The International Aid System: What's Next?

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What if Aid harmonisation and alignment occurred exactly as intended?

A reality check on the Paris Forum on Aid Effectiveness

Andrew Rogerson
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1. Scope and Summary

This paper investigates what features of today's international aid landscape might be most at odds with the model of aid effectiveness that underpins preparation of the Paris Higher Level Forum scheduled on this topic on 28 February 2005, and what might be done about them.

It summarises this 'Paris Agenda' approach to aid effectiveness, focused on: systematic support to country-owned plans for the attaining development results; increased use of national administration systems; and more coordinated and predictable actions among multiple aid actors. It tentatively traces the likely benefits of such behaviours through to poverty reduction outcomes, to identify implicit assumptions about enabling conditions and risks, and tries to sketch out a 'results framework' against which the benefits of the agenda might be judged.

It then contrasts this model with alternative views in the literature as to the rationale for aid and for the existence of aid agencies. It considers the hypothetical prospect of complete preference alignment and trust at country level between donors and recipients, and its implications for aid agency incentives. It also revisits donor 'fragmentation' versus 'consolidation' from a recipient perspective, considering trade-offs between transaction costs and risk spreading.

Finally, it identifies four institutional obstacles that cannot be tackled effectively at the country level, yet arguably stand in the way of the collective action objectives of the Forum. This selection applies the principle of *subsidiarity,* concentrating on minimum action required at other levels (cross-country and global) to validate country-level efforts, as against wider global governance aims.

The policy categories considered are: (1) options for better international balancing of country aid allocations; (2) aid instruments that match donor needs for verifiable outcomes with recipient needs for longer commitment horizons ;(3) alternative arrangements for reconciling country resource allocations to needs, not *vice versa*; and (4) credible mutual accountability mechanisms with effective sanctions for non-compliance.

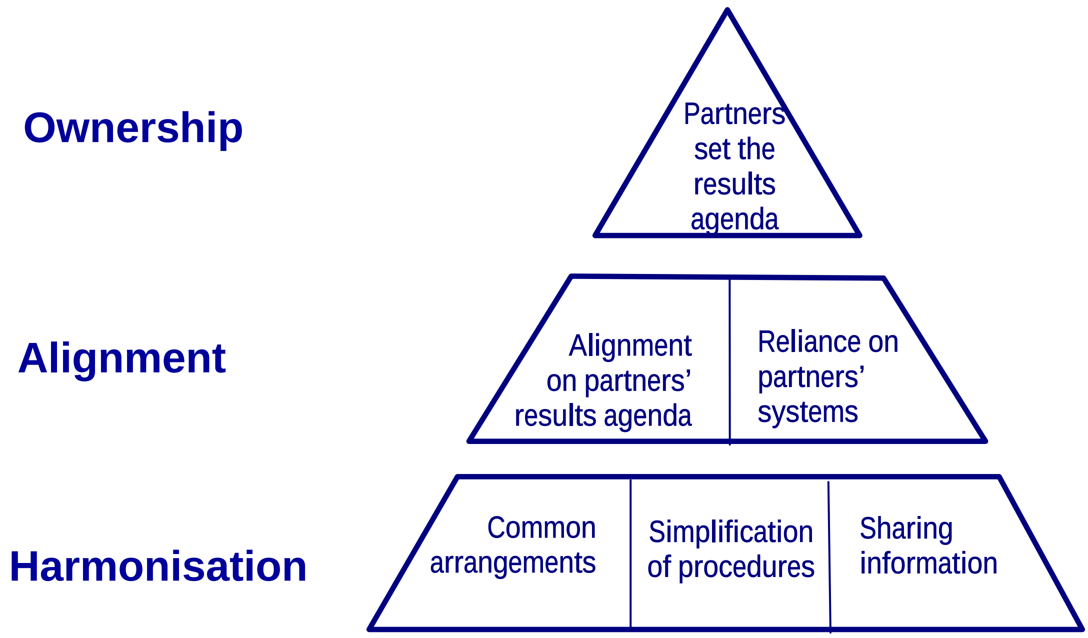
(The broader issue of global public goods and how to provide and fund them consistently with any country-based development model is acknowledged as beyond the scope of this paper, except in terms of suggested do-no-harm guidelines for funding agencies organised around such global goods).

