

## **Donor coordination and the uses of aid\***

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**Abstract:** The paper discusses donor coordination and its implications for the uses of aid. The paper starts by specifying a simple framework for the discussion, and then reviews the theoretical literature. It then provides some data on donor proliferation and discusses how coordination modalities have evolved over time, in particular during the current phase with partnership and ownership. The following sections summarize the limited empirical evidence available on the impact of coordination on transaction costs and public-sector management and governance. 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.

**Keywords:** Aid; donor coordination; transaction costs; incentive effects.

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## 1. Introduction

Already from the beginning of modern development assistance after World War II, there was a feeling that there were problems associated with having a multitude of donors providing aid, and that coordination was required. Initially the idea was that there would be coordination through the UN-system, that UNDP would coordinate donors. In reality its 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 SWAPs, HIPC debt-reduction programmes, and PRSPs, new coordination modalities emerged as well.<sup>1</sup>

If donors now decide to increase resource-transfers to Africa, as suggested by the UN (2005)<sup>2</sup> and the Commission for Africa (2005), the demands on recipient country policy-makers, who already suffer from aid-absorption and governance problems, will increase further.<sup>3</sup> The concern about large aid injections is, therefore, how are expanded programmes to be managed?<sup>4</sup> Could donor coordination make it easier for recipient governments to administer aid efficiently?

Donor interest in coordination has increased in recent years,<sup>5</sup> and some new efforts are underway to improve it. In the Rome Declaration on Harmonization (OECD, 2003:10) donors committed themselves 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. This was followed up by the Paris Declaration on Aid Effectiveness (OECD, 2005a),

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<sup>1</sup> Sagasti, Bezanson, and Prada (2005) provide a comprehensive review of the evolution of the development financing system.

<sup>2</sup> Sachs et al. (2004) argue that Africa is caught in a poverty-trap, that small changes will not be enough, that African countries will not be able to break out of poverty unless large-scale foreign assistance is injected into the system.

<sup>3</sup> As a spin-off of the recent literature on aid effectiveness, some empirical estimates have emerged that indirectly measure the administrative constraints. 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.

<sup>4</sup> Pritchett and Woolcock (2004) pointed out that many of the MDG-services proposed are both transaction intensive and discretionary. Unlike many macroeconomic reforms, the delivery of many 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 from spending on health and education to outcomes is thus notoriously weak (World Bank, 2004a).

<sup>5</sup> Tarp (2005:8) noted 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”.

where partnership commitments with regard to harmonization, alignment, ownership, and mutual accountability were further specified.

The purpose of this paper is to discuss 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 implications of coordination, or the lack thereof, on aid effectiveness. There are some case studies available, however, and there have been some theoretical papers dealing with donor-recipient relationships and their implications for incentives and aid effectiveness.

Section 2 starts by setting out the issues and specifying a simple framework for our discussion, and then in Section 3 we will review the theoretical literature. Section 4 provides some data on donor proliferation and discusses how coordination modalities have evolved over time, in particular during the current phase with partnership and ownership. The following sections summarize the limited empirical evidence available on the impact of coordination on transaction costs (Section 5) and public-sector management and 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 our discussion**

Donor coordination means horizontal coordination among donors, also referred to as donor harmonisation (1 in Figure 1), which Balogun (2005) categorized under three headings: (a) the development of common arrangements for planning, managing, and delivering aid;<sup>6</sup> (b) the gradual simplification of procedures and specific requirements in order to reduce their burden on partner governments,<sup>7</sup> and (c) the sharing of information to promote transparency and improved coordination.<sup>8</sup> But besides such essentially procedural issues, coordination

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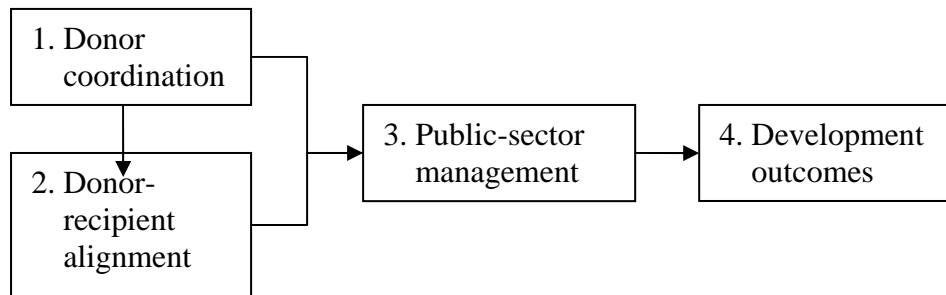
<sup>6</sup> Under this heading Balogun lists increased use of joint diagnostic reviews; collaboration and joint strategies; joint operations; joint financing arrangements; and common procedures for project environmental assistance.

