
Financing Development: What are the Challenges in Expanding Aid Flows?

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3

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Table of contents

| | |
|---|-----------|
| INTRODUCTION ET SYNTHÈSE (VERSION FRANÇAISE) | 7 |
| INTRODUCTION AND SUMMARY (ENGLISH VERSION) | 23 |
| WILLIAM EASTERLY, HOW TO ASSESS THE NEED FOR AID? THE ANSWER: DON'T ASK. | 37 |
| 1. Introduction | 37 |
| 2. The night of the planners | 38 |
| 3. The ghosts of models past | 45 |
| 4. Conclusions | 53 |
| COMMENT BY GIOVANNI ANDREA CORNIA | 57 |
| COMMENT BY JOHN BURTON | 65 |
| JAKOB SVENSSON, ABSORPTION CAPACITY AND DISBURSEMENT CONSTRAINTS | 73 |
| 1. Introduction | 73 |
| 2. A broken information (accountability) feedback loop | 74 |
| 3. Multiple objectives and tasks | 81 |
| 4. The budget-pressure problem | 83 |
| 5. Multiple principals (donors) | 89 |
| 6. The foreign aid dilemma | 93 |
| 7. Conclusion | 95 |

| | |
|--|-----|
| COMMENT BY CHRISTOPHER ADAM | 99 |
| ARNE BIGSTEN, DONOR COORDINATION AND THE USES OF AID | 107 |
| 1. Introduction | 107 |
| 2. The issues: a framework for discussion | 109 |
| 3. Literature review: theoretical effects of donor coordination | 111 |
| 4. The evolution of donor coordination | 114 |
| 5. The impact of donor coordination on transaction costs | 120 |
| 6. The impact of donor coordination on public sector management and governance | 123 |
| 7. Policy discussion and conclusions | 126 |
| COMMENT BY MICHAEL CLEMENS | 135 |
| COMMENT BY JEAN-PIERRE CLING | 153 |
| DANIEL COHEN, PIERRE JACQUET AND HELMUT REISEN, BEYOND “GRANTS VERSUS LOANS”: HOW TO USE DEBT FOR DEVELOPMENT | 163 |
| 1. The grants-versus-loans controversy | 164 |
| 2. Concessional loans, grants and debt solvency | 172 |
| 3. Beyond grants versus loans: towards modern development finance | 177 |
| 4. Concluding remarks | 182 |
| COMMENT BY MARC RAFFINOT | 191 |
| COMMENT BY PAUL REDING | 199 |
| AUTHORS AFFILIATIONS | 207 |

Introduction et synthèse

Cet ouvrage rassemble les actes de la conférence organisée le 14 décembre 2005 par l'Agence Française de Développement et le réseau de chercheurs européens EUDN (European Development Research Network) sur le thème : « Financer le développement : les défis d'un doublement de l'aide ».

Alors que se succèdent les engagements politiques sur l'augmentation des budgets consacrés à l'aide et aux annulations de dettes ainsi que les initiatives visant à mobiliser de nouvelles ressources financières, cette conférence visait à débattre des conditions d'une utilisation efficace et productive des ressources ainsi dégagées à l'intention des pays en développement.

Les discussions ont abordé les questions suivantes : comment évaluer les besoins en aide ? Quel rôle peut jouer l'aide dans des pays caractérisés par un environnement institutionnel dégradé ? Quels sont les liens entre coordination des bailleurs et utilisation de l'aide ? Et quelles en sont les conséquences pour l'appropriation des politiques de développement par les pays receivers ? Comment aider : prêts ou dons ? Quels liens entre capacité d'absorption et contraintes de décaissement des agences d'aide ? William Easterly, Arne Bigsten, Daniel Cohen, Pierre Jacquet et Jakob Svensson ont présenté quatre papiers abordant des aspects spécifiques de ce débat, dont les principaux arguments sont résumés dans cette introduction.

7

1. Comment évaluer les besoins en aide ?

En lançant un avertissement humoristique sur le caractère potentiellement choquant des propos qui allaient suivre, William Easterly donnait le ton de sa présentation

résolument provocante et iconoclaste envers les idées reçues sur les besoins en APD des pays en développement.

1.1. Qui est responsable ?

Son exposé s'attaque au rapport Sachs et au Projet des Nations Unies pour le Millénaire, en soulignant qu'ils font une référence systématique à la planification centrale et fixent des objectifs bureaucratiques et pléthoriques (449 recommandations pour atteindre 54 Objectifs de Développement pour le Millénaire, eux-mêmes regroupés en 8 grands ODM), alors que seule une action de terrain, issue de l'expérience, est efficace pour lutter contre la pauvreté. Le bilan sur le développement de l'Afrique subsaharienne est d'ailleurs un échec flagrant, ce qui, loin de conduire à une recherche de responsabilités, motive au contraire la promotion d'une augmentation du volume de l'APD (100 milliards de dollars à l'horizon 2010, soit un doublement) grâce à des actions de communication largement médiatisées. La Banque mondiale et le FMI sont également associés à ces critiques, les plans de réduction de la pauvreté étant le plus souvent hors de portée des pays dans lesquels ils sont mis en place, et leurs effets de toutes façons difficiles à isoler. La critique centrale d'Easterly sur l'approche adoptée par les institutions d'aide, et en particulier l'initiative des ODM, concerne le manque de responsabilité individuelle. Comme l'enseigne la théorie des agents multiples, la responsabilité collective, diluée entre une multiplicité d'acteurs et d'objectifs, aboutit à une absence totale de responsabilité. On ne peut, de ce fait, reprocher à personne en particulier le fait qu'aucun résultat ne suive les gestes généreux des pays riches, et ce d'autant plus que les bénéficiaires directs de l'aide ont peu de voix. Ainsi, la logique de l'aide est telle un serpent qui se mord la queue, les montants d'APD et les objectifs fixés pour le Millénaire étant déterminés l'un par l'autre dans les deux sens, en dehors de toute rationalité.

1.2. Comment évaluer les besoins en aide ?

La présentation expose dans une seconde partie les trois modèles développés dans les années 1950 pour définir le volume d'APD nécessaire aux pays en développement, modèles qui servent encore de référence aux institutions d'aide, alors même que leurs auteurs reconnaissent les faiblesses profondes de ces approches. Le premier modèle, celui du *gap* de financement (ou sa variante sur le financement extérieur), définit l'aide

souhaitable comme la différence entre les besoins d'investissement pour atteindre un taux de croissance donné (par exemple pour diminuer de moitié la pauvreté) et l'investissement domestique effectivement constaté, alors que les observations ont clairement nié tout lien aussi simpliste entre croissance et aide. Le deuxième modèle, celui de la trappe à pauvreté, postule qu'au dessous d'un certain revenu de subsistance, aucun investissement pour le futur ne peut être réalisé par les populations qui se voient bloquées dans un état caractérisé par une croissance quasi-nulle, sauf apport d'aide ponctuel destiné à les sortir de l'impasse. Le test statistique sur 50 ans de la stagnation du revenu par habitant pour les pays du quintile le plus faible infirme cette hypothèse pour toutes les périodes étudiées, sauf pour la période la plus récente (1985-2001). Durant cette période, le quintile a certes en moyenne cru moins rapidement que les autres (de 1.1 %), mais la constitution de ce quintile a largement varié sur la période, et les pays qui y sont restés durablement sont justement ceux qui ont bénéficié d'une aide importante. On peut, dès lors, conclure que d'autres facteurs explicatifs, comme la mauvaise gouvernance, sont plus pertinents que l'argument de trappe à pauvreté. Enfin, le modèle des dépenses sociales fait un rapprochement direct entre l'aide octroyée dans les secteurs sociaux comme la santé ou l'éducation et la valeur des services reçus par les populations (coût d'un médicament pour un patient par exemple), d'où l'estimation triviale des besoins d'aide pour un objectif donné (réduction de la mortalité infantile par exemple) alors qu'une fois de plus les données empiriques ne permettent que d'établir un lien faible entre ces deux variables.

En conclusion, Easterly insiste sur les succès de pays acteurs de leur propre développement (l'Inde et la Chine) et sur la nécessité de susciter ce type d'expériences endogènes par la recherche de solutions appliquées plutôt que par l'exécution de schémas globaux prédéterminés et sans caractère incitatif à fournir des services mesurables. Son pragmatisme peut ainsi se résumer par la formule lapidaire qui veut que le meilleur programme soit de ne pas en avoir, et que la meilleure réponse à la question du volume d'APD nécessaire consiste à ne pas se poser la question.

1.3. Commentaires et débats

La discussion a été lancée par Giovanni Andréa Cornia, qui a souligné le caractère quelque peu nihiliste de la présentation. Celle-ci pourrait inciter à l'abandon de toute tentative de planification et de fixation d'objectifs, et à laisser dominer le marché

puisque les pays qui ont réussi n'auraient pas eu besoin de l'aide. Cornia reconnaît pourtant la difficulté de se fixer des objectifs chiffrés tels que les ODM alors que les chocs externes comptent autant que l'aide (crise financière en Argentine par exemple). S'il reconnaît également les faiblesses des modèles présentés pour évaluer les besoins d'aide, il met en garde contre la corrélation contestable entre croissance lente et mauvaise gouvernance (ainsi la Chine, et même le Japon et l'Italie peuvent être des contre-exemples partiels). Ainsi, la complexité des mécanismes de l'aide et la dimension d'économie politique du donneur (aide liée, etc.) et du receveur ne doivent pas conduire à diaboliser la bureaucratie des organisations internationales, mais plutôt à reconnaître les limites de l'intervention du privé et à réhabiliter la responsabilité collective, en particulier en présence de biens publics comme l'éducation ou la santé.

Le second discutant, John Burton, a tenté de répondre aux critiques frontales portées par Easterly aux idées défendues par le DFID. La multiplicité des ODM s'explique ainsi par la complexité du phénomène de pauvreté qu'il n'est pas possible de réduire avec un modèle unidimensionnel. Le caractère arbitraire des chiffres proposés comme objectifs est moins important que l'acte politique de choix d'une référence et de recentrage des finalités de l'aide sur la pauvreté (plutôt que sur les exportations par exemple). Il faut donc prendre les ODM « sérieusement, mais pas à la lettre », et pouvoir les équilibrer selon les géographies. En outre, il est nécessaire que les gouvernements se fixent des objectifs, des budgets et des politiques afin d'encadrer leur action. Enfin, le lien entre aide et croissance est encore largement débattu et il convient de ne pas en présenter une vision trop restrictive.

Les débats ont souligné que les ODM constituent surtout un signal politique de réorientation de l'aide vers la santé et l'éducation, et que leur définition vise avant tout une prise de conscience des enjeux dans les PED, de même que le modèle de fossé de financement a servi d'instrument politique aux Nations Unies dans le débat Nord/Sud (à l'image des fonds structurels européens). Par ailleurs, et malgré la difficulté de tout planifier dans le détail, il reste important de définir une direction pour un pays, et l'aide reçue par la Chine ou l'Inde a été utilisée de façon efficace précisément grâce à une politique publique forte et à une vision stratégique claire.

La question de la responsabilité a également été au cœur des débats, et s'il apparaît que l'action collective comporte des limites en termes d'incitation et de

redevabilité, aucun modèle optimal de responsabilité individuelle n'a pour autant été proposé comme alternative : comment assurer la coordination ? Avec quelle dose de décentralisation ? De même, il resterait à expliciter les modèles de développement sous-jacents à l'exposé d'Easterly (existence de rendements croissants ? équilibres multiples ?) et à développer les limites des approches unimodales (action dans le seul secteur de la santé par exemple).

2. Capacités d'absorption et contraintes de décaissements

Jakob Svensson analyse les problèmes d'incitations qui pèsent aussi bien sur les comportements des pays bailleurs que sur les bénéficiaires de l'aide. Ensemble, ces contraintes déterminent fortement l'efficacité globale des mécanismes de l'aide au développement.

2.1. Décaissements et accountability

Les agences d'aide font face à une série de problèmes classiques dans le secteur public : (i) la coexistence d'objectifs multiples ; (ii) la difficulté d'évaluer les résultats de l'aide ; (iii) l'absence d'incitations à la performance. Habituellement, les usagers (clients) des agences publiques d'un pays sont informés des programmes qui les concernent, des bénéfices qu'ils peuvent en retirer et, en tant que citoyens, ont la possibilité de sanctionner les politiciens responsables de la qualité du service délivré par ces agences.

11

En matière d'aide, ces hypothèses ne sont pas vérifiées puisque ceux qui financent l'aide (les contribuables des pays donateurs) n'en sont pas les bénéficiaires directs et ne sont donc pas à même d'en évaluer l'efficacité. De leur côté, les bénéficiaires de l'aide n'ont pas le droit de voter dans les pays bailleurs et donc pas de pouvoir de sanction sur les responsables des politiques d'aide. Les mécanismes de transmission de l'information (et de responsabilisation) entre payeurs et bénéficiaires des politiques publiques, normalement rétroactifs, sont par conséquent inopérants dans le cas de l'aide.

Cette situation complique sérieusement les trois problèmes listés plus haut. Du côté des donateurs, les volumes d'aide versés sont devenus la principale mesure de la

performance du système et le principal enjeu politique, les citoyens des pays donateurs n'étant pas en mesure d'observer d'autres variables plus représentatives de l'impact effectif de l'aide. Deuxièmement, cette situation de faible responsabilité (*accountability*) des agences d'aide vis-à-vis des citoyens explique le poids des consultants et des experts dans la définition des objectifs de l'aide. Troisièmement, les médias ont acquis une influence considérable en matière de politique d'aide extérieure (beaucoup plus que sur la plupart des questions politiques internes) puisqu'ils sont, pour les contribuables des pays donateurs, la première voire l'unique source d'information et de retours d'expérience sur le sujet.

2.2. Capacités d'absorption et contraintes institutionnelles

Du côté des pays bénéficiaires, en l'absence d'information des populations, de mécanismes de supervision et d'évaluation d'impact effectifs, les flux d'aide ont une probabilité élevée d'être captés par d'autres bénéficiaires que ceux initialement visés par les programmes d'aide. Dans deux grands programmes d'éducation mis en œuvre dans les années 1990 et évalués *a posteriori*, les fuites (fonds non affectés aux fins prévues) ont atteint 80 % des montants d'aide alloués en Tanzanie et 87 % en Ouganda.

D'autres problèmes organisationnels viennent aggraver les risques d'inefficacité de l'aide. Premièrement, la coexistence d'objectifs multiples et le taux de rotation des personnels à différents postes dans les agences d'aide incitent ces personnels à se consacrer aux tâches pour lesquelles ils ont des chances d'être récompensés. Ces tâches impliquent généralement un important investissement quantitatif, alors que d'autres objectifs, plus qualitatifs, mais moins facilement mesurables et « opérationnalisables » sont sensiblement plus difficiles à faire valoir aux yeux de leur hiérarchie et donc relégués au second plan ou simplement évacués.

Deuxièmement, la pression institutionnelle à engager et décaisser les fonds d'aide est structurellement forte, indépendamment de la qualité des résultats. Aussi la menace de ne pas déboursier l'aide engagée si certaines conditionnalités ne sont pas respectées est-elle finalement assez peu crédible. Enfin, troisièmement, la multiplicité des donateurs augmente considérablement les coûts de transaction (incluant les ressources humaines accaparées dans les pays bénéficiaires) et crée de redoutables problèmes d'action collective.

Jakob Svensson évoque plusieurs pistes pour pallier cette série de problèmes : engager davantage les populations bénéficiaires de l'aide dans son évaluation, et notamment mobiliser les médias locaux pour informer les populations sur les programmes en cours et contraindre les responsables politiques à leur rendre des comptes sur la gestion des fonds d'aide (J. Svensson analyse notamment l'exemple de l'Ouganda) ; organiser une coordination systématique des bailleurs, comme dans le cas du Plan Marshall où les Etats-Unis ont clairement joué un rôle de point focal.

2.3. Commentaires et débats

Christopher Adam concentre son commentaire sur deux points. Il estime tout d'abord que le tableau brossé par J. Svensson, avec son insistance sur les problèmes d'incitation et les blocages institutionnels de l'aide, minimise les progrès réalisés par les donateurs. Ces progrès sont notables en matière d'évaluation indépendante (par exemple au FMI), de transparence et de responsabilité (par exemple à DFID), de coordination (avec la Déclaration de Paris de mars 2005 mais aussi la désignation de points focaux parmi les bailleurs – *lead donors*), et enfin en termes d'incitations à la performance (voir les conditionnalités incitatives de la Commission européenne).

Second point soulevé par Christopher Adam, le basculement de l'aide vers davantage d'appui budgétaire n'est pas qu'une bonne nouvelle : de nouvelles tensions macro-économiques pourraient en résulter. En effet, dans la mesure où les donateurs ne peuvent pas s'engager de manière crédible sur l'irréversibilité et la stabilité des flux d'aide à terme, un afflux massif d'aide peut paradoxalement être interprété comme une mauvaise nouvelle par le secteur privé domestique puisque si les volumes d'aide venaient à diminuer ultérieurement, l'inertie budgétaire et l'inertie des dépenses publiques piégeraient alors le gouvernement accoutumé à d'importants flux d'aide. Pour prévenir ce risque de tensions budgétaires et inflationnistes (et contrer ne serait-ce que les anticipations d'un tel risque), Christopher Adam propose de maintenir une discipline budgétaire stricte et de créer des réserves spéciales de devises tout au long de la période d'afflux d'aide. Les bailleurs devraient encourager le recours à ces instruments pour prévenir les risques de volatilité macro-économique induits par l'aide.

Au cours des débats, Patrick Guillaumont souligne que, malgré les multiples incitations au décaissement mentionnées par J. Svensson, les bailleurs font aujourd'hui

face à des taux de décaissement extrêmement bas. Par ailleurs, Pierre Jacquet remarque que le débat reste très centré sur les contraintes des bailleurs et s'intéresse peu à la façon dont l'aide pourrait aussi contribuer à accroître les capacités d'absorption des bénéficiaires. Il explique également que l'évaluation indépendante joue au moins deux rôles supplémentaires pour une agence d'aide, outre sa fonction d'évaluation d'impact proprement dite : d'abord un rôle interne de suivi des activités et d'apprentissage de l'efficacité, ensuite une fonction de responsabilisation des bailleurs. Chacune de ces dimensions joue sur des mécanismes différents.

John Burton soutient l'idée de création de réserves pour contrer les risques de volatilité future et estime que les pays bénéficiaires ne seraient pas opposés à leur mise en place. Marcel Fafchamps rappelle que l'alignement des objectifs des bailleurs avec ceux des bénéficiaires est une chimère, puisque par définition, s'ils étaient alignés, il n'y aurait plus besoin d'agences d'aide et il suffirait de verser directement l'aide aux gouvernements qui en feraient la demande. Katia Michaëlowa souligne le lien entre les dimensions d'évaluation micro et d'instabilité macro : la réaction positive du gouvernement ougandais suite à l'évaluation de sa politique d'éducation en a fait un *donor darling* alors que d'autres, comme la Tanzanie, se retrouvaient dans le même temps « orphelins de l'aide » en matière d'éducation. Jean-Marc Châtaigner plaide, pour sa part, pour un allongement des horizons de l'aide et de son évaluation, ainsi que pour une mise en concurrence des bailleurs avec un rôle prédominant des bénéficiaires dans la sélection.

14

En guise de conclusion, Jakob Svensson répète qu'il ne faut pas attendre de miracles de l'évaluation et qu'elle ne résoudra pas à elle seule le problème massif d'irresponsabilité qui caractérise l'industrie de l'aide. Les bailleurs devraient investir bien davantage dans l'expérimentation de tous les outils et mécanismes susceptibles d'aider à atténuer ce phénomène.

3. Coordination des bailleurs et utilisation de l'aide

3.1. Cadre conceptuel

Avec l'accent mis sur l'aide programme, la coordination entre les bailleurs est devenue une question cruciale qui a donné lieu à plusieurs initiatives internationales :

déclaration de Rome (2003), déclaration de Paris (2005), Commission pour l'Afrique (2005).

Arne Bigsten propose de lister ce que recouvre le concept de coordination. Il retient quatre aspects : (i) le développement de mécanismes communs de planification, gestion et déboursement de l'aide, (ii) la simplification progressive des procédures de manière à réduire les contraintes pour les gouvernements partenaires, (iii) le partage d'informations pour promouvoir la transparence et améliorer la coordination et (iv) la coordination au niveau des objectifs et des politiques.

Jean Némoto a, de son côté, ajouté que l'harmonisation des bailleurs pouvait se réaliser à plusieurs niveaux : (i) au niveau de la mise en œuvre d'un projet, (ii) de l'exécution d'un programme, (iii) des orientations des politiques nationales et (iv) des stratégies internationales permettant aux bailleurs de fonds de s'accorder sur les grandes priorités.

La question centrale est celle de l'impact de l'harmonisation sur l'efficacité de l'aide en matière de développement, mais ce lien est difficile à établir et à analyser. La discussion s'est donc concentrée sur l'impact de l'harmonisation sur la formulation et la mise en œuvre des politiques, c'est-à-dire l'impact sur les coûts de transaction et les structures incitatives pour les pays receveurs.

En proposant une revue de la littérature, Bigsten note que la majorité des économistes utilisent un modèle de type principal-agent (un donateur et un receveur) pour modéliser les relations engendrées par la transaction consistant en un transfert financier. Dans le cadre de ce modèle, la condition pour un accroissement de l'utilité du donateur et du receveur suite au transfert, est que les deux partenaires aient des préférences identiques ou au moins très proches. Le non respect de cette condition entraîne un problème habituel d'aléa moral, selon lequel l'agent tend à modifier son comportement une fois que le contrat est signé, posant la question du contrôle du comportement des receveurs et des incitations. La conditionnalité devient alors le prix à payer pour que les bénéficiaires aient accès à l'APD.

Selon Jean-Pierre Cling, ce type de modèle ne nous indique ni les avantages, ni les inconvénients d'une coordination des bailleurs. Il est donc nécessaire de passer à

un modèle à plusieurs donateurs. Torsvik (2005) montre l'intérêt de la coordination dans le cadre d'un modèle avec une fonction d'utilité à 2 éléments (consommation domestique et consommation des pauvres dans le pays aidé). Si un donneur supplémentaire intervient, l'utilité du premier donateur s'accroît si s'instaure une coopération entre les deux. Différents modèles de coopération (non conçus spécifiquement pour étudier le cas de l'APD) peuvent s'appliquer dans ce domaine en montrant que l'action collective peut permettre d'atteindre des objectifs inaccessibles à un individu seul. L'analyse en termes de coûts de transaction s'appuie alors sur les rendements d'échelle liés à l'harmonisation. Cling souligne un inconvénient de ces modèles : aucun ne met en évidence d'effet négatif potentiel de la coordination sur l'efficacité de l'APD (effet de cartel).

3.2. Evolution de la coordination des donateurs

Malgré la multiplication des initiatives internationales et des agences en charge de la coordination de l'aide, très peu de progrès ont été réalisés. L'accent mis sur la réduction de la pauvreté et l'adoption par la communauté internationale des Objectifs du millénaire ont toutefois, à défaut d'une harmonisation des approches, conduit à une harmonisation des grands objectifs. En revanche, la mise en œuvre des politiques d'aide donne lieu à une certaine compétition entre bailleurs. Compétition qui, selon Clemens et Jacquet, tient au fait que les bailleurs bilatéraux sont des Etats-Nations ayant besoin de convaincre leurs contribuables et de justifier l'aide à partir de réalisations tangibles et visibles. Cette contrainte explique aussi la stagnation de la part de l'aide totale affectée aux institutions multilatérales depuis les années 1970 et la pérennité de l'aide bilatérale.

3.3. Impact de la coordination sur les coûts de transaction et la structure incitative

En théorie, les efforts d'harmonisation ont pour effet de diminuer les coûts de transaction de l'aide (coûts d'instruction, de négociation, de suivi et de mise en œuvre des accords de prêts ou de dons). Clemens souligne que ces gains sont très difficiles à mesurer et qu'aucune estimation convaincante n'est disponible. Les quelques études réalisées indiquent que les bénéfices de l'harmonisation sont plutôt minces et posent

donc la question de la priorité à accorder à ces efforts. Clemens conclut en appelant à un effort de la recherche dans ce domaine.

L'impact des efforts d'harmonisation des bailleurs sur les incitations à mener une bonne gestion publique de la part des receveurs est encore plus incertain. Un certain nombre d'évidences empiriques tendent à montrer que la fragmentation de l'aide entre plusieurs donateurs a un impact négatif sur le fonctionnement des structures administratives des pays receveurs. Alioune Sall fait remarquer que ce risque est d'autant plus élevé que certains donateurs interviennent dans les pays receveurs en fonction de leurs propres priorités, sans tenir compte de la réflexion menée localement sur les stratégies de développement à retenir. Pour prolonger cette remarque, Pierre Jacquet distingue deux types de pays : (i) les pays qui ont la capacité de définir leur propre stratégie de développement, et dans ce cas la coordination des bailleurs se fait dans le cadre de cette stratégie sous l'égide du gouvernement receveur, et (ii) et les pays où cette capacité n'existe pas et où un certain degré d'ingérence des bailleurs est nécessaire.

En conclusion, si la communauté des bailleurs de fonds s'accorde sur le fait que les efforts d'harmonisation doivent être poursuivis, notamment dans le cadre d'instances comme le Comité d'aide au développement de l'OCDE, les arguments théoriques justifiant ces efforts manquent. Ce manque est particulièrement crucial lorsqu'il s'agit de mesurer leur impact sur l'efficacité de l'aide en matière de développement. Des questions restent en suspens : l'harmonisation doit-elle être une des priorités des bailleurs ? Une certaine forme de compétition n'est-elle pas inéluctable, voire nécessaire pour inciter les bailleurs à mobiliser davantage de ressources financières, à améliorer leurs pratiques, à renforcer le dialogue avec les pays partenaires ?

4. Prêts ou dons ? Dépasser la question

Les excès de l'endettement des pays en développement et les efforts récents pour y mettre fin ont donné matière à controverse depuis 2000 sur les instruments de l'APD, une « alliance » de conservateurs et d'altermondialistes préconisant d'abandonner les prêts concessionnels aux pays pauvres et de financer ces derniers exclusivement par des dons. Dans ce contexte, les auteurs proposent une analyse de

l'avantage comparatif de ces deux instruments de l'APD, avant d'en déduire des pistes pour l'action à l'attention des bailleurs.

4.1. Efficacité relative des dons et des prêts

P. Jacquet insiste sur l'utilité de cette controverse qui montre surtout à quel point l'élément don est masqué dans les prêts d'APD. Elle offre ainsi l'occasion de plaider pour davantage de transparence dans l'utilisation de l'argent des contribuables. Il rappelle en effet que tout prêt concessionnel est un prêt au taux du marché assorti d'une subvention. L'essentiel de l'APD (75 % des décaissements bruts en 2004) est d'ores et déjà constitué de dons et la véritable nouveauté serait de s'interroger sur les raisons de la si faible part des prêts dans l'APD totale.

Selon les partisans d'un recentrage des bailleurs publics sur le don, (i) les marchés financiers sont *a priori* mieux à même d'évaluer les risques et d'ajuster les modalités de prêt selon les contextes nationaux ; (ii) les agences d'aide ont parfois été tentées d'imposer de nouveaux prêts aux pays receveurs (*loan pushing*) destinés au refinancement de prêts antérieurs ; (iii) à l'inverse, des dons assortis de conditionnalités sur leur affectation exerceraient des incitations positives sur les bénéficiaires et contribueraient davantage au développement ; (iv) enfin, le découplage de l'élément prêt (fourni par le marché) et de l'élément don (relevant de l'APD) ne générerait aucun coût supplémentaire pour le donneur et pour le receveur.

Les prêts présentent toutefois un certain nombre d'avantages comparatifs : ils favorisent notamment la construction de capacités de gestion dans les pays receveurs, ainsi qu'une plus grande discipline budgétaire. Alors que les dons se traduisent par une baisse de l'effort de collecte fiscale, les prêts incitent à une gestion plus rigoureuse des dépenses publiques et réclament une plus grande responsabilité, tant du côté du prêteur que de l'emprunteur.

Surtout, les arguments des promoteurs de l'approche par le don reposent sur l'hypothèse d'un libre accès des PED aux marchés financiers, hypothèse invalidée par les pratiques réelles des opérateurs financiers. D. Cohen revient sur le paradoxe de Lucas : pourquoi les marchés financiers ne prêtent-ils pas aux pays qui ont le plus grand besoin de capitaux ? La faiblesse du cadre institutionnel (qui ne permet pas de garantir

les remboursements), l'insuffisance des infrastructures de base nécessaires aux investisseurs (appelant elles-mêmes des prêts de long terme à taux préférentiels), le coût relatif élevé du capital dans les PED ou encore la volatilité extrême de ces pays qui conduit les investisseurs privés à assortir leurs financements de lourdes primes de risque, sont autant de facteurs explicatifs des difficultés des PED à trouver sur le marché les ressources nécessaires.

Les éléments d'analyse théorique et empirique disponibles ne plaident donc pas en faveur d'une supériorité des dons sur les prêts, au contraire. L'approche par le don exclusivement pour les PMA reviendrait à créer *de facto* un statut de pays assistés, définitivement exclus des capitaux privés. En outre, les marchés ont beaucoup de mal à évaluer les risques dans les PED tandis que les agences d'aide peuvent s'appuyer sur une meilleure connaissance du terrain et des relations construites dans la durée. De même, les prêteurs publics ont une plus grande capacité à gérer sagement les circonstances difficiles, évitant ainsi les crises financières graves (cf. les initiatives d'allègement de la dette). Enfin, les études disponibles ne permettent pas de conclure sur l'efficacité respective des prêts et des dons sur la croissance.

Il apparaît donc que le véritable défi consiste à ne pas exclure les PED de l'accès au crédit tout en apprenant à mieux gérer la dette. Ce défi appelle une modernisation de l'APD.

4.2. Pistes pour l'action

19

P. Jacquet identifie trois pistes principales de renouvellement des pratiques de l'APD. Tout d'abord, diversifier les partenaires : au-delà des gouvernements, les bailleurs doivent pouvoir prêter/donner plus qu'ils ne le font aujourd'hui aux collectivités locales, au secteur privé, aux organisations de la société civile, etc.

Ensuite, repenser le rôle des bailleurs : plutôt que d'être des dispensateurs d'une aide évaluée essentiellement en volume, ces derniers devraient devenir des promoteurs de « solutions de financement du développement » associant des instruments du marché et des instruments hors marché (par ex. *via* des garanties, des partenariats public-privé, des incitations à la production de biens publics mondiaux, etc.).

Enfin, imaginer de nouveaux types de prêts, de type « prêts contingents », dont les modalités de remboursement éviteraient aux emprunteurs de replonger dans un cycle de surendettement.

Parmi les solutions techniques possibles, P. Jacquet invite à créer de nouveaux instruments assortis d'une clause contingente permettant d'annuler la dette en cas de choc (par ex. en indexant le service de la dette sur les prix à l'exportation). D. Cohen propose d'utiliser l'élément don des prêts concessionnels pour alimenter des fonds de réserve. Ces « matelas » seraient utilisés en cas de choc afin de maintenir l'endettement à un niveau soutenable. La répartition des PED par groupes en fonction de leur niveau de vulnérabilité permettrait d'ajuster le niveau des réserves requis. Ces types d'instruments, outre qu'ils préserveraient l'accès des PED au marché financier, auraient un effet de levier sur les ressources privées tout en créant une dynamique laissant aux pays bénéficiaires la possibilité de changer de classe de risque. En outre, l'incitation des emprunteurs à rembourser se trouverait renforcée, d'une part par la perspective de bénéficier ultérieurement de davantage de fonds, d'autre part si ces réserves sont comptabilisées comme APD, limitant ainsi l'aléa moral.

4.3. Commentaires et débats

Les différents intervenants s'accordent sur l'hypothèse formulée par les auteurs : les prêts concessionnels « remodelés » sont efficaces pour le développement, sous réserve que le niveau de la dette reste soutenable.

S'agissant de l'efficacité relative des deux instruments de l'aide, M. Raffinot insiste sur le danger que représenterait une exclusion des pays pauvres très endettés (PPTE) des marchés financiers, les montants d'APD étant trop limités pour assurer le financement de leur développement. Il voit en outre dans les conclusions du sommet de Glenneagles un véritable changement de logique (d'un allègement de la dette à son annulation totale). Ce recul sur l'endettement des PED au niveau souverain entre en contradiction avec les préconisations de la microfinance au niveau micro-économique (où il serait possible de prêter aux très pauvres avec des taux de remboursement honorables). Il rappelle que le don « empoisonne » les relations entre le donateur et le receveur, ce dernier se trouvant dans l'incapacité de refuser, et que l'efficacité des instruments de l'APD tient pour une large part à leurs modes de gestion. Les

commentateurs s'accordent également sur la nécessité de réformer la comptabilisation de l'APD afin d'en exclure les coûts d'administration et de rendre compte du coût budgétaire réel pour les donateurs en découplant les éléments prêt et don. Ces questions de définition, outre leur sens économique, ont un impact non négligeable en termes de politique économique des bailleurs.

S'agissant de la faisabilité technique des propositions émises, P. Reding attire l'attention sur le fait que l'efficacité des instruments de prêt suppose la mise en place de conditionnalités crédibles. Se pose en outre la question de la détermination des seuils de vulnérabilité, des types de chocs externes retenus, etc. Enfin, s'agissant de la faisabilité politique des propositions, il est clair que ce type d'innovations dans les instruments financiers exige une coordination des bailleurs afin de répartir les risques et d'éviter les comportements de passager clandestin (quid de la Chine par ex., non membre du CAD mais désormais l'un des principaux bailleurs en Afrique ?).

En somme, la crise de l'endettement n'est pas tant le résultat d'un excès de prêts, mais d'une multiplication des chocs, notamment sur les prix des produits de base. S'il n'existe pas encore de solution à la vulnérabilité des PED aux chocs, des prêts bien conçus semblent mieux à même que des dons de gérer cette volatilité. Surtout, il appartient aux agences de développement, bi- et multilatérales, de tirer parti de leur position privilégiée pour faire bénéficier les PED de toute la palette d'instruments offerte par l'ingénierie financière actuelle.

Introduction and summary

This volume presents the proceedings of the conference “Financing Development: What Are the Challenges in Expanding Aid Flows?”, organised jointly by the Agence Française de Développement and the European Development Research Network (EUDN) and held on 14 December 2005.

In a context of repeated policy commitments by donors to increase aid budgets and debt cancellation, as well as initiatives to raise fresh financial resources, the aim of this conference was to debate the conditions required for efficient, productive use of the resources earmarked for developing countries.

The discussions addressed the following issues: How should aid needs be evaluated? What role can aid play in countries with an impaired institutional environment? What links exist between donor coordination and the uses of aid, and what are the implications for development policy ownership by recipient countries? Should aid be delivered in the form of loans or grants? What links exist between absorption capacity and the disbursement constraints of aid agencies? William Easterly, Arne Bigsten, Daniel Cohen, Pierre Jacquet, Helmut Reisen and Jakob Svensson presented four papers dealing with specific aspects of this debate. Their main arguments are summarised in this introduction.

23

1. How to assess aid needs?

In giving a whimsical warning of the potentially shocking nature of the remarks that were to follow, William Easterly set the tone for his deliberately provocative presentation, which takes an iconoclastic stance regarding conventional ideas on the aid needs of developing countries.

1.1. *Who is responsible?*

His paper criticises the Sachs report and the United Nations Millennium Project, pointing out that they systematically make reference to central planning and set a plethora of bureaucratic goals (449 recommendations on how to achieve 54 Millennium Development Goals, which are in turn grouped into 8 broad MDGs), whereas the only effective means of fighting poverty is action on the ground, based on experience. Moreover, a progress report on the development outcomes obtained in sub-Saharan Africa testifies to the blatant failure of the plan, which, far from leading to an effort to identify who is responsible, has been used as an argument for increasing the volume of ODA (\$100 billion by 2010, or twice the current volume) in high-profile media campaigns. The World Bank and the IMF are also singled out for criticism, as their poverty reduction plans often set their sights too high for the countries where they are implemented, and the effects of these plans are in any case difficult to isolate. Easterly's central criticism of the approach adopted by aid agencies, particularly the MDG initiative, concerns the lack of individual accountability. As the theory of multiple agents teaches us, collective responsibility, spread over a multitude of actors and goals, leads to a total lack of responsibility. As a result, no individual can be blamed for the fact that the generosity of rich countries brings no results, especially since the direct beneficiaries of aid have little say in the matter. Thus, the rationale for aid is like a snake swallowing its own tail, with the amounts of ODA and the Millennium Goals determining, and being determined by, each other, in a circular and wholly irrational manner.

1.2. *How should aid needs be assessed?*

The second section of Easterly's presentation describes the three models developed in the 1950s to determine the volume of ODA needed by developing countries. Aid institutions still refer to these models, even though their authors acknowledge that these approaches have grave shortcomings. First, the "financing gap" model (as well as a "two-gap" variant that includes external financing) defines the desirable amount of aid as the difference between the investment required to reach a given growth rate (for example, enough to cut poverty by half) and actual current domestic investment, even though observation has clearly rejected any such simplistic link between aid and growth. Second, the "poverty trap" model postulates that, below a certain subsistence level of income, people can undertake no investment for

the future; they thus find themselves locked into a situation of virtually zero growth unless they receive an aid package designed to pull them out of this trap. However, a statistical test for stagnation of per capita income in the countries in the poorest income quintile over 50 years rejects this hypothesis for all periods studied except the most recent (1985-2001). During the latter period, the lowest quintile did show lower average growth than the others (by 1.1 %), but the countries making up the quintile changed considerably over the period, and those which remained in it for long periods are precisely those which received substantial aid. It may therefore be concluded that other explanatory factors, such as bad governance, are more relevant than the poverty trap argument. Lastly, the social expenditure model postulates a direct link between aid granted in social sectors such as health and education and the value of the services received by the people (e.g. the cost of medicine for one patient), which leads to a derisory estimate of the amount of aid required to achieve a given objective (e.g. reduction of infant mortality); here again, the empirical data indicate only a weak link between these two variables.

In conclusion, Easterly emphasises the success of countries that have engineered their own development (India and China) and the need to stimulate this kind of endogenous experience by seeking practical solutions rather than by implementing comprehensive, pre-determined schemes that offer no incentive to provide measurable services. His pragmatic view is encapsulated in the succinct phrase that the best aid plan is to have no plan, and that the best answer to the question of how much ODA is required is not to ask the question.