2. The Framework of the Aid Effectiveness Agenda leading into the Paris Forum

The three main elements of the aid effectiveness agenda set out in the Rome 2003 and Marrakech 2004 declarations, and about to be revisited in Paris, are: *ownership, alignment, and harmonisation*, each emphasising results (OECD 2004).

The **first** element commits the development community to 'respect the right – and responsibility – of the partner country itself to establish its development agenda, setting out its own strategies for poverty reduction and growth'. The **second** commits donors to align their development assistance with the 'development priorities and results-oriented strategies set out by the partner country' and to 'progressively depend on partner countries' own systems' (e.g. for financial management and audit), while partner countries should strive to improve them. The **third** commits donors to implement good practices in aid delivery, including 'streamline and harmonise their policies, procedures, and practices…….*and develop staff and management incentives... to foster recognition of the benefits of harmonisation'* (my italics).

This is summarised schematically in the 'Aid Effectiveness Pyramid' (OECD, 2004):



Considerable effort has already been undertaken at country and international level in pursuit of these aims, as laid out in the draft Paris progress report. In particular, donors and recipients have formed joint groups to help coordinate budget support and sector-wide approaches in many countries. Such groups usually involve a joint performance assessment framework (in some instances involving targets for donors as well as recipients) and some standardisation of conditionalities and procedures.

Some countries (India, Afghanistan e.g.) have experimented with a more directive approach, refusing to deal with more than a small number of donors at a time or in a given area, and assigning specific roles to them, incurring no obvious penalty in terns of aid foregone. A number of 'joint assistance strategies' involving tighter ever coordination between individual recipients and several major donors are in various stages of preparation in Africa and Asia. They might cement this rising soft power of well-organised recipients, or they may add more layers of process without corresponding improvements by way of binding mutual accountability or added flexibility in aid use – it is still too early to tell.

Not surprisingly, progress over such a broad and ambitious spectrum is perceived as at best uneven so far, including by its more committed donor and recipient country participants.

On the recipient side, this breaks down into three distinct environments. Middle-income countries, facing on average fewer donors and being less dependent on them overall, often prefer to steer the relationship with each donor individually, rather than working with a donor syndicate (this preference is revisited later). At the other extreme, fragile states and other very low-governance environments deserve special attention, principally because the lynchpin of country ownership rarely obtains there, and donor stances are correspondingly more guarded. Promising new responses are being considered (such as ’shadow’ alignment) which have yet to be proven.

In the middle, there is a substantial group of relatively well-performing low-income countries facing multiple donors and high aid dependency. These countries seek a material payoff from the Paris agenda (used as shorthand from here on) in terms of more flexible and predictable aid, and less conditionality, from the donor collective, in exchange for intensified efforts on aid coordination and public finance management on the recipient’s part.

On the donor side, the harmonisation agenda has also hit limits in some areas. These include aid untying, where key sovereign interests are at stake. There is also the limited domestic policy flexibility donors often have to adjust country aid allocations to fit local strategies, to shift resources quickly between sectors and instruments, or to forgo explicit or implicit conditions which increase aid volatility. In all these areas powerful national or institutional interests and incentives vie with weaker signals in favour of greater collective discipline across donors. Some of these are discussed below.

More immediately, this agenda which so strongly emphasises results is not yet explicit as to its own results framework. Its benefits are usually presented primarily in terms of reduced costs of aid management, which would either no longer be inflicted on recipients, or saved by donors and passed on to recipients in the form of added net flows. (See, e.g. OECD, 2003). This logic focuses attention on *transaction costs* and their attribution across development actors. (The image of a small poor country receiving more visiting donor ‘missions’ than there are days in the year became the badge of shame that fuelled commitment to change by some donors).

However, by this narrow standard, there is no conclusive evidence that the Paris agenda approach is succeeding, or might succeed if adopted more widely or rigorously, at least not in the short and medium terms. On the contrary, there is a plausible basis for expecting total transaction costs to *rise* for a lengthy transitional period. This is because new costs of intense multi-donor coordination and monitoring processes, for example for budget support, coexist with the legacy of traditional aid mechanisms which will take many years to wind down (Killick, 2004). Moreover from the perspective of institutional economics, as discussed in Section 4 below, some aid transactions have categories of benefits (e.g. to reduce uncertainty of contract enforcement), that the Paris Agenda does not explicitly integrate.

