The Cost of Non-Europe in Development Policy

ANNEX III

Quantifying the economic benefits of increased EU donor coordination

Research paper
by Prof. Arne Bigsten

Abstract
This research paper discusses the costs of the lack of coordination with the EU on development aid, and seeks to quantify the benefits of further coordination between EU donors and to identify the most appropriate tools to carry it forward. Chapter 2 presents the evidence from recent analyses of the costs associated with poor donor coordination within the EU, i.e. by the Commission and the 27 member countries. It is noted that EU could save €800 million (in 2012 prices) per year through reductions in donor transaction cost. Chapter 3 suggests that about €2000 million extra growth could be achieved by moving to more general forms of aid, that reduced volatility of aid would be worth €1800 million per year for the recipient countries, and that coordinated untying of aid could save another €900 million per year. It is further estimated that €8,400 million worth of extra poverty reduction could be achieved if country allocation was completely coordinated with the EU with poverty reduction as the only target. The chapter also discusses some important issues relating to the global economic system, where coordination of Europeans would be useful. Finally, against the background of the identified costs due to poor coordination, Chapter 4 discusses what the EU should do, in terms of changes in aid policy and in the way EU aid is organized.

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Contents

List of abbreviations

ACP	Africa, Caribbean, and Pacific group of states
CPA	Country programmable aid
COM	Commission of the EU
DAC	Development Advisory Committee
DFID	Department for international Development (UK)
EU	European Union
EU15	EUs member countries before enlargement
EU27	EU's 27 current member counties
GBS	General Budget support
GDP	Gross domestic product
IFIs	International Financial Organizations
LDC	Less developed country
MAR	Multilateral Aid Review (of DFID)
NGO	Non-governmental organization
ODA	Overseas development assistance
ODI	Overseas Development Institute
OECD	Organization of Economic Cooperation and Development
PBA	Programme Based Approaches
Sida	Swedish International Development Cooperation Agency
UK	United Kingdom
UN	United Nations
UNDP	United Nations Development Programme
USA	United States of America
USD	US dollars ($)
WTO	World Trade Organization

Executive summary

The European Parliament has commissioned this report on the costs of the lack of coordination with the EU on development policy. The purpose of this work is to ascertain and quantify the benefits of further deepening/broadening coordination between EU donors and to identify the most appropriate tools to carry it forward.

Chapter 2 first discusses the evidence from recent evaluations on the progress and challenges of harmonisation, but the focus is on Bigsten et al.'s (2011) analysis of the costs associated with poor donor coordination within the EU, i.e. by the Commission and the 27 member countries. They estimate the costs savings that EU-donors could achieve by coordinating their activities better. The estimation of transaction cost savings is done in two steps. First they estimate how much can be saved by reducing the number of partner countries for each donor, and then they estimate how much could be saved by shifting money from projects to programs (which have less administrative costs) in accordance with the target set in the Paris agenda. Total savings from these changes for EU27+COM is about €800 million per year in 2012 prices. These savings could then be used to extend aid activities to the benefit of recipient countries.

Chapter 3 first looks at the administrative burdens placed on developing countries and the costs of those. The types of costs discussed here are the administrative costs associated with the handling of many partners and projects as well as the negative consequences of the unpredictability of aid. There are no systematic estimates of the magnitude of transaction costs in recipient countries, but there is an abundance of anecdotal evidence suggesting that they are substantial.

It is empirically very hard to identify the effects of aid on growth (presumably via improved governance) in recipient countries, but Bigsten et al. have anyway sought to estimate how the growth effects vary by aid modality. Their very crude estimates suggest that channelling more of aid as General Budget Support increases recipient country incomes the first year by about €2000 million. Moreover, apart from this positive growth effects, general forms of aid to governments would be associated with lower administrative burdens on recipients.

Bigsten et al. also estimated the potential savings for recipients of reduced volatility of aid. Their rather conservative estimates suggest that there would be an annual saving of at least €1800 million if aid was perfectly predictable.

They also presented estimates that poor recipient countries lose about €900 million per year because EU donor countries tie aid transactions to suppliers in their own countries. This estimates only includes officially reported tying, but there are certainly also a large grey zone here were donors favour their own suppliers even if they are not the best options.

Bigsten et al. have also analysed how much more of poverty reduction could be achieved by a better allocation of all EU aid among recipient countries (the problem of aid orphans), and they also put a value on this potential improvement. The estimated net gain from the reallocation is about €8,400 million, after adjusting the estimated allocation for differences in the quality of recipient governance. This estimate is certainly an upper limit of what can be achieved, since this would require donor countries to give up many of their other aims of giving aid to specific countries. It is hard to determine how large the politically feasible reallocations are, but the estimates anyway suggest that there is a huge potential gain from coordination of country allocation of aid.

The chapter concludes with a section which discusses some important issues relating to the global economic system, where coordination of Europeans would be useful. This relates to the distribution of influence within the international financial institutions (IFIs) and with regard to policies on global public goods. The EU should develop a policy on the governance of global economic institutions. The EC might also have a particular role to play with regard to measures seeking to push for accountable governance. One could possibly seek to shift from classical policy conditionality to governance conditionality, since the former has tended to undermine accountability to citizens. A good system would be common to all donors, predictable and agreed. This is an area where the EC could have a comparative advantage relative to the member states. This could both push European democratic values, while it at the same time improving efficiency. Economic Partnership Agreements could be used to support private investment and export promotion.

Finally, against the background of the identified costs due to poor coordination, Chapter 4 discusses what the EU should do, and in short the following is proposed:

Aid policy changes

1) Each EU donor should be present in fewer countries.

2) EU donors should shift to more general forms of aid such as budget support.

3) There should be better coordination of the day to day activities of EU donors. This could be in the form of coordinating the donors' reporting systems, or by simply deciding (in good EU tradition) that if the reporting system of one EU member is used, it should accept by the other EU members as well. Synchronisation of rules and procedures as well as meetings with the recipients would also help. Joint analytical work could be done to a higher degree.

4) As long as a recipient government pursues a credible policy, donors should continue to seek to align aid to recipient policy. However, when policies are not acceptable, donors should use non-government channels for aid, or try to change government behaviour with the help of governance conditionalities.

5) EU donors should agree on the untying of aid.

6) Donors should coordinate to make country programmable aid flows less unpredictable and volatile. To make aid contracts longer one may need to have conditions associated to them specifying what should be done in case there are instances of inappropriate behaviour.

7) Donors should support measures that make recipient governments' budget procedures more transparent, since this is required for donors to be willing to accept more general forms of aid. Donor would be helped if they could put in place a specialized agency or mechanism able to collect information about the governance characteristics of the potential recipients, and to circulate information among EU donors (or all DAC donors).

Changes in EU's aid organization

8) One way to bring about increased coordination would be to increase the role of the Commission. This can be increased in two ways. Either the member countries can decide to channel more of their aid through the Commission, or it can provide tighter coordination of the aid of the EU member states.

9) Increased coordination of country allocation does not necessarily require channelling resources through the Commission (even if that would be one way of doing it). It would be enough if countries jointly decide about the country allocation of their aid, and it might seem natural that the negotiations are organized by the Commission.

10) Increased predictability is much harder to organize in a decentralized fashion, since all the donor countries have their own political and budgetary processes. This would be easier to handle if aid was channelled through the Commission, since there would essentially be one process to try to stabilize. But there are of course also other considerations that countries take into account when they decide on the fraction of their aid that they want to channel through the Commission.

11) The untying of aid does not require coordination *per se*, but it is probably easier to implement if it is done in a coordinated fashion. Peer pressure could help to advance the process.

12) Reductions in transaction costs would probably be easier within one structure, but again the bilateral donors also have other considerations to take into account. Steps to organise a division of labour should anyway be beneficial, and maybe the Commission could be a broker in this process.

13) Apart from the issues just mentioned, there may sometimes be other reasons for choosing the Commission route rather than the bilateral route. Some types of aid

might be better handled for political reasons in a multilateral setting. It should be part of EU's strategy to improve policies, enhance policy coherence, and improve implementation and delivery mechanisms. But there is a certain coordination fatigue among the bilaterals, so the political costs of reduced donor ownership of their aid policies may constitute a severe brake on closer coordination.