1.3. Commentary and discussion

Giovanni Andréa Cornia, who initiated the discussion of Easterly's presentation, stressed its somewhat nihilistic nature. The arguments expressed therein could lead to the abandonment of any attempt to plan and to set objectives, and leaving development entirely up to market forces, since the countries that have succeeded did not, in Easterly's view, require any aid. Cornia recognises, however, the difficulty of setting quantitative targets such as the MDGs, given that external shocks can have as much impact as aid (e.g. the financial crisis in Argentina). Although he also acknowledges the shortcomings of the models for assessing aid needs presented by Easterly, he issues a warning against the debatable correlation between slow growth and poor governance

(China, and even Japan or Italy, may serve as partial counter-examples). Thus, the complexity of aid mechanisms and the political-economy dimension on both the donor (tied aid, etc.) and recipient sides should not lead us to demonise the bureaucracy of international organisations, but rather to recognise the limits of private-sector action and to rehabilitate collective responsibility, particularly with respect to public goods such as education and health.

The second discussant, John Burton, endeavoured to reply to Easterly's head-on criticisms of the ideas defended by the DFID. The multiplicity of the MDGs can thus be explained by the complexity of poverty, which cannot be reduced through the use of a one-dimensional model. The arbitrary nature of the figures proposed as targets is less important than the political act of choosing a reference point and refocusing the end purpose of aid on poverty (instead of on, say, exports). The MDGs should thus be taken "seriously, but not literally", and should allow for some adjustment based on geographical differences. Moreover, governments need to set targets, budgets and policies as a framework for their activity. Lastly, the link between aid and growth is still being widely debated, and one should not take an overly restrictive view of it.

The discussions stressed the fact that the MDGs are primarily a political signal that aid should be reoriented towards health and education, and the primary reason for setting them is to stimulate awareness of what is at stake in developing countries, just as the financing gap model served as a policy instrument at the United Nations in the North/South debate (and in the case of the European Union's structural funds). In addition, and despite the difficulty of planning every action in detail, it is important to set a direction for a country: China and India have made efficient use of the aid they receive precisely because these countries have strong public policy and a clear strategic vision.

The discussions also focused on the issue of responsibility. While collective action has its limits in terms of incentives and accountability, no optimal model of individual responsibility has yet been proposed as an alternative. How, for example, would coordination be handled? With what degree of decentralisation? Similarly, it would still be necessary to give explicit expression to the development models underlying Easterly's presentation (are there increasing returns? multiple equilibria?) and to analyse the limits of one-dimensional approaches (such as action in the health sector alone).

2. Absorption capacity and disbursement constraints

Jakob Svensson analyses the incentive problems that distort the behaviour of both donor countries and aid beneficiaries. Taken together, these constraints have a strong impact on the overall efficiency of development aid mechanisms.

2.1. Disbursements and accountability

Aid agencies face a number of problems that are traditional in the public sector: (i) the coexistence of multiple objectives; (ii) the difficulty of assessing aid outcomes; (iii) a lack of performance incentives. Usually, the users (customers) of a country's public agencies are informed of the programmes that concern them and the benefits they can derive from such programmes; in their capacity as citizens, they can sanction the politicians responsible for the quality of service delivered by these agencies.

In the case of aid, this no longer holds true, since those who finance aid (taxpayers in donor countries) are not the direct beneficiaries and thus are not in a position to gauge its effectiveness. Aid beneficiaries, for their part, do not have the right to vote in donor countries and hence have no power to sanction those responsible for aid policy. The "feedback loop" – the mechanism that normally transmits information (and accountability) between those who pay for public policies and those who benefit from them – is thus broken in the case of aid.

27

This situation renders the three problems listed above substantially more complicated. On the donor side, first of all, the volume of aid disbursed has become the principal means of measuring the performance of the system and the main political issue, since the citizens of donor countries are not in a position to observe other variables that better represent the actual impact of aid. Second, the fact that aid agencies are not accountable to citizens explains the influence of consultants and experts in defining aid objectives. Third, the media have acquired considerable influence over foreign aid policy (much more than they have over most domestic policy issues), because they are, for donor country taxpayers, the leading or even the only source of information and feedback on this subject.

2.2. Absorption capacity and institutional constraints

On the recipient country side, in the absence of public information and of effective oversight and impact evaluation mechanisms, there is a high probability that aid flows will be captured by other beneficiaries than those initially targeted by aid programmes. In two major education programmes implemented during the 1990s and evaluated *a posteriori*, "leakage" (funds not allocated to the purposes they were supposed to serve) amounted to 80% of the amounts of aid allocated in Tanzania and 87% in Uganda.

Other organisational problems compound the risks of aid inefficiency. First, the coexistence of multiple objectives and the rate of staff turnover in aid agencies give agency personnel an incentive to focus on tasks for which they have some chance of being rewarded. These tasks generally entail significant quantitative investment, whereas other goals that may be more qualitative but are also less easy to measure and to operationalise are considerably more difficult to justify to one's superiors, and are thus relegated to the back burner or simply dropped. Second, institutional pressure to commit and disburse aid funding is structurally strong, regardless of the quality of aid outcomes. Thus, the threat that aid will not be disbursed unless certain conditionalities are met is ultimately not very credible. Third, and lastly, the presence of multiple principals (i.e. donors) considerably increases transaction costs (including the cost of "poaching" human resources in beneficiary countries) and engenders formidable collective action problems.

Svensson points to several ways of addressing this series of problems: greater involvement of beneficiary populations in evaluation of aid, and specifically mobilisation of the local media to inform the public on current programmes and to force politicians to account for their management of aid funds (Svensson analyses among others the example of Uganda); and systematic coordination among donors, as in the case of the Marshall Plan, in which the United States clearly played the leading role.

2.3. Commentary and discussion

Christopher Adam's commentary is focused on two points. First, Adam considers that the situation described by Svensson, emphasising incentive problems and

institutional constraints on aid, minimises the progress made by donors. Considerable progress has been made in independent evaluation (e.g. at the IMF), transparency and accountability (e.g. at the DFID), coordination (through the Paris Declaration of March 2005 and the designation of lead donors) and performance incentives (see the incentive conditionalities of the European Commission).

Second, Adam points out that the shift towards more budget support is not an unmixed blessing, as it could give rise to further macroeconomic pressures. Since donors cannot credibly commit to providing stable, irreversible long-term aid flows, a massive inflow of aid may paradoxically be interpreted as bad news by the domestic private sector: if aid volumes were subsequently to decrease, budgetary and public spending inertia would then trap the government, which would have become accustomed to large aid flows. To forestall this risk of budgetary and inflationary pressures (and even the expectation that such a risk would arise), Adams proposes that strict budget discipline be maintained and special hard-currency reserves built up throughout the period of aid inflows. Donors should encourage the use of these instruments to avoid the risks of aid-induced macroeconomic volatility.

During the discussion, Patrick Guillaumont pointed out that, despite the numerous incentives for disbursement mentioned by Svensson, donors today are facing the problem of extremely low disbursement levels. Pierre Jacquet remarked that the debate is highly focused on the constraints facing donors and gives little attention to how aid could also help to increase beneficiaries' absorption capacity. He also explained that independent evaluation plays at least two additional roles for an aid agency, apart from its function of impact evaluation properly speaking: an internal role involving the monitoring of activities and learning how to achieve efficiency, and a role in making donors accountable. Each of these aspects works through a different mechanism.

John Burton supported the idea of constituting reserves to cover the risks of future volatility and believed that beneficiary countries would not be opposed to such a step. Marcel Fafchamps pointed out that aligning donor objectives with beneficiaries' objectives is an idle fancy, since, by definition, if they were aligned there would be no need for aid agencies and aid could simply be paid directly to governments requesting it. Katia Michaelowa emphasised the link between microeconomic evaluation and macroeconomic instability: the positive response of Uganda's government following the

evaluation of its education policy made Uganda a donor darling, whereas others, such as Tanzania, at the same time became “aid orphans” where education is concerned. Jean-Marc Châtaigner argued in favour of extending the time horizon of aid and aid evaluation, as well as placing donors in a competitive situation in which beneficiaries play a predominant role in selection.

In conclusion, Jakob Svensson repeated that evaluation cannot be expected to perform miracles and that it alone will not resolve the enormous problem of non-accountability that characterises the aid industry. Donors will have to devote considerably more effort to experimenting with all the tools and mechanisms that might help alleviate this problem.

3. Donor coordination and the uses of aid

3.1. Conceptual framework

With the emphasis today being on programme aid, coordination among donors has become a crucial issue that has given rise to several international initiatives, including the Rome Declaration (2003), the Paris Declaration (2005) and the Commission for Africa report (2005). Arne Bigsten sets out to list the elements covered by the concept of coordination, finally retaining four aspects: (i) the development of joint aid planning, management and disbursement mechanisms, (ii) gradual simplification of procedures so as to reduce the burden on partner governments, (iii) information sharing to promote transparency and improve coordination and (iv) coordination of objectives and policy.

Jean Nêmo added that donor harmonisation could be undertaken at several levels: (i) project implementation, (ii) programme implementation, (iii) national policy positions and (iv) international strategies enabling donors to agree on broad priorities.

The key issue is the impact of harmonisation on the development effectiveness of aid, but this link is difficult to establish and analyse. The discussion therefore focused on its impact on policy formulation and implementation, that is, its impact on transaction costs and incentive structures for recipient countries.

Reviewing the literature on this topic, Bigsten notes that most economists use a principal-agent model (one donor and one recipient) to model the relationships engendered by the transaction (i.e. a transfer of funds). In this model, an increase in the utility of both donor and recipient following the transfer depends on the condition that the two partners have identical or at least very similar preferences. If this condition is not satisfied, a familiar moral hazard problem arises in which the agent tends to modify its behaviour once the contract is signed, which raises the issue of how to control recipient behaviour and incentives. Conditionality thus becomes the price to pay if recipients are to obtain ODA.

According to Jean-Pierre Cling, this type of model shows neither the advantages nor the disadvantages of donor coordination, and it is therefore necessary to use a multiple-donor model. Torsvik (2005) demonstrates the value of coordination via a model using a two-element utility function (domestic consumption and consumption by the poor in the recipient country). If an additional donor is involved, the utility of the first donor increases if cooperation is established between the two. Various models of cooperation (not designed specifically for the case of ODA) can be applied to this situation, showing that collective action can make it possible to reach goals that are inaccessible to a single individual. In this case, the analysis of transaction costs is based on the returns to scale arising from harmonisation. Cling points out a disadvantage of these models: none of them indicates any potential negative effect of coordination on aid effectiveness (such as a cartel effect).

3.2. *The evolution of donor coordination*

Despite the proliferation of international initiatives and agencies responsible for aid coordination, very little progress has been made. Lacking harmonisation of approaches, however, the focus on poverty reduction and the international community's adoption of the Millennium Goals have brought about harmonisation of broad objectives. On the other hand, the implementation of aid policies engenders a degree of competition among donors. According to Clemens and Jacquet, such competition stems from the fact that bilateral donors are nation-states that need tangible, visible achievements in order to persuade their taxpayers and justify aid provision. This constraint also explains why the share of total aid that is allocated through multilateral institutions has stagnated since the 1970s and why bilateral aid has persisted.

3.3. *The impact of coordination on transaction costs and incentives*

In theory, harmonisation efforts have the effect of reducing the transaction costs of aid (the costs of preparing, negotiating, monitoring and implementing loan or grant agreements). Clemens stresses that such gains are very difficult to measure and that no convincing estimates are available. The few studies that have been carried out indicate that the benefits of harmonisation are rather slight, which raises the question of what priority should be given to these efforts. Clemens concludes by calling for further research in this area.

The impact of donor harmonisation efforts on recipients' incentives to conduct good public policy is still more uncertain. A certain amount of empirical evidence tends to show that the fragmentation of aid among multiple donors has a negative impact on governmental bodies in recipient countries. Alioune Sall pointed out that this risk is all the greater because some donors operating in recipient countries act in accordance with their own priorities, without taking account of local thinking on which development strategies should be adopted. Building on this remark, Pierre Jacquet distinguished two types of country: (i) countries that have the capacity needed to define their own development strategies, in which case donor coordination takes place within the framework of this strategy under the leadership of the recipient government, and (ii) countries where such capacity does not exist and where a measure of donor interference is necessary.

In conclusion, although the donor community is in agreement that harmonisation efforts should continue, particularly within bodies such as the OECD Development Assistance Committee, there is a lack of theoretical justification for such efforts. This lack is particularly crucial when it comes to measuring their impact on development effectiveness. Many questions remain unanswered: Should harmonisation be a priority for donors? Is not a certain form of competition inevitable, or even necessary, to give donors an incentive to mobilise more funding, improve their practices and strengthen the dialogue with partner countries?

4. Beyond "grants versus loans"

The over-indebtedness of developing countries and recent efforts to resolve this problem have since 2000 engendered a controversy over ODA instruments, with an

"alliance" of conservatives and anti-globalisation NGOs asserting that concessional loans to poor countries should be abandoned and that such countries should be financed exclusively through grants. Against this background, Daniel Cohen, Pierre Jacquet and Helmut Reisen present an analysis of the comparative advantages of these two ODA instruments, from which they derive a number of suggestions for donor action.

4.1. *The relative effectiveness of grants and loans*

Pierre Jacquet stresses that this controversy is useful primarily because it shows the extent to which the grant element in ODA loans is hidden. It thus offers an opportunity to argue for greater transparency in the use of taxpayers' money. Jacquet points out that any concessional loan is a loan at market rates combined with a subsidy. Grants already make up the bulk of ODA (75% of gross disbursements in 2004), and a truly new approach would be to consider the reasons why the share of loans in total ODA is so small.

According to those who argue that public donors should refocus on grants, (i) the financial markets are presumably in a better position to assess risk and to adjust loan terms and conditions to national contexts; (ii) aid agencies have sometimes been tempted to push recipient countries to take out new loans for the purpose of refinancing earlier ones; (iii) in contrast, grants that are subject to conditionalities would provide positive incentives for beneficiaries and have a greater development impact; (iv) lastly, separating the loan element (provided by the market) from the grant element (provided as ODA) would entail no additional cost for either donor or recipient.

33

Loans do have a number of comparative advantages, however: in particular, they help to build management capacity in recipient countries, as well as improving budget discipline. Whereas grants have the effect of decreasing tax collection efforts, loans provide an incentive for more sound management of public spending and demand more responsibility on the part of both lender and borrower.

Most important, the proponents of the grant approach base their arguments on the assumption that developing countries have free access to the financial markets – an assumption contradicted by the actual practice of financial institutions. This consideration leads Daniel Cohen to the Lucas paradox: why do the financial markets not lend to the

countries most in need of capital? Factors that explain these countries' difficulties in finding the resources they need on the market include the weakness of their institutional frameworks (making it impossible to guarantee that loans will be repaid), an inadequate supply of the basic infrastructure needed by investors (such infrastructure itself calls for long-term loans at soft rates), the high relative price of capital in developing countries and the extreme volatility of such countries, which leads private sector investors to demand large risk premiums for providing financing.

The theoretical and empirical analyses available thus do not indicate that grants are superior to loans. To the contrary, an exclusively grant-based approach to the least developed countries would amount *de facto* to creating a class of assisted countries which would be definitively excluded from private capital markets. In addition, markets have great difficulty in assessing risk in developing countries, whereas aid agencies can rely on better knowledge of conditions on the ground and relationships built up over the long term. Similarly, public lenders are better able to provide flexible management when circumstances are difficult, thus avoiding serious financial crises (cf. the debt reduction initiatives). Lastly, the studies available do not allow us to draw any conclusions about the respective impact of loans and grants on growth.

It can thus be seen that the real challenge is to avoid cutting the developing countries off from access to credit, while at the same time learning to manage debt more effectively. This challenge calls for the modernisation of ODA.

4.2. *Recommendations for action*

Jacquet identifies three main avenues for improving ODA practices. First, diversify the partners involved: in addition to national governments, donors should be able to lend or grant more than they do today to local authorities, the private sector, civil society organisations, etc. Second, rethink the role of donors: instead of being mere dispensers of aid, which itself is evaluated basically by volume, they should become the proponents of "development financing solutions" that combine market and non-market instruments (e.g. through guarantees, public-private partnerships and incentives to produce global public goods). Third, devise new types of loans, designated "contingent loans", whose repayment terms would allow borrowers to avoid falling once again into a spiral of over-indebtedness.

Among the possible technical solutions, Jacquet calls for creating new instruments including a contingency clause that allows for debt cancellation in the event of a shock (e.g. by indexing debt service to export prices). Cohen proposes using the grant element of concessional loans to constitute reserve funds. These “cushions” would be used in the event of a shock in order to hold the debt down to a sustainable level. Dividing up developing countries into groups according to their level of vulnerability would allow for adjustment of the required level of reserves. These types of instruments, apart from preserving developing countries’ access to the financial markets, would leverage private resources while offering beneficiary countries the possibility of moving into a different risk category. Moreover, borrowers would have greater incentive to repay their debts, first, because of the prospect of receiving more funds later on, and second, if these reserves are considered as ODA for accounting purposes, which would limit moral hazard problems.

4.3. *Commentary and discussion*

The discussants agreed to the hypothesis put forward by the authors: that “remodelled” concessional loans are effective for development, provided that debt is held to sustainable levels.

With regard to the relative effectiveness of the two aid instruments, Marc Raffinot stressed the danger of excluding the heavily indebted poor countries (HIPC) from the financial markets, as the amounts of ODA provided are too small to finance their development. In addition, he sees in the conclusions of the G8 summit in Gleneagles a real change of rationale (from debt reduction to total debt cancellation). This change of position regarding the sovereign debt of developing countries is in contradiction with the recommendations of micro-finance at the microeconomic level (where it is alleged to be possible to lend to the very poor with respectable rates of repayment). Raffinot recalled that loans “poison” relations between donor and recipient, as the latter finds itself in a position where it cannot refuse, and that the effectiveness of ODA instruments largely depends on how they are managed. The commentators also agreed on the need to reform the accounting treatment of ODA in order to exclude administrative costs and show the real budgetary cost of aid to donors by dissociating the loan and grant elements. These definition issues, apart from their economic meaning, have a non-negligible impact in terms of donors’ economic policy.

With regard to the technical feasibility of the authors' proposals, Paul Reding draws attention to the fact that the effectiveness of loan instruments depends on the establishment of credible conditionality. The question also arises of how to determine vulnerability thresholds, which types of external shocks to consider, etc. Lastly, as regards the political feasibility of the proposals, this type of innovative financial instrument clearly requires donor coordination in order to spread the risk and to avoid free-rider problems (consider the case of China, for example, which is not a DAC member but is now one of the biggest donors to Africa).

In short, the debt crisis is not so much the result of excessive lending as of a series of shocks, notably to commodities prices. Although no solution has been found to the problem of developing countries' vulnerability to shocks, well-designed loans seem better suited to managing such volatility than grants. Most important, it is up to development agencies, both bilateral and multilateral, to make use of their privileged status to let developing countries benefit from the full range of instruments offered by financial engineering today.

How to assess the need for aid? The answer: Don't ask

by

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1. Introduction

The aid community is awash in plans, strategies and frameworks to meet the very real needs of the world's poor, complete with cost estimates of "the need for aid". This paper contends that these exercises make sense only in a central planning mentality in which the answer to the tragedies of poverty is a large bureaucratic apparatus to dictate quantities of development goods and services by administrative fiat. The planning mindset is in turn linked to discredited theories, such as that poverty is due to a "poverty trap", which can be alleviated only by a large inflow of aid to fill a "financing gap" for poor countries. The aid inflow is of course administered by this same planning apparatus.

This is bad news for the world's poor, as historically poverty has never been ended by central planners. It is ended only by "searchers", both economic and political, who explore solutions by trial and error, have a way to get feedback on these solutions and then expand the ones that work, all of this in an unplanned, spontaneous way. Examples of searchers are firms in private markets; democratically accountable politicians; even non-democratic politicians who take a pragmatic, gradualist and experimental approach to policy making with local feedback; and front-line aid workers who adapt solutions to local demand.

2. The night of the planners

The desire of the international aid community to estimate “needs” itself reflects how planning has taken over foreign aid. The terminology of “planning”, along with its synonyms of “framework” and “strategy”, increasingly dominates aid discourse. The direct inspiration for this seems to be the Millennium Development Goals (MDGs) exercise. Lest this be thought an exaggeration, consider the following quotation from Jeffrey Sachs and the UN Millennium Project (2005) on how to assess aid needs for the MDGs:

“a needs assessment is a key input to... a policy *plan*.... The second stage of the *planning* process will be for each country to develop a long-term (10-12 year) *framework* for action for achieving the MDGs.... This MDG *framework* should include a policy and public sector management *framework* to scale up public spending and services, as well as a ... financing *strategy* to underpin the *plan*. The third stage of the *planning* process will be for each country to construct its medium term (3-5 year) poverty reduction *strategy* (PRS) based on the long term MDG *plan*. The PRS [poverty reduction *strategy*] is a more detailed, operational document, and should be attached to a Medium Term Expenditure *Framework* (MTEF).” (emphasis added)

It is perhaps understandable that aid officials would turn to complicated plans, strategies and frameworks in order to try to meet 54 Millennium Development Goals by 2015. (Some will object that there are only 8 MDGs. Apparently embarrassed at just how baroque the MDG exercise is, the designers of the MDGs have grouped the 54 goals, called “indicators”, into 18 groups of “targets”, which are in turn aggregated into the 8 MDGs.) Sachs (2005) and the UN Millennium Project (2005) offer a package proposal on how to achieve the 54 goals, comprising 10 key recommendations (which are actually 36 recommendations when all the bullet points are counted), “a bold, needs-based, goal-oriented investment framework over 10 years”, 17 Quick Wins to be done immediately, 7 “main investment and policy clusters” and 10 problems to be solved in the international aid system. In a 451-page main report with 3,300 pages of technical annexes, the Millennium Project proposes 449 separate interventions to meet the 54 MDGs by 2015. Sachs (2005, p. 285) recommends that the UN Secretary-General run the plan personally, coordinating

the actions of thousands of officials in six UN agencies, the UN country teams, the World Bank and the IMF.

The IMF and World Bank, for their part, are fervent advocates of free markets for prosperity, not statist strategising, but some unlucky countries are so poor that they face the requirement to engage in statist strategising anyway. This takes the form of a Poverty Reduction Strategy Paper (PRSP). The preparation of the PRSP requires planning that would overwhelm the most sophisticated government bureaucracy anywhere, much less the under-skilled and under-paid government workers in the poorest countries:

"The sector ministries prepare medium-term strategic plans that set out the sector's key objectives, together with their associated outcomes, outputs, and expenditure forecasts (within the limits agreed upon by the Cabinet). These plans should consider the costs of both ongoing and new programs. Ideally, spending should be presented by program and spending category with financing needs for salaries, operations and maintenance, and investment clearly distinguished." (Klugman, 2002)

If they have any time left after all this planning (not to mention time left after their meeting with the hundreds of donor missions that arrive every year to check up on the plan), they can also come up with a plan for those same donors, namely:

"an external assistance strategy in the context of the PRSP process that explicitly identifies the priority sectors and programs for donor financing... More detailed external assistance strategies can then be developed for key areas through sectoral working groups in which representatives of major donors and line agencies participate.... Agreeing on financing priorities for individual donors within the framework of a global external assistance strategy, rather than through bilateral agreements...." (Klugman, 2002)

At least the PRSP requirement is relaxed for failed states; it is thus limited to such peaceful, politically stable, abundantly staffed, well-governed poor countries as Cambodia, Democratic Republic of the Congo and Sierra Leone¹.

1. <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTPOVERTY/EXTPRS/0,,contentMDK:20240478~pagePK:210058~piPK:210062~theSitePK:384201,00.html>.

The planning nightmare deepens further when we consider that each individual aid agency actor is offering its own plan, which it can disguise only by claiming that its plan is necessary for achieving the overall MDG plan. Thus we get such mixed-species curiosities as the World Bank's 2003 *Comprehensive Development Framework Progress Report*, whose main title is *Getting Serious About Meeting the Millennium Development Goals*. The Comprehensive Development Framework (CDF), conceived by former World Bank President James Wolfensohn in 1999, must still be integrated into the MDG plan even though it has since been superseded by the IMF and World Bank's PRSP plan. Not to be left out of the planning race, even such unrelated bodies as the World Trade Organisation offer an "Integrated Framework for Least Developed Countries" (IF), which of course will connect to everybody else's plans. The IF should "incorporate [a] prioritized Action Plan (Action Matrix) into the country's national development plans such as PRSP"². The World Bank's admirable report on excessive red tape for private business in poor countries, *Doing Business*, has yet to turn its attention to the Gordian knot of CDF/ PRSP/ IF/ MTEF/ MDG planning (see World Bank, 2005).

Who is motivated to implement all of these plans? Who will be held accountable if the plans fail? Apparently, nobody. The UN Secretary-General issued a progress report on the MDG plan for the UN World Summit in September 2005 (United Nations, 2005). Along with some successes in regions where foreign aid has little role (India, China and East Asia), the report recited a litany of failure³:

"In sub-Saharan Africa, which already had the highest poverty rate in the world, the situation deteriorated further and millions more fell into deep poverty" (p. 6).

"The decline in hunger is slowing" (p. 7).

"Almost half of all deaths among children under age 5 occur in sub-Saharan Africa, where progress has slowed owing to weak health systems, conflicts and AIDS" (p. 19).

"A safe, effective and relatively inexpensive vaccine has been available for over 40 years. Still, measles strikes 30 million children a year, killing 540,000 in 2002

2. http://www.wto.org/english/tratop_e/devel_e/teccop_e/if_e.htm.

3. I am grateful to William Duggan of Columbia University, who has his own articulate take on the paradox of the UN's highlighting failure while disavowing any responsibility, for calling this report to my attention.

and leaving many others blind or deaf. Global coverage of measles immunization has risen slowly, but is lagging in Oceania, sub-Saharan Africa and Southern Asia, where about a third of all children are still unprotected" (p. 20).

"There was no change in sub-Saharan Africa, where maternal mortality is highest" (p. 23).

"Forests are disappearing fastest in the poorest regions" (p. 30).

"The growth in the number of slum-dwellers is outpacing urban improvement" (p. 35).

The report documents that the MDG plan is failing. Yet it never occurs to the UN to take responsibility for the failure of the plan it conceived, sponsored and publicised. Instead, our attention is directed again to the question of "aid needs": "If all new commitments are honoured, aid is expected to exceed \$100 billion by 2010. Still, this falls short of the amounts widely considered necessary to achieve the MDGs."

The IMF and World Bank's reports on the MDGs obey the same logic of failure without responsibility. We are told first of failure ("For the poorest countries many of the goals seem far out of reach") and then of the need to expand aid ("Many of the poorest countries will need additional assistance and must look to the rich countries to provide it")⁴.

In other words, the aid community should increase further the scale of the plans that are currently failing. The reason for pointing out failure is not to hold anyone accountable, but to document the continuing "aid needs", i.e. to give a rationale for further expansion of aid. The UN and the World Bank reports do not explain why the poor need more of the same thing that previously failed to address their needs.

The failure to meet goals could of course occur not just because of the ineffectiveness of the UN, the World Bank and other international organisations in delivering services to the poor, but also because the goals were too optimistic or depend on factors beyond the control of these organisations (this excuse is less applicable for something so measurable and feasible as measles vaccination). Far from absolving the aid community, however, this only raises the question of why so much

4. <http://ddp-ext.worldbank.org/ext/GMIS/gdmis.do?siteId=2&menuId=LNAV01HOME1>

energy is devoted to a campaign (the MDGs) that creates no positive incentives for actors because it promises too much in matters that the actors cannot control. In its *PRSP Sourcebook*, the World Bank itself cautions poor countries against setting overly optimistic targets in the PRSPs for exactly this reason: "Most often [the PRSP targets] are overambitious; they are technically and fiscally unattainable, which defeats their role as effective incentives to action" (Christiaensen *et al.*, 2002). The same document also warns: "it must be possible to disentangle the effects of poor performance by the implementing actors from the effects of external shocks". While poor country governments are held to this standard, the international organisations that design the Millennium Development Goals are apparently exempt from these same sensible rules.

The international organisations also seem oblivious to the problem that multiple goals and multiple agents pose for the incentive structure facing aid agencies. Having multiple goals (54 in this case) is equivalent to having multiple principals. It is well known in principal-agent theory that having multiple principals weakens the overall incentives for the agent to deliver to any one principal. Indeed, the optimal strategy for each principal is to try to penalise the agent for effort towards other goals in favour of effort towards the principal's own goal. In the aggregate, all the principals' incentives cancel each other out and the agent is left with little or no incentive. An agent with multiple tasks gets credit for doing some tasks and hence is not as motivated to complete any one task as an agent would be whose sole responsibility was that one task. To put this in everyday intuitive terms, a worker with multiple bosses can tell each one that he is too busy to work on that boss's task because he is working on the other bosses' tasks.

Having multiple agents creates the obvious problems of collective action and free riders. If everyone is to blame when something goes wrong, then nobody is to blame. Operating in the Bolivian mountains are the International Monetary Fund, the World Bank, the Inter-American Development Bank, USAID, the US Drug Enforcement Administration, the UK Department for International Development (DFID), just about every other rich country's aid agency, many NGOs and Bono. These agencies jointly affect what happens to economic development in Bolivia, but none is responsible for a particular outcome. When something goes wrong in Bolivia, such as the economic and political crisis in 1999-2005, after years of effort by these agencies, which one is to blame? We

don't know, so no one agency is accountable. This weakens the incentive of agencies to deliver results.

Introductory economics explains why cultivators with individual property rights (individual responsibility) get much better results than collective farms (collective responsibility). The Chinese economic miracle started with the realisation of this principle in the Chinese countryside. Jeffrey Sachs scorns these principles: "Although introductory economics textbooks preach individualism ... our safety and prosperity depend at least as much on collective decisions to fight disease, promote good science and widespread education, provide critical infrastructure, and act in unison to help the poorest of the poor" (Sachs, 2005, p. 3).

Of course, there are public goods, like those mentioned by Sachs, in which collective action problems must be solved. Rich societies do this through democratic accountability of individual politicians and bureaucrats to the voters. Voters want roads, so they vote for politicians who set up specialised ministries responsible for providing good roads. In rich country bureaucracies, the ministries of health, foreign affairs, treasury, defence, pensions and sports do not have collective responsibility for good roads. Rather, each of these ministries has specialised tasks in its own area for which it is accountable to the politicians, who are in turn accountable to the voters. That is why I can usually get a pothole in a road outside my house fixed with one phone call to a public official. Unfortunately, the foreign aid system has neither democracy, nor accountability to the poor beneficiaries, nor specialised responsibility.

The IMF and World Bank have many well-trained economists aware of introductory economics textbooks, yet they still produce documents with statements by their respective leaders like: "How to generate momentum? This report sets out an agenda spanning the responsibilities of all key actors" (IMF-World Bank, 2005, p. xi).

Instead of promoting individual agencies' accountability for specific tasks, the aid community engages in such fantasies of collective responsibility as the following: "The Paris High Level Forum on Harmonization, Alignment, and Results brought together developing countries, bilateral donors, global funds, UN agencies, civil society, and international financial institutions to assess progress and chart the way forward, including through monitoring of agreed indicators of progress" (IMF-World Bank, 2005, p. 235).

With such fatal defects, why is the MDG exercise so widely embraced? The political economy of aid in the rich countries tends to reward grand gestures and utopian promises rather than piecemeal efforts to improve gradually the well-being and opportunities of the poor. The former attracts Bono, Angelina Jolie and Tony Blair; the latter attracts only hard-working front-line aid workers who toil in the field mostly unnoticed by the public and media in rich countries. In other words, rich country politics rewards those who make the largest promises, particularly in a situation where there will be only weak monitoring years later of whether the promises were kept (and even then the collective responsibility system will protect any one actor from being singled out to blame for failure).

More prosaically, the MDGs may appeal to many aid agencies because they offer some hope of answering the question in the title of this paper: how to assess the need for aid? Unfortunately, the models used to calculate costs from goals are themselves vestiges of the long-discredited planning mentality that dominated the early days of development economics, as discussed in the next section.

Even if it were possible to estimate costs from goals, however, this only begs the question of how the goals were determined. Millennium Development Goal 1 is to cut in half the proportion of people living in extreme poverty (as well as halving the proportion of hungry people, with six indicators altogether, so as usual Goal 1 is actually six goals). Why half? Why not cut it by two-thirds or three-quarters? Why does Sachs plan to achieve the end of poverty only by 2025, rather than 2020, or 2015? Even if we ignored the already fatal modelling problem, the only hope for pinning down "aid needs" is to pin down goals.

The *PRSP Sourcebook* that guides the IMF and World Bank PRSPs gives some crucial insight into what is going on with the Millennium Development Goals: "Mobilizing resources is without doubt a primary function of targets set by the international donor community such as the International Development Goals" (Christiaensen *et al.*, 2002). There is something to admire in the World Bank so brazenly stating that the whole thing was circular all along: increased aid is required to reach the goals, and the goals are required to increase aid. Although this circularity destroys any last shred of hope of determining at what number the "aid needs" reach closure, mathematical indeterminacy is nothing compared to the public relations genius of the whole exercise.

3. The ghosts of models past

If Rip Van Winkle were an aid policy maker, he could have gone to sleep in 1955 and woken up in 2005 without too much discomfort. The same models that were used to justify foreign aid in the 1950s are used in 2005, unfortunately distracting attention from the real problems of creating incentives to make aid effective. These models give undeserved and spurious precision to “assessing the need for aid” today.

Three models, all of them now discredited in the literature, underlie the estimates of “aid needs”:

The “financing gap” or “two-gap” model of aid, investment and growth;

The “poverty trap” model of underdevelopment;

The expenditure-to-outcomes model in health and education.

We will discuss each of these three models in turn.

3.1. The ghost of financing gap

One of the most widely cited papers estimating the costs of meeting the Millennium Development Goals is by three World Bank researchers (Devarajan *et al.*, 2002). One has to feel some sympathy for the contortions these well-regarded authors had to go through to arrive at an estimate, which they say more or less explicitly that they do not believe themselves. The central exercise in the paper is to use the “financing gap” or “two-gap” model of aid, investment and growth to estimate aid requirements.

45

According to this model, economic growth is proportional to investment, which in turn is financed by domestic saving plus foreign aid. To reduce poverty rates by half (Goal 1 of the MDGs), one calculates a “required growth rate”, which in turn determines a “required investment rate”. If domestic savings is not adequate to finance “required investment”, then there is a “financing gap” – the difference between required investment and available savings. The role of aid is to fill the financing gap. (A variation on this model was the “two-gap model”, which included a foreign exchange gap in addition to the investment-saving gap.) The model predicted that investment would increase one for one with aid and that an increase in investment would have a predictable, stable, immediate effect on growth. Thus aid seemed to be a panacea for creating economic development. After the 1960s and 1970s, however, the

development economics literature discarded these simplistic predictions in the face of evidence to the contrary⁵.

In case there is any doubt that this is exactly the model the authors are using, they say, "To estimate the additional ODA [official development assistance] needed to reduce poverty rates to half of the 1990 levels, we begin with a simple, 'two-gap' growth model in which growth depends upon the level of investment and the efficiency with which investment is turned into output" (Devarajan *et al.*, 2002). In a footnote, the authors note that the gap model suffers from some defects, namely being outdated and wrong: "The workhorse development model of the 1960s and 1970s, the two-gap model has been criticized as being inappropriate for projections (Easterly [1999]) and for analyzing policies (Devarajan *et al.* [1997]) and poverty (Devarajan *et al.* [2000])".⁶

In other words, the authors themselves give no reason to believe in the model (including their own previous research). Nevertheless, the estimates they made on the basis of this lack of conviction became the benchmark for much of the discussion about "aid needs" for the MDGs. Coincidentally, their calculation was that aid should approximately double, the same increase that World Bank President James Wolfensohn had called for publicly before the paper was written (simultaneously embraced by Tony Blair, Gordon Brown, Bono and other dignitaries).

3.2. *The poverty trap*⁷

The second model assumes that the poorest countries are in a poverty trap, from which they cannot emerge without an aid-financed "big push", involving investments and actions to address all constraints to development, after which they will have a "takeoff" into self-sustained growth and aid will no longer be needed. This was exactly

5. See discussion in Easterly (2001), Chapter 2.

6. The references are Devarajan, S. *et al.* (1997), "Simple General Equilibrium Modeling", in J. Francois and K. Reinert (eds.), *Applied Methods for Trade Policy Analysis: A Handbook*, Cambridge University Press, New York; Devarajan, S. and D. Go (2000), "A Macroeconomic Framework for Poverty Reduction Strategies", World Bank (processed), Washington, DC; Easterly, W. (1999), "The Ghost of Financing Gap: Testing the Growth Model Used in the International Financial Institutions", *Journal of Development Economics* 60(2): 23-38.

7. This section is based on Easterly (2005).

the story that gave birth to foreign aid in the 1950s; it is exactly the story that the advocates of a massive aid increase are giving today⁸.

According to Sachs and the UN Millennium Project, among others, the big push of massive aid increases is supposed to get poor countries out of a “poverty trap”, which automatically prevents very poor countries from growing. As Sachs explains:

“When people are ... utterly destitute, they need their entire income, or more, just to survive. There is no margin of income above survival that can be invested for the future. This is the main reason why the poorest of the poor are most prone to becoming trapped with low or negative economic growth rates. They are too poor to save for the future and thereby accumulate the capital that could pull them out of their current misery.” (Sachs, 2005, pp. 56-57)

Sachs also argues that the poverty trap stems from increasing returns to capital:

“An economy with twice the capital stock per person means an economy with roads that work the year round, rather than roads that are washed out each rainy season; electrical power that is reliable twenty-four hours each day, rather than electric power that is sporadic and unpredictable; workers who are healthy and at their jobs, rather than workers who are chronically absent with disease. The likelihood is that doubling the human and physical capital stock will actually more than double the income level, at least at very low levels of capital per person.” (p. 250)

47

Under these circumstances, Sachs argues, “foreign aid ... would enable the economy to break out of the poverty trap and begin growing on its own” (p. 250).

We can check this story out. A statistical compilation by the economist Angus Maddison provides data on per capita income from 1950 to 2001 for 137 countries (we will exclude Communist economies and Persian Gulf oil producers as special cases). We rank countries according to their per capita income in 1950. Did the poorest countries in 1950 remain stuck in poverty over the next half century? The answer is no: the poorest fifth of countries in 1950 increased their income over the next five decades

8. The classic references are Paul Rosenstein-Rodan, Sir Arthur Lewis and Walt Rostow.

by a factor of 2.25, while the other four-fifths increased their incomes by a factor of 2.47. The difference in growth rates between the two groups is not statistically distinguishable from random fluctuation. We can statistically reject the notion that the growth rate of the poorest countries as a group was zero. When all periods are examined, only the 1985-2001 period fits the “poverty trap” story; we will return to this period shortly.