<sup>7</sup> 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.

<sup>8</sup> 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 donors to regularly disclose commitments and disbursements at country- and sector-level.

may also relate to objectives and policies. We will also need to distinguish explicitly among various aid modalities, primarily projects; sector-programmes; and macro/budget support.

**Figure 1: Analytical framework**



To relate donor coordination to the uses of aid, we also obviously need to consider the relationship between the donors and a recipient government, referred to as donor-recipient alignment (2 in Figure 1).<sup>9</sup> Balogun (2005) breaks this down into (a) donor actions and (b) recipient-government actions. (a) Donor actions: Base donor-country strategies, programmes, and policy dialogue on partners' national development strategies and results frameworks; draw, as much as possible, conditionality from partner's national development strategies; rely on country-owned monitoring and evaluation systems to track progress against 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 macro-economic 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 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. The ultimate 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). Since this link is hard to identify and analyze we confine our discussion to the impact of coordination on public policy formulation and implementation (3 in Figure 1). Donors affect

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

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 growth constraint, at least in Africa.<sup>10</sup> An important question is therefore how the international community influences institutions and policy.<sup>11</sup> Aid of course 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 can also provide technical assistance and training and be used to build legal systems and accounting offices. But aid can also make it more difficult to improve governance due to the tragedy of the commons, moral hazard, and free rider problems. So the question here is 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 contents of the relationships, we see that there are mainly two dimensions of the impact of donor coordination that need to be considered. The focus of discussion among donors has been on what can generally be called transaction costs. But another important dimension concerns the incentive effects of donor behaviour. We will try to discuss both dimensions separately, though they are of course strongly related.

### **3. Literature review: Theoretical effects of donor coordination**

So how could aid be more efficient if its 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. Many different donors, each concerned with their own commercial and possibly security objectives at the same time, also

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<sup>10</sup> 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 different anti-growth syndromes were identified. First, there is the regulatory syndrome, which refers to excessive government intervention in markets. Then, there is the redistributive syndrome, where efficiency-reducing resource transfers dominate in the formulation of government policy. Another is 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. Finally, there is the state breakdown syndrome, that is, civil wars or severe political instability. Some countries were also characterized as syndrome-free. The empirical analysis showed that an absence of syndromes increased the growth rate by almost 2% per year.

<sup>11</sup> Adam and O'Connell (2000) analysed some dimensions of this issue theoretically.

generate a complex set of collective action problems. Aid agencies seek to maximize their aid budgets, requiring them to satisfy their parliament and various advocacy groups. They thus need visible aid results clearly attributable to the donor's activities, even if the development impact of the development budget is thereby reduced. And in fact all these mixed incentives distracts donors from maximizing overall development (Knack, and Rahman, 2004:3). Coordination of donors' goals, if possible, would reduce these problems, and increase the overall development impact of aid, even if donors then act separately.

But even if donors had the same goals there might be coordination failures. Hallonen-Akatwijuka (2004) identified several causes of coordination failures with project aid. First, if projects are complementary, complete information about the other donors' budgets is needed and donors need to take decisions simultaneously to achieve an efficient allocation. Second, if donors' utilities depend on projects funded by other donors, we may again get an inefficient allocation of resources across projects. Third, each donor can claim only a small share of the total benefits, in terms of project success, from aid efforts to improve the overall administration of the country, which would contribute to the success of the donor's own projects but also to that of other donors' projects. Thus, again the incentives to support such activities is weak.

