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Evaluating the Transaction Costs of Implementing the Paris Declaration

CONCEPT PAPER

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Overview and Acknowledgements

This paper has been commissioned by the Secretariat for the Evaluation of the Paris Declaration and written by Andrew Lawson of Fiscus Limited, UK. It provides a definition of the concept of transaction costs and an illustration of how the concept may be applied firstly to aid operations as a whole and secondly to the analysis of the costs of implementing the Paris Declaration. It considers whether it would be possible and useful to measure the transaction costs of aid and/ or the transaction costs of implementing the Paris Declaration.

It emphasises that the notion of 'transaction costs' is best considered as a metaphor, rather than as a precise measureable concept. Although transaction costs represent a real concept of demonstrable importance to the structuring of markets and organisations and to the efficiency of aid operations, this is not a concept which lends itself to easy measurement. This is in large part because investments in 'transaction activities' may generate benefits as well as costs. In principle, one may identify an inflection point in the 'transaction cost curve' where investments begin to generate only net costs but identifying this point would in practice be virtually impossible. For this and other practical reasons, any serious attempt to measure the transaction costs of aid or the transaction costs of the Paris Declaration is likely to be expensive but ultimately futile, and is not recommended.

However, informed resource persons do have clearly held perceptions about trends in transaction costs, about their incidence (between donors and partner governments), about the main sources of transaction costs and about the effects to date of the Paris Declaration. Such perceptions are worth documenting, triangulating and analysing. In addition, it seems likely that there are examples from particular countries of specific good practises which have served to reduce transaction costs and to facilitate implementation of the Paris Declaration. There would be real merit in documenting these examples and examining how they might be reproduced on a wider scale. The paper therefore concludes with a set of structured questions on transaction costs which it is proposed should be introduced into the Country and Agency studies, which will be conducted as part of the second phase of the evaluation of the Paris Declaration.

An initial outline of the key arguments in this paper was presented to the Evaluation Management Group at a meeting in London in September, 2009. I am very grateful for the helpful comments received there many of which have been incorporated into the current text. A second round of comments on the first draft of this concept note was also received from the Evaluation Management Group and from other stakeholders and their incorporation in this version has helped to add clarity and consistency to the text. Nevertheless, any responsibility for the arguments or proposals here presented lie with the author alone.

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1. Introduction

1. The second phase of the evaluation of the Paris Declaration on Aid Effectiveness of March 2005 is currently under design. The first phase was conducted with the purpose of strengthening aid effectiveness by assessing changes in behaviour and identifying better practices for partners and donors in implementing the Paris Declaration. It was concluded in July 2008¹ and fed into the discussions at the third High level Forum on Aid Effectiveness and into the subsequent Accra Agenda for Action (AAA). The second phase will be conducted over 2009 and 2010 so as to be concluded in time for the fourth High level Forum on Aid Effectiveness to be held in 2011. It will focus on assessing the development results achieved from increased aid effectiveness, considering both the intended and unintended development outcomes that can be attributed to the aid effectiveness agenda of the Paris Declaration. The question of the transaction costs of aid is directly pertinent to this second phase. This Concept Paper has been commissioned by the Secretariat for the Evaluation of the Paris Declaration in order to define an appropriate approach for incorporating concerns about aid transaction costs.
2. Whilst the fundamental objective of the Paris Declaration and the subsequent Accra Agenda for Action of September 2008 is to increase the **effectiveness of aid** by enhancing the development outcomes which it can generate, both documents recognise that a first step in this direction would be to increase the **efficiency of aid**, by reducing the relative costs of aid outputs. A key problem identified at the time of the Paris Declaration, and reiterated in Accra, was that aid was seen to have high **transaction costs**, many of which were perceived as being avoidable or at least reducible.
3. The 2008 monitoring survey on the implementation of the Paris Declaration did not explicitly address the question of transaction costs but it did note:

'Reducing the transaction costs of providing aid to partner countries is one of the fundamental objectives of the Paris Declaration. The 2008 Survey provides clear evidence that the cost of managing aid continues to be high for partner countries and donors. Furthermore, on a business as usual basis, these costs can be expected to increase significantly in the near future as the volume of aid is scaled up and new development actors enter the field.' OECD-DAC (2008a), p.15.

4. The 2008 monitoring survey also pointed to the modest level of progress achieved in implementing those aspects of the Paris Declaration most likely to impact positively on aid transaction costs. In particular, it noted that in 2007 only 47 % of aid flows were managed through coordinated mechanisms for aid delivery (such as Programme Based Approaches) against a target of 66 % for 2010 (Indicator 9). Similarly, it noted that more than 14,000 donor missions

¹ Wood B., Kabell D., Sagasti F. & Muwanga N, (July 2008), *Synthesis Report on the First Phase of the Evaluation of the Implementation of the Paris Declaration*, Copenhagen.

were fielded to the 55 countries which took part in the 2008 survey and, of these missions less than one in five was coordinated with another donor (Indicator 10a).

- In all, of the 7 indicators most likely to be correlated with positive impacts on aid transaction costs (Indicators 4, 5a, 5b, 6, 9, 10a and 10b), only the alignment and coordination of technical assistance (Indicator 4) showed clear progress. (See Figure 1 below.) While the survey did recognise that decisions to adjust the structure of aid were likely to have lagged effects (as old programmes were closed and new, more harmonised and aligned programmes were initiated), it nevertheless emphasised that change would have to be considerably accelerated in order to achieve the targets set for 2010.

Figure 1: Overview of the Results of the 2008 Monitoring Survey on the Implementation of the Paris Declaration

Performance in 2007 against 14 Key Paris Declaration Targets

| | | 2005 | | 2010 Targets |
|------------|--|------|-------------------|--------------|
| 1 | Operational Development Strategies | 17% | 22% | 75% |
| 2 | Reliable Public Financial Management Systems | | 36% | 50% |
| 3 | Aid flows are recorded in countries' budgets | 42% | 49% | 85% |
| 4 | Technical assistance is aligned & coordinated | 48% | 59% | |
| 5a | Donors use country PFM Systems | 40% | 43% | [80%] |
| 5b | Donors use country procurement systems | 39% | 42% | [80%] |
| 6 | Donors avoid parallel PIUs | 1832 | 1483 | 611 |
| 7 | Aid is more predictable | 41% | 45% | 71% |
| 8 | Aid is untied | 75% | 88% | [100%] |
| 9 | Donors use coordinated mechanisms for aid delivery | 43% | 42% (slippage) | 66% |
| 10a | Donors coordinate their missions | 18% | 20% | 40% |
| 10b | Donors coordinate their country studies | 42% | 44% | 66% |
| 11 | Sound frameworks to monitor results | 7% | 9% | 38% |
| 12 | Mechanisms for mutual accountability | 22% | 22% (No progress) | 100% |

- Thus, the 2008 survey strongly supports the view that the aggregate transaction costs of aid are not falling and that, with the scaling up of aid and the entry of new development partners, they are likely to increase². A secondary message, more implicit in the documentation of the 2008 Monitoring Survey, was that the implementation of the Paris Declaration was itself generating

² As we note above, the 2008 Survey did not explicitly assess transaction costs and made no comment, for example, on the trend movement in average transaction costs per dollar of aid.

significant new transaction costs: many new frameworks, mechanisms and coordinating structures for moving forward with the Paris Declaration had been created which were demanding of administrative and managerial resources, but had not yet generated benefits.