Chapter 1 - Introduction

This policy brief seeks to contribute to the debate about the development policy of the EU. The terms of reference note that "in recent years, the focus on aid effectiveness has led to a growing consensus that development aid is underperforming notably as a result of too little coordination among donors and the existence of too many projects and programmes with different actors and procedures." It further notes that "development cooperation is widely recognised as one of the EU policy areas of strategic importance." This is also reflected in the agreements of the broader donor community in Paris 2005[1], Accra 2008, and most recently in Busan 2011. It is also reflected in official EU policies such as the Lisbon treaty, which states that effective coordination of aid programmes is an obligation for the Union and its Member States.[2] The importance of aid coordination is further noted in the European Consensus on Development[3], the Code of Conduct on Division of Labour[4], and the Operational Framework[5]. The European Parliament has noted that, in spite of all the rhetoric, there is a lack of satisfactory implementation of the commitments and has called for more efforts towards a better coordination. (It may also be noted that although the EU is committed to providing 0.7 per cent of Gross National Income in aid no later than 2015, it seems obvious that many European countries will not honour this commitment.)

Because of these concerns the European Parliament has commissioned this Report on the Cost of Non-Europe in the field of development cooperation, to support the reflection on increasing coordination between the EC and the Member States on development aid programmes. The purpose of this work is to ascertain and quantify the benefits of further deepening/broadening coordination between EU donors and to identify the most appropriate tools to carry it forward. The analysis is based on a comprehensive literature review, and it draws in particular on the Bigsten, Platteau, and Tengstam (2011) study on the aid effectiveness agenda.

The paper is structured as follows: Chapter 2 reviews the evidence on the magnitudes of benefits and costs associated with better donor coordination within the EU. The focus here is on the analysis of the costs savings that donors could achieve by coordinating their activities better. These savings could then be used for new aid activities to the

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[1] The Paris Declaration covering ownership, alignment, harmonisation, managing for results, and mutual accountability provided a comprehensive agenda for aid processes.

[2] Article 210 of the Lisbon treaty states: "In order to promote the complementarity and efficiency of their action, the Union and the Member States shall coordinate their policies on development cooperation and shall consult each other on their aid programmes including in international organisations and during international conferences".

[3] European Commission (2006). The European Consensus on Development, 2006C 46/01).

[4] Council Conclusions of 15 May 2007 on "EU Code of Conduct on Complementarity and Division of Labour in Development Policy", doc. 9090/07

[5] Council conclusions of 17 November 2009 on an Operational Framework on Aid Effectiveness, doc. 15912/09, and Council Conclusions of 14 June 2010 on Cross-country Division of Labour in Development Aid (doc. 10348/10)

benefit of recipient countries. Chapter 3 looks at the administrative burdens placed on developing countries and the costs of those. The types of costs discussed here are the administrative costs associated with the handling of many partners and projects as well as the negative consequences of the unpredictability of aid. This chapter also presents an estimate of how much money poor countries lose because EU donor countries tie aid transactions to suppliers in their own countries. It also presents evidence about how much more of poverty reduction that could be achieved by a better allocation of aid among recipient countries. The chapter concludes with comments on some issues of international collaboration that need to be considered by the EU. In Chapter 4, against the background of the identified costs of the lack of coordination, the way forward is discussed.

Chapter 2 - Quantification of benefits and costs on the donor side of increased EU donor coordination

The efficiency of aid measured in terms of effects for the intended beneficiaries depends on the quality of governance on both the donor and the recipient sides. Donors must organize their aid activities effectively (the focus in this paper is on coordination), and the recipients must implement sound policies and use aid money effectively. Both sides are important for the end results.

In this chapter the focus is on the donor side. We will discuss how large efficiency improvements can be achieved through a better coordination of donor activities. In particular we will present estimates of how aid transaction costs can be reduced by better coordination.

2.1 Review and discussion of previous evaluation evidence

It is hard to come up with precise estimates of the costs of not coordinating the aid activities of the European Union. An early EU-study (EC, 2009) sought to identify and measure costs of ineffective and fragmented aid and potential savings in transaction costs. That study looked at the costs of donor proliferation, fragmentation of aid programmes, tied aid, volatility and lack of predictability in aid flows, as well as shortcomings in the donors' use of country public procurement systems. The report sought to estimate savings from consolidation of programmes and projects, use of joint financing arrangements, delegated cooperation, and an agreed division of labour. It also estimated the costs of fragmentation in terms of staff time and consultants for design, formulation, appraisal and approval of new projects. It further noted that the current pattern of aid delivery puts a high burden on recipient governments, but it was not able to come up with any cost estimates of this. It estimated the costs associated with the tying of aid to purchases and deliveries from specific donor countries, and noted that aid volatility was causing major problems for recipients. Finally, it discussed the importance and role of recipient country ownership, but again without being able to provide any estimates of magnitudes. The report concluded that the EU could improve aid in particularly two areas, namely by improving aid predictability and improving the inter-country division of labour. The study suggested that the total annual savings of the EU could be in the range of €3-6 billion.

There are other studies trying to measure and compare donor quality from broader perspectives than cost effectiveness in aid delivery. There is the DAC peer review process, which monitors each donor's aid programme and provides information on a broad range of aspects of aid collaboration. The most comprehensive study of this nature has been done by Birdsall and Kharas (2010), who benchmark countries and agencies against each other. This study looks at country programmable aid (CPA) only, which means that they exclude the management of humanitarian aid, debt forgiveness, donor administrative costs, refugee support in donor countries, student scholarships in donor

countries, food aid, and core financing of NGOs. The performance in the latter areas is harder to measure and compare. There is also DFID's (2011) Multilateral Aid Review, which constructs indices of the quality of multilateral donors.

In the run-up to the Busan meeting in late 2011 donors jointly undertook a comprehensive set of studies seeking to evaluate the impacts of the implementation of the Paris agenda. These studies provide useful discussions of a range of problems associated with aid delivery including coordination issues, but they generally find it hard to evaluate the effectiveness of the Paris agenda. It is noteworthy that some of the country studies find a certain "Paris fatigue" among donors, partly related to their desire to be able to measure the impacts of their specific aid interventions. This may mean that donors become less willing to coordinate and use common arrangements. *It is possible that the current drive towards impact evaluation may make it harder to improve donor coordination.* Still, the potential savings from better coordination should be an incentive for closer collaboration.

An interesting study was done by Odén and Wohlgemuth (2011), who review the implementation of the Paris agenda in Tanzania, Zambia, and Mozambique. They find that there has been some progress with regard to harmonization among the donors, but that there are increasing problems with regard to the dialogue between the donors and the recipient governments. The focus on General Budget Support in these countries has meant that the dialogue has become more political in nature[6], which they fear may imply a reduction in ownership. There is also increasing pressure from the donors for quick results, since they experience increased pressure from politicians at home for quick and visible results. They believe that transaction costs with the recipients have been considerably higher than expected, and they also note that donors increasingly want to micromanage programmes in the consultation bodies set up for coordination. It is also noteworthy that some donors do not want to be coordinated, for example the US, China, India, Brazil, as well as the rapidly expanding vertical or global funds, which run their projects outside the government. It is therefore far from clear that ownership and recipient control of coordination is on the rise. They draw the conclusions that there is weak willingness and capacity of the host governments to take up the leadership role in the Paris agenda process, at the same time as there is less willingness from the home consistency of the donors to accept delays due to increased ownership. The dialogue structure has become complex and demanding leading to increased transaction costs. One conclusion that one can draw from this report is that *the problems and transaction costs reported could be reduced if there were fewer players involved*. And one way to this is to have a better division of labour among donors.