Table 1.
Testing the poverty trap for long periods

| Per capita growth per year for: | 1950-2001 | 1950-75 | 1975-2001 | 1980-2001 | 1985-2001 |
|--|-----------|---------|-----------|-----------|-----------|
| Poorest fifth at beginning of period indicated | 1.6% | 1.9% | 0.8% | 0.5%* | 0.2%* |
| All others | 1.7% | 2.5%** | 1.1% | 0.9% | 1.3%** |
| Reject stable income for poorest fifth | Yes | Yes | Yes | Yes | Yes |
| Fail to reject unstable income for poorest fifth | Yes | Yes | Yes | Yes | Yes |

*Poorest fifth not statistically distinguishable from zero.

**Growth of all others statistically distinguishable from poorest fifth.

Sample: 137 countries. Statistical tests exclude 12 transition economies and Gulf oil states.

Source: Maddison.

Other statistical tests can be used to assess the poverty trap hypothesis. If this hypothesis holds, then the poorest countries should have stagnant income at a very low level. Income will fluctuate randomly around this level but will always tend to return to it. We can test whether low-income countries have stationary income in two ways: we can assume stationarity and see whether the data reject that assumption, or we can assume non-stationarity and see whether the data fail to reject that assumption. When we test for the stagnation of income over the subsequent half century for the poorest fifth of countries in 1950, we decisively reject the hypothesis of stationarity. When we assume non-stationarity – such as positive growth – the data provide no evidence against that assumption.

Perhaps it was aid that enabled poor countries to break out of stagnant income? If we break the sample in half into those poor countries that had above-average foreign aid and those receiving below-average foreign aid, we find identical results for 1950-2001 in the two halves, as with the above tests of stationarity. Over the 1950-2001 period, countries with below-average aid had the same growth rate as countries with

above-average aid. Poor countries without aid had no trouble recording positive growth⁹.

Among the poorest countries, to be sure, there were individual countries that failed to grow. Chad had zero growth from 1950 to 2001. Zaire/Democratic Republic of the Congo actually had negative per capita growth over this period. Aid still has a role to play in helping those unlucky enough to be born into a stagnant economy.

The stagnant economies were offset by such success stories as Botswana, which was the fourth poorest in 1950 but increased its income by a factor of 13 by 2001. Lesotho was the fifth poorest in 1950, but increased its income by a factor of 5 over the half-century. Other success stories that were among the poorest in 1950 are China and India.

Let us keep looking for confirmation of the two main predictions of the poverty trap hypothesis: (1) that growth of the poorest countries is lower than other countries, and (2) that per capita growth of the poorest countries is zero or negative. The poorest did have lower growth in an earlier period, 1950-75, than the others. However, this was not a poverty trap, as their average growth during this period was still a very healthy 1.9 per cent per year (roughly the same as the long-run growth rate of the United States' economy, for example).

There is no evidence of lower growth for the poorest countries in recent periods, such as 1975-2001 or 1980-2001. Their growth was disappointing – much worse than in the previous period – but so was growth in middle-income countries. The poorest fifth of countries at the beginning of those periods posted growth performance over the subsequent period that was statistically indistinguishable from the other four-fifths of countries. Only when the starting point is put at 1985 does there finally appear evidence that the poorest performed less well.

The evidence that Sachs (2005) adduces for the poverty trap is from this later period. Thus, from 1985 to the present, it is true that the poorest fifth of countries have

9. More systematically, a large literature on aid and growth fails to find a robust causal link from aid to growth or to investment. See Rajan and Subramanian (2005) for a survey of where this literature stands now, and for their own tests of the aid and growth relationships.

had significantly lower per capita growth (about 1.1 percentage points lower) than other countries. Even for this period, however, we reject the hypothesis that all of the poorest countries had stable per capita income from 1985 to the present.

The numbers in the table do not seem to add up: the poorest countries did not have lower growth in the whole period 1950-2001, but they had slightly lower growth in 1950-75 and much lower growth in more recent periods. The solution to the conundrum is that the identities of the poorest countries at the start of each period keep changing. It does not help the poverty trap story that 11 of the 28 poorest countries in 1985 had *not* been in the poorest fifth back in 1950. These countries were not stuck in poverty but rather declined into poverty, while others escaped. If the identity of the countries in the poverty trap keeps changing, it must not be much of a trap.

To make things worse, in the last decade the poorest countries were getting more foreign aid as a percentage of their income than in previous decades (as we saw above in the case of Africa). Foreign aid is supposed to be helping the poor countries escape from the poverty trap; hence the poorest countries in the recent decade should have been *less* likely to be stuck in poverty than the poorest countries in previous decades, which received lower foreign aid. (We test separately below for whether aid raises economic growth.) All told, the evidence of a poverty trap snapping shut on the poorest countries is not very strong.

Other scholars have also failed to find any evidence for a poverty trap¹⁰. Kraay and Raddatz (2005) studied the saving rate and found that, at low income levels, saving does not behave in the way required by the poverty trap hypothesis. The reasons why countries stay poor must lie elsewhere.

What about the lower growth and stagnation observed in poor countries in the 1985-2001 period? The UN Millennium Project and Sachs argue that it is the poverty trap rather than bad government that explains poor growth of low-income countries and the failure to make progress towards the MDGs. According to Sachs (2005), "the claim that Africa's corruption is the basic source of the problem [the poverty trap] does not withstand practical experience or serious scrutiny". Similarly, the UN Millennium Project

10. Kraay and Raddatz (2005); Graham and Temple (2004).

(2005) affirms, "Many reasonably well governed countries are too poor to make the investments to climb the first steps of the ladder".

Why does it matter whether it is bad government or a technological poverty trap? The case for planning is even weaker if planners must deal with the complexities of bad government. Sachs (2005, p. 226) worries that, "If the poor are poor because ... their governments are corrupt, how could global cooperation help?" Unfortunately, whether poor country governments are corrupt must be determined by evidence, not by hopes for global cooperation.

Let us test bad government against the poverty trap as a story for poor economic growth. The earliest available rating on corruption is the International Country Risk Guide, which dates from 1984. We also have a rating on democracy for the same year from Polity IV, a research project at the University of Maryland. Countries that have the worst ratings on both corruption and democracy will be designated "bad governments". While poor countries did worse, it is also true that the 24 countries with bad governments in 1984 had significantly lower growth from 1985 to the present: 1.3 percentage points slower than the rest. There is some overlap between these two stories, as poor countries are much more likely to have bad government. So which is to blame, bad government or the poverty trap? When we control for both initial poverty and bad government, it is bad government that explains slower growth. We cannot statistically discern any effect of initial poverty on subsequent growth once we control for bad government. This is still true if we limit the definition of bad government to corruption alone. The recent stagnation of the poorest countries appears to have more to do with awful government than with a poverty trap, contrary to the Sachs hypothesis.

3.3. The expenditure-to-outcomes model in social sectors

Returning to Devarajan *et al.* (2002), the authors of this paper also report an attempt to derive aid needs for the MDGs based on the costs of inputs to the health and education outcomes covered by the MDGs. Of course, it is one thing to estimate the cost of providing a health service as being, say, \$1 per drug dose, and quite another to assume that an additional \$1 of foreign aid will result in a drug dose being given to a sick patient. Much as they did with the "gap model", Devarajan *et al.* explain that they see no reason to believe their own calculations: "empirical evidence from developing

countries suggests only a weak link between public spending on education and school enrollments, or between health expenditures and mortality or disease".

The authors of the empirical works cited by Devarajan *et al.* (Filmer, 1999; Filmer *et al.*, 2000), who are also World Bank researchers, point among other things to the results of a survey taken at government health centres in the Mutasa district of Tanzania. In the survey, new mothers reported what they least liked about their birthing experiences assisted by government nurses. The poor mothers-to-be were "ridiculed by nurses for not having baby clothes (22 percent) ... and nurses hit mothers during delivery (13 percent)"¹¹. Owing to the insistence on working through governments, aid funds get lost in patronage-swollen national health bureaucracies (not to mention international health bureaucracies). In countries where corruption is as endemic as any other disease, health officials often sell aid-financed drugs on the black market. Studies in Guinea, Cameroon, Uganda and Tanzania estimated that 30 to 70 per cent of government drugs disappeared before reaching the patients. In one low-income country, a crusading journalist accused the ministry of health of misappropriating \$50 million in aid funds. The ministry issued a rebuttal: the journalist had irresponsibly implied that the \$50 million disappeared in a single year, whereas the sum had actually been misappropriated over a three-year period.

The same fallacy – that aid service costing implies aid service delivery – is at work in the Millennium Project's *Investing in Development* (2005), Sachs' *The End of Poverty* (2005) and the earlier *Report of the Commission on Macroeconomics and Health* (World Health Organisation, 2001). Each of these works contains elaborate costing exercises based on unit costs of multitudinous inputs, but each fails to address the issue of how countries will be motivated to deliver these inputs to the poor in such a way that they produce better outcomes. Devarajan *et al.* (2002) cite, as support for the estimates in their paper, the estimates of the Commission on Macroeconomics and Health, which are based on the same flawed methodology that their paper disqualifies on evidentiary grounds.

11. Filmer *et al.* (2000). Bureaucracies in rich countries where clients have little voice could be equally oppressive, such as the customs and immigration services in the United States. During the Clinton Administration, the US government tried to make various agencies more client-friendly. According to an anecdote recounted by John Nellis, the response of customs officials to this initiative was "we don't have clients; we have suspects".

4. Conclusions

The exercise of estimating “how much aid is needed” shows a planning mentality at odds with elementary principles of economics. That foreign aid by itself could accomplish the MDGs was always a delusion. Most of the hope for reduction of poverty and human suffering comes from the self-reliant efforts of the poor themselves in free markets. While aid community planners were dithering about whether to increase foreign aid by \$50 billion for all poor countries, the citizens of just two large poor countries – India and China – were generating an increase in their income of \$715 billion every year.

Aid can still do much good for the poor, but only when individual aid agents have the incentive to deliver tangible services for which they can be held accountable. The bad incentives created by top-down planning, collective responsibility and multiple goals can be replaced by individual accountability for aid agents, based upon independent evaluation of aid outcomes, which will motivate a search for what works in the field under the varied circumstances of each time and place.

The best aid plan is to have no plan. Just reward aid agencies for doing more of what works, and less of what does not work. It is not possible to say how much aid “is needed”. However, when the public in rich countries sees aid delivering the many things that do work to expand opportunities and reduce suffering for the poor, then public support for more aid will increase accordingly.

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by

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William Easterly has presented a provocative paper that deliberately aims at making us reflect on some recent development fashions, as indicated by its ending, which argues it is impossible to estimate how much aid is needed to achieve the MDGs and that “the best aid plan is to have no plan”.

The paper revolves around six main arguments: (i) any MDG planning and costing exercise is futile; (ii) any approach to estimating aid needs is dated, reflecting a planning mentality that has been abandoned with the demise of socialism and the end of “development planning”; (iii) the economic models (such as the World Bank’s RSMS model, the two-gap model and the low-level equilibrium poverty trap model) used to estimate aid requirements are discredited and offer a poor guide to aid policy making; (iv) there is no evidence that increased aid expenditure on health, education and other social areas improves outcomes in these sectors; (v) where it occurs, development arises from the self-reliant efforts of “searchers” (firms, NGOs, communities, etc.) operating in free markets; (vi) the lack of development, especially over the 1985-2000 period, is due not to insufficient aid but to bad governance and corruption.

57

This line of argumentation provides some interesting insights, some of which are shareable. An important critique made by the paper concerns the notion that halving poverty by the year 2015 can be achieved solely by raising external aid. Indeed, the development debate is increasingly being cast in terms of increases in aid flows for the achievement of the MDGs, and therefore focuses almost obsessively on the setting of social goals, the speed of progress towards them, and the associated costing and monitoring. Such an approach is reductionist and ignores the much more important

changes that affect development, poverty, mortality, education and so on; examples of such changes include deep technological change, an uncritical and often premature shift towards domestic and external liberalisation inspired by the “one size fits all” philosophy, rising volatility and financial crises. As observed by Lustig (2000), the largest increases in poverty in Latin America during the last two decades, excluding wars, were observed on the occasion of financial and currency crises. In Russia, similarly, male life expectancy at birth fell by three years in the aftermath of the financial crisis and the 100 per cent devaluation of the rouble in August 1998. How these and other changes can be ignored by the current MDG approach – which implicitly treats them as white noise – remains a mystery to me. For these reasons, Easterly’s critique is right on target: poverty, mortality and so on are in fact much more sensitive to macroeconomic, financial and technological change (or the lack thereof) than to the aggregate volume of aid flows.

Easterly’s paper can nevertheless be criticised from a number of viewpoints. To start with, it attributes the slow growth recorded over the 1985-2000 period in a number of developing countries to bad governance and corruption rather than to a host of other macroeconomic, microeconomic and institutional factors, some of which were mentioned above. To prove his case, Easterly presents the results of a regression correlating negatively the growth in GDP per capita with the International Country Risk Guide Index (proxying corruption) and the Polity IV index (proxying the degree of democracy of a country). Both the argument and the evidence are unconvincing. While there is no doubt that bad governance and corruption are morally condemnable and that they hurt growth, they are unlikely to be “the” cause – or even the main cause – of the slow growth observed in certain countries during the last two decades.

First of all, Easterly’s regression suffers from huge measurement problems. Bad governance and corruption are notoriously difficult to define, let alone measure, and – to the best of my knowledge – there are no widely accepted indices for carrying out serious empirical analyses in this field. Developing countries are particularly sensitive to the use of such indices, which are invariably developed by Western institutions and reflect Western values, ideologies and preferences for models of social organisation.

Second, the empirical evidence on the relation between corruption and bad governance on the one hand and growth on the other is not strongly in favour of

Easterly's argument. The two fastest-growing economies, China and India, are well known to be affected by major corruption problems, while democratic institutions in China are still in their infancy. Similarly, the wunderkinds of growth of the 1960s and 1970s, Japan and the Republic of Korea, were characterised by a high incidence of kickbacks on public contracts. In Italy, while kickbacks to political parties on public contracts have been drastically reduced over the last ten years, growth has slowed markedly.

Third, it is likely that Easterly's argument and regression both suffer from endogeneity problems. Even assuming that all measurement problems are solved and that the correlation results are robust, a negative correlation coefficient does not prove causality between "bad governance/corruption" and "slow/negative growth in GDP per capita". Most likely, the dependent and independent variables are simultaneously determined by other, unobserved variables. In the case of sub-Saharan Africa, for instance, they might be determined by such variables as high illiteracy or low land productivity, which simultaneously reduce growth in GDP per capita and the salaries of civil servants, who therefore solicit bribes whenever possible.

Easterly's attribution of the slow growth in the 1980s and 1990s to "bad governance/corruption" is all the more surprising in view of other recent writings of his that point to more plausible causes of the poor economic performance in such countries. In one paper, for instance (Easterly, 2001), he argues that countries with IMF-World Bank stabilisation and structural adjustment programmes experienced a slower rise in poverty during periods of recession, possibly because of the cushioning of the crisis through Bank-sponsored social safety nets, but that these countries grew more slowly during spells of economic expansion than countries with "home-grown" adjustment programmes. In another (Easterly, 2004), he questions the ability of IMF financial programming models to guide stabilisation efforts and – by implication – long-term growth. In short, as suggested by the current debate on pro-poor macroeconomics and development policies (Cornia, 2006), there are other, possibly more relevant factors – including the nature of the macroeconomic policies followed and the neglect of agriculture – that explain the slow growth recorded by many poor countries over the last twenty years.

A second problem with the paper concerns the assertion that aid and other foreign resources have little impact on growth in recipient countries. Here the paper probably

suffers from aggregation bias. To be sure, Easterly is right to remind us about the fungibility between external and domestic resources (as suggested by the often-observed substitution between external and domestic sources of investment finance), and to note that an aid-financed increase in capital accumulation may be inefficient, leave growth unaffected and cause distortionary effects. As shown by the current debate on the effectiveness of aid and foreign direct investment (FDI), however, conclusions in this regard can hardly be generalised, since results depend on the concrete features of the aid and other flows, their sectors of allocation, the domestic institutions that channel these resources, the incentives of donors and recipients, and so on. While in many cases an increase in external resources did not raise growth and reduce poverty, in many others it did achieve these objectives. For instance, the transfer of 3 to 4 per cent of GDP for two decades to countries such as Spain, Portugal and Ireland certainly facilitated their convergence towards the average European Union GDP per capita. Positive effects of aid and FDI have also been observed in developing countries such as Mauritius, Malaysia and China (Cornia, 2006), as well as Mozambique. The key question is not whether foreign aid, FDI and international loans are effective, but rather, what are the incentives (for donors and recipients), domestic institutions, sectoral allocations of aid and FDI, accountability mechanisms, delivery channels and so on that make foreign resources generate the desired effects.

The paper's aggregation bias is particularly evident as regards the supposed lack of relation between aid-supported social expenditures and social outcomes. As rightly noted in Easterly's paper, most of the literature shows little correlation between *aggregate* health expenditure and outcomes. There is solid evidence, however, that primary health care interventions rapidly reduce infant and under-5 mortality rates (IMR and U5MR). An example is child immunisation. During the 1980s, the governments of developing countries, with the financial and technical assistance of UNICEF, which provided \$1 to \$1.5 billion in aid over the decade, raised vaccination rates from 20-30 per cent in the early 1980s to about 70-80 per cent by the end of the decade. This programme, as well as other low-cost, high-efficiency actions to promote oral rehydration therapy against diarrhoea, breastfeeding, pregnancy care, salt iodisation and so on, reduced the number of annual deaths among children of under five years of age by an estimated 3 million by the year 1990 – the fastest decline in IMR and U5MR recorded in human history. This was also a very cost-effective form of aid. Indeed, if one assumes that the number of children saved increased arithmetically between 1980 and 1990, the total

number of lives saved during that period was 16.5 million, at a cost of \$6 to \$9 a year in foreign aid per life saved. While this calculation ought to include also the important inputs made available by governments and communities in the delivery of such programmes, there is no doubt that this was an effective and low-cost form of aid.

There are many other past and current examples of cost-effective measures that work well, including smallpox eradication; the provision of basic drugs against tuberculosis, malaria, HIV/AIDS and upper respiratory tract infections; simple water pumps for rural areas that provide more than 20 litres of fresh water to each villager; micronutrients supplementation; provision of primary education and textbooks; adult literacy; conditional transfers and basic vocational training. In short, many types of programmes have been shown to be cost-effective and have clearly improved social outcomes. The main problem is that less than 20 per cent of both domestic social expenditure and foreign aid allocations are directed to such programmes because of distorted incentives on both sides of the fence. In developing countries, domestic lobbies highjack a large part of health budgets to build expensive hospitals that care for the elite, while donor support is often absorbed by activities (including the technical assistant bill for expatriate consultants) that have a limited health impact. Thus, it is the composition rather than the level of aid and domestic social expenditure that determines social impact. In this regard, the efforts of Jeffrey Sachs in emphasising the need to increase aid to basic health, education and nutrition, in calculating the approximate foreign exchange component of such activities and in advocating a rise in such aid are very much needed. In fact, he should be congratulated for his passionate advocacy in this area.

As noted, the main problem here is the political economy of donors and domestic actors, a topic that is discussed in other papers presented during this conference. Problems of tied aid, multiple principals and agents, lack of accountability, sub-optimal aid allocation between bilateral, multilateral and NGO channels, donor coordination, proliferation of NGOs, inadequate programme monitoring, short time horizons and so on erode aid effectiveness, which is dependent on often unpalatable key choices in donor and recipient countries alike. Yet we know that the basic aid programmes provided by multilateral agencies such as UNICEF, WHO, IFAD, WFP, Oxfam and Save the Children are quite effective and that their impact could be greater if the resources allocated to them were increased.

A third criticism of the paper concerns the demonisation of the word “planning”. To be sure, Soviet central planning failed, and failed abysmally. “Development planning” has also shown considerable limits and has to a large extent been abandoned. Planning for achievement of the MDGs is something much more limited, however, which does not require control of property rights, prices or resource allocation. It entails only a greater and longer-term degree of organisation and preparedness for the activities that governments and aid agencies have to implement. Public administrations, utility companies, national firms and multinational corporations all have investment plans, personnel plans, research plans, marketing plans and so on that span several years. In the field of aid as well, most decisions require early preparation and action, careful multi-year planning and strict coordination among the actors involved. Projecting the future activities needed to improve the conditions of the poor is absolutely necessary, and nothing in this regard has been discredited.

Does all this require the establishment of large, costly and inefficient bureaucracies? Not really. The effectiveness of the UN, World Bank and bilateral donors can be vastly improved, though the problem lies in most cases not so much in the degree of competence and commitment of the staff as in the political approach the agencies are asked to adopt by the main actors. Moreover, these are rather small bureaucracies. During my five years in Finland, I was often reminded that the yearly budget of the WHO worldwide was smaller than that of the Helsinki Central Hospital. Similarly, the procedures set up to compute and monitor the overall costs of foreign aid and PRSPs do not seem particularly complicated when compared with the budgeting and administrative procedures adopted by even the most efficient and decentralised governments. Of course, here too the problem may lie not so much in the size of the administrations involved or the cumbersome nature of their procedures as in top-down implementation of these procedures.

Lastly, it is difficult to believe that poverty alleviation, mortality reduction, the eradication of illiteracy and so on can be achieved through an approach inspired by the motto that “the best plan is no plan”. These problems typically result from acute market failures in weak states that are assisted by bilateral donors for whom aid is often an instrument of foreign policy, promotion of domestic industry and pursuit of other national interests. The collective action problem in all the above areas is inescapable, though obviously difficult to pursue for the many reasons illustrated in Easterly's

excellent contribution. To be sure, the amount of aid, its type, its sectoral and sub-sectoral allocation, delivery channels and incentives, as well as the accompanying macroeconomic and development policies, require a serious debate, a variety of approaches and, perhaps, a bit of the healthy scepticism that pervades Easterly's paper. To conclude, we do need a "plan", though, as many have noted, such a plan needs to be taken "seriously but not literally".

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Comment

by

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Introduction

It is a challenge to comment on a paper that criticises head-on many of the most fundamental beliefs and core policies of an industry in which one has worked for many years. Amongst the most sacred of these are the paramount importance of delivering the Millennium Development Goals; the need for government-led and government-owned poverty reduction strategies; and the need to scale up aid from its current modest level (0.24 per cent of the gross national income of DAC donors in 2004).

This commentary considers the following six issues:

- the function of the MDGs;
- the PRSP and central planning;
- the link between aid and growth;
- the poverty trap;
- the case for scaling up social sector expenditure;
- the basis on which to estimate aid “needs”.

65

1. What is the function of the MDGs and do they promote accountability?

Easterly describes the MDGs as a 54-goal agenda, which is “equivalent to having multiple principals”. This equates to no accountability for delivering results, he says, because failure on one goal can be explained either by efforts to meet other goals or by the failure of others in the international system.

The origin of the MDGs is in targets negotiated at UN conferences and summits. They are indeed a complex agenda, because the development agenda itself is complex. Poverty is multi-dimensional. Reducing it to a single "goal" would, to be sure, improve the feasibility of holding donors and recipients to account, but it would also mean that the multi-dimensional aspects of the poverty challenge would not be addressed.

Before the MDGs, the purpose of aid was unclear. The MDGs have had a value in seeking to place poverty at the centre of the aid objective framework. Growth remains a very legitimate objective, but only insofar as it leads to poverty reduction.

Other objectives of aid, such as promoting donor's exports or seeking political influence, have become far less legitimate. In the context of the MDGs, the Department for International Development (DFID) was able to make the case to abolish a scheme that promoted UK exports but did little for poverty. We were also able to gain agreement to untie our aid, which has increased the value of that aid to recipients.

The MDGs have also been extremely valuable in galvanising public and political opinion. We are able to articulate clearly what aid is for, in objective, measurable terms that relate to issues with which the public identifies.

The MDGs thus have a purpose beyond imposing accountability. Even here, though, they have some value. As the MDGs move from aspirational goals to, potentially, failed delivery, difficult questions start to be asked by the likes of Easterly about who is responsible for the failure. We as aid donors would be in a much more comfortable world if we followed his advice that "the best aid plan is to have no plan".

Targets must be SMART (specific, monitorable, achievable, realistic and timely). As we approach 2015 we need to reflect on what has been achieved and to produce new targets. Dwight Eisenhower said that "plans are nothing, planning is everything". DFID's last Chief Economist, Adrian Wood, said that the MDGs should be taken seriously, but not literally. It does not matter much, for example, whether we pick 2020, 2025 or 2030 for the next set of targets, but there is merit in having some clear goals in mind.

2. The PRSP: a central planning paradigm?

Easterly accuses donors of pushing the model of complex planning, especially in the poorest countries, which he describes pejoratively as “statist strategising”.

The PRSP aims to bring together the government and the key donors in a country behind a single strategy, which would explain how government policies, domestic resources and external aid could combine to tackle poverty. The move to one plan from multiple plans – one for each and every donor and another for the government, and each having its own monitoring framework – should surely be seen as less rather than more strategising.

A poverty reduction strategy (PRS) is indeed likely to be better designed and implemented in countries that have relatively strong planning capacity, such as Uganda, than in the weakest countries. But would donors and recipients be better off with no plan at all, as Easterly recommends? A plan, in terms of a set of objectives, an allocation of public resources and an implementation arrangement, remains a relevant tool for making the best use of public sector resources. This is surely a reasonable aspiration.

3. The link between aid and growth

One of the major arguments for aid is that it leads to additional growth, and thereby to poverty reduction. This was the basis of the aid and growth literature (following Burnside and Dollar, 2000). Easterly cites the survey by Rajan and Subramanian (2005) showing the absence of a robust causal link. Much other literature, not even mentioned in this paper, has been more positive (e.g. McGillivray, 2005¹; Clemens *et al.*, 2004).

Endogeneity in the relationship between aid and growth hampers analysis. It is not clear whether countries with poor institutions are penalised with less aid, reflecting low aid effectiveness, or rewarded with more aid because of continuing poverty. Does more aid lead to better institutions or do better institutions lead to more aid absorption? It is very difficult to find “robust” econometric evidence even when there is in fact a relationship.

1. Footnote 1 of McGillivray's paper provides a summary of the aid and growth literature.

The recent work by the IMF (Rajan and Subramanian, 2005), which seeks to unravel this evidence, suggests that the relationship between aid and growth, if it even exists, is not very robust. Only so much can reliably be discerned from cross-country regressions, and the authors acknowledge that relationships may be obscured by "noise in the data". We do not know the precise relationship between aid and growth, which is likely to be non-linear and subject to variation over time. We have no reliable counterfactuals.

Does this mean that there is no evidence base for aid? Given the weight of previous literature on the positive relationship between aid and growth, there may be further analysis which looks again at the results of the IMF paper. In any event, the case for aid may be based more on micro evidence of whether aid programmes achieve their objectives and deliver a high internal rate of return. Country case studies demonstrate typical rates of economic return from aid that exceed 20 per cent (Foster and Keith, 2003). Moreover, aid can have benefits other than through economic growth. For example, it has contributed to the increase in immunisation rates from 5 per cent in the 1970s to 70 per cent today.

4. The poverty trap

Easterly rejects Sachs' assertion of a poverty trap – the idea that there is a low-level stable equilibrium that prevents poor countries from converging with rich ones. In the period since 1950, some poor countries have become much richer, and some richer countries have become much poorer.

Development is a long-term process. It can happen very quickly in the right circumstances, but where constraints on development are great, rapid progress is hard to achieve. The notion that a quick, major push of aid is likely to lead to countries suddenly escaping the trap and rapidly converging with rich countries is a simplistic interpretation of the poverty trap.

Easterly does acknowledge that "from 1985 to the present, it is true that the poorest fifth of countries have had significantly lower per capita growth ... than other countries". Development prospects for the poorest countries have worsened in more

recent times, as a result of both the breakdown of productive systems (owing, for example, to HIV/AIDS and increased population pressure on natural resources) and changes in the global economy (as international competition has increased with globalisation and development elsewhere). Does this changed situation since 1985 not warrant a more determined response by rich countries, and not only in terms of aid?

The paper presents evidence that low growth has more to do with corruption and bad governance than initial poverty. But would poor and badly governed countries have been better off with less aid than they actually received, or worse off? The fact that a patient is still ill at the end of a course of medical care may show that the care did not cure him, but it does not show that the care did not prevent the patient from getting any worse or make his illness more bearable.

In our view, the existence of bad governance and corruption does not excuse us from seeking to help the 1 billion people living on less than \$1 per day. Celebrating the achievement of the millions of people lifted out of poverty in India and China without the help of much aid does not make aid irrelevant to the millions of people remaining poor in Africa. Two-thirds of capital flows into Africa are official flows. There is no prospect of trade and private sector investment for African countries on the scale that Asia has seen.

5. The case for scaling up expenditure in the social sectors

69

A further challenge to the case for aid is the argument that there is no causal link between expenditure on social sector outcomes and the outcomes themselves. Some countries spend little and achieve much, whilst others spend much and achieve little. In any case, there is no guarantee that extra aid for, say, health or education will be used for the purposes intended.

It is certainly possible to scale up expenditure on social services and find that outcomes do not improve. The extra funds may have an inflationary effect on the cost of services, or leakage and corruption in the system could absorb all the extra funds. But can we provide adequate health, education and other essential services in poor countries without providing additional resources? Existing budgets and incomes are too low to finance such an effort. Public expenditure on health in Africa is just \$6 per

capita, as compared to \$1,763 in high-income countries. Easterly refers to “patronage-swollen” national health bureaucracies, but frankly on \$6 per capita the bureaucracies cannot be all that corpulent.

More money alone will not deliver the outputs required, but more money would seem to be a necessary if not sufficient condition for substantial progress. It could be combined with efforts to, for example, address corruption and improve the efficiency of service delivery.

6. The basis on which to define aid “needs”

Easterly points out the circularity between a set of MDGs created in order to make the case for aid, and an aid “need” which is defined as the cost of delivering the MDGs.

In an ideal world we would have perfect information about the marginal cost and utility of aid to taxpayers (alongside information about the marginal effectiveness of every aspect of public expenditure, including perfect information about the marginal benefit of aid to recipients). In the absence of this, the approach of donors has been to agree to some ambitious but, it was hoped, attainable objectives, and more recently to seek to identify the cost of achieving them. The MDGs resulted from a political consensus, and seeking to achieve them with a costed plan seems to be less arbitrary than Easterly’s first best solution of “no plan”.

70

One can agree with Easterly that the notion “that foreign aid by itself could achieve the MDGs was always a delusion”. We need to address all aspects of the challenge – whether it is liberalising trade or supporting peacekeeping activities.

Conclusion

This is a provocative paper, and those who believe in aid should take seriously some of the core messages:

- the complexity of the MDGs makes it difficult to impose accountability for progress on individual organisations;

- PRSPs may over-stretch the limited administrative capacity of weak governments;
- the evidence on the link between aid and growth is not robust;
- evidence for the poverty trap is contradicted in history by the success of some poor countries;
- social sector outcomes are not strongly correlated with social expenditure, and it is possible that additional resources may be wasted.

Many in the aid business are willing to agree with most and perhaps all of these propositions, but I for one do not go so far as to conclude that we should abandon agreeing objectives and producing costed plans. Has Easterly thrown the baby out with the bathwater?

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Absorption Capacity and Disbursement Constraints

by

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1. Introduction

In many respects, foreign aid agencies are very similar to other public agencies in that they face a number of incentive problems, including multiple objectives, difficulties in measuring output and performance, and weak performance incentives. Although these incentive constraints are common in most of the public sector, they are often more pronounced in the aid sector. In addition, certain features of the aid business make foreign aid particularly subject to adverse incentive effects. These include the presence of multiple principals, i.e. donors, and a broken information (accountability) feedback loop between the providers and the beneficiaries.

Why do donors and recipients act the way they do? This paper tries to provide a partial answer to this question by studying the aforementioned incentive problems. While many other factors influence the way aid is disbursed and used, the key message of the paper is that to understand donor (and recipient) behaviour, these incentive issues must be thoroughly studied, and that to increase the effectiveness of aid, the incentive problems must be (at least partly) overcome. The rest of the paper is organised as follows. Section 2 discusses the implications of the broken information (accountability) feedback loop, arguing that this feature – which differentiates foreign aid from

73

domestically financed services – explains why both donors and recipients focus on the volume of foreign aid rather than on results and why contractors and domestic suppliers of aid-financed goods and services have disproportionate influence on decision making. Ways of mitigating the problems caused by the broken information (accountability) feedback loop are discussed, and this discussion is illustrated with two case studies on aid-financed public spending on primary education in Uganda and Tanzania. Section 3 offers a brief discussion of the problems caused by multiple objectives and tasks – features that are common in most of the public sector – and of why the incentive problems that arise from the multiplicity of tasks and objectives are likely to be more pronounced in the aid sector. Section 4 turns to one specific issue – the budget pressure problem – arguing that it is partly a function of the incentive issues raised in sections 2 and 3. Some evidence of the macroeconomic implications of the budget pressure problem is provided, along with a discussion of how the pressure to disburse can be relaxed. Section 5 discusses the problem of multiple principals – that is, the fact that foreign aid is handled not by one but by multiple agencies – highlighting both the transaction cost implications and collective action problems that arise when multiple donors give aid to a recipient without being fully coordinated. Section 6 addresses the difficult trade-off facing donors today between long-run objectives of institution building and the short-run objective of minimising capture and corruption.

2. A broken information (accountability) feedback loop

Foreign aid agencies, like most agencies in the public sector, face various incentive constraints that influence how they behave and how and why they prioritise the things they do. Three important incentive constraints that have been discussed in the agency literature on public administrations are (i) multiple objectives, (ii) difficulties in measuring output and performance, and (iii) weak performance incentives. Although these institutional features are common in the public sector, they are often more pronounced in donor agencies. Aid agencies differ from other organisations in the public sector in some important ways. Perhaps most importantly, the people for whose benefit aid agencies are supposed to work (poor people in recipient countries) are not the same as those from whom their revenues are obtained (taxpayers in the donor country). As noted in Martens *et al.* (2002), this geographical and political separation between taxpayers and beneficiaries blocks the normal performance feedback process.

In a standard model of public accountability, individuals and households have dual roles, as citizens and clients. As clients, individuals hope to benefit from various public programmes. As citizens, individuals and households use various mechanisms to influence and control politicians and, indirectly, the performance of the public administration. When individuals and households are well informed and have mechanisms to sanction the politicians who represent them – for example, the right to vote them out of office – the latter have potentially strong incentives to monitor public institutions and pressure them to do what individuals and households want¹. Two key assumptions in these type of models are that individuals and households as clients are informed about programmes intended for their benefit and that individuals and households as citizens can hold their representatives accountable for their actions by sanctioning poor performers (politicians).

In the case of foreign aid, geographical and political separation between the beneficiaries (clients in the recipient country) and the donors (citizens in the donor country) severely constrains both mechanisms. Citizens in the donor country have no direct knowledge or experience of the programmes financed by the aid agency. Moreover, it is very costly for taxpayers in the donor country to obtain reliable information on the outcomes of aid programmes that they finance. The intended beneficiaries (the clients), on the other hand, are not voters in the country that pays for the aid and thus have no real political leverage over domestic politicians who approve these programmes (Martens *et al.*, 2002).

The broken information (accountability) feedback loop magnifies problems arising from multiple objectives, difficulties in measuring output and performance, and weak performance incentives. It affects both donors and recipients. It also introduces additional incentive problems. First and foremost, even though many individuals – in both the recipient and donor country – are responsible for ensuring the effectiveness and sustainability of aid, no one is really held accountable (Ostrom *et al.*, 2002). This, in turn, has resulted in a number of adverse incentive effects. For example, voters in the donor country derive no direct benefit from service provision funded by foreign aid, nor do they observe outcomes in the recipient country. However, they can observe the

1. See Becker (1983) and Whitman (1995).

share of the government budget allocated to foreign aid. As a consequence, the volume of aid has become one of the key performance measures of aid, and political discussions and debates about aid in many donor countries centre almost exclusively on the question of how much should be given in aid to poor countries. To the extent that the majority of voters are in favour of assisting poor countries, this is also a focus that benefits the aid agency. An important point here is that the volume of aid and outcomes are not necessarily correlated.

The political focus on volume rather than impact also influences the way aid agencies work. When aid officials are not held accountable for performance, their incentives to spend time and effort seeking out information about the success and sustainability of ongoing projects will be adversely affected. The broken information (accountability) feedback loop also explains why the interests of domestic suppliers of aid-financed goods and services play such a dominant role in the actual decision-making process (Martens *et al.*, 2002). Consultancy companies, experts and suppliers of goods are direct beneficiaries of aid (through contractually agreed rewards) and have direct leverage on political decision-makers in the donor country. As a result, they have a disproportionately large influence on how aid programmes are designed and implemented. Cross-country work on the determinants of aid provides indirect evidence of this bias. For example, Alesina and Dollar (2000) and Collier and Dollar (2002) show that almost half of the foreign aid provided by the OECD countries has not been guided by any consideration of poverty alleviation.

Another implication of the broken information (accountability) feedback loop is that news media's influence on policy is likely to be larger for foreign aid than for most other domestic programmes. Since voters in the donor country have little or no direct experience of foreign aid, news reports are typically the sole source of information. This introduces a bias in aid policy because the news media tend to focus on newsworthy events. There is some empirical evidence of this effect. Eisensee and Stromberg (2005) find that US disaster relief, to a large extent, depends on the occurrence of other newsworthy events at the time of the disaster, which is obviously unrelated to need. They argue that the only plausible explanation for this is that relief decisions are driven by news coverage of disasters and that this news coverage is crowded out by newsworthy material. Since some types of disaster are more newsworthy than others, this also implies that certain disasters, such as earthquakes, receive a lot of attention,

while famines receive less. Eisesen and Stromberg (2005) find that to have the same estimated probability of being reported on network news as an earthquake, a food shortage must have 40,000 times as many casualties.

The broken information (accountability) feedback loop also influences the recipient's behaviour. When projects are donor-driven or donor-financed, clients in the recipient country rationally anticipate that their influence on the financier is limited at best. In short, they cannot hold the donor accountable for performance. Public officials in the recipient country assigned to the aid project or programme face a similar incentive structure and as a result have weak incentives to exert effort.