7. The first phase of the evaluation of the implementation of the Paris Declaration highlighted these same concerns. For example, the synthesis report states:

'All of the donor evaluations record that the measures called for in the Paris Declaration are leading to difficult transitional adjustments and increased transaction costs in managing their aid programmes. Partner country evaluations are not yet clear about the new demands being placed on them or about the old ones perhaps being alleviated.Overall, the evaluations do not yet yield a clear view on whether the net transaction costs of aid will ultimately be reduced as expected from the pre-2005 situation.' Wood, B et al (July, 2008), p.36.

8. In designing the second phase of the evaluation of the Paris Declaration, the issue of aid transaction costs thus remains very much alive. At a bare minimum, it seems important to know:

- Whether the implementation of the Paris Declaration shows credible signs of generating a reduction in the average transaction costs per dollar of aid?
- Whether the Paris Declaration is itself continuing to generate high transaction costs of its own and whether these show any signs of diminishing?
- Who bears the major burden of these different transaction costs? Is it mainly partner governments or mainly donors? At what level are such costs borne – amongst managerial and senior technical cadres or among administrative cadres?
- Finally, what prospects are there of future reductions in transaction costs? In the words of the 2008 Survey, is it a question of 'more pressure on the gas pedal' or does it require a 'shifting of gears'? Are there any examples of such 'shifting of gears' having taken place to date and could such examples be replicated?

9. This Concept Paper presents an approach for addressing these four core questions. In order to elaborate this approach, it is necessary first to define aid transaction costs and to consider how they might be measured. We then consider more carefully what exactly is the nature of the "transaction costs problem" before then presenting proposals. The remainder of this Concept Paper is thus laid out in three chapters as follows:

- Defining & Measuring Aid Transaction Costs
- Identifying the Pertinent Evaluation Questions
- Recommendations on the Way Forward.

2. Defining and Measuring Aid Transaction Costs

10. The notion of “transaction costs” is taken from the field of transaction cost economics, a theoretical development first pioneered by Ronald Coase in 1937 in the “The Nature of the Firm” and subsequently developed by Oliver Williamson, and by others working within the new institutional economics tradition, such as David Teece. A short bibliography of the main literature in this tradition is presented in annex. The definitions and explanations presented below are drawn from this literature but deliberately simplified to capture their essence. For a deeper understanding, readers are invited to consult the source literature, most especially Coase (1937), Williamson & Masten (1995) and Teece and Carroll (1998).

The theoretical origins of Transaction Cost Economics

11. Ronald Coase developed the notion of transaction costs as a way of explaining the emergence of the firm within an exchange economy and also as a way of understanding the particular structure and governance framework of firms in different sectors and under different circumstances. He asked: why does a firm emerge at all within an exchange economy, where the different factors of production (land, labour and capital) necessary to make goods or provide services can be freely exchanged? If the answer is to do with the nature of entrepreneurialism (specifically the ability of entrepreneurs to bring together factors of production which would not easily come together through the market mechanism alone), then why is this type of coordination achieved in some cases through entrepreneurialism and in other cases through the price mechanism? Why was it that, in some agricultural systems, bread would be made as a result of a series of exchanges between wheat farmers, millers and bakers, whereas, in other systems, all these functions would be vertically integrated within a single firm?
12. The answer he came to was that in a real economy (rather than the imaginary ‘perfect market’ of Leon Walras³), each exchange or “transaction” between farmer and miller or between miller and baker carried a cost which was additional to the actual production cost of the goods or services being exchanged. If these costs remained low, it was cost-efficient to rely on the market mechanism for coordination of transactions but, as these costs rose, integrated supply and employment contracts started to become more efficient. It was these “transaction costs” which explained the spectrum of organisational structures present in modern economies between fully independent agents – farmers, millers bakers (and also day labourers, hirers of ploughs/ donkeys / tractors, etc) – operating purely through market exchange at one end of the scale to large

³ In fairness to Walras, he also recognised that some mechanism by which prices might be shared between prospective buyers and sellers would be required in order to move to equilibrium. He described this process as “tâtonnement” or ‘groping’ towards the equilibrium price. Although his description of the process was rudimentary, it is clear that he realised at least implicitly that it would involve costs. See Walras/ Jaffe (1954), also Blaug (1986).

vertically integrated firms at the other, with a variety of hybrid arrangements in between. The rationale for all these different institutional and governance arrangements derived from the desire to economise on transaction costs.

13. Within this conception, transaction costs are defined as **'the costs which allow an economic transaction to take place but which add nothing to the value of the transaction'**. They are distinguished from the "production costs" which are essential for the creation of a product or the provision of a service. They may be broken down into "search costs", "bargaining and decision costs" and "policing and enforcement costs". Table 1, below, shows how these concepts may be applied in the context of the general economy.

Table 1: The Principal categories of Transaction Costs as defined in Transaction Cost Economics

| | |
|---|---|
| Search Costs | ❖ The costs necessary for potential buyers and sellers to identify the possibility of a mutually beneficial contract being established – essentially the costs of market research. |
| Bargaining & Decision Costs | ❖ The costs which need to be incurred in order to define a contract: specifically the cost of negotiating mutually satisfactory terms and conditions. |
| Policing & Enforcement Costs | ❖ The costs which must be incurred in order for a contract to be enforced: the cost of supervising the fulfilment of a contract and of seeking legal redress in the case of non-fulfilment. |

14. Before considering the application of the concept of transaction costs to the delivery of aid and to the implementation of the Paris Declaration, it is worth reflecting on some of the key insights emerging from transaction cost economics because many of these apply also to the transaction costs of aid. Although the literature of transaction cost economics is vast, there are three broad insights which are worth keeping in mind:

- a) Firstly, it should be remembered that **transaction costs are a metaphor⁴**, an abstract concept – certainly real and very important in guiding how exchange takes place in different contexts but not amenable to precise definition and measurement. This metaphor is designed to help appreciate the difference between an idealised "perfect market" situation and the reality of how the production and exchange of goods and services takes place in the real world. In a perfect market, there is perfect information and hence no costs need to be incurred in order for compatible buyers and sellers to

⁴ I am indebted to Francisco Sagasti, a member of the Core Team for the evaluation of the Paris Declaration, for the notion of transaction costs as a metaphor.

meet. In the real world, without some transaction costs being incurred, no market exchange would take place: it is the oil without which the wheels of the market do not turn. But is also more than just a necessary evil: some transaction costs help to improve the quality of products – for example by generating the information on consumer tastes which is necessary for the supply of products to be fully adapted to their demand. Nevertheless, it is clear that where search, bargaining and enforcement costs are low (or, to express this differently, where investments in search, bargaining and enforcement are not necessary), it is easier for transactions to occur and therefore for market needs to be satisfied. Thus, the required level of up-front investment in transactional activities is a major determinant of the volume of exchange which can take place and market agents will naturally search for ways to reduce this requirement.

- b) The **market mechanism can itself generate new products or services targeted at reducing transaction costs**. Market Research services are the most obvious example, in which information on the qualities and prices of different goods is compiled by an agent who is seen to be objective and then sold as a product in itself in order to reduce “search costs”. The role of “middlemen” or brokers of different kinds is also created by the recognition of the value of having specialised knowledge both of the prospective buyers and the prospective sellers of specific goods or services. Such services should serve to reduce both search costs and bargaining costs. Similarly, new types of services may come onto the market-place to reduce the costs of contract enforcement, such as debt collection services and specific types of insurance.
- c) The **institutions and rules which govern how markets work (the “rules of the game”, in the terminology of Douglass North) may also be adapted and refined so as to reduce transaction costs**. The most obvious example of this is the introduction of standard weights and measures and quality standards which make it easier for products to be directly compared. The creation of “market-places” in which buyers and sellers of specific products assemble at known times and places is another obvious institutional mechanism for reducing search costs. There are also more complex informal rules and codes of conduct which govern how negotiations may be closed and contracts enforced within particular types of markets or amongst specific societies or groups of people. Specifically, where established codes of conduct serve to create increased trust, transaction costs are seen to fall considerably and this may be a key explanatory factor for why markets grow faster within certain societies and locations⁵.

⁵ For example, this may be seen to explain why the Jesuits were able to trade so actively with Japan in the eighteenth and nineteenth centuries where other trading groups failed. The levels of mutual support and trust between members of the Lebanese community in West Africa and the Asian community in East Africa might also explain why their transaction costs of doing business appear lower than those of other trading communities.

Applying the transaction cost concept to Aid operations

15. Transaction cost concepts can be applied fairly readily to the area of aid transactions as can be seen from the Table below. Overall, **aid transaction costs might be defined as the costs necessary for an aid transaction to take place but which add nothing to the actual value of that transaction.**

Table 2: Principal categories of Transaction Costs as applied to Aid processes

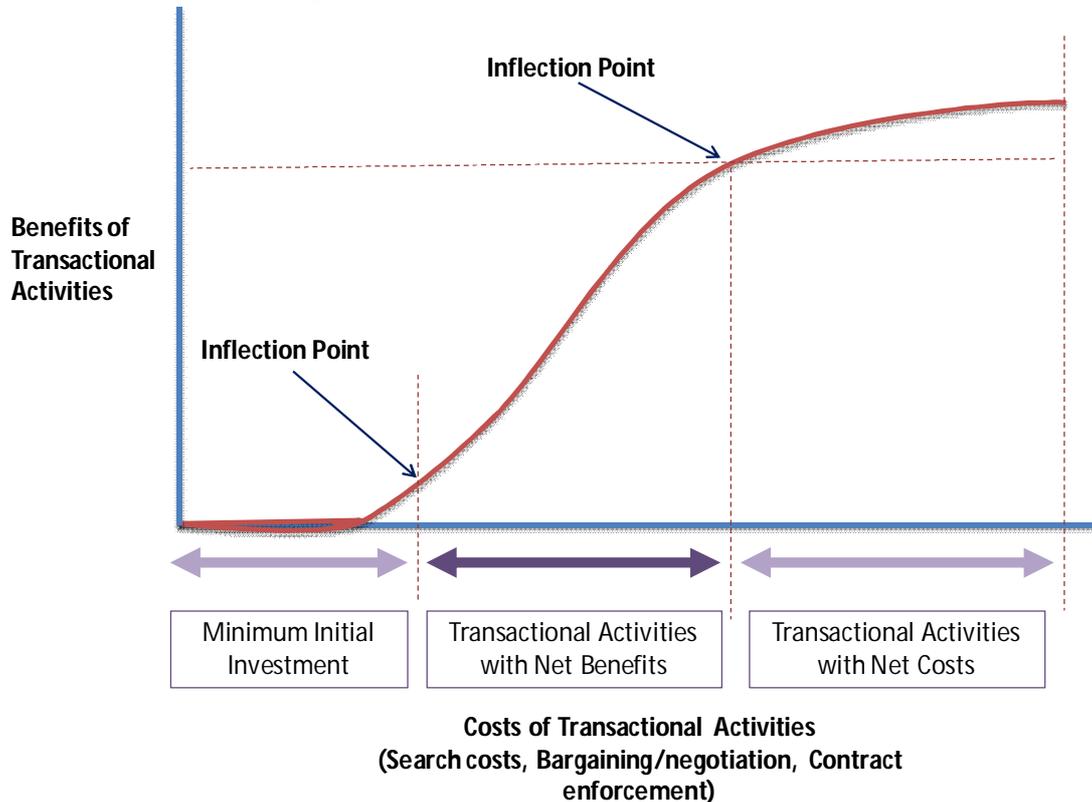
| | |
|---|--|
| Search Costs | <ul style="list-style-type: none"> ❖ The costs necessary for recipient governments/ potential donors to identify appropriate development partners. ❖ The costs (for donors) of identifying appropriate projects or programmes to fund and (for governments) of ‘selling’ project concepts to appropriate funders. |
| Bargaining & Decision Costs | <ul style="list-style-type: none"> ❖ The costs of negotiating and agreeing financing agreements for projects and other operations. ❖ The costs of defining and agreeing policy or outcome conditions for Development Policy Lending or Budget Support. |
| Policing & Enforcement Costs | <ul style="list-style-type: none"> ❖ The costs to recipient governments of fulfilling requirements for project execution and monitoring using systems other than country systems. ❖ The costs to recipient governments of monitoring donor commitments to predictable disbursements and other aspects of mutual accountability. ❖ The costs to donor agencies of supervising adherence to project and programme conditions and of undertaking corrective actions where necessary. |