Wood et al. (2011) have produced a synthesis report of the large DAC-evaluation. They find that the Paris Declaration has made a contribution by strengthening good practices

[6] Negotiations about general budget support typically cover a broad spectrum of government policies as well as governance issues, and therefore this process can be more intrusive than processes relating to projects.

and contributed to the aid volume, but they find that donor progress has been very uneven. There have been some improvements with regard to the implementation of the Paris agenda, but with regard to the aid effectiveness it summarizes results as follows (p. xiv):

> "The Declaration was aimed at improving effectiveness in three areas: the efficiency of aid delivery, the management and use of aid, and better partnerships. Overall, the picture on efficiency gains is mixed, but so far disappointing in relation to the original hopes of rapidly reduced burdens in managing aid. There has been generally little reduction to date in those burdens where Declaration-style cooperation has been applied and even increased loads are noted in a few cases. At the same time, many Declaration-style mechanisms and practices are allowing for a much better overview of aid by the partner country and donors. When matched by sufficiently robust country systems, they have increased the country ability to handle more strategic support, particularly at the sectorial level.
>
> While progress is slow and uneven, the management and use of aid has improved in the countries studied, especially in relation to the pre-Declaration situation, and Declaration-style aid appears to have made significant contributions to that change. Global programmes are found to be still mainly insufficiently integrated with other processes, but in some cases considered to be delivering stronger development results.
>
> In terms of building more inclusive and effective partnerships for development, aggregate standards are rising. The Declaration has placed an explicit focus on aid relationships, and opened up important dialogues about partnerships themselves – between countries and donors, among donors, and with other stakeholders, rather than just the technical or financing aspects of managing aid. A number of clear practical benefits are already being felt."

There are five key recommendations for the donors from the Wood et al. evaluation:

The first recommendation is to "make the hard political choices and follow through", since change will not be effective unless there is political backing of the reform process. The political problem is that there are donors that find that there are also costs associated with relaxing national control of the aid processes. This is particularly important for the large donors, who are concerned about their political stakes. A shift in the balance of interest towards the development goal of poverty reduction away from a focus other national interests requires a debate among the political parties and the electorate in donor countries and with the EU.

The second recommendation from the evaluation is to "focus on transparency, mutual accountability, and shared risk management". This recommendation is detailed to include "deepening adherence to the principles of country ownership, alignment and harmonization of donor support, and transparency and mutual accountability in tracking

and achieving results". A new feature is that they argue that one should "add shared risk management to this framework of principles of aid". But donors do pay strong attention to the risk of failures in interventions, and this may hold back reforms to enhance ownership. Donors may feel that it is more important to keep tight control of *their* projects rather than let their and other donors' interventions be managed in a coordinated fashion by the institutions of the recipient government.

The third recommendation is to "centre and reinforce the aid effectiveness effort in countries" to strengthen ownership, transparency and mutual accountability.

The fourth recommendation is similar to the previous one. It is suggested that one should "work to extend the aid reform gains to all forms of cooperation". This is an increasingly important topic, since the number of actors in the aid business is increasing fast. It is an important and strategic question whether *all* aid really should or could be coordinated within the same framework.

It is also an intricate issue to define and estimate the costs and benefits of seeking to coordinate also the aid from NGOs, and I am not aware of any systematic studies of the costs and benefits. To what extent there may be beneficial effects would depend of the types of activities that are done. For example, if an NGO is involved in providing services that are generally handled by the government, there may be benefits of coordination, while other activities might function better without being integrated with government activities. If the NGOs are running innovative and experimental projects, it may be better to let them work within the general legal framework of the country without formal coordination with the government bureaucracy. There may well be more NGOs in some areas than what would have been optimal if one started from scratch, but this is not an option and one may possibly undermine their "idealistic" activities and fund raising ability by pushing for mergers. But there should be areas where coordination among NGOs, at least, would be beneficial.

It could also become too huge and complicated an operation to coordinate all activities including those of the NGOs, since the latter typically are numerous and not that large. And they are generally not involved in setting conditions for recipient government's policy, which means that there is less need for coordinating them as well. So there are some arguments in favour of letting them operate as independent agents outside the aid coordination framework. They would then also be part of and strengthen civil society and exert pressure on governments for policy reforms or accountability.

The fifth recommendation suggests that one needs to "reinforce the improved international partnerships in the next phase of reforms".

It also recommends that donors should "face up to and manage risks honestly, admit failures". This is a relevant observation when donor governments are becoming less and less willing to take risks in aid. The idea of "corruption free aid" may lead to aid being held back from potentially important but risky areas. This is an issue which policy

makers should think through carefully. Their concern is, of course, that they are accountable to the tax payers, and also that failures may undermine the support for aid. This is a relevant concern, but it could, to some extent at least, be countered by a sensible and honest debate of the risks involved. This is a key concern if we believe in the ownership agenda.

The report provides a harsh critique against the donors for not having made more progress with regard to the aims that they have set up for themselves. The report's key recommendations are that the aid processes should be country led, risks should be managed more honestly, and there should be high-level political commitment to the Paris agenda process. At the same time there is some concern that the old agenda may become less relevant in the new aid environment with new players like China and new private initiatives. This is certainly a concern to be taken seriously and investigated further.

2.2 An estimate of transaction cost savings of coordinating EU aid

In this part we will present the results from the most comprehensive estimate so far of how large cost savings could be achieved by reducing the administrative cost of aid delivery. The estimates reported are from Bigsten et al. (2011).[7] The study focuses on two powerful ways to reduce transactions costs, namely by decreasing donor fragmentation and by concentrating activities. The number of partner countries can be decreased and the mix of aid modalities can be changed by shifting money from projects to programmes.

Since aid activities are often complementary, donors need to coordinate to avoid inefficient aid allocations (Bigsten, 2006). How difficult it is to coordinate among donors will depend on how similar their preferences are. These may differ because donors have different views on what matters for development or have different national interests. Channelling aid through multilateral institutions could help reduce these coordination costs and also the influence of vested interests within the various donor countries (Kanbur, 2000, 2003). This was originally the reason why for example UNDP was set up, and this could potentially be a role that the EU could shoulder to a higher degree.

When discussing aid coordination it is of course also important to consider how it would affect governance in the recipient countries. The question is how the efficiency is affected by reduced administration of aid interventions. Some administrative controls are obviously important – and in particular if aid is given to poorly governed and possibly corrupt countries. The appropriate level of administration is obviously not zero. The estimates by Bigsten, Platteau, and Tengstam (2011) presented in this section focuses on

[7] The report was extensively discussed at a Roundtable meeting at ODI in London, in June 2012, with participation from the EC, donor organizations and the academic community. Prizzon and Greenhill (2012) presented a report with comments and critique on the EU-study. An extension of this analysis covering also non-EU donors is presented in Bigsten and Tengstam (2012).

the short-term or transaction costs of aid on the donor side, while costs and indirect governance effects on the recipient side are discussed in Chapter 3.

The transaction costs of aid have been defined as "the costs arising from the preparation, negotiation, implementation and enforcement of agreements for the delivery of ODA" (Brown et al, 2000). A more detailed definition of transaction costs (EC, 2009, p. 8) is as follows: "These are overhead costs associated with programming, identification, preparation, negotiation, agreement, implementation, monitoring and evaluation of aid activities (programmes and projects) including the policies, procedures and diverse donor rules and regulations for managing aid projects and programs, translations and adjustment to divergent fiscal periods. They may be incurred by donor governments, implementing agencies, or partner governments. These costs cover country analytical work carried out in the context of developing country/sector cooperation strategies, impact assessments (e g gender, environment or education) and capacity assessments (public expenditure and financial management system assessments and reviews). Such studies are often undertaken by each donor and can involve significant costs to both donor and partner governments, who are expected to provide information and staff time".

The main problem in identifying potential cost savings is to come up with reasonable estimates as to how much could be saved by rationalizing aid allocation.[8] It is clear from the definitions of aid transactions given above that proliferation has costs both on the donor and recipient sides.