In any case, a consistent baseline of aid management costs at country level that would permit rigorous evaluation of harmonisation efforts in years to come has yet to be established. We only have comparable data for the bilateral donor administration costs as reported to the DAC and scored against ODA, which are just the tip of the iceberg.

A bigger cost pool is either financed through service and interest charges of multilaterals, absorbed under technical cooperation and project management rubrics at the project or program level, or simply borne by recipients in various forms. So it will be hard to tell, even years from now, whether there have been major net savings in aid-related transaction costs passed on to recipients, savings in some donor or government agencies but at the expense of increased costs for others, or no overall savings at all. Establishing and monitoring such a baseline, which involves some sensitive probing and discounting of aggregate donor reporting, is presumably a priority for research, to the extent transaction costs really matter – and they must, to some extent.

However, a more compelling case for aid effectiveness, in this Paris agenda sense, surely rests on its potential impact on the quality of governance, especially of fiscal management and public expenditure choices, in the recipient country. As external assistance generally supplies only a modest fraction of the resource pool for recipient country development, aid could perhaps have a multiplier effect in helping to 'lock-in' pro-poor national policies and institutions or, conversely, undermining them, through the more or less effective deployment of this bigger pool of resources.

It does so, goes this argument, by encouraging (or not undermining) domestic accountability mechanisms, such as budget processes, and their link to development outcomes via better public decision-making. In the principal-agent approach of institutional economics, it repairs the 'broken feedback loop' between recipient and donor citizens, by ensuring that donors broadly adopt the accountability framework linking recipients with their governments.

Whether effective aid delivery efforts actually do encourage better national economic governance institutions and whether the latter deliver major development outcomes are separable questions, to which a growing body of country-based research relates. These are concentrating especially on tracking the poverty outcome effects of budget support (reference to ongoing multi-country, multi-donor GBS evaluation program, which is still at inception reporting phase).

At this point, early indications are, on the first question, that better coordinated aid arrangements are indeed promoting improved recipient country financial management systems. We still do not know for sure *why* this is so, or which way the causality runs, as we know very little about the underlying drivers of institutional change, let alone aid's impact on them and its sustainability (Evans, 2004). At worst, aid agencies may be indulging in high-risk 'monocropping', transposing institutional models generated in developed country contexts, rather than encouraging home-grown solutions. It is also possible, according to aid sceptics like Easterly (2001a) that donors can only 'support genuine change on those precious occasions on which it happens', assuming they can detect it. However, they cannot bring it about.

This state of affairs, if proven, would correspondingly reduce the impact of the Paris agenda. However, if we consider the agenda's aims to be a joint responsibility of donors and recipients, overall progress could conceivably be significant even if the contribution of donors to it is negligible. In this case the political signal from Paris is 'recipients take control, donors accept benignly'.

More worryingly, on the second question, ultimate poverty outcomes are not yet showing clear and commensurate improvement, even when better aid accompanies better national fiscal management. This may be due to lags in improving service delivery systems or to factors beyond the control of good fiscal governance *per se*, such as elite capture of policies in other areas with a higher impact on poverty, like land reform. This apparent disconnect certainly deserves, and is receiving, more investigation, given the risk to donor credibility of expanding budget support in the absence of a demonstrable poverty impact. For present purposes what matters is that there may be significant risk or enabling factors at work well outside the control of the Paris agenda, and expectations should be managed accordingly.

3. Alternative research views of aid effectiveness

There is a vast literature on the links between aid, growth and poverty reduction, but as Gunning points out in a landmark paper (Gunning, 2004), almost all of it goes to the question 'granted that we have aid, under what circumstances does it work well?', rather than the more fundamental question 'why give aid?'. This can be paraphrased in several ways. For present purposes, consider something like 'if aid is the best solution, what precisely is the problem?'

It proves a very difficult question to answer rigorously, and the most promising candidates reviewed by Gunning – imperfections in credit markets, the growth cost of taxation, and national contributions to public goods – are not what motivate most donor activity today. The recent UN Millennium Project report (Sachs *et al*, 2005) has a forthright answer of its own, that aid (in low-income countries) is indispensable to bridge accumulated physical, institutional and human infrastructure gaps that are so large that they deter private investment, hence sustainable growth and poverty reduction. This argument stands or falls on the primacy of additional capital in public hands, compared to other factors, in unlocking better growth performance through targeted public investments and better governance – much like our discussion of the logical framework for the Paris agenda above.