16. As with the application of the transaction costs concept to the exchange of goods and services in the economy, aid transaction costs are also best considered a metaphor. Ideally, one would wish aid transactions to take place without the need to incur search costs or subsequent costs for bargaining or contract enforcement and yet, in the real world, it is clear that, without these, aid transactions would not take place at all. These are not costs which can be indiscriminately cut because this would jeopardise the completion of aid transactions. Transaction costs are an integral part of the design and implementation process for aid programmes and investments in these “transactional activities” will up to a certain point bring tangible benefits – in terms of improved project selection and design (resulting from ‘search costs’) or more efficient project execution (from the supervision component of ‘enforcement costs’). The supervision of conditions for Development Policy Loans/ Budget Support may also assist in refining policy design and/ or in strengthening national capacities for policy dialogue, monitoring and execution.

17. Thus, transaction costs are necessary for aid interventions to occur and, up to a certain point, investments in “transactional activities” may raise the net benefits of aid operations. Yet, in many

aid recipient countries the level of transaction costs being incurred is perceived to be substantially higher than necessary and no longer a source of net benefits. How may we explain this? And how can this widely held perception be consistent with the observation that investments in transactional activities also bring benefits?

Figure 2: The Transaction Costs Curve



18. Conceptually, we may consider that all investments in transactional activities will carry costs but only some of these will carry benefits. In Figure 2 above we present a graphical illustration of the "Transaction Costs Curve", showing the relationship between costs (on the 'x' axis) and benefits (on the 'y' axis), as higher levels of investment in transactional activities are undertaken. We hypothesise that:

- a) for any aid operation to be undertaken, a minimum level of investment in transactional activities is needed which carries costs but does not itself enhance the net benefits of that operation. For example, a minimum level of search costs must be incurred simply for donors and partner countries to agree to work together – diplomatic ties must be established and letters of agreement signed for example. Similarly, in relation to supervision costs, a basic framework of reporting and monitoring must be established simply to ensure that information is available.
- b) As investments in these transactional activities increase, benefits start to be created and a first inflection point is reached where the gradient of the cost curve is greater

than 45 degrees, meaning that benefits are now greater than costs. Here, investments in search costs are starting to make a real difference to the quality of the design of the aid operation, and investments in supervision costs are generating feedback on monitoring reports which serves to correct problems and improve execution.

- c) As investments continue to increase the marginal benefits start to fall until a second inflection point is reached where the gradient of the curve is again below 45 degrees so that there are again net costs. Here we might consider that investments in search costs are involving such a wide set of stakeholders and such a complex range of feasibility studies that the costs are now exceeding the benefits. Similarly, supervision missions are now so frequent and so expensive that costs start to exceed the benefits.

19. Aid transaction costs are defined above is **as the costs necessary for an aid transaction to take place but which add nothing to the actual value of that transaction**. In keeping with this definition, only those costs incurred to the left of the first inflection point in the graph and to the right of the second one may properly be defined as transaction costs.
20. The Paris Declaration and its related initiatives aim to eliminate all transactional activities taking place after the second inflection point, whilst not jeopardising the beneficial transactional activities which take place prior to this point. In addition, they aim to move the whole curve leftwards so as to reduce the overall level of investment in transactional activities which is necessary for aid transactions to occur.
21. Any measurement of transaction costs would need to assess the aggregate cost of investment in transactional activities during a given time period but would also need to distinguish between costs attributable to the 'minimum initial investment' (bringing no benefits in aid quality but necessary nonetheless), costs of transactional activities bringing net benefits (investments in between the two inflection points) and costs of transactional activities with net costs (investments to the right of the second inflection point). In practise it would be extremely complicated to measure precisely the respective values of transactional activities in each of these categories.
22. There are at least four reasons why measurement would be complicated:
 - a) In the first place, the cost of "transactional activities" is measured predominantly in time use – time spent in the activities of searching, bargaining and contract enforcement – and, in particular in time used by government and aid bureaucracies who do not generally measure time use in a detailed manner.

- b) Secondly, the transactional activities corresponding to the 'minimum initial investment', those taking place before the 'second inflection point' (bringing benefits in aid quality) and those taking place after it (and therefore bringing net costs) would not be easily distinguishable. Indeed they would probably be the same types of activities, undertaken at different scales of complexity and comprehensiveness.
- c) Thirdly, adding the transaction cost curves of different agencies and interpreting them correctly would be complicated because investments in transactional activities would almost certainly be characterised by economies of scale. Thus search activities (programming and design work) or supervision activities could in principle be undertaken by one agency on behalf of several others – which is exactly why the Paris Declaration promotes joint analytical work and joint missions as well as 'divisions of labour' and 'silent partnerships'. Where opportunities for joint working are missed, this should be recorded as a transactional activity with a net cost but from the perspective of the individual agencies it might look like an investment with net benefits.
- d) Finally, the position of the curve as a whole and of its inflection points would not be static and would not be the same between countries. Just as in the general market, new products and services would arise to reduce the level of investment in transactional activities necessary for a successful aid operation. For example, the Commitment to Development Index, which is constructed annually by the Center for Global Development in Washington D.C., provides an independent ranking of the quality of the development programmes of different nations⁶. Increased use of this index should serve to reduce the search costs for recipient governments looking for appropriate development partners. Increased use of this index should therefore shift the Transaction Cost Curve leftwards. Similarly, the Paris Declaration is effectively an institutional innovation which has changed the rules of the aid game, changing the overall position of the transaction costs curve and of its inflection points. Whether it has succeeded in shifting the curve leftwards as intended (i.e. reducing the level of investment necessary in transactional activities) or has generated a temporary shift to the right as frequently alleged is the key issue at question in this paper. But few would doubt that it has generated changes and that these changes have yet to work their way fully through the aid system. Thus, in some countries it may have succeeded in shifting the transaction cost curve leftwards, while in others at an earlier stage of transition, a rightward shift may have occurred. To measure this moving target at a snapshot in time may prove to be very misleading, particularly if it was not possible to discern the overall trend.

⁶ See www.cgdev.org/cdi.