How can the bias in aid policy induced by the broken information (accountability) feedback loop be mitigated? Martens *et al.* (2002) argue that because of the broken "natural" feedback loop in foreign aid, inserting an explicit evaluation function in foreign aid programmes is necessary to eliminate performance problems. At best, however, this can be only a partial solution. First, to the extent that evaluations are handled by the aid agency itself, which is typically the case, it will be subject to attempts at manipulation. For example, lower-quality evaluation studies might be preferred, as this would make it harder to draw firm conclusions on actual performance. Moreover, even if the evaluations are competently executed, if there is no mechanism in place to act on these evaluations – i.e. no mechanism to disseminate the information to the public – the aid agency's behaviour will likely not be affected. An independent aid evaluation agency could mitigate these concerns². Second, even if donors adopt formal evaluation as a key component in aid programmes, there would still be difficulties in exercising external influence without undermining local accountability relationships (World Bank, 2003).

These problems point to the need for a complementary approach of enhancing client power. For example, when possible, donors can encourage citizens to monitor aid-financed projects through report cards and public expenditure tracking surveys, as illustrated in the case study on Uganda below.

2. In Sweden, an independent agency for the evaluation of foreign aid has been formed. However, domestic regional development concerns determined the location and budget for the new agency, raising concern about its political commitment to credible and independent evaluations of foreign aid.

2.1. Two case studies: educational spending in Uganda and Tanzania

In all governments, resources earmarked for particular uses flow within legally defined institutional frameworks. Typically, funds pass through several layers of government bureaucracy down to service facilities, which are charged with spending the funds. In developing countries, however, information on actual public spending at the front lines or by programme is seldom available. To remedy this problem, a so-called public expenditure tracking survey (PETS) was developed. A PETS is designed to follow the flow of resources through various strata of government to determine how much of the originally allocated resources reach each level. It is therefore a useful device for locating and quantifying political and bureaucratic capture, leakage of funds and problems in the deployment of human and in-kind resources. It can also be used to evaluate impediments to the reverse flow of information needed to account for actual expenditures (Dehn *et al.*, 2003).

2.1.1. The case of Uganda

The first PETS was implemented in Uganda in the mid-1990s. The study was motivated by the observation that despite a substantial increase in public spending on education, the official reports showed no increase in primary school enrolment. Specifically, the hypothesis was that actual service delivery, proxied by primary enrolment, was worse than budgetary allocations implied because public funds were subject to capture (by local politicians and public officials) and did not reach the intended facilities (schools).

To test this hypothesis, a survey was conducted of 250 randomly chosen primary schools. The survey collected five years' data on spending (including in-kind transfers), service outputs and provider characteristics. These data were then linked to survey data from 18 local governments (districts) and detailed disbursement data from three central government ministries (Reinikka and Svensson, 2004). The programme in question – a capitation grant to cover primary schools' non-wage expenditures – is a fairly standard one in developing countries. Like many other spending programmes in heavily aid-dependent countries, it was largely funded by donors. As part of an ongoing structural adjustment programme, the World Bank was also involved in monitoring the programme. When evaluated on the basis of central government budget data, the programme

appeared to work well. Funds were disbursed by the ministry in charge on a regular basis, and a benefit incidence analysis carried out by the World Bank suggested that the benefit incidence of public spending was neutral.

As in many other spending programmes in low-income countries, however, the situation on the ground was completely different from the official statistics (Reinikka and Svensson, 2004). Over the 1991-95 period, on average, only 13 per cent of the total yearly capitation grant from the central government reached schools. Eighty-seven per cent either disappeared for private gain or was used to finance various political activities at the local level. A majority of schools received nothing. The picture looks slightly better when the sample is restricted to the last year of the period. Still, only around 20 per cent of the capitation grants from the central government reached schools in 1995 (Reinikka and Svensson, 2004).

The situation in Uganda in the mid-1990s illustrates two problems due, at least in part, to the broken information (accountability) feedback loop. First, while funding the school grant programme, the donor community had no idea (and had done little to find out) about what impact it had, i.e. whether schools received the funds and, if so, whether this improved the learning environment. In fact, in this case the main beneficiaries of the school grant programme were local officials and politicians. As discussed in Ostrom *et al.* (2002), this lack of knowledge of the reality on the ground is not an exception. When donors or individual staff are not held accountable for performance, they will rationally focus their attention on other tasks. Second, the intended beneficiaries (parents) typically had no information about the school grant programme – most probably did not even know it existed – which of course made it easier for local officials and politicians to capture the funds.

The Ugandan case also illustrates the power of impact evaluations in general and of quantifying corruption in particular as a spark for reform. Hard evidence of corruption or capture is difficult for governments simply to brush aside, and the central government reacted swiftly to the high degree of local capture of education funds. Interestingly, the response was not the typical one – to improve the financial management system through increased monitoring by central government agencies. Instead, the central government decided to engage the citizenry. Led by the Ministries of Local Government and Finance, it began to publish data in the national newspapers on the monthly transfers of capitation

grants to districts. Later on, the Ministry of Education proposed extending the information campaign to all school communities. Primary schools (and district administration headquarters) were required to post notices on actual receipts of funds for all to see. In short, in this two-part campaign, information on entitlements transferred by the central government was made available through newspapers, while information on what each school actually received was posted at schools to inform parents.

In Reinikka and Svensson (2005a), we use a repeat PETS to assess the effects of the newspaper campaign. The raw data suggest a large improvement. In 2001, schools received an average of 80 per cent of their annual entitlements, and the newspaper campaign can account for a large fraction of this improvement.³

The Ugandan case also illustrates that interventions aimed at improving accountability in the public sector may be the best way, i.e. the most cost-efficient way, to improve service delivery outcomes, as social service delivery in developing countries is often plagued by inefficiencies and corruption. Specifically, both enrolments and student achievement increased substantially in schools that, due to the information campaign, managed to claim a higher share of their entitlements (Reinikka and Svensson, 2005b).

2.1.2. The case of Tanzania

The Primary Education Development Plan (PEDP) was launched jointly in 2002 by the government of Tanzania, various bilateral donors and the World Bank. The programme comprises three parts: a capitation grant disbursed both in-kind (textbooks) and as a monetary grant, a development grant for investments and a capacity-building grant.

A public expenditure tracking study on the PEDP was implemented in 2003-04 (see Tungodden, 2005, for details). In several respects, the findings were similar to the Uganda study. For example, just as in Uganda, the donor community lacked information about the programme's impact. Even more strikingly, the donor community was under the impression that a single ministry was running the programme, when in fact it was

3. Specifically, in Reinikka and Svensson (2005a) we show that public access to information can indeed be a powerful deterrent to capture of funds at the local level. We show that head teachers in schools closer to a newspaper outlet are more knowledgeable concerning the rules governing the grant programme and the timing of funds releases by the central government. These schools also managed to claim a significantly larger part of their entitlement after the newspaper campaign had been initiated.

run by three different ministries. As a result, the donors did not know how much money was being disbursed to the local administrations, nor whether these funds actually reached the intended beneficiaries.

The result of the Tanzania PETS were alarming. First, it was unclear whether all funds disbursed by the donors to finance the programme had indeed been disbursed to beneficiaries. In one of the largest programmes (the funding of school books), only around 20 per cent of the funds disbursed reached the schools on average. Thus, just as in Uganda, the donors had little knowledge about the reality on the ground, and the intended beneficiaries had little knowledge about how the programme was meant to work. The case of Tanzania also illustrates the power of impact evaluations, although the reaction here came from within one of the key donors. Specifically, when information about the project was discussed in the Norwegian news, the Auditor General in Norway initiated an investigation on whether it was inappropriate for the Norwegian Embassy to continue releasing money to the programme despite information about leakage, corruption and incomplete reporting.

3. Multiple objectives and tasks

Most donors have multiple objectives. The Swedish International Development Agency (SIDA), for example, while recently narrowing its list of main objectives to a general goal (equitable and sustainable global development), lists eight central areas for Swedish development cooperation: (i) human rights; (ii) democracy and good governance; (iii) gender equality; (iv) sustainable use of natural resources and protection of the environment; (v) economic growth; (vi) social progress and security; (vii) conflict management and security; and (viii) global initiatives to protect the environment and combat contagious diseases. Development being multi-dimensional, it is not surprising that the agencies working on development have multiple objectives. The problem with multiple objectives is that they typically imply trade-offs, particularly in the short run. Donor agencies seldom make these trade-offs explicit, so individual managers are typically uncertain about what should be prioritised in a given situation⁴. Since it is not uncommon

4. The solution is not to define a very broad and general objective that encompasses almost everything. The problem goes deeper than that.

for managers in donor agencies to shift positions at regular intervals, policy choices in a given sector or country typically shift over time, and long-term commitments become more difficult to stick to. Obviously, the recipient country may act accordingly. Trying to meet short-run objectives becomes more important than reaching long-term goals. The problem is amplified by the broken information (accountability) feedback loop and the fact that many donor organisations do not have adequate mechanisms to ensure effective knowledge transfer when managers and staff change.

Officials in an aid agency also perform a multiplicity of tasks. While this characterises job descriptions in many public agencies, the broken information (accountability) feedback loop makes the incentive problem arising from multiplicity of tasks more pronounced in donor agencies. When faced with multiple tasks that compete for their time, agents will tend to focus on those that are more likely to further their career concerns or that require less effort. Since some tasks are more easily monitored by their supervisors (such as input activities like budget, procurement, hiring of consultants), these tasks will receive a disproportionate attention at the expense of less easily monitorable tasks (for example, effort exerted in actual implementation of a project). Thus, the disruption in the performance-feedback loop, combined with the difficulties of measuring performance and the fact that career advancement is often unrelated to the performance of past projects, results in a disproportionate focus on input activities at the expense of attention given to the quality of outputs, i.e. the actual result of the aid programme (Martens *et al.*, 2002).

There is no easy way around this problem. First, with multiple objectives it is more difficult to write, or agree on, output or performance contracts, particularly if some goals are more difficult to measure or operationalise than others. Second, even if this could be solved, such a contract requires that salaries or career concerns be linked to the performance of aid projects or programmes – a type of payment schedule that is far from the traditional enumeration system of public officials in most donor countries⁵. Interventions that address the broken information (accountability) feedback loop, for example by inserting an explicit evaluation function in foreign aid programmes, could go some way to mitigating this problem.

5. Ostrom *et al.* (2002) report that only 2 per cent of the respondents interviewed at SIDA indicated that promotions are based on the performance of the projects on which individuals have worked in the past.

4. The budget pressure problem

“Both donor and recipient have incentive systems which reward reaching a high volume of resource transfer, measured in relation to a predefined ceiling.... In many administrations, both bilateral and multilateral, the emphasis is on disbursements and country allocations. Non-disbursed amounts will be noted by executive boards or parliamentary committees and may result in reduced allocations for the next fiscal year.... Results are measured against volume figures, with no regard for the quality.... Besides, when the time has come to evaluate the actual outcome, most of those responsible for the project on both sides will have been transferred.” (Edgren, 1996, p. 11)

Even in the case of a single task, there are incentive problems in the donor agency that tilt attention to committing and spending budgets rather than focusing on outcomes. In most donor organisations, allocation and disbursement decisions are made separately⁶. Typically, the allocation process is centralised (in many countries general guidelines and country allocations are set by the parliament), while the disbursement decision is decentralised (i.e. country- or project-specific). This set-up also characterises foreign aid at the project level: the planning and initiation of a project are typically coupled with a commitment of funds to that particular project, while disbursement of committed funds is a matter for subsequent decision.

This institutional set-up has resulted in a strong bias towards “always” disbursing committed funds to the recipient or project designated *ex ante*, irrespective of the recipient government’s performance, or project performance, and of the conditions in other potential aid recipient countries or projects. Thus, resources are not shifted towards projects or countries where they can be more effectively utilised, and *ex ante* “threats” of not disbursing committed aid if the recipient fails to implement certain policies are not credible. The bias, in turn, arises because the opportunity cost of a given aid budget (or a committed adjustment loan) for the disbursing donor agent is low. Why is the opportunity cost low? Studies of bilateral donor organisations have emphasised that, in practice, “spending the budget” has become a key goal in itself (Paldam, 1997; Edgren, 1996), in large part due to the problem of multiple objectives and the broken

6. This section draws on Svensson (2003).

information (accountability) feedback loop. Moreover, the existence of substantial unused resources is typically viewed as a sign that the country department, or the specific project, has a problem: why else can it not disburse its funds? Since the allocation of the overall aid budget across country departments is partly determined by the disbursement history, a country department failing to disburse its committed funds will most likely receive a smaller allocation the following year⁷. The size of the budget, in turn, not only constrains the overall spending programme of the country department, but also determines the status of the job (for general references to the theory of bureaucratic interests, see Wintroppe, 1997; Moe, 1997; and Niskanen, 1994).

The same argument applies to project- or sector-specific aid. Evaluations of the lending process within the World Bank have pointed to similar incentives. Mosley *et al.* (1995) argue that the World Bank's country loan officers are under intense pressure to meet disbursement targets regardless of how unpromising that government's subsequent implementation performance may be. Apart from the "maximisation of the budget" argument, they stress a coordination/free-rider problem: bearing in mind what other countries have gotten away with, Bank staff know that it will not be financially productive to refuse to disburse the committed funds in order to make an example of one particular recipient that defaults on its conditions. Moreover, the enforcement of conditionality might be in conflict with other goals of the Bank, such as providing quick-disbursing finance so as to forestall a potential default on outstanding loans.⁸

Donor incentives also influence the behaviour of recipients. When assistance is given as conditional aid, it typically implies that the donors pay the recipient to do something it would otherwise not do. For this to be a credible contract, the donor agent must *ex ante* have incentives to halt disbursements if the conditions have not been met. However, if the true objective of the donor agent is to disburse the budget, not the actual performance of the aid project or programme, such an aid contract will not be credible.

7. Ostrom *et al.* (2002) provide empirical evidence of the budget pressure problem at SIDA. For example, they note that in many country departments, as much as 40 per cent of the year's disbursement takes place in the last two months of the budget cycle and that it is not uncommon for division chiefs to come up with their own projects at the end of the budget year so as to increase their ability to disburse funds.

8. As discussed in Svensson (2003), there exists a number of screening devices within the World Bank to counteract any pressure towards "irresponsible" lending. However, many conditions attached to Bank loans are phrased in terms permitting a subjective assessment ("substantial progress", "satisfactory performance"), which in turn facilitates the release of tranches of committed funds.

That is, aid will be disbursed irrespective of what actions the recipient takes. This in turn adversely influences the recipient's incentives to take actions according to the contract specified *ex ante*.

The hypothesis regarding the low opportunity cost of committed funds has a stark empirical implication: the disbursement decision should be independent of reform implementation. That is, the committed funds should be disbursed irrespective of the recipients' actions. Svensson (2003) provides some preliminary evidence consistent with this hypothesis. Drawing on information from a recent study on the determinants of some 200 structural adjustment programmes (Dollar and Svensson, 2000), Svensson (2003) uses as a proxy variable of reform effort a binary variable reflecting the failure or success of World Bank-supported reform programmes, as determined (*ex post*) by the Operations Evaluation Department (OED) of the World Bank. The advantage of using this variable is that it provides a consistent measure of whether reform programmes succeeded or failed; the disadvantage is that the measure of success is subjective⁹.

To assess whether the disbursement decisions depend on perceived reform outcome, Svensson (2003) uses a two-stage procedure. First, the probability of reform is estimated by means of a probit model (following Dollar and Svensson, 2000). Second, the estimated probability is used as proxy for the perceived success of reform in explaining the difference between committed and disbursed funds. Formally, the two-step procedure can be stated as:

$$\pi_i = \text{probit}(r_i = \beta_0 x_i + v_i) \quad (1)$$

$$sfi_i = \gamma \pi_i + \beta_0 z_i + \epsilon_i \quad (2),$$

where r_i is the binary reform proxy discussed above (*reform*); x_i is a vector of political determinants of reform (as identified in Dollar and Svensson, 2000); sfi_i is the share of committed funds disbursed during the reform period; π_i is the estimated probability of reform success; z_i is a vector of other controls influencing the disbursement decision; and v_i and ϵ_i are iid error terms. Dollar and Svensson (2000) show that a small number of political-economy variables can predict the outcome of an adjustment programme 75 per cent of the time. Their results suggest that successful reform is

9. See Svensson (2003) for details.

associated with democratic government (*demo*) and political stability (*stability*). High degrees of ethnic fractionalisation (*ethnic*) are bad for policy reform, and long-term incumbents (*tenure*) are not likely candidates for reform. The basic finding in Dollar and Svensson (2000) is replicated in Table 1.

To estimate the second-stage equation, Svensson (2003) assembles data on committed and disbursed funds. As additional controls in equation (2), Svensson (2003) includes the logarithm of initial GDP per capita (*logGDPc*) and the logarithm of initial population (*logpop*). Both of these variables have been shown to be highly correlated with aid flows (see, for instance, World Bank, 1998). Mosley *et al.* (1995) argue that an implicit goal of policy-based lending is to provide quick-disbursing finance so as to forestall potential default on outstanding loans. To control for this possibility, Svensson (2003) also adds the initial debt-to-GDP ratio (*debt*).

What happens with respect to the committed funds when the recipient is perceived as failing to reform? The answer, depicted in Table 2, is “very little”. As is evident, there is no significant relationship between the share of committed funds disbursed and the estimated reform effort¹⁰. In fact, the estimated reform measure has the “wrong” sign, although it is close to zero. There is some evidence that smaller countries (measured by size of population) are more likely to receive committed funds and defensive lending; that is, countries with larger initial debt are less likely to experience cancellations of commitments, irrespective of the reform outcome. Column (2b) shows that the results are similar when only World Bank IDA lending is considered¹¹. A possible objection to the results reported above is that the dependent variable *sft* combines concessional and non-concessional sources of financing. Column (2c) presents the results obtained when the share of committed concessional funds disbursed (i.e. bilateral ODA and concessional IDA lending) is used as the dependent variable *sfc*. The results are very similar to those reported in column (2a).

How can the donor agencies relax this pressure to disburse independent of the outcome of a project or programme? A possible solution is to find ways to internalise the opportunity cost of aid at the disbursement stage. One way to achieve this is to

10. *sfti* is the share of total funds committed that was actually disbursed during the reform period.

11. *sfwbi* is the share of World Bank commitments disbursed during the reform period.

Table 1.
Probit model of reform, 1980-95

| Dep. var. | c | demo | stability | ethnic | ethnic2 | tenure | tenure2 |
|-----------|-----------------|----------------|-----------------|----------------|-----------------|-----------------|-----------------|
| Preform | -.098 (.304) | .585 (.224) | -1.30 (.330) | 5.93 (1.43) | -6.51 (1.53) | -.089 (.043) | .0033 (.001) |

Note: Standard errors in parentheses. All variables except the constant (c) are significant at the 5 per cent level.

No. of observations: 220 (reform episodes). Predictability ($p > .05$) = .75. Log likelihood: -119.8

Source: Svensson (2003).

Table 2.
Disbursement decision, 1980-95

| Equation | (2a) | (2b) | (2c) |
|------------------|--------------------|-------------------|--------------------|
| Dep. var. | sft | sfwb | sfc |
| constant | 1.23*** (.154) | .680*** (.126) | 1.94*** (.255) |
| estimated reform | -.056 (.058) | .065 (.045) | -.088 (.111) |
| logGDPc | -.010 (.013) | -.003 (.010) | -.065** (.027) |
| logpop | -.018** (.008) | .015** (.006) | -.038*** (.012) |
| debt | .0004** (.0002) | .0002* (.0001) | .0003** (.0001) |
| No. | 208 | 209 | 182 |
| R2 | .12 | .05 | .17 |
| S.E. regression | .141 | .107 | .208 |

Note: OLS estimation with White-heteroscedasticity-consistent standard errors in parentheses.

Estimated reform derived from Table 1. *** denotes significance at the 1 per cent level; ** at the 5 per cent level; * at the 10 per cent level.

Source: Svensson (2003).

pool projects and programmes, i.e. to centralise the disbursement decision to some extent. Thus, instead of committing *ex ante* a fixed amount of aid t to each recipient (or project) n , and making aid conditional on reform or outcome, the donor links the allocation and disbursement decision by committing a larger amount ($t \cdot n$) to a group of recipients or projects, but making the actual amount disbursed to each individual country or project dependent on its relative performance *ex post*. Linking the allocation

and disbursement decisions has two important advantages over present practice. First, it raises the opportunity cost of disbursing aid *ex post*, thereby giving the donor stronger incentives to use aid funds where they are most effective. Second, competition among recipients or projects (an aid tournament, so to speak) allows the donor to make inferences about common shocks, which would otherwise conceal the recipients' choice of action. This enables the donor to give aid more efficiently. Both effects also raise the incentives for the recipient to exert effort (or implement reforms).

Two objections to such an institutional reform are worth stressing. First, it could be argued that competition among recipients introduces uncertainty about financial flows, which renders planning more difficult and makes fiscal spending too volatile. This may be true in comparison with the way the aid system currently seems to work (commitments are always disbursed), but not if we compare it with the conditionality outcome as the latter is supposed to work. In fact, if the shocks facing recipients are (highly) correlated, the uncertainties will be reduced by having the recipients compete in an aid tournament.

Second, it could be argued that the degree of reform implementation, or effort exerted by the recipient, depends on domestic political-economy forces rather than on conditional aid. In fact, recent evidence suggests this to be the case (Burnside and Dollar, 2000; Dollar and Svensson, 2000). However, these studies analyse the impact of conditional aid as it seems to work, not as it was meant to work. Therefore, one should not expect any significant correlation between aid flows and policy reform. More important, the institutional reform briefly discussed above deals with the incentive structure within the donor organisation. Even if the degree of policy reform is determined solely by domestic political-economy forces, i.e. is independent of foreign assistance, linking the allocation and disbursement decisions will still be useful since this provides incentives for the donor to allocate/disburse aid to where it can be effective.

A question left partly unanswered is as follows: if linking allocation and disbursement decisions improves outcomes, why does not the donor community explicitly link these decisions? One answer is of course that the potential cost of tournament-type aid schemes is perceived as being very high (for example, the cost related to the political risk of creating competition among countries or projects). However, the extent of competition among countries, and thus the potential cost, can be controlled by varying

the share of aid disbursed through a tournament-type aid scheme. Moreover, this concern seems less important in the case of project aid. A more plausible explanation is related to the change in the existing power structure within donor agencies or the donor community implied by such a regime shift. In essence, the reform would reduce the discretionary power of many managers in charge of disbursement decisions. Moreover, making the opportunity cost explicit in the decision process would require the management to make “tougher” choices. Recipient-specific interest groups (e.g. domestic firms, NGOs), and potentially the recipient government, may also oppose an institutional change that would imply aid flows conditional on performance, rather than *ex post* unconditional disbursements.

5. Multiple principals (donors)

Foreign aid differs in yet another important way from domestically financed services: foreign aid is handled not by one but by multiple agencies. When the donors are not fully coordinated, this can give rise to severe collective action problems. An interesting historical parallel is the success of the Marshall Plan (see Knack and Rahman, 2004).

The relative success of the Marshall Plan has been attributed to the quality of the group of recipients. Unlike most recipients of foreign aid in recent decades, Western Europe had a huge advantage in putting aid to effective use. It had skilled labour, experienced managers and entrepreneurs, and reasonably efficient legal and financial institutions. Public administrations were also considered relatively competent. However, differences on the donor side may also have contributed to the success of the Marshall Plan (Birdsall, 1999). Recipients had to deal only with a single donor, in contrast to the large numbers of bilateral and multilateral donors and NGOs that are active in the foreign aid sector today. De Long and Eichengren (1993) further argue that assistance under the Marshall Plan, “history’s most successful structural adjustment program”, was not disbursed in the form of a huge number of separate donor-managed projects in each recipient country. As noted in Knack and Rahman (2004), aid success stories in Taiwan, Botswana and Korea have also been attributed to the presence of a dominant donor (Bräutigam, 2000).

The median number of official donors in recipient countries in 2000 was 23 (Acharya *et al.*, 2003), and in the typical African recipient aid is provided by “some thirty official

donors in addition to several dozen international NGOs ... through over a thousand distinct projects and several hundred resident foreign experts" (van de Walle, 1991, p. 58).

Why would the fact that multiple donors are involved with each recipient affect the efficiency with which aid is given and used? Aid involves a set of collective action problems. When there are multiple donors, each concerned partly with development in the recipient country but also with domestic concerns, individual donors will typically not internalise the full costs of a foreign aid project, while at the same time fully internalising the short-run benefits, or in some cases fully internalising the costs but not the social benefits. Specifically, one donor's action may – indirectly or directly – influence the efficiency of other donors' actions. This externality is usually not taken into account when a decision is made. The collective action problem may severely influence the efficiency of foreign aid and more generally the recipient's financial ability and administrative capacity to govern.

The costs associated with proliferation of donors can be grouped into three broad categories. The first is the increased transaction costs associated with numerous and diverse donor rules and procedures for managing aid projects and programmes (Berg, 1993). The Tanzanian government, for example, has to prepare about 2,000 reports of different kinds for donors and receives more than 1,000 donor delegations each year (World Bank, 2003). Duplications of analytical work such as poverty assessments, public expenditure reviews, governance and investment client assessments are other examples of increased implementation costs. Easterly (2003) notes that the authors of these reports are frequently unaware of recent studies on the same topic in the same country funded by a different donor.

The second type of cost arises from the fact that in many cases, foreign aid projects are associated with large fixed costs and high returns to scale. If each donor works on its own projects, these returns to scale may go unexploited.

The third category is less direct in that it affects the recipient's financial ability and administrative capacity to govern (Knack and Rahman, 2004). First, donors have tended to provide project aid – either working with individual line ministries, or engaging providers under local governments and directly funding front-line providers (schools and

health clinics) – rather than budget support. Although this is slowly changing and budget support has its own limitations, this response, while officially a response to inadequate institutions and government capabilities in the recipient country, is also influenced by the fact that each donor fully internalises the individual costs and benefits of a project but does not fully internalise the more diffuse notion of strengthening the recipient's financial, budget, and service delivery systems, as budget support is thought to do.

Second, donors tend to support only capital spending (investment), expecting the recipient government to supply complementary inputs (staffing and maintenance). In this case, each donor in effect treats the budget for recurrent expenditures as a common-pool resource (Bräutigam, 2000), producing a tragedy of commons in which roads are built but not repaired, and schools and clinics are constructed but not staffed. Noting the widespread failure by recipient country governments to maintain infrastructure funded by foreign aid once construction is completed, donors have often reached the wrong conclusion about causes. Specifically, many observers have pointed to a lack of “ownership”, not to the failure to internalise the externality, i.e. the reduced capacity to maintain other donor-funded projects if a new project is initiated. Advocates of financial sustainability emphasise the importance of local ownership of projects, and they promote actions requiring only start-up funding which then can be maintained locally without external support (Kremer and Miguel, 2004). Where the real problem is donor proliferation, such a recommendation may only exaggerate the problem.¹²

Third, individual donors typically work with counterparts in the local bureaucracy and attract these local experts by paying salary supplements to the most talented local staff (Knack and Rahman, 2004). Since the distinction between purely private consulting work for a donor and official work in the local bureaucracy is often blurred (Cohen and Wheeler, 1997), this practice distorts incentives for civil servants, causing them to turn their attention away from their other responsibilities – even those with a greater impact on development – and towards donor projects (Knack and Rahman, 2004). This distortionary effect of donor behaviour affects not only the division of effort for

12. Ownership becomes an issue when donors fund projects in which recipient governments are not interested. If a given project does not encourage a new approach through its demonstration effect, or is not specifically designed as a one-time intervention, such an approach contradicts ownership and would not be sustainable (World Bank, 2003).

government staff but also the overall allocation of talent within the recipient country. When high-level managers in the civil service can make ten times as much working directly for a donor, the most talented will leave the public sector to work for a donor (Knack and Rahman, 2004). Similarly, in many African countries, working for a donor is much more profitable than most entrepreneurial endeavours. In short, the most talented people will tend to work for donors rather than in the civil service or the private sector. As in the case of the decision to support investment rather than recurrent expenditures, donors, in deciding whether to hire the better-qualified civil servants or agents in the private sector, treat the government bureaucracy, or more generally the pool of talented people, as a common-pool resource. While an individual project manager's decision on whom to hire may not have much effect on the recipient government's ability and administrative capacity to govern, the aggregate effect may be large when all donor managers act in the same way. The total effect may be even more detrimental when one takes account of the incentive effects of having local staff work on donor projects. As working for a donor brings a relatively much higher financial return than other work, talented local staff have incentives to protect and extend aid projects from which they benefit, regardless of the merit of those projects (Knack and Rahman, 2004). Performance contracts for local staff could help to overcome the latter problem.

Some cross-country evidence suggests that the costs associated with proliferation of donors can be substantial. Knack and Rahman (2004) show that higher donor fragmentation (reflecting the presence of many donors with a small share of aid) is associated with a decline in bureaucratic quality. These results, however, should be interpreted as suggestive rather than providing causal evidence.

Should donors therefore refrain from hiring local staff or ensure that they are paid according to what they make in their current occupations? The answer is most likely no. The injection of resources from high donor-paid salaries potentially has a positive net impact on development, despite the adverse impact on the functioning of government (Knack and Rahman, 2004). This also implies, however, that the same benefits may be obtained without the negative effect on government's ability to implement and formulate policy. The recent trend towards budget support is viewed by many as a means of reducing transaction costs and providing both donors and recipients with incentives to focus on strengthening financial, budget and public service delivery systems.

Institutional arrangements such as designating a lead donor for the country or sector, as a way to get individual donors to internalise the full costs and benefits of a foreign aid project or programme, would be a way forward, although it may not be feasible politically. It should also be noted that efforts are under way to improve donor coordination on one aspect of this problem, namely efforts to reduce transaction costs by harmonising operational policies and procedures and establishing a website to disseminate information on completed and planned country work. An assessment of the extent to which these initiatives have improved outcomes would be highly valuable.

6. The foreign aid dilemma

The core problem facing the donor community is that it wants to help poor countries to alleviate poverty. Poverty in turn is a function of both exogenous and structural features which the recipient government can do little about, at least in the short run, and of the recipient government's policy decisions. This simple fact has two stark implications.

First, good aid projects and programmes will typically be associated with high risk. The very reason why the recipient needs foreign aid is that its own institutions are weak, and this will affect the expected return to aid. Thus, to allocate aid only to recipients with well-functioning institutions and good policies will typically not be optimal if poverty alleviation is the dominant criterion for foreign aid. However, owing to the broken information (accountability) feedback loop, voters in the donor country face a moral hazard problem. Observing poor outcomes, they do not know to what extent these result from an *ex ante* good aid project or programme with a risky return or from poor design or implementation by the donor. Realising this, the donor will tend to choose projects and programmes that minimise the risk of bad publicity, not those that *ex ante* maximise the expected poverty alleviation.

Second, to the extent that the recipient expects foreign aid to be governed by considerations of poverty alleviation, the recipient may have little incentive to make strong efforts (or channel its own resources) towards achieving this objective. It may well be that interventions which would assist the poor are implicitly taxed, if such interventions

would result in less aid being received in the future¹³. This “Samaritan’s dilemma” is compounded by moral hazard problems: the donor cannot perfectly distinguish whether a poor outcome is the result of low effort (bad policies) or bad luck (Svensson, 2000).

Over the past few years, several donors have argued for a shift in foreign aid practices. Partly as a response to the incentive problems highlighted above and disappointment about the aggregate effects of foreign aid during the last four decades, the argument is that donors should try to harmonise their support around recipient systems (see e.g. World Bank, 2003). When recipients have a well-functioning national development strategy, a budget process that can serve as a common framework, and institutions in place to hold both politicians and providers at least partly accountable for their actions, this recommendation makes a good deal of sense. If foreign aid should also be channelled primarily to poor countries, however, there are few potential recipients that fulfil the necessary criteria. While this problem is sometimes swept under the rug, the World Bank for example explicitly argues that these conditions are not prerequisites for the shift in foreign aid policy. Even in their absence, harmonisation and pooling of aid – typically as budget support – can offer significant benefits and reduce transaction costs (World Bank, 2003, pp. 212-13). In short, the argument for an alternative way to deliver foreign aid is that it would reduce transaction costs but also shift the responsibility and hence accountability towards the recipient. This would build recipient capacity and create stronger incentives (and free up time) for donors to monitor and evaluate impacts and results.

The concern with such an approach is the increased fiduciary risk of channelling untied funds for the recipient to use. It is a delicate matter to strike the right balance between when to pool their support and align it around the recipient’s system and when basically to continue with current practice while at the same time trying to minimise or at least reduce transaction costs. The political-economy literature on poor countries, and sub-Saharan Africa in particular, has pointed to severe and structural problems of accountability. In many African countries, power is concentrated in small elites interconnected by common schooling, marriage, friendships, shared ethnicities or

13. An illustrative example is given in Fisher (2001) and quoted in Ostrom (2002). Fisher tells of interviewing a Nuba rebel leader who visited an area in southern Sudan that had received considerable food aid from the United Nations. The rebel leader explains that although the people of the area are great farmers, they have not been farming because of the relief aid.

religion. Sustaining this power balance is costly and public funds are used to fuel a system of patronage politics, where patrons give clients material rewards for their political loyalty and services (Reinikka and Svensson, 2004). The patronage system takes various forms, including the diversion of public resources by government actors for their own campaigns and those of friends and family, and financing of local and private causes to neutralise voter dissatisfaction. Political parties must also supply patronage goods to their workers and members. In a rural setting, an important way of maintaining an effective political organisation is through personal presence, which means a well-staffed institutional hierarchy all the way down to the village level. This model assumes substantial resources, and diversion of public resources is often the only source of funding available.

If the incentives for reform, possibly including political reforms, are too weak, channelling large untied funds to the recipient may help the current elite to cement its position, at least in the short run. Such an outcome may be difficult to sell to voters in donor countries, and donors thus face the difficult pedagogical task of convincing voters in their countries that such a risk is worth taking. Promoting “citizen voice” is a complementary strategy, but probably the most difficult one for donors. Identifying what type of aid interventions can strengthen the relationship of accountability among politicians, service providers and beneficiaries is probably the most important issue facing the donor community today. As knowledge is limited and as traditional approaches to improving governance have produced weak results in most developing countries, experimentation and evaluation of new tools to enhance accountability should be high on the donor agenda.

7. Conclusion

This paper has highlighted some of the most important incentive constraints facing donors and recipients. Some of these constraints – such as multiple objectives, difficulties in measuring output and outcomes, and weak performance incentives – are problems faced by most public agencies, although they are often more pronounced in donor agencies. Others – such as multiple agents (donors) and a weak or broken information (accountability) feedback loop between beneficiaries in the recipient country and donor country voters and politicians – are unique to the foreign aid sector. The paper

argues that donors' incentives also influence the recipients' behaviour and their ability to use aid productively.

This paper is not a survey of the various incentive problems in foreign aid, and discussions of how to make foreign aid more effective need to take a much broader approach. Still, while many other factors influence the way aid is disbursed and used, the incentive problems raised in this paper are likely to be among the leading candidates for understanding donor (and recipient) behaviour. Addressing these incentive constraints should therefore be high on the agenda when donors (and recipients) discuss ways to improve how aid works.

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by

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1. Introduction

The challenges of effective scaling-up of aid to low-income countries are at the centre of contemporary policy debates amongst donors and recipients (see for example Gupta *et al.*, 2005). Much of this debate is concentrated at the macroeconomic level with a focus on resource mobilisation on the one hand and macroeconomic concerns about aggregate incentives, principally on competitiveness, on the other. However, to paraphrase the former Speaker of the US House of Representatives, Tip O'Neil, this is an area where "all macroeconomics is micro". The magnitude of macroeconomic effects depends critically on the micro-structure of the supply side of the recipient economy, on labour markets and on the incentive structures shaping the relationship between donors and recipients. Jakob Svensson's excellent paper provides a *tour d'horizon* of some of the key incentive and agency problems associated with aid transfers and offers some tentative suggestions on how they might be mitigated. His bottom line is clear: "while many other factors influence the way aid is disbursed and used, the incentive problems raised in this paper are likely to be among the leading candidates for understanding donor (and recipient) behaviour. Addressing these incentive constraints should therefore be high on the agenda when donors (and recipients) discuss ways to improve how aid works."

His paper is constructed around five key themes. To recap briefly, these are:

- Broken information flows undermine relationships of accountability between the contributing taxpayer, implementing donor agencies and the ultimate recipients of aid-funded expenditures, resulting in poor oversight of aid-financed activities by those who provide the resources and the risk of capture of aid by implementing agencies (on both the donor and recipient sides).
- Multiple donor objectives tend to generate low-powered performance incentives for donor agencies in general and aid managers in particular.
- Pressures to disburse – combined with a low opportunity cost of disbursing committed funds – undermine the credibility of donors' conditionality.
- The multiplicity of donors raises the transaction costs of aid and undercuts efficient aid allocation, generates collective action problems and may exacerbate problems of rent-seeking and patronage.
- Fundamental dynamic inconsistencies in the aid relationship produce a "Samaritan's dilemma" – the inability not to reward low reform effort.

Many of these themes are not unique to the aid relationship, but Svensson argues that most are amplified in the particular settings of the contemporary aid relationship. The principal channel of such amplification arises from the interaction of donor altruism on the one hand and the separation of payers, providers and recipients on the other.

100

The important contribution of this paper is that it goes beyond the characterisation of these incentive problems to draw out key operational implications. Specifically, the paper identifies a number of important implications for efficient, second-best mitigation of these adverse effects. Some of the suggestions have been entertained for some time – "aid tournaments", for example – but others are more novel, with the evidence on the powerful effects of information (and a media-promoted "voice") in promoting transparency and accountability in local-level education financing in Uganda.

Commentary

I shall limit my comments to three main points and devote most of my attention to the third of these, which attempts to link donor incentives and the design of aid delivery to some first-order macroeconomic concerns.

The first point is that to highlight the main themes of the paper, Svensson has, to some extent, developed a caricature of an aid process almost paralysed by incentive problems. It is true that caricatures need not be true to be useful, especially when they illuminate core issues as is done here, but in a number of instances, this caricature is rather too backward-looking and may actually obscure some of the important innovations and reforms in aid that have occurred in recent years – cases where practice is ahead of theory. One could make a case that the motivating question of Svensson's paper should not be "Why do donors behave the way they do?" but rather "Why have donors changed the way they behave?".