The first EC-study on the topic (EC, 2009) used a bottom-up approach trying to add cost savings of some micro-reforms. For example, it looked at the number of donor offices in a country, and then discussed how much could be saved by various reductions in donor office presence – say max 3 EU offices. It further looked at the number of expatriates per office, costs of preparing country programmes for priority countries and differentiated costs between priority and non-priority countries, number of missions and studies which increase with the number of donors. There could also be an addition for change in Headquarter costs. They identified savings from reduced country level donor proliferation via joint programming exercises, reduction in the number of offices, and reduced duplication of missions and studies. They further consider gains to be had from eliminating minor donors, whose resources could be disbursed through delegated cooperation arrangements. Finally, they looked at the costs of starting up new aid activities. They discussed both costs of preparation, and implementation. They arrive at very high estimates on the latter, which are not credible (see discussion in Bigsten et al., 2011).

Because of the problems of obtaining good estimates of the costs of lack of coordination in the way tried by the cited study, Bigsten et al. (2011) decided to use another approach.

[8] Djankov et al (2008) and Knack and Rahman (2007) have done some estimates of the effects of proliferation.

They looked at the number of partner countries and the number of activities each donor is involved in. To come up with an estimate of potential donor savings they sought to make some reasonable assumptions about the scope for reduction in the number of partner countries and activities per donor as well as estimates of the cost savings this would imply. They included all administrative costs that the donors report (admittedly not perfectly reported) and estimated to what extent the budget could be reduced. The question of what to include in administrative costs is admittedly a difficult one. The data used are from the DAC database, and includes a broader range of cost than those directly relating to the managing of programmes. It has been pointed out that policy work at donor headquarters may be included, while in other instances some administrative costs may be reported as programme costs. So clearly that data have weaknesses, but more precise data are not available.

The analysis of Bigsten et al (2011) thus starts with aggregate estimates of administrative aid costs of EU27 + COM and evaluates how much of these costs could be saved by donors provided they concentrated their activities. Two ways to save money are analysed. Money can be saved either via concentration to fewer countries or via concentration to fewer activities. They assume that the aid budget will not shrink, which means that the activities remaining after concentration will be larger. They acknowledge that they cannot grow in size without some increase in administrative overheads, but there are clearly economies of scale so the increase in project costs is not proportional to the growth of the budget. They derived econometric estimates of the magnitude of the economics of scale in aid delivery.[9]

They made computations of administrative savings possible for the year of analysis, 2009, as follows: First they scaled down the administrative cost by reducing the number of partner countries. They estimated the percentage reduction in administrative costs when reducing the number of recipients, while keeping the overall aid budget constant and not changing the composition of the aid flow, that is the mix of projects and programmes.

In the next step they reduced costs further by changing the aid modalities. They investigated how much money could be saved by shifting money from projects to programmes. This gave an extra cost saving on top of the effect of country concentration. They estimated how much aid needed to be shifted from project support to programme support to meet the target set up in the Paris declaration. This degree of concentration was chosen because it was once politically decided. To get an estimate of how large the cost savings are, they needed an estimate of the administrative cost reductions such a shift implied. One might here expect that there are also efficiency consequences of a switch from projects to programmes. Administrative costs of recipients would probably

[9] Anderson (2011) has estimated economies of scale in aid delivery among bilateral donors, and also he finds that there are high donor costs of fragmentation, that is the spread of aid among many recipient countries. He suggests that there are large gains to be had if donors coordinated their allocation decisions and specialised. If the donors globally would allocate their aid according to his formula they could potentially save as much as US$ 2 billion.

tend to fall, but it is possible that corruption can increase so that more aid is wasted. There may also be specific instances where projects should be preferred, for example when new types of interventions are tested. When resources are moved from projects to programmes when a project arrangement would have been more appropriate, then the gain in terms of lower costs would have been reduced by lower efficiency. However, it was not possible to come up with estimates of these potential effects.

The average number of recipient countries per donor (the sample here included of all bilateral DAC donors plus COM) is 101, and the question is how large a reduction one should simulate. The study followed the tradition in economics and tested the effect of a reduction in the number of partner countries by one standard deviation, that is 37 countries (a reduction in the number of partners by 37%) This would lead to a decrease in annual administrative costs for EU donors (EU27+COM) by about 20 % or €498 in 2012 prices[10]. One might discuss exactly which changes one should discuss (here as elsewhere), and some critics of the report have suggested that one should assess what is an "appropriate" improvement on the basis of political feasibility rather than promises made. But since it is hard to establish what is politically feasible, the authors only discussed the political constraints on the choices to be made but left it to policy makers to decide on how far to go in the reforms.

Once donors have focused on fewer countries, they can as a second step change the modalities of aid. It is a challenge to get estimates of how the price tags of administration differ between modalities. Since comprehensive information was not available they used information from the Swedish aid agency, Sida. This is a medium sized bilateral donor, which probably can be taken to be rather typical in terms of administrative costs.[11]

Sida undertook a detailed analysis of its administrative costs of Swedish aid 2010 (Sida, 2011). The administrative costs identified were of four types:

1. Preparation of policy strategy and method documents
2. Implementation of strategies for development cooperation
3. Collaborate and advice internationally and nationally
4. Management, steering and support.

These data showed that the cost of transferring aid resources in the form of programme aid was only a third of what it was if transferred as project aid. General budget support

[10] The estimates were originally made for 2009 in 2009 prices, but they have here been converted to 2012 prices with the EU rate of price increase of 8% over the three years.

[11] Easterly and Pfutze (2008) collected information from donors about administrative costs. They describe their data on overhead costs as the most novel, but note that this kind of aid data is the least trustworthy. It is hard to get consistent data. They compute the ratio of costs to official development financing (defined as the sum of ODA and non-concessional loans). This indicator takes the entire administrative budget. The estimates they present (their Table 4) indicates that there is a huge variation across countries and multilaterals. The average for bilaterals is 7%. It is noteworthy that the share of administrative costs in their sample of 21 countries is close to their own estimate for Sida (6.5%).

was especially cheap in terms of administration with a cost of 19 % relative to the average for project support. Technical assistance had a transaction cost of 46 % of the costs for a project. Thus, also technical assistance is associated with relatively low administrative costs.

The focus in the Paris Declaration is about shifting to programme based approaches (PBA) from non-PBA, i.e. projects and technical assistance. What Bigsten et al. simulate is a shift from projects to programmes, while they leave technical assistance aside. The goal set up was to have 66 % of the aid through PBA, so they looked at such a reduction on the project side in favour of programmes. By increasing the proportion of CPA that is PBA from the actual level for 2009 of 44 % to 66%, the administrative costs related to CPA would be lowered by 21 %. That represents an annual cost saving of €306 million for EU27+COM (2012 prices). Summing up the results of our two steps we get a total saving on transaction costs of €804 million (2012 prices). This is equivalent to about one per cent of total annual ODA of the EU27+COM.

Bigsten et al (2011) also compared COM with EU15 (for which data were available) to see whether administrative costs differ between the COM and the EU15. They simply compared average costs per unit of aid-Euro delivered, but found no significant difference between the costs in the two channels.

It should be noted that as much as 29 % of CPA is technical assistance, and this was not included in the computation. There were two reasons. First, it was possible to reach the 66 % target by shifting resources from projects to programmes. And, as noted, there was a bigger saving from shifting from projects to programmes than shifting from technical assistance to programmes. Secondly, it is less clear that it is as feasible to shift this type of aid into programmes, although there should be some scope for savings also here that donors could exploit if there is a political will to do so.

So the total annual cost savings from lowered transaction costs according to the base estimate would be about €800 million. They did some sensitivity analyses to show how sensitive these results are to changes in assumption and the precision of the estimate of the effects of concentration on costs. It is clear that there is a considerable margin of uncertainty around the base prediction, but it is clear that potential transaction costs savings are sizeable.

Chapter 3 – Quantification of benefits and costs of improved EU donor coordination on the recipient side

After discussing potential savings in donor transaction costs, we now shift to the analysis of recipient costs. These costs are certainly the more important ones, but here it is harder to come up with good estimates. The recipient costs can be broken down into administrative transaction costs on the one hand and indirect costs on the other. The latter work through effects on recipient country governance and its effects on relevant outcome variables such as growth. In principle gains from reduced transaction costs could be eaten up by deteriorations in governance - or the gains could be extended by improvements in governance. Bigsten et al. (2011) made an attempt to analyse the indirect effects. This includes effects on growth, the costs for recipients associated with aid tying and aid volatility, as well as an estimate of gains that could be achieved by coordinating country allocation of aid within the EU.