23. Not surprisingly, the only two studies which have made serious attempts to actually measure aid transaction costs essentially failed to achieve this objective. These are the UNDP study of aid transaction costs in the Zambia and Senegal education SWAps led by Patrick Watt (2005)⁷ and the ODI study of aid transaction costs in Vietnam undertaken for UNDP and UK DFID (Fozzard, A. et al. 2000)⁸. Each of these studies provides interesting reflections on aid transaction costs but neither is able to generate a system of measurement and valuation which might permit comparison across sectors, countries or time periods of average transaction costs per US \$ dollar of aid. From our more detailed analysis of the underlying theory, we can see clearly why this should be so.

Transaction costs and the Paris Declaration

24. As we have noted above, the Paris Declaration can be described as an institutional innovation which seeks to change the rules of the “aid game”. One of its specific objectives is to reduce the level of investment in transactional activities which is necessary for aid operations to occur. It seeks to do this through three related types of activities⁹:
- **Aid alignment and enhancement of Country Ownership** through which the quality of national development strategies and systems is enhanced and aid delivery mechanisms are re-oriented towards investments in nationally specified policy priorities and towards the use of country systems.
 - **Aid harmonisation** through which aid agencies collaborate to make increasing use of common systems, by undertaking joint missions and joint analytical activities and using common funding and management arrangements.
 - **Development of frameworks to measure results and promote mutual accountability**: the creation of frameworks by which development results might be specified and measured and the respect of mutual commitments by donor agencies and partner governments might be monitored.

⁷ Watt, P. (2005), Transaction Costs in Aid: Case Studies of Sector Wide Approaches in Zambia and Senegal, UNDP Human Development Report Office Occasional Paper, New York.

⁸ Fozzard, A., Brown, A., Naschold, F., Conway, T., Bui Quang Huy and Duong Quoc Thang (2000), Aid Transaction Costs in Vietnam, UNDP and UK Department for International Development, Hanoi.

⁹ The Paris Declaration actually presents these as five initiatives focused respectively on Ownership, Alignment, Harmonisation, Managing for Results and Mutual Accountability. However, actions to promote Ownership are virtually indistinguishable from actions to promote alignment and actions to measure results are a necessary precursor to ensuring mutual accountability. Thus, as a practical framework for defining the transaction costs of different types of activities, we believe it makes sense to consider ownership and alignment together and results and mutual accountability together.

25. Whether the Paris Declaration has actually succeeded in reducing average transaction costs per dollar of aid is the first fundamental question. We noted above that this would be exceedingly difficult to measure. The 2008 survey on the implementation of the Paris Declaration did not explicitly assess transaction costs but it did report on the perceptions of donor agencies and partner governments in this regard. Its findings strongly supported the view that, in 2008 at least, the average transaction costs of aid were not falling.
26. A further and related question is whether the Paris Declaration is itself generating transaction costs? The Table below shows how the Paris Declaration might be expected to generate costs for search activities, bargaining and negotiation and contract enforcement. For practical purposes, it groups together actions to promote ownership and aid alignment as well as actions to promote management for results and mutual accountability. (See Footnote 9.)

Table 3: The nature of Transaction Costs generated by the Paris Declaration

| | Ownership & Aid Alignment | Aid Harmonisation | Frameworks for Results & Mutual Accountability |
|---|---|---|--|
| Search Costs | <ul style="list-style-type: none"> ○ For Governments: finding Donors willing to use country systems and respect ownership ○ For Donors: assessing Country systems which might conform to adequate fiduciary standards | <ul style="list-style-type: none"> ○ For Governments: finding ways of encouraging or compelling aid harmonisation ○ For Donors: identifying like-minded donors and appropriate opportunities for undertaking joint activities | <ul style="list-style-type: none"> ○ Identifying partners willing and able to engage in the development and establishment of frameworks for results and mutual accountability |
| Bargaining & Decision Costs | <ul style="list-style-type: none"> ○ Defining, negotiating and agreeing mutually satisfactory conditions for the use of Country systems | <ul style="list-style-type: none"> ○ Defining, negotiating and agreeing mutually satisfactory conditions for harmonisation | <ul style="list-style-type: none"> ○ Defining, negotiating and agreeing appropriate indicators of performance and methods of measurement |
| Policing & Enforcement Costs | <ul style="list-style-type: none"> ○ Fulfillment by all parties of agreed reporting requirements . ○ Monitoring of fulfillment by other parties ○ Reacting to censure parties not fulfilling commitments | <ul style="list-style-type: none"> ○ Fulfillment by all donors of agreed reporting requirements . ○ Monitoring of fulfillment by other parties ○ Reacting to censure parties not fulfilling commitments. | <ul style="list-style-type: none"> ○ Fulfillment by all parties of agreed reporting requirements . ○ Monitoring of fulfillment by other parties ○ Reacting to censure parties not fulfilling commitments. |

27. We may see from the table above that the implementation of the Paris Declaration will require a variety of investments in transactional activities which will be necessary in order to make progress on ownership/ alignment, harmonisation and the creation of frameworks for results and mutual accountability. Casual observation of the many monitoring frameworks, conventions, committees and task forces which have been created suggests that investments in transactional activities have already been very high. There is nothing to suggest, however, that measuring the value of those investments, distinguishing between those generating net benefits and those generating net costs (i.e. identifying the 'inflection points') and reaching quantifiable conclusions on the transaction costs of the Paris Declaration will be any easier than it would be for aid transaction costs as a whole.

Summing Up

28. What conclusions can we draw from this brief review of the theories of transaction cost economics and their application to aid and the Paris Declaration?
- Firstly, the concepts of transaction costs deriving from the Transaction Costs Economics literature can be seen to be directly applicable to the delivery of aid as a whole and to the implementation of the Paris Declaration.
 - In each of these areas, we may identify transaction costs related to search, bargaining/ negotiation, and contract enforcement.
 - Due to the fact that information flows are not perfect, a minimum investment in transactional activities is necessary in all markets simply for transactions to occur. The same is true for aid and the Paris Declaration: without investing in transactional activities, aid would not be effectively disbursed and the Paris Declaration would not be implemented.
 - A minimum initial investment in transactional activities seems to be necessary simply for transactions to take place. Thereafter, investments in transactional activities probably bring net benefits but after a second inflection point is reached on the transaction cost curve, further investments bring only net costs.
 - Both in the aid world and in the world of normal economic exchange, agents seek both to eliminate the transactional activities which bring only net costs (the activities to the right of the second inflection point) and to find ways of moving the transaction costs curve to the left so as to reduce the minimum required level of investment in transactional activities (to the left of the first inflection point).