Donor motivations for aid, at least as revealed by regressions of their country aid allocations, show that political and strategic considerations are still remarkably important determinants of their behaviour, compared to country need (poverty) and policies (good/bad). In particular, former colonies that are not democratic, or that have 'closed' trade policies, get on average about twice as much aid from the former colonial power than democratic, or open, non-colonies. Moreover, the degree of emphasis on poverty, democracy or openness differs from donor to donor even controlling for strategic and historic considerations (Alesina and Dollar, 2000).

Gunning points out that as development objectives are clearly not the sole or even main aim of many donors, it is not surprising that their aid programs can not be fully 'effective' when judged only against development criteria. The simple fact that country allocations are so often disconnected with poverty reduction by design, not accident, seriously limits the field of intervention of the Paris agenda. (In the extreme case that a donor is allocating aid entirely to the 'wrong' purposes, one might want them to be totally ineffectual in doing so).

A second strand of the aid effectiveness discussion, dominated by Burnside and Dollar (2000) and Collier and Dollar (2002) and their critics (for reviews see e.g. McGillivray 2003, Beynon 2003), focuses instead on defining the policy environments in which aid, whatever justifies it, is more and less associated with poverty reduction. The crucial determinants were originally seen to be the quality of country policy performance and the incidence of poverty. This led to policy recommendations for greater country selectivity in aid allocations – an approach which in several aid agencies has now become synonymous with aid effectiveness. Despite subsequent expansion of the circumstances in which aid may be effective (recovery from shocks at low levels of policy performance, e.g.), and other doubts as to the explanatory power of this model, the 'poverty and performance' basis for selectivity remains strongly entrenched in donor pronouncements (e.g. Global Monitoring Report 2004, Clemens, M.A. *et al* 2004).

However, as most bilateral donors and the EU are still in the (Alesina-Dollar) real world of mixed objectives for aid, but most multilaterals and some bilaterals (notably the UK, the Netherlands and some Scandinavians) fully espouse the poverty-performance selectivity model, the result is a patchwork of country allocations. It has peaks and troughs only loosely related to either relative need or absorption capacity. It appears to cater well, even too well, both to the very 'good' and to the 'bad with powerful friends', but not that well to many deserving cases in between. It generates, in other words, both 'donor darlings' and 'donor orphans', and lesser anomalies (Rogerson, 2004).

As historic ties and strategic objectives of individual bilaterals are presumably impervious to third-party influence, how is the aid system to correct for this built-in asymmetry? The most likely answer lies on the side of the existing multilaterals, absent a *deus ex machina* like the International Financing Facility, one of whose main side-benefits would be the potential to redress just such imbalances. We discuss options for achieving this correction below.

4. The rationale for aid agencies as intermediaries

What of the rationale, not for aid, but for aid agencies, and what it tells us about aid effectiveness? A small but growing literature, summarised in Martens (2004) investigates the role, incentives and biases of donor agencies as intermediaries between donor and recipient preferences, which can and do diverge. Misalignment of preferences can be corrected through conditionality, but that involves both substantial transaction costs and uncertainty. Donors can trade off less of the latter for more of the former. They do this mainly by investing in commitment devices for contract execution, such as monitoring of inputs, outputs and outcomes, agreed policy frameworks and procedures, etc – much of the lexicon of the Paris Agenda.

However, from this different perspective, such transaction costs also bring clear *benefits*, from reduced uncertainty in achieving acceptable alignment of preferences (e.g. ensuring money delivers outputs intended, or is spent only on tied inputs). As such, it is not reasonable to expect such costs to fall steadily, unless a cheaper and equally effective commitment mechanism is at hand. The Paris agenda could benefit from screening alternative proposals from that angle. If a donor-required transaction has absolutely no value for reducing the uncertainty of meeting relevant conditions, eliminating it should be a less challenging endeavour.

The preference-alignment and incentives approach has many possible extensions. Ostrom (2001) for example demonstrates that different interests coexist within Swedish aid, one of which lobbies for commercial as against poverty goals. However, because Sweden has no colonial ties, there are far more countries on which commercial interests can potentially be targeted, and correspondingly more flexibility to marry them with development approaches. Martens (2004) looks at the Bretton Woods institutions in terms of their superiority in information-gathering and analysis over recipients and donors alike. They also offer donors a politically less contentious channel for collective action on sensitive problems, and recipients a modest but direct representation in such decisions.

