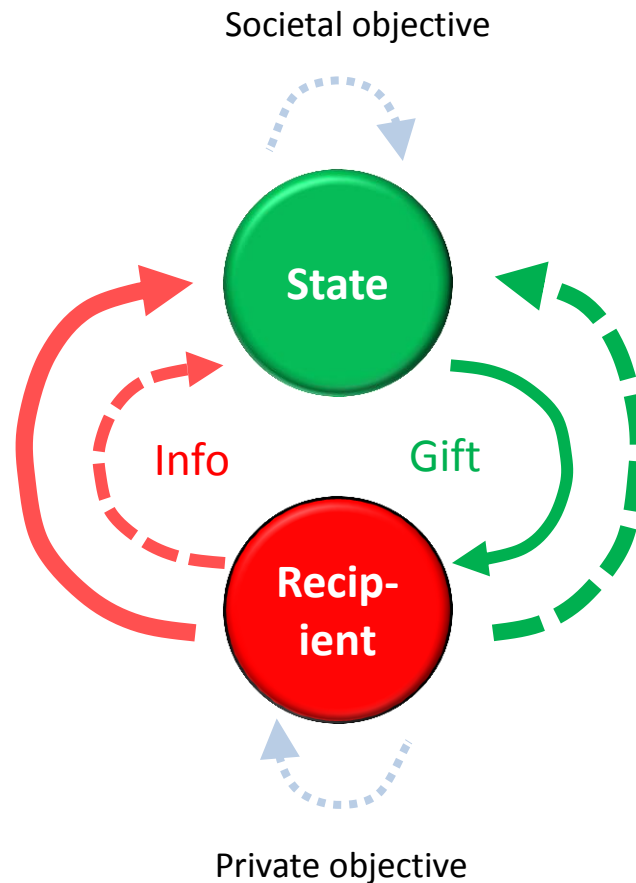
- Low project success, especially tactical and strategic
- Final cost «surprisingly high»
- Overinvestment and excess capacity
- Poor realization of intended direct effects as well as spinoffs (regional etc.)
- Five of the projects would probably not have been approved if:
 - the government had realistic information about cost and benefits
 - the initiators had been responsible for (some of) the cost
- There were cases where the financial scheme was unclear, misunderstood or changed ex post (recipients themselves ended up with the bill)

Countermeasures

The problem is twofold – therefore measures should be twofold

Information asymmetry

→ Measures to facilitate or improve information to the donor

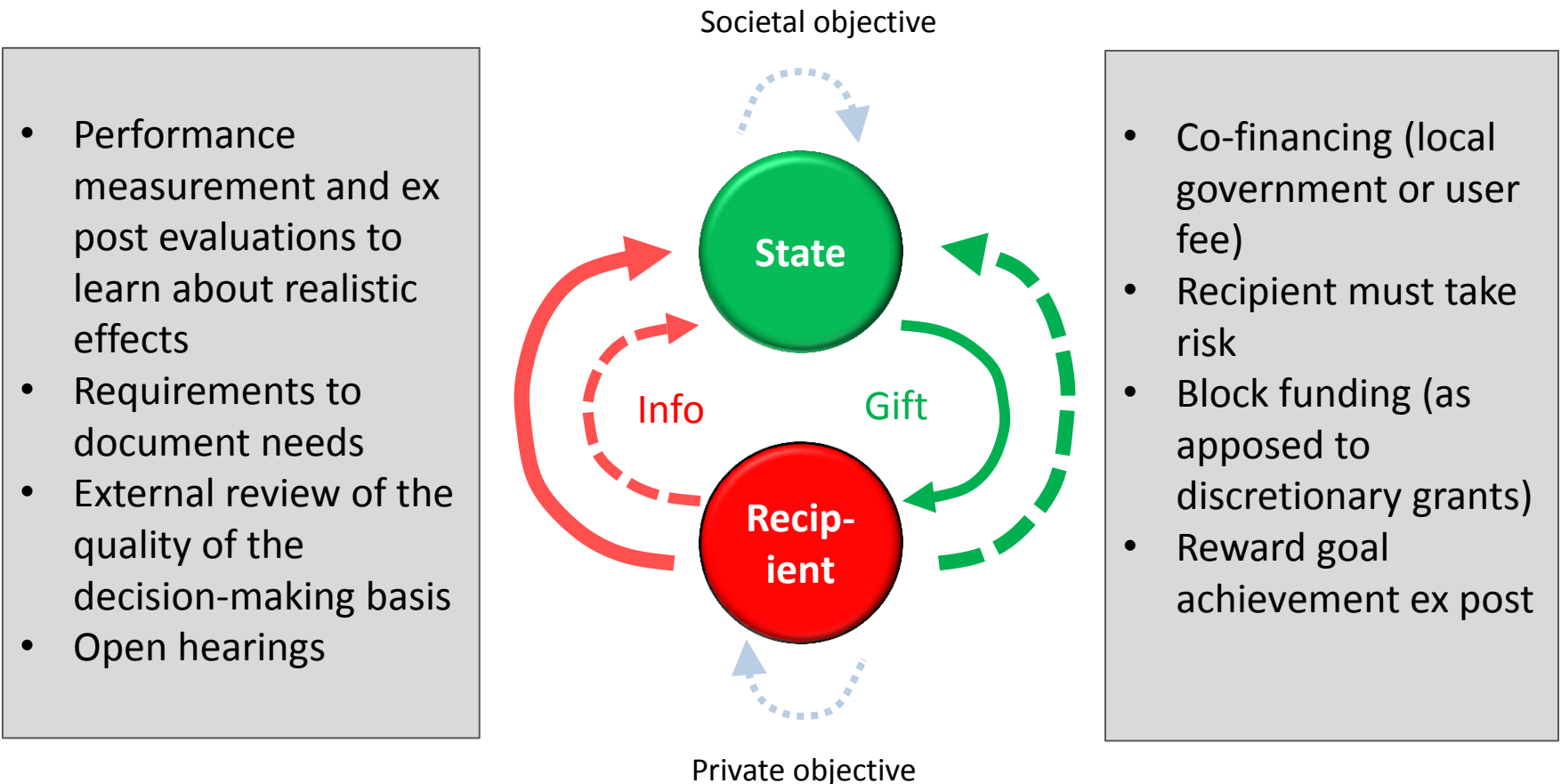


Conflict of interest

→ Measures to bring recipients' interests in accordance with societal objectives

Countermeasures (continued)

The problem is twofold – therefore measures should be twofold



Recommendations

- The most obvious measure is to require a certain degree of co-financing from recipients.
- Investments should be based on real needs. Problems and needs analysis should be performed at an early stage
- QA1 could help to sift out the worst conceptual solutions early on
- Block funding, guided by objective criteria for the use of funds, might be better than state funding of specific infrastructure projects
- More research is needed, to explore the scope of the problem and to gain more knowledge about causes and effects.

Thank you