- Both commercial market innovations and institutional innovations are continuously introduced in pursuit of these objectives.
 - The Paris Declaration may be characterised as an institutional innovation aiming to achieve these very same objectives in relation to aid transaction costs.
 - However, the Paris Declaration has itself generated new transaction costs by introducing new types of search, negotiation and contract enforcement costs.
 - Ideally, one would want to track the net transaction costs per dollar of aid disbursed and to be able to distinguish which of those transaction costs derive directly from the Paris Declaration.
 - In practise, conceptual and practical difficulties make net transaction costs per dollar of aid virtually impossible to measure.
 - Yet the Paris Declaration signatories perceive that transaction costs per dollar of aid are inherently too high and that additional transaction costs have been added by the implementation of the Paris Declaration.
 - Assessing the validity of this perception and gauging the underlying trends in aid transaction costs thus remain crucially important challenges, despite the evident measurement problems.
29. How then should one proceed? Clearly, it is futile to attempt any detailed measurement of net transaction costs per dollar of aid. Nevertheless, there is probably some value in assessing the perceptions of transaction costs across different resource persons and triangulating these observations in order to get a sense of overall trends. But which perceptions are most important? And whose perceptions are most important? We need first to define the “transaction cost problem” more clearly before we can answer this question and we do this in the following chapter. We then propose a way forward in our concluding chapter.

3. Identifying the Relevant Evaluation Questions

30. In this section we consider more carefully the nature of the “transactions costs problem” in order to define more precisely why it would be useful to evaluate aid transaction costs. This then leads to the identification of a set of pertinent evaluation questions. In the final chapter, we will consider whether these can be evaluated and if so, how.

The magnitude of aid transaction costs, their trends and incidence

31. The notion that aid transaction costs are excessively high has now become conventional wisdom. It lies at the heart of the Paris Declaration and drives much of contemporary policy towards development cooperation. Some have argued that it would be useful to actually prove this proposition. We would disagree: this proposition is already adequately proven by the wealth of information on proxy indicators of transaction costs – numbers of visiting missions per year, numbers of project reports per year and concrete data on design and supervision budgets for specific development agencies – and by the strongly shared perceptions of different types of stakeholders in the field. Especially in the light of the conceptual difficulties we have identified above, it would seem futile to attempt to measure comprehensively the average level of transaction costs per dollar of aid.
32. However, it does seem more important to have a sense of the direction of change. Is the average level of transaction costs rising or falling or remaining stable? Given the extensive investments already made in the implementation of the Paris Declaration and the demand for still higher levels of investment underlying the Accra Agenda for Action, it would be very useful to have some sense of whether those investments are having an impact. Answering this question requires first an assessment of the trend movement of transaction costs and then some investigation of causality. Is it the implementation of the Paris Declaration which is causing change (where it is happening)? Or is this driven by parallel measures taken independently by different governments or by unrelated developments in the wider economic or political environment? This second question may be difficult to answer conclusively but having some confidence over the recent trends would be a first step.
33. The second general set of questions worth addressing relates to the incidence of aid transaction costs. Some agencies and some staff within particular agencies are better placed to absorb additional transaction costs than others. Specifically, it seems a reasonable general assumption that Developing Country governments, who already meet significant capacity constraints in the normal business of government, should carry less of the burden of aid transaction costs than the Development Agencies, whose budgets can more easily be expanded to carry these costs. However, within both Governments and Development Agencies, high level managerial and

technical staff are scarce and aid transaction costs borne by such people would have a higher opportunity cost than those which can be borne by lower level administrative staff.

34. Thus, it is also important to know, or at least to be able to estimate, how aid transaction costs are divided between Developing Country Governments and Donors on the one hand and between managerial/ technical staff or administrative staff on the other.

The relative influence of the Paris Declaration

35. Although causality is always difficult to prove conclusively, obtaining some sense of the relative influence of the Paris Declaration is obviously important. Do the informed commentators who actually manage aid operations on a day to day basis believe that the Paris Declaration is having a positive or negative influence on aid transaction costs?
36. Because the implementation of the Paris Declaration can be broken down relatively easily between measures to promote ownership/ aid alignment, aid harmonisation and frameworks for results/ mutual accountability¹⁰, it is also possible to ask which aspect of the Paris Declaration is driving change and in which direction. This could give a clear sense of where further investment of efforts is likely to bring positive results and where some restructuring and adaptation of approaches might be needed.

Future trends and potential for change

37. The direction of change can be assessed both from perceptions of past changes and from expectations of future changes. The latter is obviously more conjectural but nevertheless likely to be of some value in the case of informed commentators who have direct personal experience of the implementation of the Paris Declaration. What perhaps would be of more value would be to ask these same informed commentators to identify what sorts of changes in the implementation of the Paris Declaration might generate more favourable impacts on aid transaction costs. In the words of the report of the 2008 Monitoring Survey is more 'pressure on the gas pedal' all that would be required or would a 'change of gears' be needed? And if a change of gears, what precisely might that mean?
38. In terms of finding ideas for positive changes in the mode of implementation of the Paris Declaration, it would also be useful to draw from the diversity of experiences across countries to find if there are not already certain examples of good practise which might be replicated. One of the great disadvantages of the aid world is that it is a highly imperfect market. In a commercial

¹⁰ We note in Footnote 9 above that categorising measures according to the five axes of the Paris Declaration is more difficult because measures to promote ownership will simultaneously promote alignment (and vice-versa) and measures to improve management by results would also help to promote mutual accountability. We therefore favour a clustering into three groups of measures as presented here and in the questionnaire in Chapter 4.

market, ideas for reducing transaction costs quickly become packaged up as new services, sold and replicated. In the aid world, aid transactions are not in general managed through market exchange but through bureaucratic hierarchies. These are essentially civil service hierarchies, pursuing a range of sometimes competing objectives, where the internal incentives driving the behaviour of individual staff members may not always be consistent with the stated corporate objectives, notably in relation to the implementation of the Paris Declaration¹¹. In so far as the assessment of aid transaction costs might help to speed the dissemination of innovative practices, which would not so easily be promoted by existing incentive structures and mechanisms of collaboration, then this would clearly be advantageous.

¹¹ For this reason, there has been a variety of studies examining the consistency of internal incentives within aid agencies with the objectives of the Paris Declaration. The OECD DAC Joint Venture on Managing for Development Results commissioned a 'self-assessment tool' to assess the consistency of these internal incentives and help to promote improved practise. See ODI (2006) and PriceWaterhouseCoopers [2008 a) and b).]