Another type of coordination problem that has been debated 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 maximize the poverty reducing impact of their own projects. The success of the projects was assumed to increase at a decreasing rate with the amount of skilled local staff time put into the project, 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 maximize the joint poverty reduction impact of their projects. 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 their concern for the success of the projects of other donors increased. Lack of coordination leads to excessive donor recruitment of administrators. Thus, coordination of donor goals has important implications for the impact of aid.

We noted in the previous section that 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 (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 the population in extreme poverty. He assumes that the donors are all 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, consumption at home and consumption of the poor in the aid-receiving country. Torsvik asks whether donors should cooperate or give aid independently. With altruistic donors, poverty alleviation is a public good among them. If one donor then provides aid, it has a positive effect on the welfare of all donors. Non-cooperation in such a situation leads to an undersupply of aid (the common goods problem), and cooperation is thus desirable.

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

However, Torsvik does not believe that the principal-agent model captures the donor-recipient relationship fully, and instead models it as a non-contractible relationship. The key question in such a setting is whether the recipient can exploit the altruism of the donors and extract a rent.<sup>12</sup> Assuming that the recipient regards both consumption of the poor and of the rich as normal goods, it is clear that the recipient has an incentive to reduce domestic transfers from the rich to the poor when aid for the poor comes in (the crowding-out problem).

Thus, donor coordination can solve the free-rider problem of aid, but the question is still how it affects domestic support for the poor. Torsvik investigates two different interaction regimes

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<sup>12</sup> Azam and Laffont (2000) analysed the trade-off between rent-extraction and efficient poverty alleviation in the one donor, one recipient case.

when enforceable contracts are not available. First, if the donors do not face a Samaritans dilemma and all parties involved move simultaneously in a non-cooperative game, donor-cooperation increases foreign support but also increases crowding-out. 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 also lose domestic consumption of their own, while the consumption of the poor in the recipient country does not increase optimally, due to crowding-out. Donor cooperation is only beneficial from the donors' point of view if the recipient government is sufficiently poverty averse. If the recipient puts a low priority on the welfare of the poor, and 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, with the recipient government realizing this and adjusting 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. So it might be beneficial for donors to cooperate when facing a Samaritan's dilemma, even if the recipient government put priority on the rich rather than the poor.

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

#### **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 set up and given a mandate to coordinate aid (Disch, 1999:12).<sup>13</sup> But donor countries have been reluctant to give up control to these

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



multilateral institutions. The share of multilateral aid in total aid increased to only about quarter in the mid-1970s and has remained at that level since.

The World Bank and the IMF are financed by their member-countries and therefore provide a form of donor coordination. They also sometimes fill a coordinating role at country level, by being 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. European countries nowadays also channel some of their aid through the EU, which can thus also be seen as a coordinating agency. Still, as long as the bilateral donors maintain their own programmes, it is not at all clear that the introduction of yet another agent into the aid process actually reduces transaction costs.

Donors coordinate their handling of the debt problems of LDCs through the Paris Club. There are also various recipient dominated regional bodies, which naturally wield less influence than the donor dominated ones.

International donor coordination at its most general level may take the form of large international meetings, resulting in agreements on general goals and principles by 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 until 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 CG meeting. The fact that coordination may be conducted by the Ministry of Finance is not always easily accepted by other ministries, and there is also a risk that these kinds of local bodies undermine the role of the parliament in policy formation. Meetings, of course, focus on country specific development problems, and the whole set of objectives, policies, and implementation procedures, as well as fund raising issues, may be discussed. The UNDP or the World Bank can also chair meetings with the

donor community at the country-level to share information, discuss policy, and harmonize positions.

Since the 1980s there have been extensive attempts to introduce donor coordination at the sector level, known as sector wide approaches (SWAPs), where donors agree to pool resources within some specific sector such as healthcare. Such pooling schemes can be seen as a step in the direction of budget support, but the costs for negotiating these programmes have often been high (OECD, 2003), and progress has been rather slow.

The structural adjustment loans that became important in the 1980s were associated with policy conditionality, and various forms of debt forgiveness including the HIPC-programme have also been associated with conditionality. But domestic political and economic forces were strong, 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 sanctions they had threatened to impose (the Samaritan's dilemma). Svensson (2003:383) noted that there is "no link between a country's reform effort, or fulfilment of 'conditionality', and the disbursement rate".<sup>14</sup> Conditionality was therefore rather ineffective in changing recipient policies in a sustained fashion. Still, when donors were coordinated, it was easier to shift the decisions of the recipient government in the direction desired by the donors.