Consider, for example, the issues of the role of independent evaluation, of coordination amongst multiple donors and of attempts to sharpen recipients' incentives to maximise reform "effort". Across these three themes we see important developments. On evaluation, for example, the independence of the IMF's Independent Evaluation Office has proved much more robust than many critics had feared, and the office has produced a number of influential reports on the Fund's operations and instruments (for example, its report on the IMF's role in the Argentinian crisis). Svensson notes that other countries (Sweden, for example) have moved in similar directions, but this shift is more than superficial. The general rise of a culture of transparency and accountability – often outside the traditional channels of oversight – has shifted norms of public sector accountability in a range of areas, from central bank independence to freedom of information to performance charters in public services.

This cultural shift spills over into evaluating aid programmes in ways that go far beyond a simple focus on aid volumes. For example, the 2002 International Development Act in the United Kingdom binds the Department for International Development (DFID) to clear principles of transparency and accountability. This shift can be seen in other areas as well. Picking up on Svensson's first themes – the weak information link between donor-country taxpayers and recipients – we could argue that while some commentators felt that Live8 and the Make Poverty History campaign in the UK trivialised the "aid and development" debate, one important legacy of the 2005 Agenda (as well as the earlier Jubilee campaign) has been a significant increase in "development literacy" amongst the population and with it a more subtle discourse on aid effectiveness and evaluation.

Donor coordination and the design of conditionality are also probably more advanced, at least in some environments, than Svensson's caricature admits. The Paris Declaration on Aid Effectiveness of March 2005 attempts to codify some of the best-practice developments observed in a number of countries. These include the untying of aid, the use of "lead donors", the central role of sectoral Memoranda of Understanding in heavily aid-dependent economies and so on. Other developments include attempts to address specific incentive problems head-on. For example, Adam and Gunning (2002) and Adam *et al.* (2004) review the initial implementation by the European Commission of "performance-based conditionality", which attempts to address directly the moral hazard problem in conventional aid contracts.

My second point concerns the switch towards general budget support and the perception that this involves donors relinquishing "too much" control to recipients. In general, the move towards budget support and lower "micro conditionality" is to be welcomed, but this necessarily forces donors to abandon the somewhat naïve, almost apolitical model of government behaviour embedded in many PRSPs in favour of a model that explicitly recognises that recipient governments operate under the constraints of political reality. This is a very difficult issue for donors to deal with, not least because it brings issues of political sovereignty starkly to the fore. Again, we may point to DFID's *Partnerships for Poverty Reduction: Rethinking Conditionality* (March 2005) as an attempt to develop a coherent policy that recognises the political reality of the aid relationship.

102

For my third point, I want to move from the general to the specific and address a practical issue of the macroeconomic management of aid. This takes me away from the central thrust of Svensson's paper but picks up the question of the credibility and predictability of aid flows. Svensson notes recent moves towards greater reliance on budget support as a means of reducing the transaction costs of aid and, arguably, shifting "the responsibility and hence accountability towards the recipient. This would build recipient capacity and create stronger incentives (and free up time) for donors to monitor and evaluate impacts and results."

This may well be true, but there are reasons to be concerned about deeper tensions in the shift to budget support that need to be confronted by both donors and recipients. To understand these tensions, consider the following three observations:

- First, donors want aid to be spent: neither their constituencies nor their institutions are well adapted to the norms of prudence that economists preach in analysing the appropriate spending response to volatile sources of revenue or financing, most notably in the context of commodity booms.
- Second, even if donors *intend* to support scaled-up public spending programmes on a continuing basis, they cannot credibly pre-commit to doing so.
- Third, even if recipient governments *intend* to adjust spending and revenue to fluctuations in external financing, major fiscal commitments are likely to be partially irreversible, on political grounds if not otherwise.

Taken together, these observations imply that a major increase in aid carries with it the possibility of future financing gaps that will have to be made up domestically.

Under these conditions, aid surges that would otherwise be consistent with private capital inflows and stable or falling inflation (see Buffie *et al.*, 2004) give rise instead to capital outflows and high inflation. Monetary policy alone cannot handle this problem because, with thin and undeveloped bond markets, a tight monetary stance causes interest payments and future seigniorage requirements to balloon. The resulting increase in expected future inflation then creates inflation problems in the near term. Barring interventions that directly address concerns about the reliability of future aid flows or the reversibility of fiscal commitments, some degree of near-term fiscal restraint – most likely in the form of a reserve buffer stock – becomes part of the optimal policy response to aid and is a necessary component of a successful strategy. Maintaining a foreign reserve buffer stock is something that many donors have been reluctant to countenance. Denied this option, recipient governments may, at best, be forced to return to an inefficiently high level of “fiscal flexibility” or, at worst, see the private sector’s fears that aid may be temporary become self-fulfilling as a loss of control over inflation induces donors to scale back aid commitments.

Recent work by Buffie *et al.* (2005) illustrates this particular problem using a formal simulation model calibrated to the key characteristics of countries benefiting from HIPC-style debt relief, such as Uganda and Tanzania. When there is no uncertainty about the permanence of aid flows, macroeconomic adjustment is smooth and aid increases can be absorbed without macroeconomic volatility.

Very different dynamics emerge if the private sector views aid as a fiscal time bomb. In particular, when the private sector believes that high aid flows cannot last, and that when aid disappears the government will be unwilling or unable to make an immediate fiscal adjustment, a surge in aid therefore brings with it a net deterioration in the expected time path of the fiscal deficit after grants. This implies an increase in future seigniorage and a rise in future inflation. The prospect of future inflation reduces money demand even during the high-inflow period.

Pessimistic expectations may be grounded in plausible concerns about the durability of aid and the government's capacity for fiscal retrenchment. The private sector may well be too pessimistic: in reality, the aid may be permanent, or there may be no fiscal inertia. If this is not assured, however, low credibility will still alter the macroeconomic impact of the aid inflow. Low credibility reduces money demand during the high-inflow period and thereby renders any given path of the money supply more inflationary. Inflation rises in response to the aid surge.

Tight money and temporary fiscal restraint represent two natural approaches to the credibility problem. Neither approach works efficiently on its own, and we show that winning the battle against weak credibility requires a combination of fiscal restraint and the use of a foreign exchange reserve buffer in which reserves are banked during the aid inflow (the boom phase) and then sold to control money growth while fiscal adjustment takes place. This, in turn, requires donors to recognise that when they cannot resolve deeper issues of predictability, they must, at least, recognise the importance of not denying recipients the fiscal instruments needed to manage aid efficiently.

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Donor coordination and the uses of aid

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1. Introduction

From the beginnings of modern development assistance after World War II, it was already felt that having a multitude of donors providing aid would pose problems and that coordination was required. Initially, the idea was that coordination would be handled through the United Nations system, with the United Nations Development Programme (UNDP) coordinating donor activity. In reality, UNDP's role as an aid coordinator has been limited. Over time, as the emphasis of aid programmes shifted from project aid to high-conditionality programme aid, then to sector-wide approaches (SWAps), Heavily Indebted Poor Countries (HIPC) debt-reduction programmes and Poverty Reduction Strategy Papers (PRSPs), new coordination modalities emerged as well¹.

If donors now decide to increase resource transfers to Africa, as suggested by the UN Millennium Project (2005)² and the Commission for Africa (2005), the demands on recipient country policy-makers, who already suffer from aid-absorption and governance

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1. Sagasti *et al.* (2005) provide a comprehensive review of the evolution of the development financing system.
2. Sachs *et al.* (2004) argue that Africa is caught in a poverty trap, that small changes will not be enough and that African countries will not be able to break out of poverty unless large-scale foreign assistance is injected into the system.

problems, will increase further³. The concern about large aid injections is thus, how are expanded programmes to be managed⁴? Could donor coordination make it easier for recipient governments to administer aid efficiently?

Donor interest in coordination has increased in recent years⁵, and some new efforts are under way to improve it. In the Rome Declaration on Harmonisation (OECD, 2003, p. 10), donors gave a commitment to “harmonise the operational policies, procedures, and practices of [their] institutions ... to improve the effectiveness of development assistance”. The declaration went on to spell out specific steps to be taken to improve coordination and reduce transaction costs. It was followed by the Paris Declaration on Aid Effectiveness (OECD, 2005a), in which partnership commitments with regard to harmonisation, alignment, ownership and mutual accountability were further specified.

This paper discusses donor coordination and its implications for the uses of aid. This is not an easy issue to address, since there is little systematic academic research on the impact of coordination, or the lack thereof, on aid effectiveness. Some case studies are available, however, as well as some theoretical papers dealing with donor-recipient relationships and their implications for incentives and aid effectiveness.

Section 2 sets out the issues and specifies a simple framework for our discussion, and Section 3 presents a review of the theoretical literature. Section 4 provides some data on donor proliferation and discusses the evolution of aid coordination over time, in particular during the current phase of partnership and ownership. The following sections summarise the limited empirical evidence available concerning the impact of coordination on transaction costs (Section 5) and on public sector management and

3. As a spin-off of the recent literature on aid effectiveness, some empirical estimates have been published that measure the administrative constraints indirectly. Hansen and Tarp (2001) found that aid could have a positive effect on growth even in bad policy environments, but they also identified an absorption problem in the form of decreasing returns to aid.

4. Pritchett and Woolcock (2004) point out that many of the services proposed as part of the Millennium Development Goals (MDGs) are both transaction-intensive and discretionary. Unlike many macroeconomic reforms, delivery of health and education services requires the collaboration of many individuals who make highly discretionary choices in an environment where many key actions are unobservable. Such services cannot be delivered by a few politically protected technocrats. The empirical link between health and education spending and outcomes is thus notoriously weak (World Bank, 2004a).

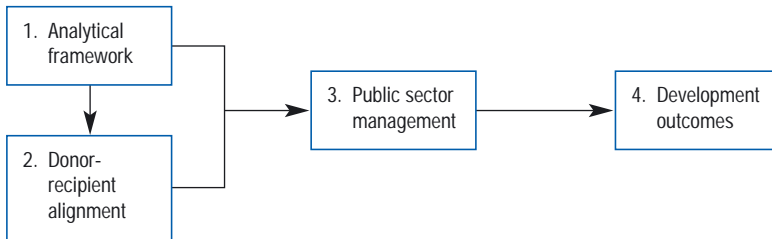
5. Tarp (2005, p. 8) notes that “the institutional set-up for bilateral aid deliveries remains complex, uncoordinated, and overburdened with many diverse tasks and aims, and calls for reform of the UN have become common”.

governance (Section 6). A key issue with regard to the latter is how donor coordination affects the incentives of the recipient government. The paper concludes with a review of the policy debate and some policy conclusions.

2. The issues: a framework for discussion

Donor coordination means horizontal coordination among donors, also referred to as donor harmonisation (1 in Figure 1), which Balogun (2005) categorised under three headings: (a) the development of common arrangements for planning, managing and delivering aid⁶; (b) the gradual simplification of procedures and specific requirements in order to reduce the burden they place on partner governments⁷; and (c) the sharing of information to promote transparency and improved coordination⁸. In addition to such essentially procedural issues, coordination may relate to objectives and policies. We will also need to distinguish explicitly among various aid modalities, primarily projects, sector programmes and macro or budget support.

Figure 1.
Analytical framework



6. Under this heading, Balogun lists increased use of joint diagnostic reviews, collaboration and joint strategies, joint operations, joint financing arrangements and common procedures for project environmental assistance.
7. Balogun lists streamlining conditionality, reducing the number of field missions, reducing the number of reports required by donors, harmonising financial management and procurement procedures, and delegated cooperation.
8. Balogun mentions that donors should allow access by partner governments and other donors to the donor's country analytical work, increase the use of diagnostic reviews from other agencies and introduce systems for regular disclosure of donors' commitments and disbursements at the country and sector levels.

To relate donor coordination to the uses of aid, we must also consider the relationship between donors and a recipient government, referred to as donor-recipient alignment (2 in Figure 1)⁹. Balogun (2005) breaks this down as follows:

- (a) Donor actions: Base donor strategies, programmes and policy dialogue on partners' national development strategies and results frameworks; to the extent possible, draw conditionality from partner's national development strategies; rely on country-owned monitoring and evaluation systems to track progress towards the objectives set out in partners' national development strategies; use country systems and procedures where these provide reasonable assurance that aid will be effectively used for agreed results.
- (b) Partner country actions: Base national development strategies on sound macroeconomic policy and poverty diagnoses; translate these national strategies into operational, results-oriented frameworks, with clear policy commitments and improved strategic prioritisation, programmes and costing; further strengthen the results orientation of national development strategies by increased focus on developing monitoring and evaluation systems that are useful for managing results; and establish mechanisms to monitor progress in implementing national development strategies that are firmly embedded in domestic institutions.

We want to identify how the uses of aid are affected by the extent and character of donor coordination. Ultimately, the question we would like to answer is what impact donor coordination can have on aid effectiveness in terms of development outcomes (4 in Figure 1), but since this link is hard to identify and analyse, we confine our discussion to the impact of coordination on public policy formulation and implementation (3 in Figure 1).

Donors affect recipient governments via the transfer of resources, but also via policy dialogue, conditionality and the like. Much of the recent growth literature has in fact identified poor institutions as the major constraint on growth, at least in Africa¹⁰.

9. We will also briefly touch upon general coordination of donor aid policies for many or all recipient countries.

10. An ambitious study trying to explain African economic growth, or rather the lack thereof, was undertaken by the African Economic Research Consortium (O'Connell, 2004; Collier and O'Connell, 2004). The main conclusion of the study is that African growth has faltered due to dysfunctional political-economic configurations or syndromes. Four anti-growth syndromes were identified: the regulatory syndrome, which refers to excessive government intervention in markets; the redistributive syndrome, in which efficiency-

An important question, therefore, is how the international community influences institutions and policy¹¹. Aid can have a positive effect on governance, to the extent that it releases the government from revenue constraints, enabling it to strengthen domestic institutions by paying higher salaries to civil servants; it may also include technical assistance and training or be used to build legal systems and accounting offices. Aid can also make it more difficult to improve governance, however, owing to the tragedy of the commons, moral hazard and free-rider problems. The question here is thus whether donor coordination could improve the positive effects while reducing the negative effects of aid.

This quick review of the issues has identified the linkages that are relevant for our discussion of donor coordination and the uses of aid. Looking at the content of the relationships, we see that consideration needs to be given mainly to two dimensions of the impact of donor coordination. Discussion among donors has focused on what can generally be called transaction costs, but another important dimension concerns the incentive effects of donor behaviour. We will discuss these two dimensions separately, though they are of course strongly related.

3. Literature review: theoretical effects of donor coordination

How could aid become more efficient if donors coordinated their efforts? When there are many independent, uncoordinated donors, responsibility for success or failure is diffused, and no single donor has much at stake in the recipient country. The presence of many donors, each concerned with its own commercial and possibly security objectives at the same time, also generates a complex set of collective action problems. Aid agencies seek to maximise their aid budgets, which requires them to satisfy their parliaments and various advocacy groups. They therefore need visible results that are clearly attributable to the donor's activities, even if the development impact of the

111

reducing resource transfers dominate in the formulation of government policy; the inter-temporal syndrome, with resources redistributed from the future to the present via, for example, looting by the elite or unsustainable government spending booms, generally followed by sharp adjustments; and the state breakdown syndrome, that is, civil wars or severe political instability. Some countries were also characterised as syndrome-free. The empirical analysis showed that an absence of these syndromes increased the growth rate by almost 2% per year.

11. Adam and O'Connell (1999) have analysed some dimensions of this issue theoretically.

development budget is thereby reduced. In fact, all these mixed incentives distract donors from maximising overall development (Knack and Rahman, 2004, p. 3). Coordination of donors' goals would alleviate these problems and increase the overall development impact of aid, even if their actions remained uncoordinated.

Coordination failures might occur even if donors had common goals, however. Hallonen-Akatwijuka (2004) identified several causes of coordination failures in the case of project aid. First, if projects are complementary, complete information about other donors' budgets is needed, and donors need to take decisions simultaneously to achieve an efficient allocation. Second, if the utility of each donor depends on projects funded by other donors, resources may again be allocated inefficiently across projects. Third, aid efforts to improve the overall administration of the country would contribute to the success of the donor's own projects but also to that of other donors' projects, and hence each donor can claim only a small share of the total benefits in terms of project success. Thus, once again the incentive to support such activities is weak.

Another type of coordination problem concerns the effect of donors' recruitment of staff in recipient countries. Knack and Rahman (2004) constructed a small model to analyse the problem of poaching in a situation where each donor is assumed to want to maximise the poverty-reducing impact of its projects. The success of projects was assumed to increase with the amount of skilled local staff time put into the project, but at a decreasing rate, so the optimal level of local administrator time in each project could be derived. Administrator input was also derived for the case where donors sought to maximise the joint impact of their projects on poverty. Knack and Rahman showed that the number of administrators hired declined when a donor's share of other projects in the country declined and when concern for the success of other donors' projects increased. Lack of coordination leads donors to recruit an excessive number of administrators. Thus, coordination of donor goals has important implications for the impact of aid.

As noted in the previous section, alignment between donors and recipient governments has important incentive aspects. A series of principal-agent models have been used to analyse alignment between one donor and a single recipient government (see, for example, Azam and Laffont, 2000; Svensson, 2000). Recently, the discussion has been extended to consider how such alignment is affected by the presence of

several donors and the extent of coordination among them. Torsvik (2005) considers a group of rich countries that independently provide aid to a poor country with a large share of its population in extreme poverty. He assumes that all the donors are poverty-averse and want to improve the living standards of the poor in the recipient country. The utility functions of the donors are assumed to have two elements: donors' domestic consumption and consumption by the poor in the recipient country. Torsvik asks whether donors should cooperate or give aid independently. Among altruistic donors, poverty alleviation is a public good. Thus, if one donor provides aid, it has a positive effect on the welfare of all donors. Failure to cooperate in such a situation leads to an under-supply of aid (the common goods problem), and cooperation is thus desirable.

Torsvik next addresses the question of how foreign aid affects policy in the recipient country. The recipient government's utility function is assumed to have two elements: consumption by the rich and consumption by the poor. Does foreign aid reduce the recipient government's incentive to use domestic resources to help its poor population? This becomes a problem if the recipient government does not share donors' priorities, and if contracts cannot be used effectively to align their interests. Torsvik shows that donors are always better off with coordination if they can use enforceable conditional aid contracts to influence the recipient's policy.

Torsvik does not believe, however, that the principal-agent model captures the donor-recipient relationship fully, modelling it instead as a non-contractible relationship. The key question in such a setting is whether the recipient can exploit the altruism of donors and extract a rent¹². Assuming that the recipient regards consumption by both poor and rich as normal goods, the arrival of aid for the poor clearly gives it an incentive to reduce domestic transfers from the rich to the poor (the crowding-out problem).

Thus, donor coordination can solve the free-rider problem, but the question is still how aid affects domestic support for the poor. Torsvik investigates two interaction regimes when enforceable contracts are not available. First, if the donors do not face a Samaritan's dilemma and all parties involved move simultaneously in a non-cooperative game, donor cooperation increases foreign support but also increases crowding-out.

12. Azam and Laffont (2000) analyse the trade-off between rent extraction and efficient poverty alleviation in the case of a single donor and a single recipient.

The incomes of the poor increase when donors coordinate and give more aid, but it is not obvious that the utility of the donors increases, since they lose consumption in their own countries while, owing to the crowding-out effect, consumption by the poor in the recipient country does not increase optimally. From the donors' point of view, donor cooperation is beneficial only if the recipient government is sufficiently poverty-averse. If the recipient gives low priority to the welfare of the poor and if crowding-out is extensive, coordination may reduce donor utility.

Alternatively, in a Samaritan's dilemma, donors act as Stackleberg followers, unable to commit not to help the poor. The recipient government realises this and adjusts its policy accordingly. It could do so by reducing its support for its poor population, which would generate more foreign aid. Cooperation among donors would again lead to increased aid flows, but not necessarily to more crowding-out. Thus, it might be beneficial for donors to cooperate when facing a Samaritan's dilemma, even if the recipient government places priority on the rich rather than the poor.

Given that donors have the welfare of the recipient country at heart, then, is it always desirable for them to coordinate? If the recipient has the same goals as donors, cooperation is clearly beneficial. If the recipient government does not share these goals and if contracts cannot be used effectively to align the recipient with the donors, then coordination is not necessarily beneficial.

4. The evolution of donor coordination

4.1. Donor coordination at the international level

At the end of World War II, the Bretton Woods conference created the World Bank and the International Monetary Fund, and the UNDP was established and given a mandate to coordinate aid (Disch, 1999, p. 12)¹³. Donor countries have been reluctant to give up control to these multilateral institutions. The share of multilateral aid in total aid increased to only about one-fourth in the mid-1970s and has remained at that level ever since.

13. The International Development Association (IDA) of the World Bank was founded in the 1960s to provide soft loans to the poorest countries.

The World Bank and the IMF are financed by their member countries and therefore provide a form of donor coordination. At times, they also play a coordinating role at country level, by serving as the lead donor or by deciding whether a country is on track or off track. If the IMF says that the reform process is on track, bilateral donors will be more likely to release money to the government, primarily as budget support. The European Union may also be seen as a coordinating agency, as European countries now channel some of their aid through it. As long as bilateral donors maintain their own programmes, however, introducing yet another agent into the aid process will be unlikely to reduce transaction costs.

Donors coordinate their handling of the debt problems of less developed countries through the Paris Club. There are also various recipient-dominated regional bodies, which naturally wield less influence than those dominated by donors.

International donor coordination at its most general level may take the form of large international meetings, resulting in agreements on general goals and principles against which donor governments can be measured and also possibly held accountable. The Millennium Summit in September 2000 is a recent example of a general conference where world leaders agreed on certain common targets, the Millennium Development Goals, for development efforts through 2015.

4.2. Donor coordination at the country level

Internally, recipient governments have established local aid coordination bodies, usually chaired by the ministry of finance or the central bank, which meet regularly or for special purposes, such as to prepare for a Consultative Group meeting. Coordination by the finance ministry is not always easily accepted by other ministries, and there is also a risk that such local bodies will undermine the role of the parliament in policy formation. Meetings focus on country-specific development problems, and the discussions may cover the whole range of objectives, policies and implementation procedures, as well as fund-raising issues. The UNDP or the World Bank can also chair meetings with the donor community at the country level to share information, discuss policy and harmonise positions.

Since the 1980s, extensive attempts have been made to introduce donor coordination at the sectoral level through sector-wide approaches (SWAPs), where

donors agree to pool resources within some specific sector such as health care. Such pooling schemes can be seen as a step in the direction of budget support, but the costs of negotiating these programmes have often been high (OECD, 2003), and progress has been rather slow.

The structural adjustment loans of the 1980s were associated with policy conditionality, as were various forms of debt forgiveness, including the HIPC programme. Domestic political and economic forces were strong, however, and they often resisted policy changes. Killick (1999), Kanbur (2000) and others have concluded that conditionality did not work very well, largely because donors could not agree to impose the threatened sanctions (the Samaritan's dilemma). Svensson (2003, p. 383) notes that there is "no link between a country's reform effort, or fulfilment of 'conditionality', and the disbursement rate"¹⁴. Conditionality was therefore rather ineffective in bringing about sustained change in recipient policies. Still, it was easier to shift the decisions of recipient governments in the direction desired by donors when the latter were coordinated.

4.3. Partnership, the Millennium Development Goals, poverty reduction strategies and donor coordination

The structural adjustment era nonetheless led many countries to shift to market-oriented policies. Since the growth outcomes were generally poor, in Africa at least, the focus later shifted from these policies towards the structures and institutions that implement them. A key question is thus how donor coordination affects policy implementation or public sector management.

Recently, the United Nations launched the Millennium Development Goals (MDGs) and the World Bank launched its Poverty Reduction Strategy (PRS), both focused on poverty reduction. These two major initiatives have not been substantively coordinated, and there is sometimes even competition between the institutions at country level. As the two initiatives have different implications for development strategy and policy choices, alignment between donors and recipient governments has been made more complicated. This problem of international donor coordination needs to be addressed.

14. Svensson (2000) suggested that one way to deal with this problem would be to delegate part of the budget to a multilateral agency that might be less poverty-averse than the donor.

Aid will be better aligned if donors pursue a common set of goals. Previously, the structural adjustment programmes filled this coordinating function to some extent. The question now is whether the new Poverty Reduction and Growth Facility (PRGF) has helped to coordinate donors and align them with recipient governments.

The international financial institutions have evaluated implementation of the PRGF in several countries (IMF-IEO, 2004; World Bank, 2004*b*), with four main results: (1) In the future, the emphasis should be placed more on establishing a good process than on producing good documents. In other words, implementation is the key¹⁵. (2) Feedback in the planning process, needed to improve forward budgeting, is still very weak. (3) Underlying analysis is also often weak and needs to be strengthened. (4) Partnership with donors remains weak in some areas, particularly in the prioritisation and costing of aid operations. The typical African country suffers from a lack of implementation capacity, and many countries are struggling under reform overload. Donors should not impose too many conditions on the government, thereby further overloading an already overworked administrative system¹⁶. In particular, they should not impose different sets of conditionalities. Lack of donor coordination makes the absorption problem even more acute.

The Poverty Reduction Strategy Papers (PRSPs) produced by African countries generally seem sensible, except that their demands on the administrative system are often high. Not only do the implementing institutions lack the required skills, but there is also serious concern about incentives. Even if people know what they should do, they may choose not to because the incentive to do so is too weak. Inadequate salaries may be the issue here, especially if administrative staff can benefit from the existing system in ways that make them reluctant to change it.

The aim of the PRGF was to give governments more policy space, and to some extent this has been achieved. The IMF has been more flexible with regard to fiscal

15. A key recommendation of the IMF-IEO (2004) evaluation is to 'shift the emphasis of the initiative from the production of documents to the development of sound domestic policy formulation and implementation processes'.

16. For example, the recent World Bank (2004a) Country Assistance Evaluation for Rwanda showed that the country was struggling with absorption problems with regard to the projects supported by the Bank. A major finding of the study was that the projects were too ambitious and too complex, given the limited capacity of the Rwandan government.

targets, and it has been more willing to overlook breaches of macroeconomic targets in countries with good performance on social expenditures. Conditionality has thus been reduced to a modest extent, but the degree of reduction that donors will accept is closely related to how quickly recipient governments can establish adequate and transparent budgeting and reporting systems.

On the whole, recipient country policy making is now based on the PRS system demanded by donors, although the process of preparing the PRSPs has involved considerable consultation with various groups in society, which may have helped to coordinate donor activities and to align them with countries' development programmes.

Compared to the Enhanced Structural Adjustment Facilities used in the past, PRGFs seem to allow greater fiscal flexibility and to support increased social spending. Often, however, the conditionality associated with them is not derived directly from the PRSP. Alignment has improved, but it could be much better. Country ownership of programmes and policies has increased, but implementation is still the problem. This needs a country-based solution, which unfortunately will not be realised any time soon.

4.4. Changes in the structure of international aid flows

Can we say anything in quantitative terms about changes in donor coordination over time? Unfortunately, there are no aggregate data on aid flows by type of coordination. As noted above, the share of aid going through the multilateral system has hardly changed since the 1970s. The multilateral institutions have thus not increased their direct control over the transfer of aid, although their influence on bilateral donors has certainly increased through the structural adjustment programmes of the 1980s and the current PRGF arrangements.

What can we then say about changes in bilateral flows? Table 1 shows change in bilateral aid by purpose. Until 1990, the largest flow went to programme assistance, including general development contributions such as balance-of-payments assistance, budget support and sector-unallocated structural adjustment assistance, which one would expect to be less prone to coordination problems than project aid. The same is true of debt-related aid, which frees up resources in the budget. While the share of

programme assistance has fallen, this has been partially offset by an increase in the share of debt-related flows. Nonetheless, it seems that bilateral donors have actually shifted their aid away from easily coordinated programme aid towards project aid, mainly for social infrastructure, reflecting the new poverty focus in development thinking. Donors thus do not seem to have moved to forms of aid that make coordination easier, but the data do not tell us anything about what has happened to coordination within the various categories, where, for example, SWAps may have increased.

Table 1.
Bilateral ODA commitments by purpose

| | 1973 | 1975 | 1980 | 1985 | 1990 | 1995 | 2000 | 2003 |
|---|---------|---------|----------|----------|----------|----------|----------|----------|
| 1. Social infrastructure and services | 10.8 | 12.1 | 8.8 | 14.7 | 16.1 | 32.7 | 35.0 | 31.6 |
| 2. Economic infrastructure and services | 18.1 | 11.8 | 24.0 | 20.0 | 24.4 | 26.6 | 17.8 | 9.7 |
| 3. Production sectors | 14.3 | 13.4 | 18.1 | 18.6 | 13.9 | 9.5 | 7.9 | 5.6 |
| 4. Multisector | 1.2 | 2.4 | 2.4 | 2.0 | 8.9 | 6.2 | 7.7 | 7.3 |
| 5. Programme assistance | 48.7 | 45.8 | 34.8 | 39.8 | 25.6 | 7.7 | 9.2 | 6.7 |
| 6. Actions relating to debt | 0.8 | 6.7 | 8.2 | 2.1 | 8.1 | 5.8 | 8.2 | 22.9 |
| 7. Emergency assistance | 0.8 | 0.4 | 0.8 | 1.8 | 2.0 | 7.1 | 7.8 | 9.1 |
| 8. Unallocated | 5.2 | 7.5 | 2.9 | 0.9 | 1.1 | 4.3 | 6.5 | 7.0 |
| | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 99.9 | 100.0 | 100.0 |
| Total bilateral aid (current US\$) | 5,120.6 | 6,999.8 | 16,802.5 | 18,160.5 | 33,202.4 | 47,061.4 | 43,566.1 | 68,972.0 |

Note: The data cover all DAC donors. The sectoral distribution of bilateral ODA commitments refers to the economic sector of destination (i.e. the specific area of the recipient's economic or social structure targeted by the aid), rather than to the type of goods or services provided.

1. This category covers assistance to develop human resource potential and to ameliorate living conditions, including education, health and water supply.
2. This category covers assistance for networks, utilities and services that facilitate economic activity, including energy, transportation and communications.
3. This category covers assistance to the directly productive sectors: agriculture, manufacturing, trade, banking and tourism.
4. This category covers support for projects which straddle several sectors, including environmental projects, gender projects, and urban and rural development.
5. This category covers all general development assistance, other than debt reorganisation, with no pre-imposed sector allocation, e.g. balance-of-payments and budget support, and funds for capital projects at the recipient's choice, not subject to agreement by the donor. This item includes sector-unallocated structural adjustment assistance.
6. This category covers debt forgiveness, rescheduling, refinancing, etc.
7. This category covers emergency and distress relief in cash or in kind, including relief food aid and aid to refugees.
8. This category includes aid which cannot be assigned to another category, because the sectoral destination was not specified.

Source: OECD (2005b).

The number of donors that recipient countries have to deal with has increased rapidly over the last 30 years. There are now 27 bilateral donors and many more international NGOs, most handling very small amounts of aid. Archarya, de Lima and Moore (2004) have used an index of donor proliferation to show that, on a global scale, donor proliferation has been uninterrupted since 1975, with the number of donors increasing faster than the amounts of aid disbursed. The countries most prone to proliferation are those that have the most altruistic aid programmes; these countries, unconstrained by historical and strategic considerations, have extended their programmes to a vast range of poor nations¹⁷. Overall, the proliferation problem has certainly not gone away. A question not answered here is whether other changes in the way aid is transferred have reduced the complexity of aid flows enough to compensate for the increase in the number of donors.

5. The impact of donor coordination on transaction costs

We identified two main dimensions of the impact of donor coordination on the uses of aid: transaction costs and incentive effects. Brown *et al.* (2000) define transaction costs in this context as those arising from the preparation, negotiation, monitoring and enforcement of agreements for the delivery of official development assistance (ODA).

The costs of transferring aid have been the focus of heated debate ever since the beginning of modern aid. Bauer (1971, pp. 99-100) argued that,

"it is by no means unusual for projects to absorb domestic inputs of greater value than net output, especially when the cost of administering the projects and the explicit and implicit obligation to maintain and replace fixed assets originally donated is also considered. Large losses in activities and projects financed by aid have been reported in many poor countries."

More recently, Kanbur (2003, p. 18) noted,

"aid flows, and the mechanisms donors adopt to track and monitor them, are very intensive in terms of recipient capacity. Each donor agency has its own reporting system. In a typical African country, there can be upwards of 20 aid agencies from

17. Berthélemy and Tichit (2004) have analysed the aid allocation decisions of bilateral donors.

different countries and multilateral agencies. The hard-pressed civil servants spend much of their time managing the paper flow. At the political level, ministers have to spend a considerable amount of time in turn meeting with donor delegations. But perhaps as important as the sheer time use is that these senior technocrats and politicians become oriented towards convincing the aid agencies to keep the aid flow going, rather than towards listening to the domestic population and the local development agenda.”

Transaction costs are increased by the multitude of rules and procedures used by donors to manage aid projects, and the problem is aggravated by the use of different languages and fiscal calendars. In addition, there is duplication of various forms of analytical work, “such as poverty assessments, public expenditure reviews, governance and investment climate assessments, and fiduciary analyses sponsored by donors” (Knack and Rahman, 2004, pp. 3-4). Where donor fragmentation is combined with tied aid, different donors may supply equipment having incompatible specifications. Channelling aid to projects rather than through budget support, bypassing central government units via project implementation units¹⁸ and relying on expatriates rather than training and using local staff can all undermine government institutions.

Anecdotal evidence on transaction costs is plentiful, but there have been few solid empirical estimates of their magnitude. Brown *et al.* (2000) attempted to measure transaction costs in Vietnam. They noted the lack of an accepted method, the lack of good underlying data and the unacceptably high transaction costs of actually collecting data from respondents. Balogun (2005) discusses the difficulties of measuring the administrative cost savings realised through donor coordination, for example by reducing the number of project implementation units. He argues that the major saving is in time costs, but there have been no substantive analyses of these among donors.

Donors have set up some systems to monitor coordination¹⁹. These provide a general impression, but once again, they have not yet yielded solid empirical estimates

18. From 1985 to 1995, the majority of donors in Mali used project implementation units rather than working through the regular bureaucracy (Bräutigam and Knack, 2004, p. 261).

19. Balogun (2005, p. S20) mentions “the monitoring programmes of the OECD-DAC’s WP-EFF and the Budget Support Working Group of the Strategic Partnership for Africa (SPA), in country initiatives such as the Independent Monitoring Group in Tanzania, the Programme Aid partners monitoring system in Mozambique, and the Vietnam Partnership Group on Aid Effectiveness (VPGAE) and monitoring of National Harmonisation Action Plans”. For example, see OECD-DAC (2005).

of the benefits. SWApS might be able to reduce transaction costs, but it is difficult to determine whether they have actually been reduced or have merely shifted: the decrease in direct administrative costs has in some instances probably been counterbalanced by increased coordination costs.

The bulk of the evidence on donor coordination derives from evaluations of programme aid. One of the most ambitious attempts to coordinate donor efforts within a single country was conducted in Tanzania (Helleiner, 2002). It seems clear that the transaction costs fell to some extent once all the donors providing Poverty Reduction Budget Support (PRBS) accepted a single reporting system, the Performance Assessment Framework. The Tanzanian Ministry of Finance now need prepare only one report rather than 14 separate ones. To date, however, no clear evidence has been found that the total transaction costs of aid in Tanzania have fallen (IMG, 2002; Odén and Tinnes, 2003; Booth *et al.*, 2004), owing to the high cost of managing projects and common basket funds. Although common basket funds seem to provide a way to reduce transaction costs, so far the costs of setting up and managing them have been high. All three of the studies cited concluded that aid transaction costs will not show a marked decline unless the number of projects decreases further. They were unable to determine whether public expenditure management as such has improved. A study of Mozambique (Batley *et al.*, 2004) discusses the relative merits of alternative forms of aid delivery, concluding that the benefits of donor coordination around the PRBS have been limited by the effects of other aid modalities on government planning and expenditure systems.

Since there is little direct empirical evidence on aid transaction costs, O'Connell and Soludo (2001) attempted to construct a series of indirect measures, including the cost of lack of coordination among donors. They argue that transaction costs would be lower if aid were concentrated in the hands of a few large donors rather than many smaller ones, and compute a Herfindahl concentration index for gross ODA disbursement from the 21 DAC donors and the 51 bilateral and multilateral donors cited in DAC data in the 1990s. They present cross-sectional evidence for the 1990s to show that aid to Africa was more diffuse than aid to other regions, and thus likely to be associated with higher transaction costs (but more policy autonomy). Since the number of donors has been increasing over time, it is conceivable that transaction costs have also increased.

The less coordinated donors are, the easier it should be for recipient governments to achieve the aid allocation they desire. From this perspective, then, donor coordination is not in the interest of the recipient. As lack of donor coordination increases transaction costs, however, there is a trade-off between transaction costs and policy autonomy for the recipient government.

This brief review suggests that transaction costs may be substantial, but no solid estimates are available of how they have changed over time or of how they vary by aid modality. This is an area where useful empirical work could be done.

6. The impact of donor coordination on public sector management and governance

Empirical evidence concerning the impact of donor coordination, or the lack thereof, on governance issues such as budget formulation and implementation is even scantier than that on transaction costs. What evidence we do have suggests that donors may undermine recipient governments' policy-making efforts by distorting incentives and overburdening government administrative structures. Lack of donor coordination can create incentives that weaken the recipient country's institutions. According to Bräutigam and Knack (2004, p. 265), "large amounts of aid can create incentives that make solving the collective action problems required for government reforms less likely, moral hazard, soft budget constraints, the tragedy of the commons, and shift in accountability".

123

When a recipient government tries to reach agreements with donors, it clearly will have a problem if it faces a variety of conflicting conditionalities. Policy making will be complicated, and policy choices restricted and distorted. Thus, it might be sensible to let one donor agency manage conditionality in any given area. Donors have agreed, for example, that the IMF should take the lead when it comes to macroeconomic conditionality, while the World Bank should do so with regard to sectoral and microeconomic conditionality. This implies, however, that all donors will tend to rally behind one particular aid doctrine, suppressing innovation. Such a cartel could therefore be inferior to less coordination (Kanbur, 2003, p. 20). Aid tends to undermine genuine policy learning in highly aid-dependent countries.

Recipient countries may be unable to maintain projects once they are finally handed over by donors (Adam *et al.*, 1994). However successful a project may appear on its own terms, it will have little or no sustained impact if the policy environment in the sector is poor and if it is not integrated with other donor-funded or government projects (Easterly, 2002; Kanbur *et al.*, 1999). Donors still seem to prefer to fund their own projects, although the latter sometimes entail unrealistically high recurrent expenditures in future years. According to Bräutigam (2000), such over-investment means that donors treat the recurrent expenditures budget as a common-pool resource, producing a tragedy of the commons in which roads are built but not repaired, schools built but not staffed. Donors engage in these practices because it increases their visibility, allowing them to report successful project implementation, but short-term success for their individual projects may come at the expense of coherent policy making and capacity building in the recipient country's public sector (World Bank, 1998).