4. Recommendations on the Way Forward

39. The evaluation of the implementation of the Paris Declaration will be undertaken through a combination of four types of instruments:
- **Country-level studies**, in which commentators from Government, Development Partners and civil society would be asked to assess progress with the implementation of the Paris Declaration in specific countries.
 - **Agency-level studies**, in which commentators from within specific Development Agencies would be asked to assess overall progress within their agencies at an international level.
 - **Thematic studies**, in which specific sub-issues of the Paris Declaration (such as aid transaction costs) might be addressed through dedicated evaluation work, additional to the country and agency studies.
 - **Synthesis Reports**, in which the results of the country, agency and thematic studies would be brought together, drawing comparisons where necessary with other information sources and other literature.
40. The considerations we have outlined in chapter 3 lead naturally to a set of questions on aid transaction costs which could be addressed both within the country studies and the agency studies. These are presented in the table overleaf.
41. Consideration has also been given to the possibility of an additional thematic study dedicated to the issue of aid transaction costs. If it was intended to undertake some sort of more detailed measurement of aid transaction costs within a particular sector or country, then such a study would be necessary. Yet, as we have pointed out repeatedly, any attempt at direct measurement of aid transaction costs would be fraught with conceptual difficulties. The most that might be hoped for would be to undertake two parallel studies, estimating transaction costs in one specific sector within two different countries. Then, the question would immediately arise over the representativeness of the chosen sector and chosen countries: effectively there would be no sound statistical or research basis for extrapolating results in order to reach conclusions valid at the international level. In this context, it seems far better to make use of the sampling process which will underlie the selection of country studies and agency studies and rely on questions about perceptions addressed to a wider sample of informed commentators.

Table 4: Proposed Questions for Inclusion in Country & Agency Studies

| | | | | | | | | | | | | | | | | | | | | |
|---|---|---|---|--|---|--|---|---|--|--|---|---|---|--|---|---|---|--|---|---|
| <p>Transaction Costs Definition</p> | <p>Understanding Aid Transaction Costs as those administrative and financial costs which are necessary for aid-financed activities to be implemented but which add nothing to the benefits of those activities</p> | | | | | | | | | | | | | | | | | | | |
| <p>1. a) Trends in Aid Transaction Costs</p> | <p>From 2005 to 2010, how would you judge that annual aid transaction costs per \$ of aid in your country/ agency have changed?</p> <ul style="list-style-type: none"> ❖ They have increased substantially. ❖ They have increased modestly. ❖ They have not changed significantly. ❖ They have reduced modestly. ❖ They have reduced substantially <p>Give your reasons for this conclusion.</p> | | | | | | | | | | | | | | | | | | | |
| <p>1. b) Incidence of costs</p> | <p>For each of these categories of stakeholders, how do you judge that the burden of transaction costs which they bear has changed?</p> <table border="1" data-bbox="504 891 1535 1285"> <tr> <td data-bbox="504 891 762 987"> <p>Government: Managerial & technical cadres</p> </td> <td data-bbox="762 891 1023 987"> <p><input type="radio"/> <i>Burden has increased</i></p> </td> <td data-bbox="1023 891 1283 987"> <p><input type="radio"/> <i>No significant change</i></p> </td> <td data-bbox="1283 891 1535 987"> <p><input type="radio"/> <i>Burden has decreased.</i></p> </td> </tr> <tr> <td data-bbox="504 987 762 1084"> <p>Government Administrative Cadres</p> </td> <td data-bbox="762 987 1023 1084"> <p><input type="radio"/> <i>Burden has increased</i></p> </td> <td data-bbox="1023 987 1283 1084"> <p><input type="radio"/> <i>No significant change</i></p> </td> <td data-bbox="1283 987 1535 1084"> <p><input type="radio"/> <i>Burden has decreased.</i></p> </td> </tr> <tr> <td data-bbox="504 1084 762 1180"> <p>Donors: Managerial & technical cadres</p> </td> <td data-bbox="762 1084 1023 1180"> <p><input type="radio"/> <i>Burden has increased</i></p> </td> <td data-bbox="1023 1084 1283 1180"> <p><input type="radio"/> <i>No significant change</i></p> </td> <td data-bbox="1283 1084 1535 1180"> <p><input type="radio"/> <i>Burden has decreased.</i></p> </td> </tr> <tr> <td data-bbox="504 1180 762 1285"> <p>Donors: Administrative Cadres</p> </td> <td data-bbox="762 1180 1023 1285"> <p><input type="radio"/> <i>Burden has increased</i></p> </td> <td data-bbox="1023 1180 1283 1285"> <p><input type="radio"/> <i>No significant change</i></p> </td> <td data-bbox="1283 1180 1535 1285"> <p><input type="radio"/> <i>Burden has decreased.</i></p> </td> </tr> </table> <p>Please give your reasons for this conclusion.</p> | | | | <p>Government: Managerial & technical cadres</p> | <p><input type="radio"/> <i>Burden has increased</i></p> | <p><input type="radio"/> <i>No significant change</i></p> | <p><input type="radio"/> <i>Burden has decreased.</i></p> | <p>Government Administrative Cadres</p> | <p><input type="radio"/> <i>Burden has increased</i></p> | <p><input type="radio"/> <i>No significant change</i></p> | <p><input type="radio"/> <i>Burden has decreased.</i></p> | <p>Donors: Managerial & technical cadres</p> | <p><input type="radio"/> <i>Burden has increased</i></p> | <p><input type="radio"/> <i>No significant change</i></p> | <p><input type="radio"/> <i>Burden has decreased.</i></p> | <p>Donors: Administrative Cadres</p> | <p><input type="radio"/> <i>Burden has increased</i></p> | <p><input type="radio"/> <i>No significant change</i></p> | <p><input type="radio"/> <i>Burden has decreased.</i></p> |
| <p>Government: Managerial & technical cadres</p> | <p><input type="radio"/> <i>Burden has increased</i></p> | <p><input type="radio"/> <i>No significant change</i></p> | <p><input type="radio"/> <i>Burden has decreased.</i></p> | | | | | | | | | | | | | | | | | |
| <p>Government Administrative Cadres</p> | <p><input type="radio"/> <i>Burden has increased</i></p> | <p><input type="radio"/> <i>No significant change</i></p> | <p><input type="radio"/> <i>Burden has decreased.</i></p> | | | | | | | | | | | | | | | | | |
| <p>Donors: Managerial & technical cadres</p> | <p><input type="radio"/> <i>Burden has increased</i></p> | <p><input type="radio"/> <i>No significant change</i></p> | <p><input type="radio"/> <i>Burden has decreased.</i></p> | | | | | | | | | | | | | | | | | |
| <p>Donors: Administrative Cadres</p> | <p><input type="radio"/> <i>Burden has increased</i></p> | <p><input type="radio"/> <i>No significant change</i></p> | <p><input type="radio"/> <i>Burden has decreased.</i></p> | | | | | | | | | | | | | | | | | |
| <p>2. a) Relative influence of the Paris Declaration</p> | <p>Over 2005 to 2010, how do you think the implementation of the Paris Declaration has influenced the overall trends in Aid Transaction Costs in your country/agency? Specifically, how has it influenced aid transaction costs relative to what they would have been in its absence?</p> <ul style="list-style-type: none"> ❖ It has increased them substantially beyond what they would have been. ❖ It has increased them modestly beyond what they would have been. ❖ It has not significantly influenced Aid Transaction Costs. ❖ It has reduced them modestly below what they would have been. ❖ It has reduced them substantially below what they would have been <p>Please give your reasons for this conclusion.</p> | | | | | | | | | | | | | | | | | | | |