It is worth considering one more, truly heroic, extension. Suppose the Paris agenda proved a complete success, in that preferences of donors and recipients were fully aligned, complete trust and transparency reigned, national systems were systematically reliable, and relied upon, and costs of verification by donors became negligible. This may never happen in some countries and will surely not happen in many anytime soon, but let us assume it can and will eventually happen in several important ones. What is the future for aid in such a scenario?

In this state of the world, there is no need for any aid agencies to provide mediation between donor and recipient constituency preferences. Direct budget transfers between the two treasuries – as they now occur between the donors and, say, their own regional governments – would suffice. Aid agencies might still be justified as channels for know-how transfer and institution-building, but they would have to prove themselves in open competition with private and voluntary sector alternatives, which the recipient would be free to contract using its own funds and procedures.

This scenario illustrates how the Paris agenda effectively asks aid agencies to work ever more diligently towards their own demise. This is a perfectly valid aim, but one which does not sit well with personal and institutional incentives in many of today's donor agencies. Indeed, in recent research on donor incentives by ODI for the DAC (De Renzio *et al*, 2004) aid agency staff frequently identified the Paris agenda and rapid expansion of general budget support as being synonymous, despite official pronouncements to the contrary. A gradual but irreversible shift to budget support as the default mode of operations, well ahead of the Nirvana of perfect alignment in our hypothetical scenario, could have many consequences. One of them is a perceived threat, a terminal one, to the status and prospects of staff and managers responsible for project-level tasks and related fiduciary controls. The majority of these do not yet see a sufficient role for themselves in the arena of sector or macro policy advice and related budget support.

A final connection under this rubric relates to types of conditionality. Whilst *ex ante* donor conditionality on the effectiveness of government spending could in principle be mutually beneficial, there is ample empirical evidence that it fails to work in practice (Collier *et al*, 1997). In institutional economics, this result is explained by the lack of adequate commitment devices, such as a credible threat to cut off aid. This could be, for example, because of donor constituency opposition to such penalties, or the defensive need for a development bank to protect a broader loan portfolio from default (a.k.a. ‘evergreening’). Recipients, once aware of this, are able to pledge, stall or reverse, and subsequently re-pledge the required reforms, working around key windows for donor lock-in. There are well documented cases of donors ‘buying’ effectively the same conditionality several times over.

A plausible alternative is *ex post* conditionality, tying increases in future aid streams to past results, an approach followed in different ways by, for example, the US Millennium Challenge Corporation and the European Commission’s budget support for several African countries. Gunning (2004) reminds us that, for this approach to have the desired incentive effect, the link to performance must be both transparent and credible. We consider a substantial extension of ‘outcome-based’ conditionality in section 6 below.

5. Donor fragmentation, consolidation and complementarity

Donors collaborate as well as compete in several indirect ways (e.g. for budgets at the margin, more often for reputation and influence). As the goals of aid relate largely to public welfare, not profit, all the main actors are governmental or quasi-governmental and there is much (theoretical) scope for collective action, market analogies should be applied with caution.

Nonetheless, viewing the overall aid system as an ‘industry’ throws up typical regulatory questions of excessive concentration, versus fragmentation which generates costs but also competitive benefits (e.g. Rogerson, 2004). Is there a cartel-like structure in place, with all its negative connotations for aid recipients (Easterly, 2001a), to which the Paris agenda could presumably imply a further intensification? And how would this square with the finding by the World Bank and others (Global Monitoring Report 2004) that the problem is, on the contrary, too many fragmented actors, especially in Africa with associated high transaction costs for the host government? Is there, in other words, a structural problem here that cannot be overcome through exhortation or informal arrangements at country level?

By classical measures of industry concentration (e.g. the Herfindahl index, tracking the sum of the squares of the market shares of industry players), the aid system is now only ‘mildly concentrated’, but well below both historical levels and the threshold of concern of, say, US competition regulators, as a result of ‘a century of entry, but no exit’ (Harford *et al*, 2004). As mentioned in section 3, bilateral allocation biases for given regions can sharply increase the concentration effect at the single country level. Nonetheless, patterns of aid have diversified considerably since the end of the Cold War, and major new players (e.g. Global Fund to fight AIDS, TB and Malaria, Millennium Challenge Account) have entered the equation.