3.1 Administrative burdens placed on the public service of developing countries

Transaction costs here are the administrative costs arising from preparation, negotiation, monitoring, and enforcement of agreements for the delivery of ODA. The costs associated with the transfer of aid have been debated for a long time. Bauer (1971: 99-100) argued early on 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 (2003:18) wrote that "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 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 diverse donor rules and procedures used by donors to manage aid projects. The problem is aggravated by different languages and fiscal calendars. There is also 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, 2007: 178). They also note that the bureaucratic quality in recipient countries tends to decrease when

they receive substantial amounts of aid. When there is donor fragmentation combined with tied aid, recipient countries may also receive equipment from different donors which are incompatible and this increases operational costs of the recipients. Channelling aid to projects rather than through budget support can contribute to undermining government institutions, as can bypassing central government units via project implementation units, and relying on expatriates rather than training and using local staff.

Brown et al. (2000) attempted to measure transaction costs in Vietnam. They noted the lack of an accepted method, lack of good underlying data, and the very high costs of actually collecting data from respondents. Balogun (2005) discusses the difficulties of measuring administrative cost savings from donor coordination, for example by reducing the number of project implementation units. He notes that there are also some savings in staff time spent on missions following better donor coordination. Amis et al. (2005) note that considerable time is used in donor meetings, but again it is hard to measure and value.[12]

The introduction of Sector Wide Approaches, where donors jointly fund sector-wide activities, might be able to reduce transaction costs, but it is difficult to determine whether there has been a reduction in transaction costs rather than a shift. The decrease in direct administrative costs has in some instances probably been counterbalanced by increased coordination costs.

Three studies (IMG, 2002; Odén and Tinnes, 2003; Booth et al., 2004) of transaction costs in Tanzania found that the ambitious donor coordination activities put in place there would not lead to any marked decline in aid transaction costs unless the number of projects declines further. They were unable to determine whether public expenditure management as such has improved.

One should also keep in mind that the less coordinated donors are, the easier it should be for recipient governments to achieve the aid allocation they desire, so from that perspective donor coordination is not necessarily in the interest of the recipient. However, since lack of donor coordination increases transaction costs, there is a trade-off between transaction costs and policy autonomy for the recipient government.

This brief review suggests that transaction costs on the recipient side are substantial, but there are no solid estimates either about how it has changed over time or how they vary by aid-modality.

3.2 Effects of aid modalities on governance and growth

Donor behaviour, for example in terms of coordination, affects governance outcomes, i.e. the behaviour of recipients, which in turn affects growth and poverty reduction. Bigsten

[12] Other studies discussing these issues are Acharya et al. (2006), Roodman (2006), Aldasoro et al. (2009), and Frot (2009).

et al. (2011) analysed how the effects vary by the characteristics of the aid transfer.[13] They estimated the effects using cross-country growth regressions, but as noted in the extensive aid-growth literature it is very hard to sort out what is cause and effect in this relationship (Roodman, 2008). Therefore the results have to be interpreted with great caution. One must also note that many of the effects of aid on growth will not show up until after many years, and they would therefore not be picked up in these regressions. For example, it takes time before improvements in schools change the aggregate level of education, which influences growth. Improved health may take even longer to translate into growth. Effect from better donor coordination on the quality of governance may also take a long time to translate into higher growth.

Bigsten et al. investigated the effect on growth of three different aid modality aspects, namely Aid fragmentation, General budget support (GBS) per GDP, and Tied aid per GDP. The only one of these three variables they found to have a significant growth effect was GBS/GDP. They then simulated the effect of an 11% increase in the share of EU aid that comes in the form of general budget support, and found that this could boosts the GDP levels of the recipient countries the following year by about €2000 million. This is a large effect, and reflects the fact that everything that has an effect on growth will matter a lot.

The result is interesting from the perspective of this report, since General Budget Support is an obvious area where there is and must be donor coordination. Generally there are coordination gains to be had if donors pool resources. This makes it possible to reduce administrative inputs from the individual donors. The implication here is that an increased emphasis on GBS would have a positive effect on recipient country growth. At the same time it opens up for savings in transaction costs. And although it was not possible to show that the reduction in aid fragmentation and the tying of aid had a significant effect on growth in recipient countries, it still would reduce transaction costs and thereby make larger real aid flows possible,

3.3 Benefits from reducing unpredictability and volatility

The problem with volatile aid is that it makes policy making in the recipient countries much harder, and forces the countries to be conservative in deciding on the allocation of funds. It could also affect recipient institutions negatively. It must be noted, however, that not all volatility is bad. For example, humanitarian aid, by its nature, is, and should be, volatile. More generally, any component of aid that acts as insurance will exhibit volatility that might be welfare-increasing.

In the literature one distinguishes between the term unpredictability, which measures the extent to which actual aid disbursements from a donor to a partner country falls short of (or exceeds) the pledged amounts, while the term volatility denotes the extent to which

[13] The effects of aid on governance is hard to measure., but for example Djankov et al. (2008) have tried and find that large aid flows have a negative impact on governance.

aid disbursements vary from one year to another. Ideally one would like to analyse unpredictability, but it is hard to do because of lack of solid data. Therefore most analysis is about the consequences of volatility, which of course is related to unpredictability.

Aid flows are more volatile than other macro variables such as government revenue, private consumption, and output (e.g. Kharas 2008). Actually, a general problem with aid flows is that they tend to be procyclical. This means that they tend to go up in good times, when the resources are less needed, and go down in bad times, when resources are particularly needed.

One consequence of unpredictability is that this makes governments more conservative in their allocation of resources. They may hold back investments that would be worthwhile, since they are not sure about the size of their budget. It is generally harder for governments in poor countries to smooth revenues thorough borrowing. One may also be concerned about indirect effects of aid unpredictability on the quality of governance in recipient countries.

The volatility of aid flows can also be an incentive for recipient governments to try to spread the risks by seeking to have many different aid flows and donors to reduce the risk of large swings. And since we believe that fragmentation is negative from an efficiency point of view, this is another negative consequence of aid unpredictability.

The methodology employed used by Bigsten et al. (2011) was first used by Kharas (2008). This is a rather complex approach, which seeks to estimate how large a reduction in aid a recipient would be willing to accept provided it is perfectly predictable. The difference between the fluctuating aid and the smaller but certain amount is considered to be an estimate of the financial loss to donor countries that could have been avoided if the aid flows to the partner country were certain.

Kharas (2008) applied this methodology to the DAC data for 177 beneficiary countries between 1970 and 2006, and he found that the deadweight loss is between 15 and 20 per cent of total aid flows. This is a huge number.

Bigsten et al. (2011) presents an analysis of the cost of the unpredictability and volatility of the component of aid for which we know that volatility is bad, namely the country programmable aid for the period 2000-2009 and 129 partner countries of the EU. The result is that the benefits of reducing the volatility of EU (EU27+COM) aid for 2009 is at least €1800 million. This is a more conservative estimate than that of Kharas.

Compared with other donors the volatility of aid from EU Member States is relatively low, but fluctuations of flows from individual countries are still considerable. One thing that could be considered is to use the EU aid in some coordinated fashion to smooth swings in flows from other sources. Among EU member fluctuations of aid vary a lot. The highest volatility characterizes aid from Austria, Czech Republic, Hungary, Poland, Slovenia, and Slovak Republic, while the most stable flows come from Belgium,

Denmark, Germany, Italy, Luxembourg, and Sweden. Aid from the EU countries taken together is fairly stable, though, since flows from different countries balance each other. If the EU-donors decide on their country allocation of aid together through some joint programming arrangement, it should be possible to reduce volatility of aid flows. However, there could still be instances where the EU-group together for some reason decides to reduce aid to a country, which then could imply a substantially larger shock than piecemeal reductions by the individual countries.