| | | | | |
|---|--|--|--|--|
| 2. b) Source of influence from the Paris Declaration | What has been the respective impact on Aid Transaction Costs of the different aspects of the Paris Declaration? (NB. Bearing in mind the definition of transaction costs presented above.) | | | |
| | Efforts to promote ownership/ align to Country systems | <input type="radio"/> <i>Have increased transaction costs.</i> | <input type="radio"/> <i>Have had no influence</i> | <input type="radio"/> <i>Have decreased transaction costs.</i> |
| | Efforts to harmonise practices across Donors | <input type="radio"/> <i>Have increased transaction costs.</i> | <input type="radio"/> <i>Have had no influence</i> | <input type="radio"/> <i>Have decreased transaction costs.</i> |
| | Efforts to introduce results-based mutual accountability | <input type="radio"/> <i>Have increased transaction costs.</i> | <input type="radio"/> <i>Have had no influence</i> | <input type="radio"/> <i>Have decreased transaction costs.</i> |
| Please give your reasons for this conclusion. | | | | |
| 3. Future trends and potential for change | a) What effect do you think the implementation of the Paris Declaration will have in the next two years with no significant change in the methods of implementation? <ul style="list-style-type: none"> <input type="radio"/> It should begin to/ continue to reduce Aid Transaction Costs. <input type="radio"/> It will stop increasing Aid Transaction Costs but not reduce them. <input type="radio"/> It will continue to increase Aid Transaction Costs. | | | |
| | b) What sorts of changes do you think are necessary in order for the implementation of the Paris Declaration to have more substantial positive effects on Aid Transaction Costs ? <ul style="list-style-type: none"> <input type="radio"/> No significant changes are needed: it is simply a question of implementing the Paris Declaration more intensively and thoroughly. <input type="radio"/> Radical changes will be needed in the internal incentives of Donor Agencies. <input type="radio"/> Radical changes will be needed in the internal incentives of Partner Governments. | | | |
| | Please explain your answers to 3a) and 3b). | | | |
| c) Can you provide any examples of specific good practices or policy adjustments by Donors or Partner Governments which have already helped to generate a positive impact on Aid Transaction Costs? | | | | |

42. It is assumed that the questions above would represent just one sub-set of a wider set of questions posed at the Country and Agency Level. Thus, they would need to follow the same approach to sampling of respondents used for the overall studies. We assume that this would be a purposive sample which would deliberately target different types of resource persons and would identify the answers received by type of respondent so that answers could be triangulated

in an explicit and transparent way. Thus, the triangulation process would represent quite an important part of the methodology.

43. Would there be any value in supplementing the results of the country and agency level studies, with a detailed study of data which might be considered a proxy for aid transaction costs¹²? For example, would there be any merit in undertaking an analysis of trends in design and supervision costs within development agencies?
44. These are clearly an element of aid transaction costs but only one element, which may not be correlated with the wider trends in aid transaction costs. Moreover, such an analysis would tell us nothing about the important question of the distribution of aid transaction costs between governments and donor agencies. It would also be subject to difficulties of interpretation because these are transactional activities which ought to lie towards the left of the “second inflection point” described above and should be generators of net benefits rather than net costs. If such costs were rising, this might be a good thing – especially in agencies which had previously under-spent on design and supervision. There would also be an aggregation problem to be faced: if too many agencies were incurring such costs in the same sectors, then this would be a sign that opportunities for joint working were being missed and net costs were therefore too high. But too high by how much and for which agencies? Taking these arguments together, we see no strong case for a separate study to examine the administrative costs of different development agencies, whose results would be difficult to interpret in terms of their transaction cost implications and might be prone to simplistic and misleading conclusions.
45. On the other hand, data on the number of development agencies working in each country and on the number of development agencies active within each sector may be useful in interpreting the responses to different country and agency studies. Similarly, responses should also be compared to the results of the different monitoring indicators for the Paris Declaration. For example, if a majority of stakeholders in a particular country (or a majority of a particular type of stakeholder) were of the impression that aid transactions costs were increasing despite improved scores for a number of monitoring indicators, then this should prompt careful investigation of the reasons for

¹² One suggestion on an earlier draft of this Note was that an assessment of the costs of decentralising operations to field offices might be a useful proxy for the costs of implementing the Paris Declaration, because one of the findings of the first Phase evaluation was that agencies with decentralised structures have been more successful in promoting ownership, harmonisation and alignment. Such an indicator also seems subject to major difficulties of interpretation. In the first place, increased field costs should be partly offset by lower HQ costs and if such offsetting did not occur, it should not properly speaking be attributed to the “costs of the Paris Declaration” but rather to bureaucratic inefficiency. Secondly, and more significantly, decentralisation should be happening simultaneously with an improved division of labour across development agencies. This would imply a smaller number of agencies as a whole, and a smaller number of agencies in each partner country. Without also analysing potential administrative savings from an improved division of labour, the costs of decentralisation are likely to be a misleading proxy.

such an outcome, both through a careful re-reading of questionnaire results and potentially through follow-up interviews and discussions.

46. Would there be any valid arguments for doing a separate synthesis report presenting the conclusions on aid transaction costs arising out of the country and agency studies? Clearly, these results would need careful interpretation and contextualisation, drawing as necessary on the theoretical insights presented in this paper. However, the question of aid transaction costs is so integral to the Paris Declaration that it would seem difficult to separate the conclusions on transaction costs from the broader conclusions about the implementation of the Paris Declaration as a whole. Again, we see no strong grounds for a separate synthesis study.
47. Our final conclusion, then, is that the assessment of the aid transaction costs of the Paris Declaration should be addressed through the planned agency and country studies and that the interpretation of these results should be included in the overall set of synthesis studies. Given that the notion of transaction costs is quite frequently misunderstood and misapplied, we would further recommend a wide circulation of this Concept Paper, as a way of informing the overall debate on the Paris Declaration and its implementation.

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