#### **4.3 Partnership, millennium development goals, poverty reduction strategies, and donor coordination**

Still, the result of the structural adjustment era was that many countries shifted to market oriented policies. Since the growth outcomes, in Africa at least, were generally poor, there has been a later shift of focus from these policies themselves 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 UN launched the Millennium Development Goals (MDGs) and the World Bank launched its Poverty Reduction Strategy (PRS), both focused on poverty reduction. These

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<sup>14</sup> 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.

two major initiatives have not been substantively coordinated, and there is sometimes even competition between the institutions at country level. To the extent that the two initiatives have different implications for development strategy and policy choices, alignment between donors and recipient governments has been made more complicated. This is an international donor coordination problem that needs to be addressed. The aid of donors will be better aligned if they share the same set of goals. Earlier 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 coordinate donors and align them with the recipient governments.

The IFIs have evaluated implementation of the PRGF in several countries (IMF-IEO, 2004, World Bank, 2004b), with four main results: (1) The emphasis in the future should be more on establishing a good process rather than on producing good documents. That is, implementation is the key.<sup>15</sup> (2) Feedback in the planning process, needed for the improvement of 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 prioritization and costing of interventions. The typical African country suffers from a lack of implementation capacity, and in many countries there is reform overload. Donors should not impose too many conditions on the government and thereby contribute to a further overloading of an already overworked administrative system.<sup>16</sup> And 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) that have been written in African countries generally seem sensible, except that their demands on the administrative system are often high. There is a lack of the required skills in the implementing institutions, 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 it is too weak. This could be an issue of insufficient

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<sup>15</sup> A key recommendation from 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.”

<sup>16</sup> For example, the recent World Bank (2004a) Country Assistance Evaluation (CAE) for Rwanda showed that with regard to the projects that the Bank supports in Rwanda, the country was struggling with absorption. A major result of the study was that the projects were too ambitious and too complex, given the limited capacity of the Rwanda government to handle them

salaries, especially if they can benefit from the existing system in ways that make them reluctant to change it.

The aim of the PRGF was to give the governments more policy space, and to some extent this has been realized. The IMF has been more flexible with regard to fiscal targets, and it has been more willing to overlook breaches of macroeconomic targets in countries with good performance on social expenditures. There has thus been a modest reduction in conditionality. But the reduction that donors will accept is intimately related to how fast recipient governments are able to put adequate and transparent budgeting and reporting systems in place.

On the whole, recipient country policy making is now based on the PRS system demanded by the donors, though there has been considerable consultation with various groups in society in the preparation of the PRSPs, which may have helped to coordinate donor activities and to align them with the development programme in the country.

Thus, compared to the old ESAFs, the PRGFs seem to allow greater fiscal flexibility and to support increased social spending. However, the conditionality in them does often not derive directly from the PRSP. Alignment has improved, but it could be much better. Country-ownership of programmes and policies has increased, but the problem is still in the implementation. This needs a country-solution, which unfortunately will not be realized soon.

#### **4.4. Changes in the structure of international aid flows**

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

What can we then say about changes in bilateral flows? Table 1 shows changes in bilateral aid by purpose. Up to 1990 the largest flow was to programme assistance, including general

development contributions such as balance of payments, budget support, and sector-unallocated structural adjustment assistance, things 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, there has been a partially compensating increase in the share of debt-related flows. Still, 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 does 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 & services	10.8	12.1	8.8	14.7	16.1	32.7	35.0	31.6
2 Economic infrastructure & 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\$)	5120.6	6999.8	16802.5	18160.5	33202.4	47061.4	43566.1	68972.0

Source: OECD (2005b).

Notes: The data covers 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 whose development was, or was intended to be, fostered 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, among other things.
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.