It still seems reasonable that donors should seek to coordinate their aid to make efficient use of their resources to counter economic fluctuations in the poor economies. The European Community (EC) could also seek to secure the access of developing countries to the international financial markets to make it easier for them to pursue countercyclical macro policy. Since recipients generally have serious implementation and institutional constraints it would be preferable if aid can be given to suffering countries in the form of budget support.

3.4 The tying of aid

This issue of tying of aid is not exactly about aid coordination, but one could argue that there should be an agreement among EU countries to avoid this practice. It is clearly the case that it is more prevalent in some countries than other, and this is in a sense "unfair" competition.

DAC (OECD, 2010) characterizes aid as untied when proceeds from loans and grants are fully and freely available to finance procurement from all OECD countries and substantially all developing countries. Tied aid means all other loans and grants are classified as tied aid, whether they are tied formally or through informal arrangements. . There is also an intermediate category called partially untied tied. This is defined as loans and grants which are tied, contractually or in effect, to procurement of goods and services from a restricted number of countries, which must include substantially all developing countries and can include the donor country.

Easterly and Pfutze (2008) discuss the extra costs associated with what they consider to be ineffective aid channels. They argue that tied aid is nothing more than ill-disguised export promotion and that food aid is in kind and could generally be bought more cheaply in the market. They argue that technical assistance is often tied and reflecting donor priorities rather than those of the recipients. Also Knack, Rogers and Eubank (2010) look at those aspects when constructing their aid quality indicator.

Clay et al. (2009) provide a comprehensive review of the literature on the impact of tying aid and point out that the studies surveyed invariably conclude that there are welfare losses of tying relative to getting untied aid. There may be a counterargument indicating that the tying makes it possible or interesting for donors to give more aid. Still, the comparison in Bigsten et al.'s estimates is with the situation where donors instead of giving tied aid give an equal amount of untied resources.

When it comes to food aid the development in Europe has been favourable in comparison to the development in e.g. the USA. There has been a gradual shift from commodity-in-kind food aid towards cash based food assistance. Most of European food aid is now purchased locally or regionally, which is more efficient (Lentz and Barrett, 2008, Gaus et al., 2011). Much of European aid goes through the World Food Programme, and that part is outside the scope of our study.

There are several studies that attempt to estimate the cost to the recipient of tying. There are issues about data availability, the extent of informal tying, and the degree of fungibility and so on. All these difficulties mean that the estimates are only rough approximations. The classical reference is Jepma (1991), who reviews the literature 1960-1990, and he concludes that tying implies a 15-30% increase in costs. Since then there have been studies looking at resource transfer efficiency that estimate the excess cost associated with tying. The approach is to compare the prices under tied aid with what they would have been if aid had been untied. The review by Clay et al (2009) finds that the estimates are in the same range as those reported by Jepma.

Bigsten et al. (2011) make an estimate of the magnitude of the extra cost that EU tying has for recipient countries. To compute this, one needs two parameters, the amount of EU aid that is tied and the cost increase associated with tying. In their calculations they use the midpoint of the estimated cost increase range of 15 % and 30 %, which is a cost increase of 22.5%. Their mid-point estimate of the total cost for the two categories of tying EU aid is about €900 million.

There has been some increase in EU reported tying in later years after an early decline, but it is hard to say to what extent this is driven by changes in reporting. In 2009 the EU DAC member average was 9 %, while the worst country cases in 2009 were Portugal (72 %), Greece (50 %), Austria (44 %), and Italy (43 %).

3.5 Addressing the issue of aid orphans

Developing and donor countries state in the Accra Agenda for Action that that "we will work to address the issue of countries that receive insufficient aid". One question one can ask is what gains could be achieved by optimizing the allocation of aid across countries with the single aim to maximize the aggregate poverty reduction effect. Here it is important to discuss issues of both needs and of the ability of recipient countries to transform increased aid volumes into poverty reduction.

One can assume that there is a trade-off for European governments between aid efficiency and politics. Aid coordination can be assumed to be efficiency enhancing, but it is at the same time associated with political costs. Thus, even if there are costs in terms of lower aid efficiency, the member governments may prefer bilateral aid relationships. We first discuss the political costs and constraints on coordination of the country allocation of aid, possible efficiency arguments against coordination, and then we report the estimate

by Bigsten et al. (2011) of the gains that could be had in case these obstacles were overcome and the whole of the EU jointly sought a country allocation of aid that gives maximum poverty reduction. This exercise is done to illustrate what could hypothetically be gained from an optimization of the country allocation.[14]

It is clearly the case that political decision makers need to report results of their use of the tax-payers' money to be able to maintain support for the activity. There is no point in arguing that governments should not be concerned about their voters and the domestic policy agenda, but we can still discuss the potential costs associated with it. The individual governments may have their own agendas that they want to pursue, or simply feel that they need to be able to report to their principals, the tax payers, what has been achieved.

One would also assume that larger countries are more willing to sacrifice efficiency for political control. One would assume that the aid allocation of larger countries across countries is relatively more dependent on their own political interest than altruistic motives than is the case for smaller countries. It is hard to put a monetary value on the political costs, so we have to confine ourselves to a discussion of those issues. Here we discuss whether we can see from the country allocation choices of various EU governments to what extent they reflect political priorities or efficiency concerns.

Generally one would assume that allocation may be influenced by donor self-interest, recipient needs, and recipient merit. Self-interest may be either geo-political or commercial. The use of aid tying is one example of own commercial interests influencing aid allocation. Recipient needs are generally measured by levels of poverty, while merit indicators are related to governance. Smaller national controls of the aid budget may have political costs.

The most comprehensive analyses of country aid allocation have been done by Berthélemy. The most striking result of his analyses of country allocation of aid is that neither recipient needs nor recipient merits seem to play any significant role in the allocation of Commission aid (Berthélemy, 2006b, p.16). Instead special relationships developed between the Commission and the ACP countries since the 1970s have a significant influence. He also notes that the Commission aid allocation is influenced by British commercial interests. These results indicate that the allocation of Commission aid could be better allocated if the aim is development and poverty reduction. It thus seems as if the Commission lets political motives steer aid allocation to a rather higher degree. For other multilaterals, recipients' needs play a major role, while merits do not. Still, commercial interests influence also the bilateral allocation of aid, particularly for the large countries of France and Italy (Berthélemy, 2006b, p 11). This review indicates that there is a whole range of motives other than poverty reduction that come into play when it comes to the allocation of aid.

[14] An extension of this analysis including non-EU donors is done by Bigsten and Tengstam (2012).

So this discussion suggests that donors often have been unwilling to pay the political price of adhering to the Paris agenda – at least when it comes to the country allocation of aid. But we can also look at the adherence of donor agencies to the Paris agenda by using the relative rankings of aid institutions done by Birdsall and Kharas (2010). Their rankings are based on 30 indicators, largely drawn from the Paris agenda, and they should therefore be relevant. First, it is rather striking that the multilaterals tend to get high scores in their rankings relative to the bilaterals. The European Commission comes out as number four among the 31 institutions ranked, which of course is very good. This stands in some contrast against what was implied by the analysis of Berthélemy (2006a,b). It could be a reflection of different approaches and somewhat different questions being asked of the data, but it could also be an indication that the EU COM has managed to improve its operations.

The Commission has pioneered the allocation of aid based on recipient performance according to certain ultimate goals, and since 1999 financing conventions with ACP countries include a "variable financing tranche", where aid transfers are based on the outcomes of certain social and economic variables (Adam et al., 2004). Performance-based contracts are expected to lead to better ownership, which in turn is considered essential for good performance. It makes it possible for the recipient country to define its own policy packages, reduce the problem of donor coordination, and increase predictability of resource flows. So this is a modality that is in line with the Paris agenda (and Birdsall's and Khara's indices), and this may suggest that the Commission could handle more of the aid flows of the EU countries. These estimates give an indication of the efficiency in aid management given then current levels in the respective organizations. It is hard to evaluate whether a rapid expansion of volumes, for example within the Commission, would overburden it and lead to significant falls in efficiency. There are no good estimates available of the absorptive capacity of the Commission.