When donors work with counterparts in the local bureaucracy, they often provide pay supplements to the more talented local staff. This distorts civil servants' incentives to pay attention to their other responsibilities, even if the latter have a greater impact on development than the donor project (Arndt, 2000). It also creates incentives for officials to extend projects from which they derive personal benefit, regardless of the merit of the projects, and it may help perpetuate the practice of spending aid funds in the form of independent projects rather than in the form of SWAps or budget support (Archarya, de Lima and Moore, 2005). The distinction between purely private consulting work and quasi-official work associated with donor projects becomes blurred (Cohen and Wheeler, 1997).

"Control of salary and manpower policy is eroded as donors hire local staff for 'their' projects or contract with them to meet donor needs²⁰. Dual salary and incentive structures undermine morale and commitment among public sector employees who are left out of donor-distributed assignments.... This neglect or subversion of existing structures creates organizational confusion and contributes to the withering of government capacity." (Berg, 1997, p. 82)

20. "In Niger, for instance, the majority of NGOs appear to be operated by moonlighting civil servants and ex-ministers of cabinet. In several cases, high-level officials left government to create NGOs in order to receive donor support that had once gone to the official's ministry" (van de Walle, 2001, p. 165).

It is difficult to isolate the effect of donor coordination on public sector and policy management, especially within a single country, as this involves estimating the contribution of one factor in a very complex institutional set-up²¹. The common, though imperfect, approach to the problem of identifying a counterfactual is to use cross-country regressions. Knack and Rahman (2004) performed an empirical cross-country analysis of the impact of donors on recipient administrative quality. The econometric results support their hypothesis that aid undermined the quality of government bureaucracy more severely in those recipient countries where aid was fragmented among many donors.

Most of our discussion so far has been concerned with the central government, but donor coordination is also important at the micro level. Platteau (2004) analysed the way aid was managed in community-driven development projects. He found a high risk of "elite capture" and concluded that methods to reduce the risk of fraud were needed. A donor with a local monopoly on this form of aid can adopt sequential, conditional disbursement to try to influence the activity of the local leader, but the problem is more complicated if several aid agencies are competing for access to the local communities. In the latter case, the intended grassroots beneficiaries may get very little. Concentrating aid in the area into fewer hands can mitigate this problem. Another approach suggested by Platteau is to introduce a coordinating mechanism, known as a multilateral reputational mechanism, whereby aid agencies inform each other about fraudulent behaviour among local intermediaries. Platteau also discusses the best way to detect fraud in community-driven projects. He argues that it is hard for the local poor to report on the misdeeds of the elite, so he suggests the use of impact assessment studies to check whether outcomes for the poor have matched project expectations. He notes that such evaluations need to go beyond current practice, which is limited to bureaucratic reports presenting financial accounts and physical achievements.

Aid delivery mechanisms are clearly important for how aid is allocated and how effectively it is used. Empirical evidence as to how the results relate to donor coordination is weak, but we can still learn something from history. The first major aid effort after World War II was the Marshall Plan, generally considered to have worked very well. Its success

21. Johnson and Subramanian (2005) say that "there are considerable uncertainties in our knowledge about how institutional change can be promoted, if at all", while Kraay (2005) notes that we know relatively little about how to tackle governance issues in Africa.

was due in part to the character of the recipients, but also probably to the fact that recipients had to deal with only one donor. A more recent example where an important external agent has been successful in influencing institutions concerns the Eastern European countries' accession to the EU. Another example is the World Trade Organisation, which managed to change a number of economic institutions in China before the latter's entry into the organisation. In both of these cases the benefits have been substantial. It has also been suggested that the success of Korea, Taiwan and Botswana has been due in part to the presence of a single or dominant donor (Knack and Rahman, 2004). In contrast, most aid recipients today have to deal with dozens of official donors and NGOs and with hundreds of separate projects and programmes, as described above.

7. Policy discussion and conclusions

Could donor coordination improve the situation²²? Although donors have a common interest in development, they often have separate goals. Coordination on goals would make it easier for donors to impose policy conditions that are unwelcome to the recipient government. If the recipient country has a reasonable plan of its own, this could of course be unfortunate, but it may also happen that the recipient government faces a domestic constituency seeking policies in line with its vested interests. In this case, the government might be helped by having an agreement with a multilateral agency that forces it to stay the course, or to adopt policies running counter to those interests. Complications could arise if domestic agents go on to lobby the multilateral agency (Kanbur, 2000, 2003).

Disch (1999) found that donors and recipients have found it easier to reach agreements on policies (at least in principle) than on procedures and practices. Still, there are large potential gains to coordination at this level. The trend towards budget support may help, although "if budget support is coupled with more complex management requirements and demands by donors for deeper reform and better reporting, transaction costs may change very little, and the main benefit may come in the form of strengthening government systems" (OECD, 2003).

22. Rosenstein-Rodan (1968) argued that donors should organise themselves in consortia.

Donors should avoid poaching and not unduly distort the market for skilled labour. There should be agreements among donors on codes of recruitment, salary and benefit levels, and the use of government officials for short-term consultancy work. Donors should contribute to organisational capacity building (policy making, budgeting etc.), as this would reduce their preference for project funding rather than budget support.

The implications of greater donor coordination for ownership and independence in policy formation are harder to judge. Poor coordination makes it easier for recipient governments to play off donors against each other to achieve the aid allocation they desire, to extract better terms and to escape conditionality (Platteau, 2003). Lack of coordination also increases uncertainty about government policies, which tends to have a negative effect on investment.

Lack of donor coordination seems to impose greater transaction costs and create negative incentives. Kanbur *et al.* (1999) suggested coordinating via a common pool:

"The objectives are (i) to reduce day-to-day interference in the management of the aid program, (ii) reduce fragmentation within and across projects and policies, (iii) improve 'ownership' of the development strategy by the domestic political economy of the recipient country, and (iv) still give donors the right to modulate their funding based on recipient characteristics. The concept works as follows. Aid flows support the overall program of the government rather than this or that project. After a period of dialogue, with the donors but more importantly with its own population, the government puts forward an overall program of expenditures, with alternative scenarios based on different level of aid flows. The donors look at this, and put into a common pool resources that will finance the overall program along with domestic and other resources. At no time is a particular part of the program identified with a particular donor. All aspects of aid are folded into this structure."

Another alternative that at least partially addresses the same issue was proposed by the Commission for Africa (2005, p. 364), which emphasised that the World Bank needs to improve coordination of its procedures and conditions with other donors, ideally under the leadership of the recipient government. Thus far, donors have been happy to see other donors coordinate around their own practices, but they have been less

willing to change their practices to match those of others. The Commission for Africa suggested, as an interim solution, that donors should mutually recognise each other's procedures. This has generally worked within the European Union, where the members have accepted each other's procedures as valid without requiring harmonisation around a specific procedure. Here it would mean that donors would work from each other's reports and thereby reduce the reporting burden on recipient countries. The World Bank should take the initiative in launching such a system.

Both of these strategies run into problems. First, how would one aggregate donor preferences and aid doctrines? They reflect not only different views on what matters for development, but also different national interests that are not easily reconciled.

Second, there is a free-rider problem in that some donors may try to claim more than their share of credit for successful joint projects. Donor accountability for development results could be enhanced by the appointment of a lead donor, which would have an enhanced reputational stake in any given country's development outcome. Alternatively, donors could specialise by sector in any given country. Donors could also decide to channel aid to a sector through another agency. To date, the use of lead agencies and silent partners has not been extensive.

Donors often say that they would like to concentrate their aid on fewer countries, but this has not in fact happened. The importance of a global presence weighs more heavily than aid efficiency. The publication of indices of donor performance, including an indicator of proliferation, might have some effect.

Donor coordination cannot substitute for coordination of the activities of the recipient government itself; rather, the two coordination processes need to be aligned. The recent trend towards increased policy of ownership on the part of recipient governments has implications for donor coordination. For donors to be willing to enter into true partnerships or to increase the use of more general aid transfer modalities giving the recipient government a higher degree of control, the recipient government must have the competence to handle coordination and must be credible. Donors will always have to report back to their voters, and this will require transparent and credible accounting from recipient governments.

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Comment

by

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This is a compact, comprehensive review and a valuable critique of existing theory and evidence on the effects of donor coordination on aid effectiveness. It is very timely; several European countries have predicted large increases in ODA over the next few years, without specifying whether or exactly how such expenditures may be coordinated, and the United States is in the midst of historically large increases in bilateral aid to certain sectors and countries. We need lessons on how much coordination will matter in these endeavours.

As Bigsten's paper reveals, however, we do not know very much. Moreover, the little evidence we have is open to other interpretations than this paper gives. The paper reviews several studies of the transaction cost effects and incentive effects of poor donor coordination, concludes that the costs constitute a problem that "needs to be addressed" by policy and lists several ways in which policy could or should do so. A different reading of the same studies suggests the opposite: that transaction cost effects are a comparatively minor determinant of aid effectiveness undeserving of priority, and that we have little idea whether the cures for the incentive effects would be worse than the disease.

Only the availability of much more evidence could lead us to the kind of strong and practical conclusions towards which this paper leans. The paper thus evokes an empirical research agenda that is tractable, relevant and ripe. It is thereby provocative in the best way.

135

Transaction costs

The paper methodically reviews the literature attempting to measure the transaction costs of aid, concluding that these costs are “substantial”. This conclusion seems unjustified. This section mentions one study of Vietnam in which the transaction costs of aid could not be measured because, presumably without an intentional play on words, the transaction costs of measuring them were too high. It then reflects on recipient administrators’ time savings from coordination, but “there have been no substantive analyses of these”. Cross-country attempts to assess donor coordination have “not yielded solid empirical estimates of the benefits”. The paper goes on to mention an assessment of “one of the most ambitious attempts to coordinate donors”, in Tanzania, but “no clear evidence has been found that the total transaction costs of aid in Tanzania have fallen”.

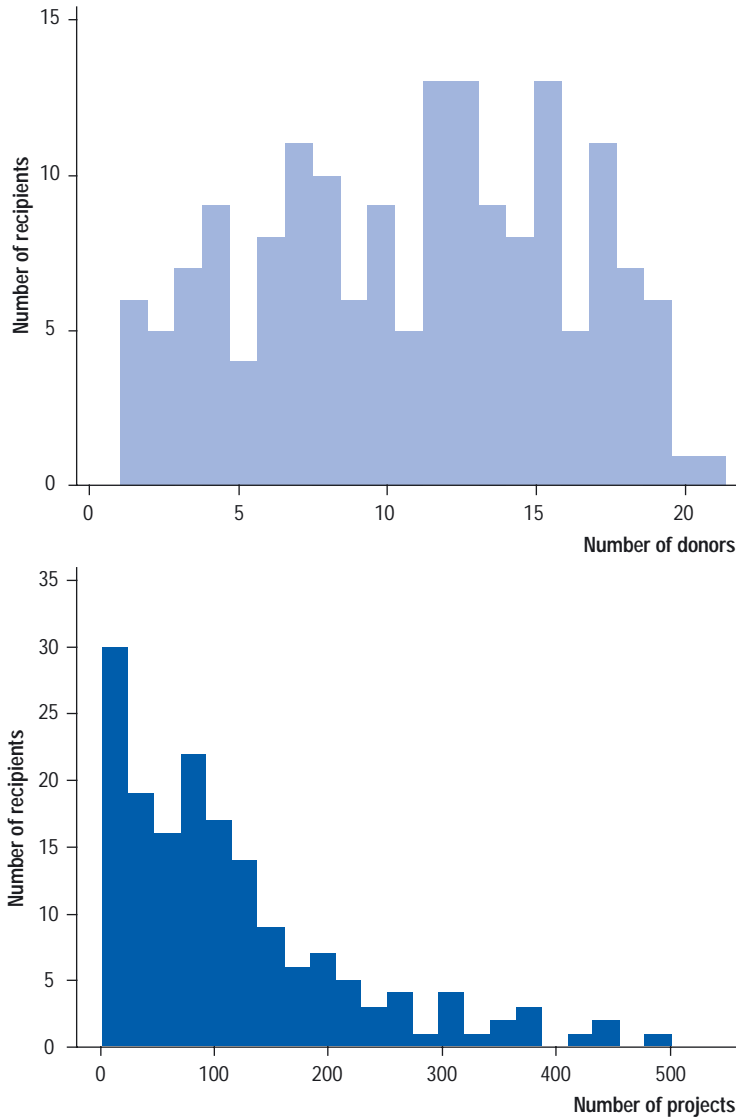
In short, *all* of the studies of transaction costs reviewed in the paper are described as failing to provide any clear evidence of the magnitude of these costs or the benefits of coordination. What, then, are the grounds for concluding at the end of this section that transaction costs are “substantial”, or large enough to merit large-scale policy intervention? The reason they are so difficult to measure reliably may very well be precisely that they are small relative to other determinants of aid effectiveness, and thus not deserving of priority policy action.

136

In the same breath, the paper recommends more empirical work to measure transaction costs, which is certainly needed. One way forward would be to assess the effects of project proliferation on outcomes of interest, across countries and over time. That is, interesting future work would build on that of Knack and Rahman (2004), who attempt to measure the effect of donor-level fragmentation on governance, and would extend this to assess the relationship between project-level proliferation data (Roodman, 2005*a*, 2005*b*) and various desirable human development outcomes.

Here we can dip just a toe into those empirical waters. Figure 1 presents histograms of the extent of donor-level fragmentation and project-level proliferation in the OECD DAC database. The upper panel shows, for example, that five aid recipient countries received ODA disbursements from an average of 11 donor countries per year between 1995 and 2003. The lower histogram goes to the project level, showing for example

Figure 1.
Donor fragmentation and project-level proliferation



Note: Top: number of ODA recipient countries receiving ODA disbursements from each number of donor countries along the horizontal axis, average 1995-2003. Bottom: number of ODA recipient countries receiving each number of annual project disbursements along the horizontal axis, average 1995-2003

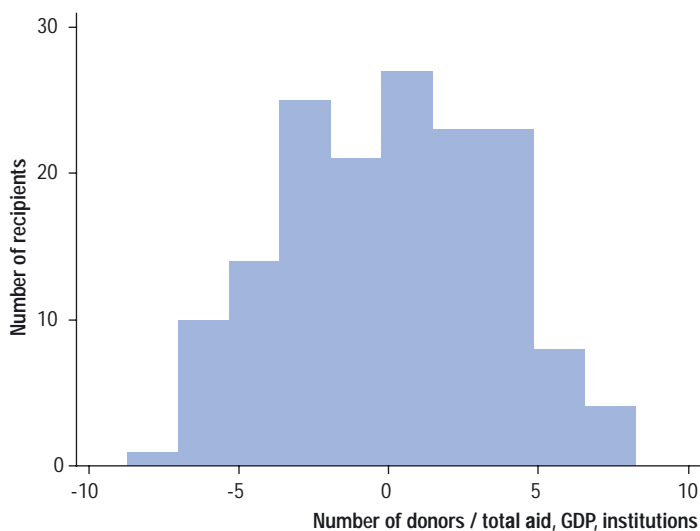
Source: Roodman (2005b) and OECD DAC database.

that four recipient countries received around 300 project disbursements per year on average between 1995 and 2003. There is a great deal of variation; some countries have very few projects from a handful of donors; some host a score of donors and hundreds of projects. How can we get a general impression of the magnitude of the costs thereby imposed on the latter group?

We want to isolate those countries that have hosted an unusually large number of donors or projects. Certainly we would expect countries that received more aid, as well as countries with larger economies, to host more donors and projects. Furthermore, we might expect countries with stronger institutions of governance to attract different numbers of donors or projects than those with poor governance.

Figure 2 shows a histogram of the residuals from a cross-section regression of the number of donors on three independent variables: total aid, GDP and the well-known

Figure 2.
Are recipients with the most donor fragmentation – controlling for aid levels, economy size and institutional quality – aid failures?



Note: Horizontal axis shows the residual after cross-section regression of the average number of donors disbursing ODA per year to each recipient on 1) total aid, in dollars during the period, 2) GDP at exchange rates, and 3) the overall governance quality indicator of Kaufmann et al. (2004). All variables averaged over 1995–2003.

Source: Roodman (2005b) and OECD DAC database.

ratings of overall governance quality produced by Kaufmann *et al.* (2004). The vertical axis shows the number of recipients having each residual within the range shown. Countries further to the right host more donors than other recipients with equivalent aid flows, economic activity and governance quality.

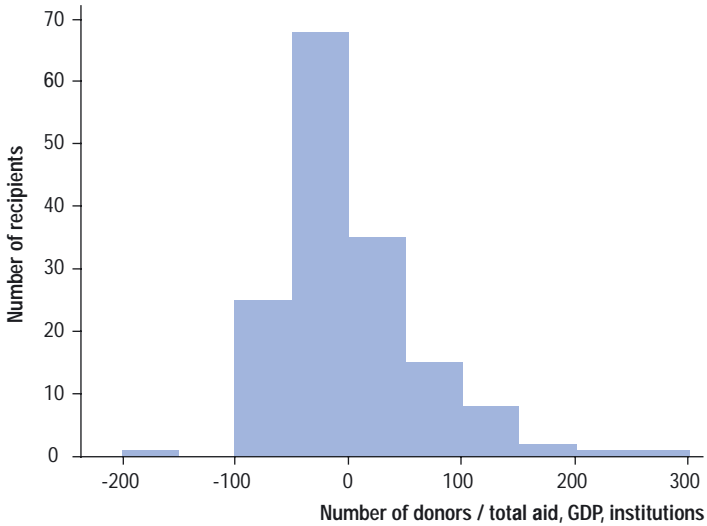
Do we find notable aid *failures* towards the right of the figure? To the contrary, we find many of the poor countries considered by several observers, including the UN Millennium Project and the US Millennium Challenge Corporation, to be those most likely to use aid effectively: Uganda, Mozambique, Kenya, Rwanda, Senegal, Botswana and Ghana. These are the success stories of aid in the opening years of the 21st century, not the basket cases. Also present are Chile, Costa Rica and others where aid has clearly been effective.

Figure 3 carries out the same exercise for project proliferation, reporting the residuals from regressing the average number of annual project disbursements on the same three variables. The lower panel shows a detail of the upper panel for clarity of presentation. Again, the countries that have received their aid chopped into an extraordinarily large number of projects include Ethiopia, Senegal, Mozambique, Uganda, Kenya, Botswana and Poland. Far from being aid disasters, these are precisely the countries that donors frequently cite as examples of ideal leaders of the coming aid “scale-up”. Where is the large-scale institutional degradation observed by Knack and Rahman?

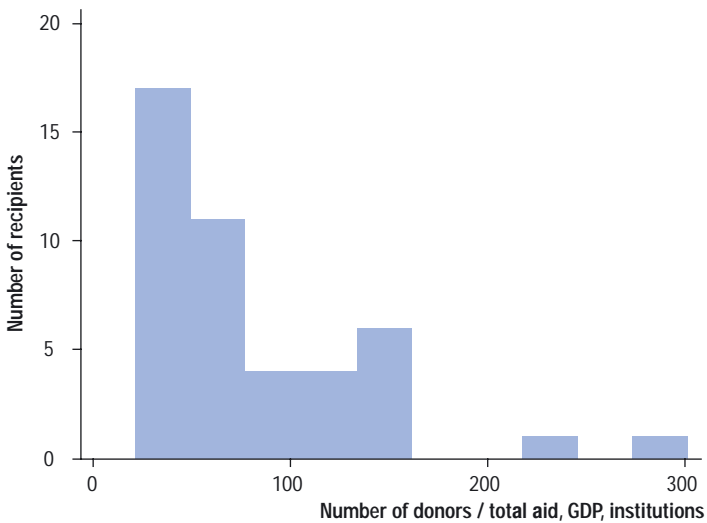
Reverse causation could certainly be at work here: a large number of donors have a large number of projects in Uganda and Mozambique *because* they perceive aid to work well there. That is, the above uses no careful identification strategy and is merely suggestive. We are controlling for governance quality, however, which addresses some of that concern, since good governance is part of what creates a “donor darling”. At the very least, we can see that a major lack of coordination at the international or country level did not generate transaction costs large enough to change overall aid effectiveness in those countries. The primary determinants of aid effectiveness lie elsewhere, and it is those primary causes that will decide the fate of the great aid scale-up in coming years. If true, this would undermine other strong but poorly substantiated conclusions in the paper, such as: “Coordination of donors’ goals ... would ... increase the overall development impact of aid” to a meaningful degree that would justify the attention we are paying to the issue. Neither the extremely preliminary evidence adduced here nor

Figure 3.

Are recipients with the most project proliferation – controlling for aid levels, economy size and institutional quality – aid failures?



Detail of the above figure, showing recipient countries with residual > 20:



Note: Horizontal axis shows the residual after cross-section regression of the average number of ODA project disbursements per year to each recipient on 1) total aid, in dollars during the period, 2) GDP at exchange rates, and 3) the overall governance quality indicator of Kaufmann et al. (2004). All variables averaged over 1995-2003.

Source: Roodman (2005b) and OECD DAC database.

the evidence cited in Bigsten's review begins to suggest that such benefits are in any way large.

Incentive effects

The paper mentions a few times, but briefly and with little discussion, the single most important incentive issue: the incentives that *cause* donors to give their assistance in uncoordinated fashion, bilaterally and as projects. This literature cannot advance until we move beyond considering the effects of fragmentation to consider its causes.

As Easterly (2002) points out, every generation exhorts donors anew to coordinate. When US President Harry Truman (1949) proposed foreign aid in its modern form, he urged donors to “pool their ... resources” for a “cooperative enterprise in which all nations work together through the United Nations ... wherever practicable”. The resounding Pearson Commission report warned of the “urgent need for early action” to standardise donors’ planning, programmes and evaluation for each recipient, as well as a large increase in the share of aid passing through multilaterals (Pearson, 1969, pp. 228-29). The World Bank’s (1981, p. 130) Berg Report noted most of the main costs of aid fragmentation pointed out in Bigsten’s paper, such as that donors “compete for scarce skills by bidding up salaries” and that the “multiplicity of donors, each operating independently, puts an especially heavy burden on small countries with limited administrative capacities”. Most recently, the report of the Commission for Africa (2005) speaks throughout of the need for coordination tools such as “joint needs assessments” to improve the impact of aid in Africa.

Even if we had solid evidence that the costs of proliferation and fragmentation were sufficiently important determinants of aid effectiveness to warrant priority policy action, the marginal return to additional exhortation to coordinate clearly reached zero decades ago. Donors are not willing to coordinate beyond a certain point, as we can see by recognizing that all coordination plans constitute some form of multilateral action, and that donors’ demand for multilateral aid channels is limited. The International Development Association (IDA) has been available as a harmonised aid channel for almost 40 years, offering its collected donors unified planning through a single Country Assistance Strategy as well as common criteria for *ex ante* selectivity and *ex post*

evaluation. It is currently moving towards outcome-based selectivity, gives *de facto* grants to many of its members (via high concessionality and debt forgiveness) and may soon give *de jure* grants as well.

Donors avail themselves of this channel in small doses, however. Early in the history of aid the limiting factor may have been the absence of policy instruments for international coordination; after IDA was created, the worldwide share of aid passing through multilaterals shot up from about a sixth to about a third. As Bigsten's paper notes without much comment, this share has stayed at about one-third ever since (Figure 4). While

Table 1.
Fraction of total ODA given through multilaterals

| Donor | 1974 | 1984 | 1994 | 2004 |
|----------------|-------|-------|-------|-------|
| Australia | 0.099 | 0.217 | 0.245 | 0.185 |
| Austria | 0.665 | 0.244 | 0.370 | 0.480 |
| Belgium | 0.235 | 0.411 | 0.401 | 0.383 |
| Canada | 0.306 | 0.361 | 0.368 | 0.234 |
| Denmark | 0.445 | 0.504 | 0.445 | 0.410 |
| Finland | 0.609 | 0.393 | 0.264 | 0.448 |
| France | 0.194 | 0.204 | 0.219 | 0.343 |
| Germany | 0.292 | 0.329 | 0.392 | 0.493 |
| Greece | | | | 0.346 |
| Ireland | 0.829 | 0.577 | 0.480 | 0.326 |
| Italy | 0.999 | 0.448 | 0.322 | 0.714 |
| Japan | 0.218 | 0.438 | 0.278 | 0.336 |
| Luxembourg | | | | 0.274 |
| Netherlands | 0.306 | 0.307 | 0.324 | 0.365 |
| New Zealand | 0.248 | 0.200 | 0.226 | 0.250 |
| Norway | 0.445 | 0.437 | 0.272 | 0.301 |
| Portugal | | | 0.307 | 0.154 |
| Spain | | | 0.345 | 0.425 |
| Sweden | 0.418 | 0.290 | 0.245 | 0.237 |
| Switzerland | 0.340 | 0.235 | 0.263 | 0.232 |
| United Kingdom | 0.367 | 0.452 | 0.449 | 0.323 |
| United States | 0.308 | 0.259 | 0.266 | 0.175 |

Note: The following multilaterals are taken into account: Af.DB, Afr. Solidarity Fund, African Dev. Fund, Andean Dev. Corp., As.DB, As.DB Special Funds, CABEL, Caribbean Dev. Bank, EC, EDF, EFTA Ind.Fund Portugal, EIB, FUNDWI, IBRD, IDA, IDB, IDB Special Oper. Fund, IFAD, IFC, IMF, IMF Int. Subsidy Acct., IMF Trust Fund, MIGA, Other Multilateral (Part I), Other Regional Banks, Other UN, UNDP, UNFPA, UNHCR, UNICEF, UNRWA, WADB, WFP.

Source: OECD DAC database.

some donors have mildly increased the multilateral share of their flows, due primarily to EU integration, others have correspondingly decreased it (Table 1). The demand for country-level coordination is also shrinking: Bigsten's Table 1 points out that programme aid has steadily declined in importance relative to project aid. We cannot hope to make progress without evidence on *why* donors do not want more coordination.

The paper certainly demonstrates awareness of political-economic forces that make donors reluctant to coordinate, noting inherent difficulties in aggregating their preferences and their need to "report home" about successful projects. These are treated as mere obstacles to greater coordination, the latter being presumed good. But no instrument of public finance is truly optimal if it is optimal only on the expenditure side, ignoring the revenue side. Have we any useful evidence? And what would it mean for policy?

Figure 5 sketches what useful evidence might look like. The horizontal axis shows total government revenue as a fraction of GDP, and the vertical axis shows the fraction of total aid given through multilaterals. The relative sizes of the bubbles reflect relative

Figure 4.
Fraction of ODA from DAC member countries given through multilateral organisations

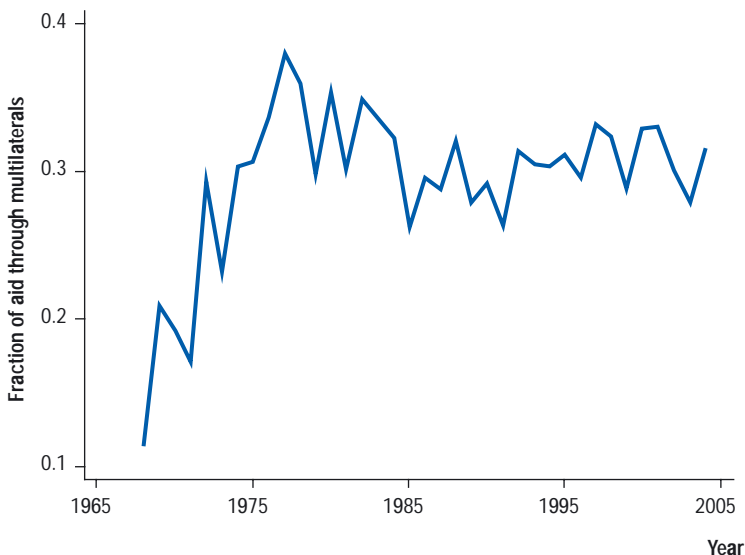
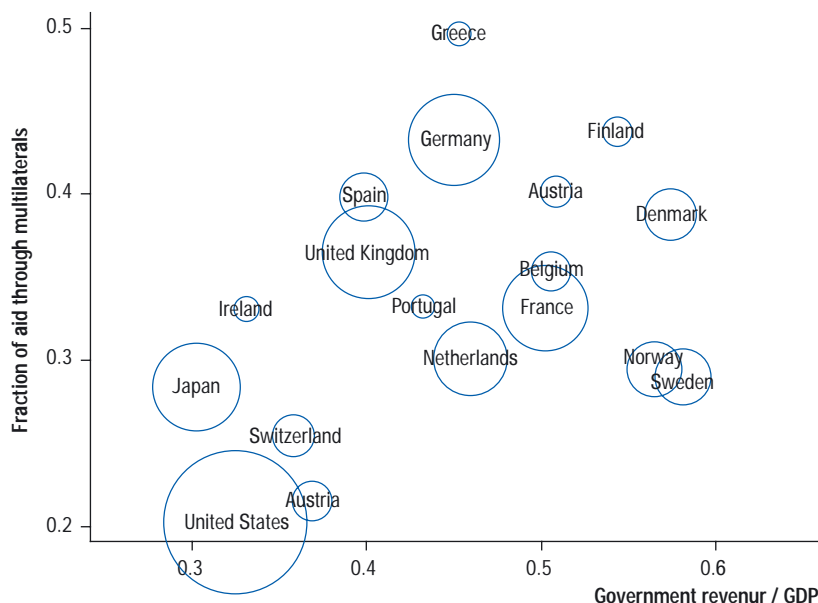


Figure 5.

Evidence suggesting that donors raising less tax revenue give more of their aid bilaterally

Note: : Figure 5: Areas of circles represent relative total ODA in US dollars in 2003. Government revenue/GDP data for 2002, from OECD national accounts. Figures 4 and 5: Fraction of aid through multilaterals is average 2000-04, from OECD DAC database. The following multilaterals are taken into account: Af.DB, Afr. Solidarity Fund, African Dev. Fund, Andean Dev. Corp., As.DB, As.DB Special Funds, CABEL, Caribbean Dev. Bank, EC, EDF, EFTA Ind. Fund Portugal, EIB, FUNDWI, IBRD, IDA, IDB, IDB Special Oper. Fund, IFAD, IFC, IMF, IMF Int. Subsidy Acct., IMF Trust Fund, MIGA, Other Multilateral (Part I), Other Regional Banks, Other UN, UNDP, UNFPA, UNHCR, UNICEF, UNRWA, WADB, WFP. One outlier, Italy, has been suppressed for presentation.

Source: OECD national accounts; OECD DAC database.

total aid in dollars. The figure offers suggestive evidence, especially for the most important donors, that countries with voters less willing to be taxed give more of their aid bilaterally. It is noteworthy that Denmark, the Netherlands, Norway and Sweden appear to give somewhat less of their aid multilaterally at comparable levels of revenue collection, and that these are also the four donors with the highest level of aid as a fraction of GDP. Perhaps the need to “plant the flag” in order to convince voters to support aid is even greater, other things being equal, when a donor devotes a particularly large fraction of revenue to aid.

The above by no means constitutes definitive evidence; it is merely suggestive. There is ample reason to believe, however, that donors’ preference for uncoordinated aid may

be revenue-optimal and may always have been. Decades ago, Rosenstein-Rodan (1968) asserted that the ideal solution to coordination problems was a single all-embracing international aid agency, but he recognized that, “Even under the present largely bilateral arrangement ... there is great difficulty in raising the volume of aid adequately. If all aid were to be channelled internationally, it seems that only a fraction of the present volume of aid (say one half or up to optimistically two thirds) might be obtained.”

This point is extremely important. Even if we believe that the costs of low coordination are very large, we cannot hope to suggest good policies without understanding the reasons behind low demand for coordination. Without such analysis, any further policy recommendations on coordination will be added to a half-century tradition of ineffective exhortation, and soon forgotten. Furthermore, a better understanding of the political economy of donors’ taxation may lead us to a different vision of optimal public finance in this case – a vision that incorporates the revenue side. The result might be a vision of fragmentation and proliferation as an equilibrium that balances the marginal costs of raising or lowering coordination.

In other words, donor coordination does have *costs*, and they may be large. “International” donor coordination means, speaking schematically, that the French government must be willing to cede control of some of its aid money to the “lead donor” in a given case – Sweden, say, or the World Bank. To the extent that the goals of the French government differ from those of Sweden or the Bank, this will make it harder to convince French taxpayers to support the effort. “Country level” donor coordination, in turn, means that the French government must be willing to cede control of some of its aid to, say, the government of Tanzania. To the extent that France’s goals differ from those of the Tanzanian government, or that the latter faces capacity constraints in utilising aid for poverty reduction, such coordination can also undermine the domestic French constituency for aid. Until we know the magnitude of these effects, sweeping policy measures are premature.

Policy

A vision of policy optimality that moved beyond the expenditure side to the revenue side – addressing the political economy of *why* we have so little coordination – might

suggest very different policies than a vision limited to optimising expenditure. Let us look first at several policy recommendations that emerge when no serious analysis is made of donors' incentives.

- Rosenstein-Rodan (1968) proposed "bilateral aid within a multilateral framework", that is, international agreements on common conditions for and evaluation of aid flows based on technical criteria. The OECD's Development Assistance Committee, he wrote, may one day be a good forum for negotiation of such agreements, but at the time it was "a feeble, unsatisfactory, insufficient beginning", because of "member governments' reluctance to commit themselves to a delegation of aid decisions". There is a serious contradiction here: in the same article, as mentioned above, he notes that ceding aid sovereignty would undermine domestic constituencies for aid and lead to a collapse in budget allocations to aid, but this does not stop him from later implicitly ascribing their "reluctance" to cede authority to a kind of ignoble, autarkic petulance.
- In a little-known move, the administration of US President Richard Nixon recommended in 1970 that *all* American aid go through multilaterals¹. Whether this was a sophisticated strategy to reduce foreign aid or genuinely motivated by concern for increasing its effectiveness is of little relevance here and may be unknowable. At any rate it did not happen, being clearly unpalatable to both the US Congress and to other donors (who, according to the plan, would also have had to make their aid fully multilateral).
- The Berg Report (World Bank, 1981, p. 127), noting the heavy burden of project proliferation on recipient administrative capacity, proposed an exciting new form of simplified programme aid called structural adjustment lending. In hindsight, many economists have had difficulty coming to a favourable assessment of this solution, to put it lightly (e.g. Easterly, 2005). Bigsten's paper mentions a number of studies that are extremely sceptical of the efficacy of structural adjustment conditionality, but then asserts without evidence that coordinated conditionality

1. On 10 August 1970, the administration sent the following confidential memo to several cabinet heads and all major US aid agency directors: "The United States should seek to channel all of its development assistance through multilateral institutions as soon as practicable, in light of the capabilities of the institutions and without raising the US share in them." National Archives RD59, S/S files, Lot 83 D 305, National Security Decision Memorandum 76 (Item 136 in State Dept. archives).

was effective in changing recipients' policies. If this was so, donors appear not to have noticed; donor fragmentation has remained stable and project proliferation has greatly increased since the structural adjustment era. Bigsten's paper also oddly claims that the Marshall Plan was "successful in influencing institutions" in its recipients in part because they "had to deal with only one donor". French political institutions were already extremely strong. Would they have become meaningfully stronger relative to the counterfactual simply because there were fewer forms to fill out in the late 1940s?

- Bigsten notes that sector-wide approaches (SWAs) have attempted since the early 1980s to pool donor resources in certain limited spheres of action, but these have been sufficiently difficult, costly and slow to negotiate that it is unclear whether there is any efficiency gain.

A similar vision of policy optimality, looking only at the donors' expenditure side, informs the policy section of Bigsten's paper. The section takes the desirability and priority of coordination as given and explores its complexities, but does not explore the possible costs of policies to increase coordination or why so many coordination schemes attempted in the past have received so little commitment from donors. This section is appropriately circumspect and for the most part wisely avoids strong policy recommendations based on weak evidence. It is nevertheless emphatic that something must be done, affirming – despite having cited several studies that are wholly inconclusive about the magnitude of the transaction costs and noted that there is even less evidence about incentive costs – that "the lack of donor coordination seems to impose greater transaction costs and create negative incentives".

The fact is that we do not know whether the costs of some of the policies discussed in this section exceed the benefits. Yes, poor coordination "makes it easier for recipient governments to play off donors against each other to achieve the aid allocation they desire", but is this bad or good? Donors are loath to see a dollar of aid spent on the military, for example, but many developing countries face real and dire security concerns. Yes, the lack of coordination "increases uncertainty about government policies, which tends to have a negative effect on investment", but sustained and predictable donor support for certain regimes has depressed investment as well – by sustaining economically ineffective leaders in Liberia, Kenya, Tanzania, former Zaire and other

countries for far too long. Investment may have benefited from *greater* aid uncertainty in those countries, that is, from more willingness by donors to quickly turn off the aid tap. What would be the general equilibrium effects of the “common pool” proposal cited by Bigsten, in which “[a]t no time is a particular part of the program identified with a particular donor”? Would this undermine donors’ domestic constituencies for aid? We do not know. The paper also floats the Blair Commission’s recommendation that bilateral donors coordinate more with the World Bank in Africa – seeming to ignore the fact that the very purpose of giving aid bilaterally rather than through IDA is that donors do not have to coordinate with IDA. If donors wanted to coordinate with IDA there would be no better way to do so than to give their aid to Africa *through* IDA. Perhaps they face political constraints that make this impossible.

The one unqualified, unequivocal normative statement in the policy section is that “[d]onors should avoid poaching [of] skilled labour”. The paper proposes agreements among donors on “salary and benefit levels” for their local collaborators to avoid bidding up their compensation. This raises eyebrows since, throughout the paper, public sector administrative capacity in recipient countries is cited as essential to effective country-level donor coordination. Collusion by donors in a labour oligopsony to keep salaries artificially low in the public sector is likely to have precisely the opposite effect, eliminating one more incentive for skilled citizens of the recipient country to join the public sector or even remain in their country at all.

148

There are certainly some policy recommendations compatible with a different vision of aid coordination optimality, though none of these would be recommendable until research – primarily empirical – gives us a better understanding of their effects. First, donors could easily decrease the internal incentives faced by their bureaucrats to “move money” at all costs – decreasing the number of projects and thus the administrative burden on recipients without any coordination among donors. Donors could focus much more on training and hiring the administrative capacity they need, thus making the sector more attractive to talented locals (whereas colluding to “harmonise” local counterparts’ compensation has the opposite effect). Both of these are in the interest of individual donors acting alone.