There is also some information on the number of donors that the recipient countries have to deal with. It 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, countries that are unconstrained by historical and strategic considerations, which have thus extended their programmes to a vast range of poor nations.<sup>17</sup> Overall, the proliferation problem has certainly not gone away. A question not answered here is whether other changes in how aid is transferred have reduced the complexity of aid flows enough to compensate for the large 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) defined transaction costs in this context as those arising from preparation, negotiation, monitoring, and enforcement of agreements for the delivery of ODA.

The costs of transferring aid have been the focus of hot debate from the very start of modern aid. Bauer (1971:99-100) 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 (2003:18) 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.”

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<sup>17</sup> Berthélemy and Tichit (2004) analysed the aid allocation decisions of bilateral donors.

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, 2004:3-4). When there is donor fragmentation combined with tied aid, equipment of incompatible specifications may be supplied by different donors. 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,<sup>18</sup> and relying on expatriates rather than training and using local staff.

There is a lot of anecdotal evidence on transaction costs, but so far very little solid empirical estimate of their magnitude. Brown et al. (2000) attempted to measure transaction costs made by in Vietnam. They noted the lack of an accepted method, lack of good underlying data, and the unacceptably high transaction 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 argues that the major saving is time costs, and there have not been any substantive analyses of these among donors.

There are some systems set up by donors to monitor coordination.<sup>19</sup> These again provide a general impression, but have as yet not provided solid empirical estimates of the benefits. SWAPs 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.

The bulk of the evidence on donor coordination derives from evaluations of programme aid. One of the most ambitious attempts to coordinate donors within a specific country was done

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<sup>18</sup> Between 1985 and 1995, the majority of donors in Mali used project implementation units rather than working through the regular bureaucracy (Bräutigam and Knack, 2004:261).

<sup>19</sup> Balogun (2005: 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 initiative 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).

in Tanzania (Helleiner, 2002). It seems clear that the transaction costs declined at least a bit after all Poverty Reduction Budget Support (PRBS)-supporting donors accepted one reporting system, the Performance Assessment Framework. The Tanzanian Ministry of Finance now need only prepare one report rather than 14 separate ones. However, there is no clear evidence yet that the overall sum of transaction costs of aid in Tanzania has fallen (IMG, 2002; Odén and Tinnes, 2003; Booth et al., 2004), since the costs of managing projects and common basket funds remain high. Common basket funds seem to provide a way to reduce transaction costs, but so far the costs of setting up and managing the basket funds have been high. All three cited studies concluded that there will not be 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. A Mozambique study (Batley, et al., 2004) discusses the relative merits of alternative aid delivery modalities, 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 noncoordination 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. They computed 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, which 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, as we have seen, 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, so from that perspective donor coordination is not 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 may be substantial, but there are no solid estimates either about how it has changed over time or 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**

When it comes to the impact of donor coordination or its lack on governance issues such as budget formulation and implementation, we have even less empirical evidence than when it comes to transaction costs. Still, what there is suggests that donors may undermine recipient government's policy making efforts by distorting incentives and overburdening government administrative structures. Lack of donor coordination can create incentives that contribute to the weakening of the recipient country institutions. Bräutigam and Knack (2004:265) say that "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."

When a recipient government tries to reach agreements with donors, it is clearly a problem if it faces a variety of conflicting conditionalities. Policy making will be complicated and policy choices will be restricted and distorted. Thus it might be sensible to let one donor agency manage conditionality in any given certain 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. But this of course implies that all donors will tend to gather behind one particular aid doctrine, suppressing innovation. So such a cartel could therefore be inferior to less coordination (Kanbur, 2003:20). Aid tends to undermine genuine policy learning in highly aid dependent countries.

The recipient countries may be unable to maintain projects once they are finally handed over by the donors (Adam et al., 1994). However successful a project appears on its own terms, it will also have little or no sustained impact in a poor sector-policy environment, and if it is not integrated into other donor-funded or government projects (Easterly, 2002; Kanbur, Sandler, and Morrison, 1999). Donors still seem to prefer to fund their own projects, although they at times imply unrealistically high recurrent expenditures in the future years. Bräutigam (2000) notes that such over-investments means that donors treat the budget for recurrent

expenditures 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, making it possible to report home about successful project implementation. However, short-term success for their individual projects may be 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 incentives for civil servants to pay attention to their other responsibilities, even if they have a greater impact on development than the donor project (Arndt, 2000). It also creates incentives for officials to extend projects from which they themselves 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 needs.<sup>20</sup> Dual salary and incentive structures undermine morale and commitment among public sector employees who are left out of donor-distributed assignments. ... This neglect of subversion of existing structures creates organizational confusion and contributes to the withering of government capacity” (Berg, 1997:82).