With regard to the bilateral EU donors that are covered by this study we find a wide dispersion of aid efficiency In the top eight we have five EU bilaterals, namely Ireland, Denmark, the Netherlands, the UK, and Finland, while in the bottom eight we have Belgium, Italy, Austria, and Greece. So there is a wide dispersion, but on the whole the European bilaterals on average come out better than the non-European ones. There is no clear pattern of variation by size of country, and the large Commission comes out well of the comparison.

Still, donors may be seemingly efficient by the indicators we have just discussed, but this certainly does not indicate that they allocate aid across countries in an optimal fashion. The estimates by Berthélemy indicated that that is not the case, particularly not for the Commission, so we need to be a bit cautious about what to conclude on the basis of these crude indices. It is clearly the case that the overall distribution of EU aid across recipient countries is not particularly focused on the poorest countries, since country choices are not coordinated and because country choice is often a very political choice. Thus, one would assume that much can be gained if 'aid orphans' got more aid with the help of a coordinated country allocation of aid.

Bigsten et al. (2011) investigate what gains the EU could achieve if it chose to jointly seek to optimize the allocation of its aid across countries with the aim to maximize the poverty reduction effect. The thought experiment we undertake is that EU27 + the Commission reallocate its aid to maximize poverty reduction. This requires the use of a complicated optimization procedure. The estimated net gain from the reallocation is about €8,400 million, after adjusting the estimated allocation for differences in the quality of governance. This improvement relative to the original allocation applies each year that the new allocation is maintained. This estimate must be seen as an upper limit as to what can be achieved. Still, this is a huge potential gain.

It is obvious that there are large gains to be had in terms of poverty reduction by reallocating aid resources according to need. So why have the proposed allocation of donor resources not been achieved? Obviously donors have other aims apart from the maximization of global poverty reduction. They want to be present in a broader range of countries for economic and political reasons.

A country reallocation of EU aid can be achieved without necessarily channel the resources through the Commission, but then donors have to get together and coordinate their allocations. This may be an easier way of moving on the proposed direction than to shift the resources to the Commission. And then again, for the Commission to achieve the optimal allocation across countries it must have the support of the countries in any case. At present it would seem that the Commission (and thus presumably its principals, the countries) rather is concerned to show a European presence across all countries. So irrespective of what form the coordination would take, there seems to be strong political restrictions on what can be achieved.

We have furthermore noted that donors have become more risk averse and it has become more important for them to transfer resources in ways that make it possible for them to trace their own money. This may limit their desire to allocate aid resources through the Commission. Previously there has also been a sense that the bilateral channels were more efficient than the Commission channels, which would also hold back resource shifts to the Commission. However, in terms of how the aid is organized, the Commission (like other multilaterals) now seems to be better adjusted to the Paris agenda than the bilaterals.

EU aid coordination could help bring about an allocation of aid resources across countries, which is closer to the optimal one in terms of poverty reduction effects. This could entail coordination both between the COM and the bilateral activities of EU member states and with the non-EU development community. Coordination can take different forms (to be further discussed below), but the extent of coordination will in the end depend on the political goals of the participating countries. The ideal model we analysed assumed that their only goal is poverty reduction, but this is not their revealed preference. There are also other aims, which will hold back the proposed reallocation.

3.6 International dimensions of coordination

Apart from coordinating classical aid interventions one also needs to consider the need to reduce the asymmetries which characterise the global economic system. This is required when it comes to the influence within the International financial institutions (IFIs), but also with regard to policies on global public goods. There are many areas which are important here relating to e.g. international pandemics, environment, regulation of international transactions, and global financial stability. A related area is the international system of trade and WTO. Since the EC handles the WTO negotiations for all member states, this is a natural area of strong EC involvement. The EU should develop a policy on the IFIs. It should review the international aid architecture and evaluate if a better division of labour can be envisaged. One needs a better system of allocating resources to the multilateral institutions. The EU should also take a stance on the governance of global economic institutions.

Aid to governments affects growth and development via two main channels. It provides resources that can be used for investment (or consumption) and it affects government behaviour. It seems rather clear that the major constraints on development in poor countries lie in the areas of policy and institutions. An important question in this context is therefore whether the international community including the EU can change institutions through aid and conditionality. The World Bank has been reluctant to push for accountable governance, but here the EU countries and the EC can take the lead because they are less constrained than the IFIs when it comes to making politically-sensitive interventions. The EC may here have a comparative advantage relative to the bilateral donors and the IFIs, when it comes to pushing for changes on the governance front. Since these areas probably will become more important, this may be reason enough not to abandon EC aid.

The greatest political challenge in Africa has been on the side of policy implementation, where the severe problems are due to both lack of competence and lack of incentives to do the right things. For policy reforms to be credible and sustainable they should be grounded in a democratic process. Democracy has two important dimensions: electoral competition, and checks and balances. System scrutiny is needed to achieve honesty, and other systems are needed to achieve efficiency. Scrutiny is a public good and donors may need to consider what can be done to support it. They could stimulate peer group evaluations, help improve access to information and to build the capacity to analyse it. One could possibly seek to shift from classical policy conditionality to governance conditionality, since the former has tended to undermine accountability to citizens. A good system would be common to all donors, predictable and agreed. This is an area where the EC could have a comparative advantage relative to the member states. This would both push European democratic values, while at the same time improving efficiency.

To be able to integrate with the world economy, developing countries need to have systems in place that make it possible for them to be an arena for outsourcing and FDI generally. This requires systems that can guarantee quality and timely deliveries. If products are part of process and a marketing drive it is fatal to deliver late. Stability and security are therefore essential for LDCs if they are to benefit from the forces of globalisation. This certainly requires major infrastructure improvements, but in a situation when governance is poor donors may have to seek other routes to support investment. For example the Economic Partnership Agreements are a major new feature of the relationship between the EU and the ACP countries. This could certainly be used to support crucial country drives for private investment and export promotion. It may also be the case that the government lacks capacity to handle aid effectively, which means that it may be advisable to seek channels outside the government instead of overburdening it with project support. One could for example try to set up investment institutions that support private investment directly, rather than trying to do so indirectly via support for government infrastructure and the like. If this were successful it would also strengthen civil society, which would possibly enhance governance. So it seems possible that one could seek to establish investment banks operating in the commercial market.

3.7 A summing up of gains from better aid coordination with the EU

The review of the evidence in the literature suggests that there are large potential gains from better aid coordination. Bigsten et al (2011) summarized the results of their analysis in the following table:

Table 1 - Summary of annual effects of an EU implementation of the Paris agenda (in billions of Euro at 2012 prices)

Type of effect	Estimate (€ billion)
Savings on transaction costs	0,8
Gains from the untying of aid	0,9
Gains from reducing aid volatility	1,8
Indirect effect	(2,0)
Total efficiency gains excluding indirect effects	**3,5**
Total efficiency gains including indirect effects	**(5,5)**
Hypothetical gains from a full coordination of country allocation	**8,4**

Note: The estimates were originally made for 2009 in 2009 prices, but for this report they have been converted to 2012 prices in accordance with the EU price increase as reported by Eurostat.

The study identified a range of gains (admittedly hard to measure) that would follow from improved donor coordination within the EU (or generally for that matter). The three first components in the table, that is efficiency gains excluding indirect effects, are measured with reasonable precision. The indirect effects are measured with a high degree of uncertainty, but they may well be very large (in particular in the longer term). Finally

the large entry on gains from full coordination is also hard to measure, but it seems clear that it should be a large number in any case.

It is clearly not politically realistic to believe that EU will move all the way towards what is described as the optimal allocation, but the estimate gives an upper limit to the potential gains. Then it is up to policy makers to weigh these benefits against other political interests. One could of course experiment with partial reallocations, but they would not add much. It is better to let policy makers take this in and then consider how much of the way or at all they want to change allocations.

It should be noted that in these estimates of the potential gains from the implementation of the Paris agenda there are components for which the authors failed to come up with sensible estimates. These include targets on aligning aid flows on national priorities, co-ordinating capacity development support, use of country systems, and using shared analysis are not covered (Prizzon, Greenhill, 2012). The gains could thus plausibly be assumed to be larger if these effects were incorporated.