Furthermore, donors could structure aid disbursements to a vastly greater degree around human development outcomes. Given such incentives, as Easterly (2002) has

proposed, what some disparage as “incoherence” would yield the *benefits* of competition. Various bold experiments are afoot to try matching disbursements more closely to development outcomes, such as the Global Partnership for Output-Based Aid, a trust-fund supported initiative at the World Bank, and the novel evaluation strategy of the Global Fund to Fight AIDS, Tuberculosis and Malaria. Donors and the poor could benefit from revamping aid systems along these lines, without an ounce of coordination. Once again, however, we do not yet know enough about how to do this. The assumption behind much of the donor coordination literature seems to be that we know exactly what to do to transform Africa from without, if we could only find a way to get along with each other and work together. But we do *not* know exactly what to do, and we also understand very poorly the causes and consequences of increased coordination. Bold experiments and rigorous evaluation are essential, and should take priority over vast scale-ups combined with (yet more) moral exhortation towards coordination.

Are radical changes wishful thinking? Eliot Berg (2002), who recommended so many changes to the aid system in 1981, concluded over two decades later that “little of the contemporary aid reform debate shows adequate appreciation of the depth of the crisis in the development assistance system, and the consequent need for its radical renovation”. Will we still be waiting for these changes two decades from now?

Research agenda

149

The following list of specific areas for further study is far from exhaustive:

Theoretical models of donor fragmentation and project proliferation, such as the excellent work of Roodman (2005*a*, 2005*b*) and Torsvik (2005), must mature to include donors’ domestic political economy rather than simply the games donors play against one another.

Cross-country identification strategies: Extending, as described above, the donor-level work of Knack and Rahman to project-level proliferation, macro outcomes besides governance, and perhaps even project-level outcomes such as economic rate of return. Problems will include identifying exogenous variance in proliferation and, if this

literature is to identify the channels of effect as well as the magnitude, *measuring* the scarce input provided by recipients (e.g. quantifying “administrative capacity” or “recurring costs”).

Natural experiment identification strategies: Can we explore cases of strictly exogenous increases or decreases in fragmentation or proliferation? Around 1991, several Central European countries, Vietnam and Cuba began working with several donors instead of one only. At other times, South Africa, Cuba, Burma and others experienced sudden, politically motivated declines in the number of donors with which they worked. Has the creation of new internal political divisions, such as the recent creation of new states in India, substantially raised the number of projects? What can we learn from past experiments in coordinated conditionality such as structural adjustment lending?

What can the large store of data on IDA replenishment negotiations, or parliamentary debates, or poll data teach us about how donors’ domestic political constraints shape their willingness to cooperate?

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Comment

by
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For many years, questions concerning the effectiveness of aid placed most of the responsibility on the side of recipient countries. More recently, however, the debate has broadened to include the responsibilities of donor countries as well (Berg, 2002). The current drive to harmonise official development assistance (ODA) is in keeping with this conceptual shift, which has become central to the thinking of the development community today¹.

The lack of coherence of donors' operations and practices has been regularly criticised over the last few decades (for an in-depth study of the case of Mali, see Naudet, 2000). The overall objectives of ODA have been harmonised to a certain extent by the alignment of the entire international community on the goal of poverty reduction defined by the Bretton Woods institutions in 1999 and subsequently by the United Nations' adoption of the Millennium Development Goals (MDGs). The Heavily Indebted Poor Countries (HIPC) initiative has also helped to make donor actions more coherent.

153

Arne Bigsten's paper examines the coordination of development aid and the implications of such coordination for the uses of aid. As noted in the introduction to the paper, little research has been devoted to the impact of coordination (or the lack thereof) on aid effectiveness, despite the appearance in recent years of an extensive literature on aid effectiveness, and particularly on selectivity. Bigsten addresses this issue from a theoretical and normative standpoint as well as empirically, analysing the current situation and the efforts made in this field.

*. The author of this commentary wishes to thank Lisa Chauvet, Jean-David Naudet and Marc Raffinot for their suggestions. The usual qualifications apply.

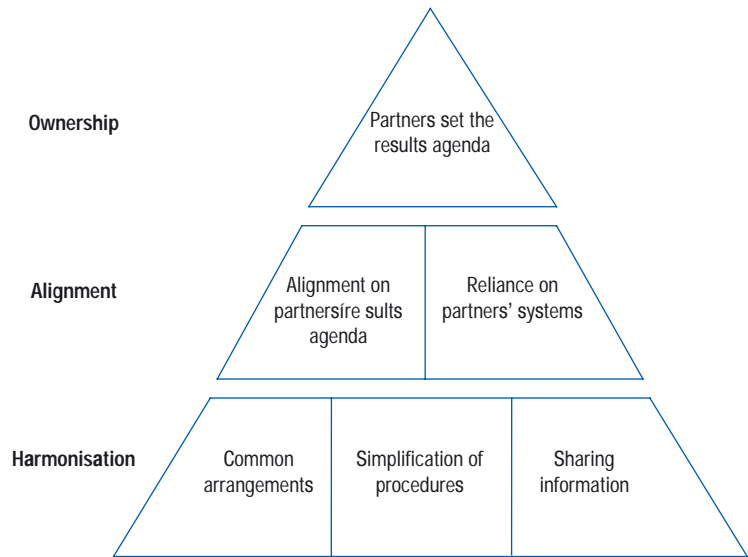
1. Development practitioners prefer the term "harmonisation" to "coordination", which is used more by economists. The former term is used here.

This commentary will focus on the empirical component, extending Bigsten's discussion in three directions: first, it describes the new principles laid down by the international community to improve aid harmonisation; second, it examines the advantages and disadvantages stemming from increased harmonisation, both for donors and for recipient countries; lastly, it shows that the process of harmonising international aid is still at the embryonic stage.

1. New principles of aid harmonisation

The effort to harmonise ODA led to the adoption of the Paris Declaration in 2005 by the member countries of the OECD Development Assistance Committee (DAC). The principal aim of the declaration is to reduce the transaction costs of aid by integrating the harmonisation process with the process of aligning donor preferences with recipient country preferences, in order to allow ownership of policy by the latter. It is accompanied

Figure 1.
Evidence suggesting that donors raising less tax revenue give more of their aid bilaterally



Source: OECD (2005).

by new, results-based forms of aid conditionality promoted in particular by the European Union (Amprou and Chauvet, 2004).

In this context, the main donor countries have defined a number of “good practices” for improving aid coherence and harmonisation. These practices are based on three broad principles: ownership, alignment of preferences and harmonisation. The aid effectiveness pyramid in Figure 1 is supposed to be read from the top down: “Partners begin by setting the agenda for achieving development results (such as the MDGs), and donors respond to this lead by aligning their support with the countries’ results-oriented strategies and relying on partners’ systems” (OECD, 2005). To achieve these goals, donor countries have set a dozen overall objectives corresponding to the three terms of the pyramid and linked to specific operational indicators.

This ideal framework for development aid, in which harmonisation becomes a crucial pillar, has been criticised by a number of observers (Coordination Sud, 2005; Rogerson, 2005). In particular, it may be thought that in an unequal relationship, alignment of donor and recipient preferences can only be imposed, and that policy ownership is largely fictitious (Cling *et al.*, 2003). In its latest review of poverty reduction policies, the World Bank (2005) acknowledged that despite the above-mentioned objectives, the populations of developing countries (DCs) have been no more involved in defining IMF programmes than in the past.

There is thus some risk that the ownership ? alignment ? harmonisation sequence will work rather in the opposite direction, from the bottom up (Coordination Sud, 2005), a risk that is also mentioned by the DAC. In this inverted framework, donors coordinate among themselves and harmonise their practices so as to influence the formulation and implementation of national policy.

2. Advantages and disadvantages of harmonisation

Generally speaking, harmonisation offers a number of advantages:

- *The transfer of transaction costs from DCs to donors*: the usual forms of ODA place a heavy burden on the governments of poor countries, which are already

subject to severe capacity limitations and must deal with a multitude of donors, procedures and so forth; the cases of Cambodia and Vietnam, which receive more than one donor mission per day, are often held up as an example of such excesses (OECD, 2005).

- *Increased transparency and dialogue*: the new approach advocated by donors stems from a desire for transparency (the content of structural adjustment programmes was not made public) and dialogue between the partners (required for country ownership of policies and for effective participatory processes).
- *Rationalisation of objectives and procedures*: instead of introducing a multiplicity of procedures outside the central government budget, the harmonisation process places the emphasis on budget support, which makes it possible to streamline procedures within the framework of objectives harmonised among donors.
- *Capitalising on comparative advantages*: as cooperation agencies do not all possess the same expertise in the various sectors of activity, greater sectoral specialisation (e.g. in the case of "delegated management" of aid) can yield efficiency gains.

Increased aid harmonisation also entails disadvantages and even risks that must not be underestimated, however, and in fact are often the flip side of the advantages listed above:

- *The main risk concerns the impact of full harmonisation of donor goals*. In our view, it is better to retain a degree of competition among donors rather than a ruling consensus, a "cartelisation" of aid, which would undermine policy ownership by recipient countries while at the same time reducing their manoeuvring room and ultimately their sovereignty. Obviously, the debate over development issues needs to continue, as the experience of the last fifty years has brought us little certainty on the content of development policies in general, on the forms of aid, etc.
- *Harmonisation generates new costs for donors*: these costs are due to the transaction costs arising from increased coordination among donors and

management of moral hazard. The new forms of conditionality are harder to implement than traditional conditionalities, which are based on policy measures enforced by recipient countries.

- Lastly, *excessive harmonisation of the geographical allocation of aid* would raise selectivity problems (risk that some countries would be selected, others abandoned, etc.), as pointed out by the UNDP *Human Development Report* (2005).

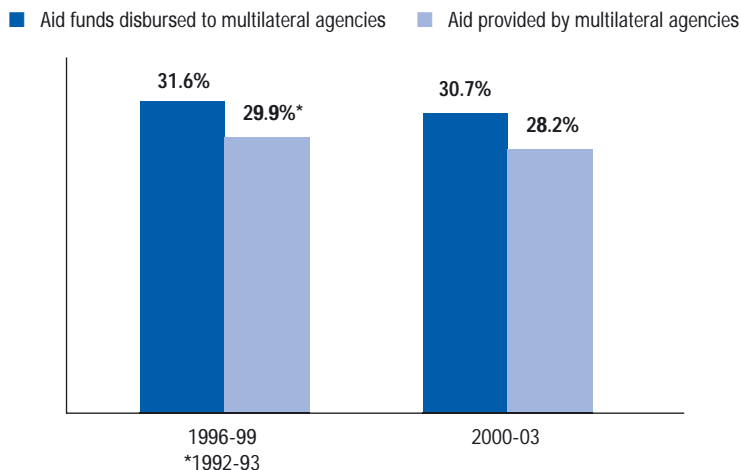
3. Progress on harmonisation in practice

Considering the international community's stated intention to improve aid harmonisation, one would expect to see a trend towards greater harmonisation of ODA over the last few years, either among donor countries, among bilateral and multilateral donors or among multilateral agencies. In practice, however, it is difficult to evaluate actual progress in harmonising aid, given that the lack of commitment to harmonisation on the part of the United States, the world's largest donor, obviously constitutes a major obstacle to the deepening of this process (a telling example is the recent creation of the Millennium Challenge Account, which was superimposed on existing aid structures).

The few indicators available show no clear trend in this respect:

- The *share of multilateral aid in total ODA* is a first indicator of donor countries' efforts to harmonise aid, since aid funds paid to or by a multilateral agency (the Bretton Woods institutions, United Nations agencies, Global Funds, etc.) eliminate the problems of harmonisation among bilateral donors. Surprisingly, this share has remained virtually unchanged over the long term and accounts for less than one-third of total aid (Figure 2), as confirmed by Clemens (2006).
- A second indicator is the *share of budget support and programme aid in total ODA*. DAC statistics, which are used as a benchmark in the ODA field, are too highly aggregated for this purpose, as they provide no information permitting a breakdown between budgetary and programme aid on the one hand and project aid on the other. Such statistics are available for aid disbursed by the European

Figure 2.
Share of multilateral aid in total ODA (percentage)

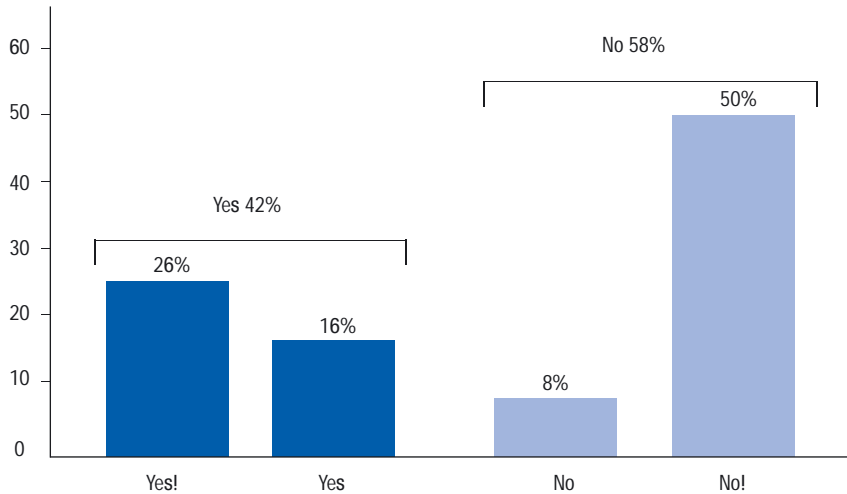


Source: OECD-DAC (author's calculations).

Union, however. They show that 31 per cent of the aid provided in 2005 through the European Development Fund to the ACP countries (Africa, Caribbean and Pacific) was budgetary aid in the broad sense (as compared to only 17 per cent in 2001); budget support also accounted for 17 per cent of total ODA paid from the EU budget (12 per cent in 2001). The EU is thus clearly ahead of the field in this respect, particularly in comparison with the United States, which authorises USAID to finance project aid only. If the aid is "fungible", however, the form in which it is provided (budget or project) is of little importance.

- A third indicator is the *share of delegated aid*, in which one donor delegates to another the responsibility for managing a project funded by the first donor. This new form of aid harmonisation is not yet in the mainstream, as shown by a survey of donors conducted on behalf of the United Kingdom's Department for International Development (DFID) in 14 developing countries (Figure 3).
- We should also mention a fourth indicator, *the geographical dispersion of ODA*. According to UNDP (2005) data, only five donors operate in fewer than 100 countries, indicating that the dispersion of ODA is considerable.

Figure 3.
Do donors delegate their aid?



Note: Survey of 14 countries in 2004: Bangladesh, Bolivia, Cambodia, Ethiopia, Fiji, Kyrgyzstan, Morocco, Mozambique, Nicaragua, Niger, Senegal, Tanzania, Vietnam, Zambia.

Source: OECD (2004).

Conclusion

On balance, aid harmonisation is a positive process from the standpoint of both donor countries (effectiveness) and aid recipients, but only under certain conditions. As we have seen, the theoretical arguments for harmonisation are extremely thin, as no comparison is made with respect to other determinants of aid effectiveness.

In particular, the example of Asian countries that received substantial aid from a single donor as from the 1950s shows the importance of strong institutions and a coherent national policy (Coordination Sud, 2005). This leads us back to the well-known institutional problems of the least advanced countries, given that the new policies promoted in the context of poverty reduction strategies do not seriously call into question the asymmetry of the donor-recipient relationship. In particular, problems still arise as a result of the unpredictability and conditionality of aid (Killick, 2004), as well as the lack of coherence of donor policies (especially trade-aid).

Lastly, the objective of harmonisation entails a major contradiction, in that full harmonisation of aid would make national agencies unnecessary (Martens, 2005). It is therefore necessary to limit this objective, in the interest of both donor countries (capitalising on the comparative advantages of each, visibility) and recipient countries (decision-making power). The question is where to set the limits, and the answer will depend among other things on the recipients' level of development.

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Beyond “grants versus loans”: how to use debt for development

by

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Since its inception in the 1980s, the developing country debt crisis has marked a dramatic watershed in official development assistance (ODA), as it brought home the fact that ODA loans had accumulated into unsustainable debt and thus called into question the use of loans to finance development. Moreover, it suggested that development institutions had indulged in “defensive lending” by using ODA loans to finance the repayment of earlier loans, thus feeding spiralling debt. Against this background, a major grants-versus-loans controversy has developed since 2000. An unlikely alliance emerged between, on the one hand, conservative academics such as Allan Meltzer and Jeremy Bulow, and on the other, “anti-globalisation” NGOs such as Attac and Friends of the Earth, to recommend a switch from concessional loans to outright grants as a natural lesson learned from the debt excesses of previous decades. These recommendations were echoed in the Meltzer report on international financial institutions (IFIAC, 2000) and in US President Bush’s proposal in 2001 during the negotiations for the 13th IDA replenishment that 50 per cent of IDA financing to poor countries should take the form of direct grants.

On the face of it, as observed by Nunnenkamp, Thieler and Wilfer (2005), this is a somewhat surprising controversy. Most ODA already takes the form of outright grants.

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According to OECD Development Assistance Committee (DAC) statistics, grants accounted for about 75 per cent of total gross ODA disbursements in 2004. Bilateral ODA is mostly channelled through grants, with the exception of Japan, where loans still account for more than half of gross ODA, and to a lesser extent Spain, Italy, Germany and France (in the last country, for example, ODA loans amounted to about 15 per cent of total gross bilateral ODA in 2004). The share of loans expanded between 1960 and 1980 but has substantially declined since the 1980s in the wake of the first wave of the developing country debt crisis initiated by Mexico's default in August 1982. The World Bank and the Asian Development Bank stand out as major ODA lending institutions, while other multilateral institutions tend to make outright grants. The replenishment of the International Development Association (IDA, the part of the World Bank engaged in highly concessional lending to the poorest countries) stands at the origin of the grants-versus-loans-controversy. What has emerged as a widely debated overall ODA question was originally concerned with the policy of one multilateral institution, although IDA is admittedly a crucial ODA provider (it contributes 8.5 per cent of total net ODA disbursements). On the basis of the available data, one might well ask why the share of loans in total ODA is so small.

This paper explores the grants-versus-loans controversy beyond the IDA debate, looking more broadly at whether and how the debt instrument still has a role to play in development finance. In a first section, we review some of the pro and con arguments on loans and grants developed in the literature. Second, we link the debate with the role of private capital flows (size of transfer, efficiency, consumption smoothing; see Reisen and Soto, 2001) and suggest that there are constructive ways to think about debt solvency in an ODA loan regime. Finally, the paper reviews ODA instruments and calls for modernisation of the way ODA is delivered.

1. The grants-versus-loans controversy

The very notion of foreign assistance implies some generosity as compared to resources raised on markets¹. A proper metric of ODA should therefore be the amount

*. This was not always the case. For example, Lewis (1955) uses the term “foreign assistance” for all foreign capital inflows.

of taxpayers’ money that is involved in any ODA instrument (and the net cash transfer to recipient countries). This is not how the OECD Development Assistance Committee (DAC) defines ODA, however, and that very fact may well help to explain why there ever was a debate between loans and grants. Instead of counting ODA as the actual budgetary cost for donor countries, the DAC defines it as the sum of grants and concessional loans (i.e. loans carrying an element of subsidisation²). In a steady state, where ODA loans are stable and identical over time in present value terms, the two definitions are equivalent, since the difference in a given year between new loans and capital reimbursements on all former loans is equal to the embedded subsidy. In general, however, the two notions will be different, and the current definition of ODA lacks economic meaning³. In itself, this casts some doubt on the relevance of a number of results derived from econometric analyses that take ODA statistics as an explanatory variable. While this paper is not primarily concerned with ODA measurement as such, it is not an unimportant issue. Measurement choices have a significant political-economy impact on donor governments keen on communicating their ODA commitments and results.

The grants-versus-loans debate is concerned with a comparison between ODA instruments. There is a temptation to discuss this comparison at constant (as currently measured) ODA. Obviously, keeping gross ODA constant would rather create incentives for donors to resort to concessional loans and for beneficiaries to prefer outright grants. If the focus is on net ODA, however, donors interested in maximising the ratio of net ODA to budgetary cost will still prefer to increase concessional loans, as net ODA is computed by subtracting amortisation of past loans from current gross flows; increasing concessional loans is therefore a superior option if the objective is public communication on the increase in a net ODA figure while minimising budgetary costs. There is little to be drawn from such a comparison, except from a pure political or political-economy vantage point. The preference for grants will be unsurprisingly supported by a number of NGOs, but also possibly by donor governments interested in checking the expansion of multilateral institutions: lending allows these institutions to expand faster than if they

2. To qualify as ODA, a loan must include a 25 per cent “grant element”, in comparison with a loan of similar nominal amount and duration carrying a 10 per cent interest rate. The rate of 10 per cent has no relation to the current market interest rate, but was chosen as an estimate of the opportunity cost of public investment for donors, which in turn can be approximated by donors’ social opportunity cost of public spending on ODA (see, e.g., Young, 2002).

3. For an alternative measure, see Chang *et al.* (1998).

have to rely on grant resources committed by member governments. Monitoring debt service payments also increases their influence.

A comparison between, say, a \$1 million grant and a \$1 million concessional loan would not make sense, however, even if both produce exactly \$1 million of gross ODA. To be meaningful, the comparison should take place at constant budgetary cost for the donor. Supposing that the donor would be willing to earmark \$X million of taxpayers' money for ODA, an interesting question is how to use X: as an outright grant, or in combination with a market loan of \$Y million to produce a concessional loan with a percentage grant element of $X/(X+Y)$. There are several lines of analysis:

- (i) What are the incentive structures involved in the use of each of these instruments?
- (ii) Is there any sense in which the X solution is to be preferred to the (X+Y) solution or vice versa?
- (iii) Do technical aspects of the X+Y combination matter (e.g. using X to lengthen the maturity, reduce the interest rate, lengthen a grace period, provide for indexing mechanisms, etc.)?
- (iv) Should anyone be responsible for making the X+Y combination, or should it be left to the market and the beneficiary of X? In other words, is there any role for financial engineering and for multilateral and bilateral development agencies in the conception of ODA instruments?
- (v) Are there meaningful differences between the political-economy implications of the two combinations from a donors' perspective?

We discuss some of these questions below.

1.1. Incentives and differential impacts

Can the way in which equivalent amounts of aid are delivered influence results? To answer that question, one must look at the different incentive structures of ODA loans and grants. We review below some of the results from the literature.

Lerrick and Meltzer (2002) as well as Radelet (2005) argue that loans carry perverse incentives, in particular linked to the pressures on creditors to make new loans to

allow countries to repay old ones, whereas grants can be devised to generate positive incentives. Contrary to loans, grants do not contribute to debt overhang. Moreover, Bulow and Rogoff (2005, p. 5) note a tendency to practise “defensive lending” by pushing new loans, notably in order to finance the repayment of older ones: “multilateral development banks sometimes have their own internal pressures to pump out loans, inducing politically fragile developing countries to take unwanted debt”.

These remarks, however, seem to relate to inefficient use of the loan instrument rather than to an intrinsic problem. Radelet’s suggestion that the allocation of IDA grants as opposed to loans should be based solely on the receiving country’s income may have some practical appeal but should not be construed as a theory. A simple analogy suggests how loans may help borrowers to escape poverty: micro-finance allows liquidity-constrained poor households to access (high-interest) loans that allow them to engage in highly productive activities. There is no *a priori* reason why ODA loans to countries could not produce similar results. The objections to the use of loans should rather call attention to the challenge of using ODA loans under a tight debt solvency constraint. While there would be no sense in further increasing the current debt of heavily indebted poor countries (HIPC) at present, refraining from further lending to them as long as solvency remains an issue is an appropriate but contingent response. Surely, a powerful rationale for restoring solvency is precisely to restore the capacity to borrow. One of the shortcomings of past loans was that risks were insufficiently taken into account and that the typical ODA instrument was too archaic to adapt to the solvency constraint of a poor country that is highly sensitive to external shocks.

What this literature points to, then, is a specific problem with managing debt. It gives no clue as to the respective effectiveness of grants versus loans. The jury is still very much out, but a number of recent studies shed some light on the impact on the beneficiary country of the ODA instrument used.

First, it is interesting to ask how ODA relates to local fiscal discipline. Since grants need not be repaid, they entail a potential disincentive on the mobilisation of public revenues and on the quality of public spending. Increased dependency on external aid may result. In principle, loan repayments should help build financial discipline and promote the efficient use of funds. Before moving to empirical results, however, the whole theoretical argument needs to be qualified. In a dynamic framework in which beneficiary countries

rely on the continuation of grants and in which development institutions are keen on producing a given level of ODA, the incentive structure is more complex. For example, if the renewal of a grant can be credibly tied to a given level of financial discipline in the recipient country, then the aforementioned disincentive is offset by the positive incentive of having the flow of grants renewed. However, “grant pushing” behaviour by development institutions might again weaken that incentive. More than a grants-versus-loans issue, this is another version of Buchanan’s (1975) Samaritan’s dilemma.

Odedokun (2003), using yearly panel data from 1970 to 1999 for 72 ODA beneficiaries, finds that concessional loans are typically associated with higher fiscal revenues, lower public consumption, higher investment rates and lower dependency of the public deficit on external financing. In poor countries, a higher level of grants in total ODA is associated with a lower tax effort. Gupta *et al.* (2004) look at a set of 107 countries that benefited from ODA between 1970 and 2000, assessing the impact of grants and loans on the domestic fiscal effort. They find that an increase in total ODA (sum of grants and concessional loans) leads to a decline in fiscal receipts in the beneficiary country. McGillivray and Ahmed (1999) and Sugema and Chowdhury (2005) reach similar conclusions using data from the Philippines and Indonesia respectively. However, Gupta *et al.* (2004) also look at the differential impact of grants and loans, finding that an increase in grants translates into lower receipts: 28 cents of each additional \$1 grant are offset by a reduction in the fiscal effort. Conversely, loans tend to be associated with increased government revenue. In countries with weak institutions, additional grants are completely offset by a reduction in domestic revenues (see also Clements *et al.*, 2004).

A second set of questions relates to the differential impact of grants and loans on economic growth and on poverty reduction. Nunnenkamp, Thiele and Wilfer (2005) conduct a simple correlation analysis to explore whether loans and grants have different impacts on economic growth. They look at the relation between, on the one hand, total net ODA, total net loans, total grants and the grant element in ODA commitments (computed as the product of the grant element as defined in DAC statistics and ODA commitments), and, on the other, average per capita growth in gross national income over the subsequent five years. Their analysis finds no substantial difference in the impact on economic growth between ODA distributed through grants and ODA distributed through loans.

The aid effectiveness literature, however, has largely ignored the question of whether the way aid is delivered (between loans and grants) matters. Clemens *et al.* (2004) explore precisely that question, by distinguishing various ODA motives: humanitarian purposes, which cannot be expected to promote short-term growth; longer-term-impact aid to support democracy, the environment or building up human capital, which should contribute to long-term growth, an effect that will not be observable in short- to medium-term analyses of the impact of aid on growth; and shorter-term-impact aid such as infrastructure finance. They do find a positive relationship between this last category (53 per cent of aid flows) and economic growth, notwithstanding governance indicators. They do not differentiate between grants and loans. However, grants are clearly better suited than loans for providing humanitarian assistance and financing longer-term-impact expenditures, at least in countries with a limited tax base. Hence, the question would seem to come down to whether potentially productive investments should be financed through grants or through loans.

1.2. Equivalence between grants and loans

The heart of Lerrick and Meltzer's (2002) argument is that all concessional loans should be thought of as an arithmetic combination between a grant and a market loan (see Annex 1 for further elaboration). ODA should rather consist of outright grants, with loans being provided by markets or financial intermediaries. This would entail no extra cost either for the donor or for the beneficiary.

This is a worthwhile discussion. Its merit notably hinges on the unbundling of a concessional loan into its basic components: not only does unbundling contribute to greater transparency, it also highlights the use of taxpayers' money (less visible in a concessional loan) and invites a stronger focus on the rationale for using subsidies in the first place. One of the crucial questions about ODA is why, when and how to use subsidies. With concessional loans, there is a risk that the subsidy is justified simply by the quest for market share under competition with other donors and with financial institutions. Unbundling thus contributes to greater efficiency.

Lerrick and Meltzer's argument, however, calls for qualification. It is based on the assumption that developing countries have perfect access to international capital markets. Their spending capacity is then determined by their wealth and international

interest rates. In that case, grants and concessional loans are fully equivalent. A grants-versus-loans controversy can therefore arise only when developing countries do not have full access to international capital markets. Under liquidity constraints and for any given willingness on the donor's side to commit taxpayers' resources, many developing country governments will lose in terms of overall resource availability if ODA is available through grants only. If a liquidity-constrained country lacks access to capital markets, then lending through a development agency relaxes the constraint. The argument thus comes down to whether developing countries suffer liquidity constraints and why, and also whether it is legitimate for development institutions to move in. The first question is an empirical one. There is ample literature showing evidence that these countries do suffer pervasive liquidity constraints.

A first explanation (Bulow and Rogoff, 2005) hinges on the idea that developing countries are insolvent due to a lack of credible institutions that would back their commitments to repay the debt. In that case, concessional loans make sense only if multilateral (as in Bulow and Rogoff) or bilateral development institutions are in a better position than private markets to be repaid despite local institutional weaknesses. While there is no empirical evidence to that effect, it remains plausible that development institutions have a better knowledge of local institutions and have established long-term relations that can provide significant leverage. Indeed, this argument underlies Rodrik's (1995) explanation of the existence of multilateral lending.

170

Another explanation relates to the so-called Lucas paradox (Lucas, 1990). Lucas asked why capital does not flow from rich to poor countries. In a neoclassical framework with standard production functions with constant returns to scale, the return to capital should be higher in countries where capital is scarce, and developing countries should thus receive massive capital inflows. The preceding explanation, based on sovereign risk, provides a possible answer. Alfaro *et al.* (2005) also conclude from their 1970-2000 empirical investigation that low institutional quality has been the leading explanation behind the paradox. Lucas, however, provided further insights based on human and physical capital externalities that in fact question the validity of the neoclassical model.

Basically, the profitability of a (private or public) capital investment depends on the presence of complementary capital assets, particularly public assets: roads, ports, airports, telecommunications, high degree of education, etc. In this case, market failure

provides a powerful justification for ODA as a way to support primitive capital accumulation to reach a critical level of capital stock beyond which further investment will be profitable. To finance such primitive capital accumulation, grants can be used, but in theory loans are a superior instrument precisely because there is an eventual return to investment. The characteristics of concessional loans (grace period, long maturities and low interest rates) allow such loans to be adapted to those of the investment considered.

Cohen and Soto (2004) and Causa and Cohen (2005) call attention to another explanation, based on insufficient integration of poor countries in international trade. They question the validity of the claim that capital is scarce in developing countries. More precisely, the claim is valid in volume terms (which matters from developing countries' point of view and to their growth prospects), but not in value terms. The comparison in volume terms is based on purchasing power parity (PPP) prices and exchange rates (*à la* Summers and Heston, 1988 and 1991). What matters from an international investor's point of view, however, is the return to capital in value, i.e. in dollar terms. The Lucas paradox in fact dissipates when the calculation is performed in dollars. In other words, investments in developing countries might be socially profitable, but the local relative price of capital is too high. This discussion relates to the grants-versus-loans debate in that a lack of integration in world markets widens the afore-mentioned difference and means that a developing country might not have the desired access to outside private market finance. In addition, international loans need to be repaid in foreign currency, which affects the country's repayment capacity. To the extent that socially profitable investments imply imports of capital equipments, grants (or possibly loans in domestic currency) are then to be preferred to international currency loans, unless the investment considered increases the country's export capacity and appears likely to generate enough foreign currency resources to service the debt.

A fourth explanation for developing countries' insufficient access to international capital markets relates to volatility in their resources. High volatility translates into higher spreads as the perceived risk on investment increases. In turn, high spreads limit borrowing capacity. Kharroubi (2005) shows how volatility tends to exclude poor countries from international financial markets. Here, the reason is related not to poor governance or to a low average return to capital, but to imperfections in financial markets, namely the relation between the lack of an effective, credible mechanism for

debt problem resolution and the level of spreads. Another imperfection is that private loans to developing countries have not helped to smooth per capita consumption but tend to increase the volatility of consumption (Reisen and Maltzan, 1999). Information asymmetries also generate herding behaviour with a risk of excesses in terms of both over- and under-investment.

This discussion illustrates that when countries lack access to international capital markets, this is not, or not only, due to poor governance and poor institutions. Some socially productive investments may not be spontaneously financed (see Annex 2). This is one of the rationales for ODA based on market failure. There is no *a priori* reason, however, why a grants-only approach should be appropriate. To the contrary, we claim that a strategy of lending makes more sense provided that it focuses much more than in the past on the issue of debt solvency and carries automatic responses to the risk of insolvency. We also argue that development agencies are better placed than markets to make these loans.

2. Concessional loans, grants and debt solvency

The case for restoring debt solvency through debt reduction and debt cancellation has been overwhelming, but this does not imply that debt instruments should be discarded. Indeed, one of the rationales for restoring debt solvency should be to allow overly indebted countries to regain access to the debt market. Kapur (2002) emphasises that the debt crisis is due to shocks rather than insufficient reliance on ODA grants. The idea that poor over-indebted countries should from now on receive outright grants only would risk labelling them as countries dependent on international generosity, bound to be under assistance and unable to regain access to international financial markets. For example, Hernandez and Katada (1996) find in a study of 32 poor African countries over the 1984-93 period that grants crowd out private investment. Conversely, loans from multilateral development institutions have been found to crowd them in (Ratha, 2001; this point is debated by Rodrik, 1995). A crucial question relates to the possibility of using ODA loans more efficiently than they have been used in the past.

Here, we focus on vulnerability to external shocks as a major factor behind the developing country debt crisis. Natural resource price volatility has long been recognised

as a major source of vulnerability for developing countries. There is ample evidence of the negative impact of export instability and of economic volatility on economic growth (Ramey and Ramey, 1995). An important question for donors is how ODA can help reduce vulnerability (for a discussion, see Guillaumont *et al.*, 2003). Our claim is that well-conceived development loans are superior (and complementary) to outright grants in trying to address this issue and attenuate the associated costs. The objective is two-fold: putting to productive use the profitability linked to good states of nature, while reducing debt repayments when the debtor faces a negative shock. Loans can be conceived to achieve both objectives and can be shown to be superior to grants (see the streamlined model in Annex 2). Indeed, the larger the volatility of a country's resources, the larger the superiority of subsidised loans over grants, provided that specific clauses are attached to these loans.

While the problem has long been known and understood, and despite several attempts, the international community has so far failed to provide a practical solution. Measures to stabilise natural resource export prices have failed in the face of the high and persistent costs of the distortions thus created given the evolution of markets. Mechanisms such as the Stabex⁴ were conceived to provide counter-cyclical relief. In practice, however, they worked rather pro-cyclically and did not achieve their objectives, for several reasons. The Stabex automatic stabilisation principle was weakened by the decision to target stabilisation funds to agricultural sectors affected by price shortfalls, which led to cumbersome delays because the European Commission was keen on monitoring the use of Stabex funds (Collier *et al.*, 1999). But the nature of the shocks has also rendered the instrument rather inadequate. Price shocks have tended to be permanent rather than cyclical. This is also one of the reasons why *ad hoc* debt rescheduling has often left debtor countries with an increasing debt burden that eventually became too heavy, as such operations were based on the false hope that higher prices and a more lenient economic environment would eventually bail out overly indebted countries.

4. The Stabex was set up in 1976 by the European Community under the Lomé convention and was discontinued in 1980. It was a system of compensatory finance to stabilise African, Caribbean and Pacific (ACP) countries' agricultural export earnings. Below a given reference threshold, a developing country would receive from the Stabex mechanism a financial transfer to cover the difference between the threshold and actual export receipts.

Guillaumont *et al.* (2003) discuss several ways to use ODA to dampen the impact of price shocks. A first option consists in explicitly linking yearly repayments to the state of nature by automatic adjustment of the public debt service to the evolution of export prices: reduced debt service during crises, faster repayment during booms. Such schemes raise several questions about the nature and calculation of the reference indicator, ways and means of indexation of debt service (cancelling or delaying instalments), the triggering mechanism and the financing needed for such an instrument. A key problem lies in distinguishing between short-term (within one year) volatility, for which market-based solutions apply; medium-term year-to-year instability, where ODA can provide some cushion; and a longer-term market trend, which calls for adaptation of the output structure and cannot be dealt with by stabilisation measures. Cohen *et al.* (2004) propose a medium-term solution that consists in smoothing out export revenues across a moving average of the previous five years, thus providing a cushion without opposing any trend. Such ideas could easily be applied towards adding a price indexation formula to concessional ODA loans. For example, creditors might monitor the difference between previous price averages and current prices. When that difference exceeds a given level, loan repayments could be either accelerated or reduced. In a similar spirit, Gilbert and Varangis (2005) call for explicit loan indexation on prime material prices⁵.

An interesting idea, also explored by Guillaumont *et al.* (2003), consists in using the subsidy element embedded in concessional loans to finance cushioning. The central repayment scheme might be based on constant annuities, but the loan would be associated with contingent grants provided in response to a temporary exogenous negative shock that would partly cover debt service. Such grants would be financed by a reduction in the primary loan concessionality, which means that the implied subsidy on the loan rate would be lower or the amortisation period shorter. If no shock occurs during the amortisation period, the associated grant might be used in whole or in part to cover the last payments under strict economic policy conditionality (to provide some incentive for sound management of any price booms).

5. Donors are currently experimenting with similar ideas. For example, the Agence Française de Développement (AFD) recently made a loan to a cotton company in an African country whose maturity depends on cotton prices.

2.1. *Towards sustainable ODA debt*

This discussion leads to a more ambitious scheme, in which the ODA subsidy involved in any concessional ODA loan would be used to adapt the debt stock to the shock pattern that debtor countries face so that debt solvency is maintained⁶. Such an idea, further developed below, faces several institutional constraints, both in terms of the rules currently governing ODA and with regard to accounting standards such as the new International Financial Reporting Standards (IFRS).

Under such a scheme, multilateral (and bilateral⁷) development institutions would build up reserves against bad and doubtful debt. Such reserves would be calibrated to cover risks related to shocks in natural resource prices and to natural disasters facing developing countries. They could use the grant element to finance the build-up in reserves. The key to the scheme would be an automatic cut in any unsustainable debt resulting from such shocks towards a sustainable debt level. The mechanism should be implemented through a careful auditing process. To give a practical example, one could conduct a detailed country risk analysis and classify developing countries in four groups, calling respectively for provisions amounting to 25 per cent, 50 per cent, 75 per cent or 100 per cent of debt. In the first group, considered as exceptional, a provision of 100 units would allow a loan of 400 units; in the second, the same provision would allow a loan of 200 units; in the third, 125. The fourth and last group would require outright grants. Countries with poor institutions and governance would belong to that group, for which the arguments presented by Bulow and Rogoff (2005) are valid.