Nevertheless, it is hard to isolate the effect of donor coordination, or its lack, on the public sector and policy management, difficult to estimate the contribution of one factor in a very complex institutional set-up, especially within a single country.<sup>21</sup> The common, imperfect, approach to the problem of identifying a counterfactual is cross-country regressions. Knack and Rahman (2004) did an empirical cross-country analysis of the impact of donors on

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<sup>20</sup> “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, 2001:165).

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

recipient administrative quality. The econometric results support their hypothesis that aid undermined the quality of government bureaucracy more severely in 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 important also at the micro-level. Platteau (2004) analysed how aid was handled in community-driven development projects. He found a high risk of “elite-capture”, and that methods to reduce the risk of fraud were needed. A donor with local monopoly in this form of aid can adopt sequential, conditional disbursement to try to influence the activity of the local leader. But the problem is complicated if there are several aid agencies in the area competing for access to the local communities. Then 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 introducing 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 that impact assessment studies should be used, in which one would check whether outcomes for the poor have matched project expectations. He notes that such evaluations need to go beyond current practice, which consists of bureaucratic reports presenting financial accounts and physical achievements.

Mechanisms for aid delivery 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 regarded to have worked very well. Its success was of course due in part to the character of the recipients, but also probably to the fact that recipients only had to deal with one donor. A more recent example where an important external agent has been successful in influencing institutions concerns the East European countries’ accession to the EU. Another example is the WTO, which managed to change a range of economic institutions in China before China’s entry into the organisation. In both of these cases the benefits have also been substantial. It has also been suggested that the success of Korea, Taiwan, and Botswana is 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 hundreds of separate projects and programmes, as described above.

## **7. Policy discussion and conclusions**

So could donor coordination improve the situation?<sup>22</sup> Although donors have a common interest in development, they often have separate goals. Donor coordination on goals would make it easier for them 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 can also be that the recipient faces a domestic constituency seeking policies in line with their vested interests. If so, the government might be helped by having an agreement with a multilateral agency that forces them to stay the course, or change the policy against those interests. This could again be complicated if the domestic agents go on to lobby the multilateral agency (Kanbur, 2000, 2003).

Disch (1999) found that it has been easier to reach agreements between donors and recipients on policies (at least in principle), while it has been harder to agree 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, transactions cost may change very little, and the main benefit may come in the form of strengthening government systems.” (OECD, 2003)

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 organizational capacity building (policy making, budgeting, etc.). This would reduce the desire to provide funds to projects 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

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

terms or escape conditionality (Platteau, 2003). Lack of donor coordination also increases uncertainty about government policies, which tends to have a negative effect on investment.

It seems as if the lack of donor coordination imposes greater transaction costs and creates 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 (2005:364), which emphasized that the World Bank needs to better coordinate its procedures and conditions with other donors, ideally under the leadership of the recipient government. So far donors have been happy to see other donors coordinate around their own particular practices, but they have been less willing to change their own practices to match those of others. The Commission for Africa suggested, as an interim solution, that donors should mutually recognize 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 harmonization around a specific procedure. Here it would mean that donors would work from each other’s reports and thereby reduce the reporting burden of the recipient countries. The World Bank should take the initiative in launching such a system.

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

Then 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 who 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 on channelling aid to a sector through another agency. The use of lead agencies and silent partners has not been very extensive so far.

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. Publishing indices of donor performance including an indicator of proliferation might have some effect.

Donor coordination of course cannot be a substitute for coordination of the activities of the recipient government itself, rather they have to be aligned together. 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 where the recipient government has a higher degree of control, the recipient government must have the competence to handle the coordination and it must be credible. Donors will always have to report back to their voters, and this will require transparent and credible accounting from the recipient governments.

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