Chapter 4 – How should the EU coordinate its aid?

Against this background, what are the policy implications for the European Union? First we consider what policies should be changed and coordinated. We then discuss the relative importance of different policy changes and the political feasibility of the proposed changes. Finally we consider how aid coordination should be organized and in particular what role the Commission should play.

4.1 Implied policy changes

It is clear that major cost savings can be achieved if donors concentrate their aid efforts to *fewer countries* and to more *general forms of aid transfers*, e.g. General Budget Support. There are certainly political problems associated with this proposal, since it would mean that major countries would have to abandon certain countries, while they may feel that they have a political interest in showing presence there. One way of at least preserving an EU presence in all countries, while still reducing the number of players in each country, is of course to channel money though the joint channel, that is the European Commission. Alternatively EU countries could sit down together and decide on who should be present in which country. To focus the assistance on more general forms of aid may be politically easier than to drop countries, but donors may be reluctant to go for general forms of aid when they are uncertain about the quality of governance. Still, it is not self-evident that the quality of governance is less important for project support than general budget support.

Further gains could also be realised by better *coordination of the day to day activities* of the donors. This could be in the form of coordinating the donors' reporting systems, or by simply deciding (in good EU tradition) that if the reporting system of one EU member is used, it should accept by the other EU members as well. Synchronisation of rules and procedures as well as meetings with the recipients would also help. Joint analytical work could be done to a higher degree.

Much can be gained by *coordinating the country allocation of aid*. Here we have noted a huge scope for achieving more effective poverty reduction by letting the allocation of EU aid be determined wholly by the extent of poverty reduction that could be achieved in different countries. According to the estimates presented above, which take the effect of differences in the quality of governance into account, such a country allocation would imply a huge improvement in poverty reduction results. However, since the proposed allocation has not emerged from the political system of the donors as yet, we must assume that such a reallocation would have high "political costs". On the list of countries that would benefit from the reallocation are countries, which are not major economic partners of the EU, nor have a strong strategic value. Thus, such a reallocation of aid would mean that EU goes all the way to an allocation that is purely altruistic and is not in any way governed by self-interest (apart from the long-term self-interest of eradicating poverty and thereby creating a more stable world). One would not expect that all the EU

countries would be willing to make the full adjustment, but we still think it is appropriate to point out what the costs are in terms of poverty reduction foregone of sticking to the current allocation.

We have also referred to (weak) evidence suggesting that there is a positive effect on growth from shifting towards *more of general forms of aid*, such as General Budget Support. As long as a recipient government pursues a credible policy, donors should continue to seek to align aid to recipient policy. However, when policies are not acceptable, donors will want to adjust their aid strategy. They can cease giving aid to the country in question, use non-government channels for aid, or try to change government behaviour with the help of conditions. But when seeking to channel resources through a government, it makes sense to see to it that this is integrated within the regular system of government, even if that increases the risk of misappropriation. It is important for sustainable development that aid helps build a viable governance structure, and that is not done by using parallel structures. That donors currently seem less willing to accept the risks of using government structures is a concern.

It is hard to find any strong economic arguments against the *untying of aid*. The argument against it would be that tying benefits donors themselves and reduces their cost of the aid transfer. But they could then instead reduce the aid allocation to an amount equivalent to the extra costs that tying implies. If donors really want to give effectively what they have set aside in their budgets, aid should be untied. The estimates provided are very approximate, but there is no doubt that major benefits would be realized.

That recipients would benefit greatly from more stable aid flows is not in dispute. The political challenge here rather relates to the issue of what is required for donors to be able and willing to *guarantee stable aid flows*. On the one hand there are the constraints implied by domestic budget procedures, which mean that there are limitations as to what can be promised. Donors could of course try to make agreements covering several years, but it is not clear for how long such agreements could be entered into in a way that reassures the recipients that the money will be forthcoming. And this leads us to the next problem with regard to the stability of aid flows (the CPA component), and this is the problem that there may be unexpected revelations of bad governance or corruption in the partner countries. The donors would then want to adjust its aid stance, which may be harder if there is a long-term agreement. So in the end there are major gains to be had if aid is more predictable, but to make aid contracts longer one may need to have conditions associated to them specifying what should be done in case there are instances of inappropriate behaviour.

Transparency is clearly important if the donors are to be willing to provide more general forms of aid, that is accept a higher degree of ownership. It is therefore essential that the budget processes of recipients are transparent and that it is possible to follow the money flows to the final beneficiaries. Given that there is more transparency and accountability, the donors would find it easier to accept more general forms of aid that leave decisions

about the use of resources more fully in the hands of the recipient governments. Increased recipient control of the policy making process will also lead to more learning.

This leads us naturally to the issue of *conditionality*. It can be argued that one should apply some form of conditionality to recipient countries, whose leaders may exploit private information and that a number of benefits can be generated in this context by aid coordination. Donor would be helped if they could put in place a *specialized agency or mechanism able to collect information about the governance characteristics* of the potential recipients, and to circulate information among donor members. Aid coordination could allow for a more effective implementation of conditionalities and in a format that reduces the transaction costs involved on the recipient government side.

4.2 The role of the Commission in EU aid coordination

The results of the analyses reported in this review suggest that there would be substantial gains from better donor coordination and a closer adherence to the Paris Agenda.[15] The question is what form this should take and in particular what role the Commission should play relative to the member countries.

Exactly how the coordination should be organized and what the outcome of the process of stronger coordination involving the EU member countries will be is not necessarily straightforward. Schneider and Tobin (forthcoming) discuss this issue and argue that EU members can influence the aid allocation process towards their national interests by forming coalitions with likeminded members. If the preferences are varied the Commission has a greater chance of pursuing an independent multilateral aid strategy. Their empirical evidence supports their hypothesis that coalitions can have a strong influence, at least with regard to who gets the aid. One could envisage that member countries give the Commission a mandate to pursue only altruistic aid focusing on for example poverty reduction. The question then is how much autonomy the Commission should have and how well protected it should be from pressures from individual members and groups of members. If they are given a very high degree of autonomy, members could maybe become reluctant to allocate their aid money to the Commission. The question about how to organise extended aid through the Commission is not trivial, but we leave this discussion here with this caveat.

We have indicated that much can be gained by coordinating aid between the EU Commission and member states. One way to bring about increased coordination would be to increase the role of the Commission. This can be increased in two ways. Either the member countries can decide to channel more of their aid through the Commission, or it can provide tighter coordination of the aid of the EU member states?

[15] There is an ongoing debate about the role and importance of coordinated policy making generally within the EU. See Sapir (2007) for a set of analyses.

We have found that large positive effects in terms of poverty reduction could be achieved with a coordination of country allocation, and that does not necessarily require channelling resources through the Commission (even if that would be one way of doing it). It would be enough if countries jointly decide about the country allocation of their aid, and it might seem natural that the negotiations are organized by the Commission.

Increased predictability is much harder to organize in a decentralized fashion, since all the donor countries have their own political and budgetary processes. This would be easier to handle if aid was channelled through the Commission, since there would essentially be one process to try to stabilize. But there are of course also other considerations that countries take into account when they decide on the fraction of their aid that they want to channel through the Commission.

The third dimension which is the untying of aid does not require coordination. It is just a matter of doing it! But peer pressure, e.g. through the Commission, could help to advance the process.

Finally, reductions in transaction costs would probably be easier within one structure, but again the bilateral donors also have other considerations to take into account. Steps to organise a division of labour should anyway be beneficial, and maybe the Commission could be a broker in this process.

Apart from the issues just mentioned, there may sometimes be other reasons for choosing the Commission route rather than the bilateral route. Aid aimed at issues relating to politically more sensitive issues such as governance, accountability, and democracy might be better handled for political reasons in a multilateral setting. It should be part of EU's strategy to improve policies, enhance policy coherence, and improve implementation and delivery mechanisms. But, as we have noted, that there is a certain coordination fatigue among the bilaterals. So the political costs of reduced donor ownership of their aid policies may remain a severe brake on closer coordination.

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