175

What debt level could be considered sustainable? Experience with the HIPC initiative gives some clues. Initially, the initiative targeted a 200 per cent debt-to-exports ratio, which according to Cohen (2001) corresponds to a 60 per cent risk of a financial crisis. At the Köln summit, this ratio was lowered to 150 per cent. But even with that further concession, all HIPC countries having reached their completion point, with the exception of Mali and Senegal, failed to stabilise their debt ratios. After an initial improvement, the ratio deteriorated. Disillusioned with the impact of the Köln initiative, the London summit eventually decided to cancel the entire multilateral debt of

6. The following paragraphs draw on Cohen and Reisen (forthcoming, 2006).

7. Development institutions that make bilateral loans (such as AFD) already provision country risk.

18 HIPC countries. Picking a target for a “sustainable” debt-to-exports ratio requires careful debate, but it would seem that 150 per cent provides a ceiling, at least for the poorest and most vulnerable countries.

Moral hazard, however, stands as an important issue. Any debt cancellation scheme introduces a bias in favour of debtor countries. The risk is that of transferring resources from properly managed countries that honour their debt commitments towards those that fail to do so. Indeed, experience with debt reduction under the HIPC initiative illustrates that risk. ODA flows seem to have benefited the most indebted countries rather than the neediest ones, even if there is no evidence that debt relief has had any significant crowding-out effect on other aid flows (Powell, 2003); and there seems to be no correlation between debt reduction and either the level of poverty (Cohen and Vellutini, 2004) or the quality of governance. Our scheme, however, offers a possibility of significantly reducing the level of moral hazard involved. First, provisioning corresponds to an explicit and transparent assessment of the country risk and thus calls attention to country specifics and policies. Second, such provisions should be counted as ODA, since their cost is not born by debtor countries. By putting aside a chunk of the volume of ODA available to any debtor country, the scheme actually encourages virtue, since the provisions required would be lower in less risky countries. Overall, it would provide a powerful incentive for sound fiscal management and a springboard towards full access to international capital markets.

Such a scheme also calls for a much tighter coordination between multilateral and bilateral donors. There is a collective action problem in dealing with debt reduction, since it is in no creditor's interest to move first lest its move facilitate repayment to other creditors. It is interesting to compare our proposal with IDA14 provisions for 2005-08. IDA plans to allocate one-third of its resources to outright grants rather than highly concessional loans. A country might qualify for IDA loans provided that its debt remains within preset debt sustainability criteria established by the World Bank and the IMF. These criteria identify debt thresholds of 100 per cent, 200 per cent or 300 per cent of exports, depending on the institutional risk as measured by the World Bank's Country Policy and Institutional Assessment (CPIA). When the debt is too high, the country qualifies for grants instead. In order to avoid penalising a solvent country as compared to an insolvent one, IDA14 has decided to cut its grants by a discount factor of 20 per cent (or 9 per cent in a major post-conflict situation). The discount is

supposed to limit moral hazard in that it penalises a country that purposely lets its debt grow astray.

Our scheme is based on similar principles, but proceeds in a more systematic fashion. The leverage factor allowed in loans is grounded on constituting provisions that correspond directly to the grant element of international aid. The more solvent a country (i.e. the more it is able to build its institutions so as to honour its debts), the higher the possible leverage. Instead of a fixed discount, our proposed solution uses a progressive scale depending on the quality of the country's governance.

3. Beyond grants versus loans: towards modern development finance

The previous discussion has highlighted that adopting a “one-size-fits-all” approach to development finance is likely to be sub-optimal. Instead, we propose to adapt ODA financial instruments to specific situations and development objectives. In the previous sections, we have focused on the traditional government-to-government approach to ODA. Here, we propose an extension of this traditional paradigm. More specifically, and beyond their contribution to local capacity building, we believe that development agencies should usefully focus on the following two issues: efficient use of subsidies, and leveraging private resources.

3.1. *Subsidies for development*

Subsidies are of course the very foundation of official development assistance. Yet, when they are hidden in concessional loans, not enough attention is paid to justifying their use. We suggest here that development agencies develop good practices with respect to subsidies. A first approach could be to argue that ODA simply pursues an international redistribution objective. In that case, the best strategy would be to provide unconditional grants calibrated either by GDP per head or by the prevalence of poverty in any given recipient country. As Naudet (2005) discusses, however, ODA also seeks to promote development and economic growth, which suggests that redistribution from donors to recipients should also be targeted to improving economic and social efficiency. From public finance theory, we know that there are two broad

justifications. One is to correct market failures, such as providing a local or global public good that the market will fail to produce. The second is to achieve specific social objectives, such as bringing basic services to the poor. In the latter case, subsidies also contribute to redistribution through goods and services rather than direct income.

The global ODA apparatus does not yet lend itself easily to such clarity. For example, formalising an international redistribution objective would require specifying not only how much each donor should give, but also how much each country is entitled to receive. We are of course far from such international coordination. Another difficulty is that bilateral ODA also legitimately serves donor countries’ interests. It somehow buys services from recipients. This is legitimate because ODA is financed by donor countries’ taxpayers. However, it would also be very useful to specify the nature of these interests, be they genuinely altruistic or based on diplomatic or other gains (for example, compensation for the legacy of history, or provision of global public goods⁸). International coordination does exist in this respect, since DAC donors, for example, have agreed to refrain from promoting direct commercial interests through tied aid. Once the price has been set, however, the question of how to use the subsidy efficiently still remains.

3.2. Engaging the private sector

Most current ODA policies are based on the following paradigm⁹. There is widespread and extreme poverty in developing countries, and insufficient growth in many of them. This points to inadequate public pro-poor growth policies and poor governance; in response, the public aid apparatus focuses on government-to-government relations. While actions based on this paradigm are both necessary and useful, the paradigm provides only part of the story. Much progress can be made regarding the role and effectiveness of development aid by moving to a more ambitious and more modern paradigm.

It is useful to recall a crucial limitation of ODA: even after a very substantial increase in volumes, it will remain small compared to private international capital flows and domestic savings. In addition, the total volume of resources available to finance

8. For a discussion of the link between ODA and global public goods provision, see Jacquet and Marniesse (2005).

9. For a broader discussion, see Severino and Charnoz (2005).

investment in developing countries – namely the combination of ODA, private and other public capital flows, various donations, workers’ remittances – is endogenous. One can fix the volume of ODA, but not the total volume of financial resources available. Investment needs themselves are endogenous, and it is a mistake to neglect the strong link between profitable investment opportunities and resource availability, and to focus instead on providing resources to meet abstract needs.

In a revised paradigm, there is still widespread poverty and insufficient growth, but the diagnosis points to a failure of coordination among a number of stakeholders: the public sector, both domestic and foreign, but also municipalities and local governments, private companies in both the formal and informal sectors, foreign firms and local populations. Development is the extraordinary mechanism through which all these stakeholders join forces to produce growth and poverty reduction. In particular, the recent focus on poverty reduction, with a strong emphasis on social spending, has underestimated the role that the private sector, both domestic and foreign, is bound to play if we wish to reach the Millennium Development Goals. This approach invites us to think of ODA as a potential catalyst rather than as a provider of ultimate resources. This is consistent with a vision of development in which ODA does not produce development and growth, but helps parts of the process to start up.

What are the operational consequences of this new paradigm? It invites us to consider development aid as the combination of two crucial components. The first, which one could call “development project engineering”, is specific expertise and know-how in helping to conceive complex programmes and projects associating multiple stakeholders in productive activities that are geared towards reaching both domestic and international public good objectives: reaching the poor and giving them access to essential services, to health and to education, advancing energy efficiency, fighting climate change, protecting biodiversity, etc. The second component of modern ODA is the capacity of donors to use a wide range of financial instruments, from direct subsidies to market loans, guarantees, taking stakes in private firms and venture capital. Each of these financial instruments is fit to serve specific beneficiaries and objectives, but more importantly to offset some of the risks that the private sector would not take directly. The key and the originality, therefore, lie in mixing taxpayers’ money with a number of market-based financial instruments, in a flexible and innovative manner. This is, of course, a major departure from the conventional conception of ODA

instruments as either direct grants or concessional loans. The applications of such innovative “public-private partnerships” (PPPs) do not lie only in infrastructure and in the provision of basic services, which traditional PPPs tend to concentrate on; they also hold much promise in the areas of health, education, empowerment of poor communities and many other uses.

Implementation of this new vision does not come easily. As argued above, donors need to think harder about how to use taxpayers’ money. A number of development operations do not need subsidisation (some examples are given below). However, subsidies may be desirable and necessary in order to engage the private sector in achieving social or public good objectives, such as combining the requirement of cost recovery in the provision of basic services with granting the poor access to those services, or using the subsidy to “buy” specific environmental services from the private sector.

A second obstacle, as mentioned above, lies with the current statistical definition of ODA, which, because of the necessity for public communication concerning the ODA figure, conditions both the nature of the ODA instruments that can be used and their destination. The time has come to open up the statistical definition so as to make full use of the potential of ODA and increase its efficiency. The debate is only getting under way and needs to be pursued within the donor community, notably within the DAC coordination framework.

180

A third obstacle consists in a better understanding of what makes PPPs work or fail. It is a fact that the record of past PPPs, in a number of areas such as water adduction, has been rather sobering and casts doubt on their capacity to contribute to poverty reduction and to reaching the MDGs. A key difficulty lies with conceiving a pricing and regulatory framework that will work in the specific local, legal and institutional environments of developing countries. PPPs are not a new recipe for development assistance, but a complex set of interactions that need to be fully thought out in a context- and country-specific way.

A number of examples¹⁰ illustrate the potential benefits of such an approach. A first example, which shows how development finance can be provided without subsidisation,

10. Drawn from the 2004-05 operations of the Agence Française de Développement.

concerns Faulu, a large micro-finance institution in Kenya that plays a prominent role in financing local entrepreneurship. Faulu benefited from a guarantee of 75 per cent of its KS 500 million (¥5.5 million) five-year bond issue on the Kenyan Stock Exchange, launched in early 2005. The bond was successfully closed a few weeks later and was oversubscribed by 150 per cent. A development bank is often better placed than other market players to provide such guarantees, as it may have better information than some local actors and the ability to take more risks than the market. In this case, Faulu was able to raise longer-term and cheaper resources than it could have obtained through bank credit. Moreover, this operation helped to establish partnerships with the local institutional investors and thus also to the institutional sustainability and expansion of micro-finance in Kenya.

A second example highlights the potential of a similar approach in the area of continuing education. Development assistance was used to help coordinate the objective of providing university access to historically disadvantaged salaried students in South Africa; the willingness of the university to offer a substantial rebate on tuition fees in exchange for a possibility of increasing the number of enrolled solvent students; the capacity of a private company, Eduloan, to help more than 70,000 students a year to gain access to higher education; and the willingness of a South African bank to grant a loan (in rands) to Eduloan. The key to this interesting and innovative PPP is again a guarantee provided by the donor agency on the bank's loan to Eduloan. What allows the system to work is that the rebate on tuition fees is given back to students through the very competitive interest rate they pay to Eduloan compared with market rates.

181

A third example, again in South Africa, shows how it is possible to integrate low-income households in a social housing programme through the local banking system. The programme is based on home ownership loans granted to households with an income between 2,500 and 7,500 rands. A concessional ODA loan with a substantial grant element was made to a local bank. An amount equivalent to the grant element in rands is used by the bank to subsidise the loan instalments for lower-income households that otherwise would not be able to take part in the programme. This is a good example of output-based aid. In this case, the bank also has a further incentive to demonstrate that it is making significant contributions to social objectives, as the government can bar banks from participating in government programmes if certain social targets are not met.

Many other examples could be adduced that show the potentialities and the diversity of this approach, again based on using ODA to coordinate multiple stakeholders into making meaningful development projects feasible and sustainable. In short, there is a huge potential of innovations to tap if donors are willing to incur more risk than they do by working only at the sovereign level. This shift would lift ODA out of its current, old-fashioned, government-to-government subsidy mode into modern development finance and make a crucial contribution to sustainable growth and poverty reduction.

4. Concluding remarks

Our basic message in this paper is that the grants-versus-loans debate as it was cast during the IDA13 replenishment has been misleading and largely irrelevant. It came in a context where most multilateral and, even more, bilateral ODA is already delivered as outright grants. It broadly disregarded financial and economic analysis and reached one-sided conclusions that do not fit well with empirical observations. By putting the focus on ODA instruments, however, it has helped to raise awareness about the link between such instruments and aid effectiveness. Our main conclusion is that there is a rationale for loans as effective ODA delivery mechanisms, that there is also a rationale for development institutions to provide concessional loans, but that a key aspect of any effective ODA loan strategy has to be the issue of debt sustainability. We have discussed various options in the paper, and we recommend that this become a central question to address in donor circles worldwide.

182

Finally, the issue is not to choose between grants or loans as a question of principle, but to ask on a case-by-case basis how best to use taxpayers' money. Once this question has been answered, there is no convincing reason to deprive development finance of the innovations that have occurred on financial markets or to restrict it to either loans or grants. Owing to their field presence and experience, development agencies, both multilateral and bilateral, are in a privileged position to “engineer” development finance. We therefore voice our dissent with claims that the necessary mix between rich countries' taxpayer resources and market-based finance should be left to markets alone. Development institutions have a role to play as providers of financial solutions mixing grants and market instruments tailored to specific development needs.

Annex 1: The equivalence between grants and loans

Let us consider a 30-year highly concessional loan of 1,000 units made by a development agency to a poor country at a 1 per cent interest rate. For simplicity, we consider that there is no grace period and that the loan is repaid in constant annuities, which therefore amount to 38.75.

Suppose now that a private or institutional investor is able, with a AAA credit rating, to borrow on international capital markets at a 4 per cent interest rate, and that the management of the highly concessional loan mentioned above (monitoring, management, disbursement, repayment, etc.) costs the equivalent of a 0.5 per cent interest surcharge. Experience from past defaults suggests that a substantial risk premium must be added to make the investor willing to invest in poor countries. Taking 15 per cent as a standard risk premium and under international competition, the investor will be willing to lend to the poor country at a yearly rate of 19.5 per cent.

In such a context, the investor will be willing to buy the initial concessional debt title at a price of 198, which corresponds to the amount of a loan made at a 19.5 per cent interest rate and served by annual instalments of 38.5. We therefore conclude that the initial concessional loan involves a subsidy element close to 80 per cent.

DAC statistics, however, use a discount rate of 10 per cent (not 19.5 per cent), which corresponds to a grant element of 63.5 per cent. This example shows how important the discount factor is. It also reflects time preference and might thus be viewed very differently from a poor country's than from a rich country's perspective. The short-term “needs” of poor developing countries imply a high rate of time preference. Suppose, for example, that this rate is 30 per cent, meaning that the country is indifferent between having 100 today and 130 in a year. With such a discount factor, the present value of a stream of 38.75 over 30 years is 129. From the country's perspective, the subsidy element is thus perceived to be more than 85 per cent. Such a preference for the present, in poor developing countries, might lead them to underestimate the debt service burden, to consider that any immediate loan is much like a grant and to indulge in over-indebtedness.

Annex 2: A theoretical analysis of contingent loans versus grants¹¹

The setting

Consider an open country in a two-period framework. The country considers an investment I_1 in period 1. We suppose that there are two states of nature in period 2. In the favourable state, the return to the investment will be Q_+ ; in the unfavourable state, Q_- (with $Q_+ > Q_-$). We suppose further that the unfavourable state occurs with probability $p < 1$. The risk-free interest rate is r .

In such a framework, the investment will be socially profitable if and only if:

$$I(1+r) \leq (1-p)Q_+ + pQ_- \quad (1)$$

In what follows, we assume that this condition is satisfied.

Financing

The country finances I through its own financing capacity Q_1 in period 1 and through a debt D_1 contracted in period 1 from outside investors, such that:

$$Q_1 + D_1 = I_1$$

Let us assume that the country suffers from weak institutions and governance problems and that these translate into an institutional capacity $\lambda \in [0,1]$ to repay the debt.[?] can be interpreted as the recoverable part of any investment by the foreign investor.

The debt can be repaid (on average) if:

$$D_1(1+r) \leq (1-p)\lambda Q_+ + p\lambda Q_-$$

Let us call ρ the risk-adjusted interest rate on debt D_1 . Foreign investors will thus require a payment of $R = D_1(1+\rho)$ in period 2.

11. This annex draws on Cohen and Portes (2005).

If $R \leq \lambda Q_-$, the country is solvent and can borrow at the risk-free rate ($r = ?$).

If $\lambda Q_- < R \leq \lambda Q_+$, the country will not be able to repay the debt should the unfavourable state of nature occur. We suppose that in such a case the country defaults. Investors will be willing to finance D_1 at a rate r such that:

$$D_1(1+r) = (1-p)D_1(1+p)$$

This implies that $(1+p)(1-p) = (1+r)$, and $p \equiv r + p$.

Finally, let us suppose that the country has no financing capacity in period 1 ($Q_1 = 0$). The investment will be possible if and only if:

$$I_1(1+r) \leq \lambda Q_+(1-p)$$

Given I and p , it is thus perfectly possible that a socially profitable investment – i.e. an investment verifying (1) above – will not be possible.

In the following, we assume $I_1(1+r) > \lambda Q_+(1-p)$ so that I_1 , which we suppose to be socially profitable, will not be undertaken spontaneously. We ask how development aid can help solve this inefficiency.

Grants, loans and contingent loans

A first option consists in making a grant G_1 to the country. G_1 will finance part of the investment (thus contributing to the country's own financing capacity) and is chosen so as to make $I_1 - G_1$ possible. The grant G_1 will thus be chosen such that: $(I_1 - G_1)(1+r) \leq \lambda Q_+(1-p)$, hence

$$G_1 = I_1 - \frac{\lambda Q_+(1-p)}{1+r}$$

A second option consists in making a loan I_1 , knowing that the country will default in the unfavourable state of nature. Such a loan will thus repay $\lambda Q_+(1-p)$ and will therefore cost an amount equivalent to G_1 . In such a setting, the loan and grant solutions are fully equivalent.

Suppose, however, that donors tailor the subsidised loan to the unfavourable state of nature and therefore ask for a repayment $R = \lambda Q_-$. In such a scenario, the country will be solvent in both states of nature. The subsidised loan will cost G' such that:

$$G' = I_1 - \frac{\lambda Q_-}{1+r}$$

It follows that if $Q_+(1-p) < Q_-$, a subsidised loan is to be preferred to a grant.

Clearly, the best solution would be to design a loan whose service is contingent on the state of nature, namely:

$$R_+ = D_1(1+p) \text{ when } Q_+ \text{ occurs, and } R_- = \lambda Q_- \text{ in case of } Q_-.$$

If private creditors are able to design such loans, then the equivalence between loans and grants is restored. If, as argued in the text, developing agencies are in a better position than markets to devise such contingent loans, i.e. if their comparative advantage lies in their ability to write down the debt when needed, then loans are once again superior to grants.

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Comment

by

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It is not easy to comment on a paper with which one is profoundly in agreement, although pleading in favour of loans may seem suspect at first sight when it comes from an agency for which loans are a source of revenue.

Let us begin with the points on which we are in agreement.

First, it should be stressed that the low-income countries must not find themselves in a position where they have no possibility of borrowing. For some time now, critiques of the Heavily Indebted Poor Countries (HIPC) initiative have pointed to the risk involved in debt reduction. Debt reduction operations are inequitable and send a negative signal to potential lenders (Bougouin and Raffinot, 2003). This was the reason why the government of Ghana initially refused to avail itself of HIPC debt reduction.

191

Second, the paper points out that the “grants only” approach seems odd in a year when the spotlight is on micro-finance. If providing credit to the poor, even at high interest rates, can be considered “aid”, it seems inconsistent to argue at the international level for elimination of loans to the poorest countries, including concessional loans which often have a very large grant element.

Third, the paper clearly shows that reform of aid accounting as practised by the DAC should be a priority. Such reform should be designed to give the industrialised countries an incentive to increase the effectiveness of aid instead of increasing the amounts provided. However, this important idea is not linked to an operational proposal. The paper suggests that guarantees should be taken into account as aid, but does not specify

how they should be valued (the provision of guarantees is presented as involving no subsidy whatsoever). In any case, this should be only a part of the proposed reform.

Lastly, the paper emphasises that we should try to avoid another debt crisis by using repayment instruments that are contingent on the state of nature. The idea, though not new, is excellent, and one can only be surprised that it has not yet been implemented.

The paper does not specifically address the question of whether loans to low-income countries should be continued (Jacquet, 2003, has already provided a persuasive treatment of this question). Rather, it aims to grasp the implications for action: How can one ensure that further loans will not lead to another debt crisis? How can loans and grants be used in tandem? Before addressing these two points, we will return to the issue of the relative effectiveness of grants and loans.

The relative effectiveness of grants and loans

The idea that loans are more effective than grants would be a telling argument in favour of increasing the use of loans, but we must analyse the reasons for their greater effectiveness. The traditional argument is that governments show greater care in utilising money that they must repay than in utilising money that has been given to them outright.

192

Following Akerloff (1990) and Marcel Mauss, however, we may add that any gift is "poisoned" ("gift" has the same root as the German word *Gift*, which means "poison"), which could explain why certain precautions should govern its use. This observation weakens Lerrick and Meltzer's (2002) argument on the superiority of grants. The "poisoning" of grant-based relations can be seen in particular in the virtual impossibility of refusing a grant, even highly unsuitable grants, and in the guile¹ that the recipient must use to maximise the advantages stemming from the grant while at the same time sending the donor a positive image of itself. Similarly, the notion that loans have contributed to the debt overhang of low-income countries has not been verified empirically. The few econometric studies devoted specifically to the low-income countries are not really conclusive.

1. On this point, see Laurent (1998).

Closer examination shows that the differences in effectiveness between grants and loans stem first and foremost from the administrative processes employed in managing these two types of flows. In Mauritania, for example, the percentage of externally funded expenditures actually executed in 2003² was 94% for loans and 39% for grants (RIM, 2004, p. 34), and this situation was not specific to this particular year. This does not mean, however, that loans are necessarily better managed than grants. In many sectors, expenditure execution rates on loan funding exceed 100%, which indicates that unplanned expenditures were made during the year – and such haste can lead to faulty execution. This difference may be explained in several ways. First, decision-makers seem to want to initiate loan-financed activities before the repayment instalments begin. The Mauritanian report gives a different explanation: grants are, on average, more tied than loans, and it is more difficult to comply with the conditionality attached to them. Lastly, donors are more apt to become involved in the execution of grant-based expenditure, and this causes delays.

A new debt crisis?

The possibility that another debt crisis would result from the resumption of loans to low-income countries is clearly a weighty argument against providing new loans. Indeed, some studies suggest that the debt reduction granted under the HIPC initiative has not necessarily restored debt sustainability to the countries concerned, as it was supposed to (GAO, 2000; Raffinot, 2004). However, these works were published before the multilateral debt cancellation of 2005.

193

Even if we accept that the risk is still present, it nonetheless remains paradoxical. Apart from a few exceptional cases, the HIPCs have not received non-concessional loans for decades. It is thus difficult to understand how external financing consisting of a mixture of grants and soft loans led to a debt crisis. The crisis itself is atypical, in that it does not really correspond to what is called a “debt crisis” in the case of the emerging countries. For example, although countries such as Burkina Faso and Mali have paid all of their debt service since 1994 with no significant problems, they have enjoyed a

2. The execution rate is the ratio between actual expenditures and programmed expenditures. A low execution rate may also indicate poor programming.

series of debt reductions. And yet, these countries which have serviced their debt properly are classified in the same group as countries that did not service their debt, often for reasons of domestic politics, administrative disorganisation or civil war. Thus, the calculation performed by Cohen (2001), showing that the value of the debt cancelled under the HIPC initiative is in fact very low, is actually a calculation of an average, which masks a great variety of individual situations.

Countries that do not have access to the international capital markets are probably not subject to the same pressures as the emerging countries to maintain the credibility of their public policy. As the paper points out, their preference for the present and liquidity constraints are so great that in practice few governments of low-income countries really distinguish between loans and grants (Chabal and Daloz, 1999, p. 140). This explains why “loan pushing” nearly always works in these countries. As Bierschenck *et al.* (2003, p. 175-76) point out, “In fact, it would announce a revolution in the aid relationship if some day the government were to refuse a substantial amount of aid offered on the grounds that it did not fit in with its own priorities”. If we add to this the signal sent by debt reduction – namely, that future debts will probably be cancelled ultimately as well – it is understandable that there is a very strong incentive to contract unlimited debt, regardless of prospects for its sustainability.

As Easterly (2002) notes, however, it is not easy to understand this fear of another debt crisis given that the low-income countries are heavily dependent on a very small number of lenders, mainly international, regional and bilateral public institutions. It should thus be easy for the IMF to monitor these countries’ level of indebtedness. Although the IMF has not succeeded in this task in the past, this was probably due not to a technical problem but to a political-economy problem specific to that institution – even if evaluating debt sustainability is no easy matter in the case of highly unstable economies. There are no international regulations analogous to those that sanction the error committed by a banker who grants, renews or maintains a loan to a bankrupt shopkeeper.

Furthermore, the paper analyses debt sustainability as an external debt problem (particularly when addressing the issue of debt thresholds). This approach needs to be reviewed, as most of the debt problems of the low-income countries relate to public debt. This is obviously the case in the Franc Zone, which has a “soft” external constraint, but it is also true in most other low-income countries, where few private agents are able

to borrow abroad. Reisen and Van Trotsenburg (1988) made this point in the case of the 1982 crisis. What was true at the time for the emerging countries is still more so today for the low-income countries.

Everything seems to indicate that the most important problem lies not in the procedures used to finance low-income countries, but rather with the slow long-term growth of these economies, along with the legitimacy of their governments and the tax pressure they are capable of applying. As we all know, episodes of strong growth in some countries have not lasted, and some have even led to major crises or civil war. If an improvement in external financing procedures can help to reduce these problems, it will mark a large step forward.

Financial engineering: mixing loans and grants

The paper argues for innovative use of financial engineering for development, and one can only agree with this recommendation. It is striking to see how inflexible the financial instruments used to finance low-income countries are, particularly in comparison to the financing of local authorities in the industrialised countries.

However, the financing techniques put forward are somewhat disappointing. Making repayment contingent on the state of nature is an old idea that could have been acted on long ago. This type of approach already existed in Ptolemaic Egypt, where taxes were proportional to the height of the Nile flood. A simple water level was used to solve the problem of finding an objective measure of repayment capacity. However, the search for a metric of this type may be a non-problem, since financial techniques should make it possible to give the debtor government full discretion concerning repayments of principal.

Similarly, the proposal to set up advance provisions is fairly similar to Buiter and Sibert's (1999) idea of making it mandatory for the borrower to buy an option called "Universal Debt Rollover Option with a Penalty" (UDROP), allowing the borrower to reschedule its debt repayment plan in the event of a liquidity crisis, subject to a pre-determined penalty. This proposal does not seem to have aroused any interest outside academic circles.

Expanding the use of guarantees is another interesting idea, but one that has already been widely used, notably in financing small and medium-sized enterprises. The real problems appear in implementation, however. Once again, the devil is in the detail. When providing guarantees to banks that lend to SMEs, it is difficult to avoid two pitfalls. The first is an overly generous guarantee system, which encourages banks to engage in large-scale lending without playing their role of selection; the second, an overly restrictive system that does not really compensate losses (or does so too late), in which case banks extend no more financing than they would have if the guarantee system did not exist.

Lastly, the notion that multilateral and bilateral development agencies “are in a privileged position to ‘engineer’ development finance” owing to their experience on the ground is debatable in that it primarily emphasises the technical aspects of the question. As Martens (2005) shows in detail, it is actually difficult to start with the idea that the preferences of the various agencies are fully aligned with those of the governments receiving aid (not to mention the ordinary citizens of such countries). If they are not so aligned, aid modalities must be analysed not as a purely technical problem, but as the consequences of complex relationships among bilateral agencies, multilateral organisations and recipient countries.

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Comment

by

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This paper provides a thorough and very convincing analysis of the ongoing debate over the comparative advantages of grants versus loans as efficient instruments of ODA. Its main thesis can be summarised by the following lines of argument:

- pervasive market failures limit access to international capital markets for ODA recipient countries;
- in many cases, concessional loans are therefore superior to outright grants in mobilising resources for development, provided they effectively address the crucial question of maintaining the sustainability of the borrowing country's debt;
- development agencies have a comparative advantage over the market in making these loans and in designing the appropriate and most efficient "bundle" consisting of a "regular loan" on the one hand (the financial intermediation element) and of "subsidies" (i.e. the grant element) on the other;
- in order to design such efficient bundles of loans plus ODA subsidies, new approaches to delivering ODA need to be explored.

This commentary elaborates on four selected themes bearing on the paper's key issues: debt sustainability; the design of new ODA lending instruments; donor coordination; the accounting framework for ODA.

199

1. Debt sustainability

Debt sustainability is clearly the issue that has, in the current “grants versus loans” debate, led to a preference for outright grants to poor countries that, given past experience, have poor prospects of being able to carry additional debt. New loans, even on appropriate concessional terms, should therefore be envisaged only for countries whose stock of debt is below a “sustainable debt threshold” and expected to remain so, under normal circumstances. Loans are in this case desirable for the recipient country because they imply a commitment on the part of the donor that is *a priori* much stronger than with a promised flow of outright grants having an equivalent net present value (NPV) in terms of ODA. The donor, however, can justify such a stronger commitment before its own constituency, or before other potential beneficiaries of the allocated ODA resources, only if the non-ODA part of the concessional loan can be expected to be fully reimbursed in all states of nature.

This raises two closely linked issues. The first concerns the appropriate design of the “conditionality framework” under which a given loan would be initially committed and within which the scheduled disbursements would later be made. On this issue, it should be stressed that *effective* conditionality necessarily means *credible* conditionality. For conditionality to be credible, two conditions must be met: i) full “country ownership” is required, as only in this case will the government of the recipient country be able to fully commit to it; ii) donors should absolutely make clear that the conditionality under which the loan is granted will indeed, *ex post*, be effectively applied as announced.

200

The second issue relates to the proper definition of the debt sustainability threshold. In the new framework for concessional ODA loans proposed by the authors, the importance of the debt sustainability threshold is two-fold: it determines whether at any moment in time a country may qualify for a loan, and it is a crucial parameter for the trigger mechanism that allows the borrower to benefit from the “insurance against adverse shocks” component embedded in the loan-grant bundle. Debt service is then adjusted in accordance with the borrower’s current debt servicing capacity, which prevents the country from falling into a debt trap.

How then should this debt sustainability threshold be defined? This is a crucial and quite complex issue, which according to the authors needs “careful debate”.

The principal threshold used for eligibility for debt reduction under the HIPC Initiative has been the debt-to-exports ratio, modulated only by the so-called fiscal window, which introduced the ratio of debt to government revenue as an alternative threshold ratio. For the debt-to-exports ratio, the threshold value for poor countries' unsustainable debt was initially set to 250 per cent, but has been progressively lowered to 150 per cent. The authors suggest that this should be a maximum. A new framework for debt sustainability analysis is indeed now being considered by the IMF. In an effort to provide stronger incentives for institutional reform, it modulates the "indicative threshold" of sustainable debt according to the quality of the country's policies and the strength of its institutions. For poor countries with weak institutions, debt would be deemed unsustainable if the NPV of debt exceeds 100 per cent of export revenues.

More generally, it stands to reason that what is required are forward-looking and "country-tailored" debt sustainability thresholds, rather than the fixed, "one size fits all" thresholds on which the HIPC Initiative has been based. In this regard, the following question arises: would it not be desirable to give a bit more emphasis to the human development perspective and, accordingly, to modulate this debt sustainability threshold according to the country's performance with respect to selected human development indicators? Indeed, given donors' strong commitment to the MDGs, would it not be appropriate, for example, that a country facing unexpected difficulties in fulfilling its human development programme, as embodied in its Poverty Reduction Strategy Paper (PRSP), be entitled to quicker and more substantial debt service relief under the insurance scheme embedded in the loan commitment?

2. The design of new ODA lending instruments

As already mentioned, a key point, rightly stressed by the authors – and to date insufficiently explored in development finance – is that if ODA lending is to be effective, it should be combined with a mechanism that insures the borrower against adverse shocks to its revenues. Hence the authors' proposal to develop new instruments that embed this insurance mechanism as an ODA-financed subsidy. Under this scheme, development finance is opened up to equity-type financial instruments, which offer more opportunities for efficient risk-sharing than do traditional loans. The authors suggest

various ways to do this, proposing a comprehensive scheme which also tries to minimise moral hazard on the borrower's side.

Obviously, mechanisms that insure the borrower against adverse shocks are today in short supply on the private market. Commodity-indexed bonds have been issued in the context of debt restructuring agreements: in the early 1990s, Mexico and Venezuela included so-called recapture clauses in the "Brady bonds" they issued as part of the debt reduction deal with their creditors. Quite recently, Argentina issued a GDP-indexed warrant for every restructured bond, thereby promising to pay more if actual GDP growth exceeds baseline projections. These are exceptions, however, and they concern only middle-income countries. Given this observed state of market failure there is clearly a role for public intervention, especially for low-income countries, which happen to be the most vulnerable to exogenous shocks. The case for public intervention is even stronger when one considers that insuring development countries against specific risks has system-wide benefits and therefore generates a positive externality.

What are the comparative advantages of development agencies in providing concessional loans that include specific insurance clauses? First, agencies are surely less exposed to informational asymmetry, given their long-term involvement with the borrower. Second, and probably more important, they can muster the capacity needed to achieve effective risk pooling across countries. If they offered GDP-indexed loans, for example, they would have the capacity to diversify the individual GDP risks, given that, as shown by recent research, GDP growth rates are weakly correlated across countries. The same would be true for inflation-indexed loans in local currency, aimed at protecting the country from the adverse effects of real exchange rate depreciation. This type of loan would also be a useful addition to development agencies' menu of ODA loans.

It should be noted, however, that strong coordination among donors, multilateral as well as bilateral, is a prerequisite for successful implementation of this insurance-oriented ODA lending framework, for the following reasons. First, to achieve optimal risk diversification, the new scheme has to be launched on a sufficiently large scale from the outset; a critical mass is necessary, and pooling across countries needs to be extensive, which, at the very least, implies that donors accept to enter into mutual reinsurance contracts. Second, without maximum cooperation among ODA donors,

debt or debt service reduction provided under this insurance scheme could easily become poisoned by free-rider problems among both creditors and donors.

A key issue is therefore whether donors are ready to engage in sufficiently close multilateral collaboration to launch this new type of ODA loan. The stakes are huge, and not only for poor countries. Indeed, steps taken by donors to provide subsidised GDP-indexed loans or inflation-indexed local currency loans might be a powerful signal and a strong incentive for private markets and actors to provide for similar bonds to be issued by emerging market sovereigns, or even by developed countries.

3. Donor coordination

While donor coordination is obviously crucial in setting up the ODA “loan *cum* insurance” framework proposed in the paper, it is not the only argument in favour of reinforcing the present level of coordination among donors. Such coordination currently occurs mainly within the OECD’s Development Assistance Committee (DAC). It needs to be extended further, given that several potentially important players, such as Russia and China, are not DAC members.

Broad coordination is crucial for establishing a harmonised framework for designing conditionality – a conditionality that promotes aid effectiveness and is tailored to the borrowing country’s needs in a way that makes full commitment by the country’s government possible, but is nevertheless sufficiently streamlined to avoid the huge costs entailed by multiple layers of “cross-conditionality”. Coordination is also needed to avoid a situation in which, as a result of donor competition and “loan pushing”, the conditionality ultimately applied is the weakest one, or in which, just as undesirably, aid is allocated without due regard for the development needs or the absorption capacity of the recipient country.

Given the obvious advantages of stronger coordination among donors and the repeated insistence with which it is called for, particularly from the side of developing countries, how does one set about fostering it? How does one rein in the observable trends towards increased bilateralism on ODA issues, trends that are no doubt due mainly to geopolitical factors? Should it not be expected of the European Union, which

after all provides a large share of total ODA, that it take a leading role in organising and inspiring a renewed and stronger coordination framework?

4. The accounting framework for ODA

The authors stress the problems raised by the way ODA is currently measured. At present, ODA is an opaque combination of outright grants and net loan disbursements; the loans include, depending on their degree of concessionality, a variable but unreported grant element (of at least 25 per cent). Without a transparent accounting framework, it is impossible to monitor the allocation of ODA properly. Efficient and equitable use of the public funds devoted to ODA cannot be guaranteed under such circumstances. What is required is a transparent identification of the two categories of flows which are aggregated in the current definition of ODA: on the one hand, aid flows, which are budgetary outlays, and on the other, loan disbursements or reimbursements, which are balance-sheet operations. Only the first category of flows should be counted as ODA.

It is therefore crucial to measure the grant element in concessional loans. Care should be taken to account properly for the ODA content in loan guarantees or other contingent, off-balance-sheet liabilities, which are an important building block in the authors' new approach to delivering ODA. Computing the value of the various types of options provided by creditors at no charge to the borrower as the "ODA-financed grant" part of the loan is not necessarily an easy matter, be it for traditional loan guarantees or for more innovative loans indexed to GDP or the real exchange rate. This issue should be addressed quickly.

A related point concerning proper ODA accounting is the fact that debt relief is treated as ODA, even that part of it which simply represents long-overdue write-offs of past losses on unrecoverable debt, and even if it transfers absolutely no real resources to the beneficiary country. In any given year, such flows can be quite substantial. For Belgium and France, for example, debt relief operations counted as ODA amounted in 2003 to an exceptionally high share of ODA – about 50 per cent. This is obviously atypical, but it points to the need for budgetary rules that embody proper loan-loss provisioning and amortisation. With such rules, the cost of debt relief could be spread over time instead of having to be budgeted fully as ODA in the year when it is

finally granted. The requirement that cancelled debt be counted at face value as budgetary outlay may have made several European governments somewhat reluctant to agree to needed debt reduction operations: given the EU's Stability and Growth Pact budgetary norm, they may have been worried about the effect of proposed comprehensive debt reductions on their budget deficits. Proper budgetary accounting of debt amortisation and relief could therefore also help to facilitate timely and orderly debt reduction for debt-distressed countries.

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207

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