Countries are therefore receiving money from more donors than before, implying greater fragmentation/competition at country level. But this increase is still from a relatively low base. Harford points out that the fragmentation index of 67 in 2002 quoted by the GMR would be produced by three equal donors sharing the entire market, while that of 56 for 1975 is consistent with a dominant one with 60% and two runners-up with 20% each. Most consumers would not rate this kind of set-up highly competitive, much less fragmented.

From a transaction costs perspective, what matter more in any case are the overall number of players and the length of the 'tail' of very small ones – for example those who provide less than 2% each of a country's aid flows. In Tanzania, for example, over a dozen small bilaterals and UN agencies share this distinction, whereas a clear majority of aid is accounted for by only four donors, out of an overall pool of some 34. This is not unique situation by any means.

At the level of individual sectors or themes, the problem may look even worse, though definitional problems complicate analysis. Some large donors (notably the World Bank) generally participate as one of a small handful of leading donors by size, or do not participate at all. Incidentally, this visible form of concentration tends to aggravate the perception that some donors, egregiously the World Bank, have dominant positions. Others who are also quite large at the aggregate country level (like DFID) may also be present in several sectors in the top three rankings, but appear in others with a token financial presence, ranking as low as tenth place. This is ostensibly at odds with their overall aid alignment intent, but reflects, for example, responses to signals of new global thematic priorities from the donor headquarters.

This more complex pattern of concentration/fragmentation paradoxically comforts both the 'cartel' theorists and those who would like to see much more consolidation. This could be achieved, for example, if each mid-to-large agency unilaterally adopted some variant of the Jack Welch (General Electric) motto of 'be the first or second in each business, or get out'. Without, of course, the threatening connotations this has for competitors in new sectors. Fragmentation at the country level would be unchanged, but the perception of greater leverage might also be enhanced.

Obviously, relative financial shares are by no means the only criterion for considering a donor's added-value or 'complementarity' with others, nor would an indiscriminate process of winnowing out all micro-donors at the country or sector level be worth the substantial loss of expertise and goodwill this could incur. A more nuanced approach would distinguish those whose primary mode of engagement is technical cooperation, as against providers of large net flows. Some two-tier recipient-led aid coordination arrangements which shield senior government officials from dealing with some of the former individually, but allow indirect dialogue through periodic joint sector groups etc., would remove most of the up-front costs of this kind of fragmentation, at negligible financial risk.

Those donors who seek even faster consolidation should give explicit assurances, if they can, that within a given country envelope, they welcome the host government's proposals to shift to higher-priority sectors and they will ensure that any temporary savings stay in the country. Not many donors have done so publicly.

Risks of cartel-like behaviour remain a factor against which the cost of more fragmentation (among significant donors) needs to be balanced by recipients. The Paris agenda acknowledges that harmonisation does not mean standardisation, and certainly not complete symmetry of conditionalities, but this is clearly still a risk factor as seen by countries (References-IMG Tanzania?).

For example, the European Commission has on occasion opposed the full alignment of conditions for release of budget support already agreed among the in-country donor group, including its own field office. This is not because of disagreement on the substance of the conditionality, but because the all-on/all-off, covariant risk of total budget support suspension, contingent on the same events, was seen to be too dangerous from a macroeconomic perspective. In such cases, the recipient should rationally seek to diversify, not align, conditionality, for the same reason.

Middle-income countries such as Morocco, with relatively few donors, say they prefer a pattern of relations with single donors based on their individual characteristics and bargaining strengths, compared to enfranchising any donor group, let alone a cartel. Group approaches risk incurring cross-conditionality or other forms of group leverage, and giving excessive ‘hold-out’ rights to the smaller donors present.

Such recipients are presumably prepared to trade relatively off higher transaction costs – much as we saw donors would – for less uncertainty, or at least a wider spread of risks. This is all the more important in environments where political conditionality relevant to bilaterals or the EU might be reinforced by macroeconomic conditionality from the IFIs. Aid harmonisation and alignment in this context means donors improving their individual offers in terms of flexibility and predictability, perhaps based on a code of behaviour agreed with Government, rather than new arrangements for group-based decision-making.

The next phase of research on incentives for alignment and harmonisation should ideally focus more on such interactions between donor and government incentives in-country, and in particular on gaming strategies between recipients and a clutch of dominant donors, in heavily aid dependent and less dependent contexts.

6. Supportive Actions needed beyond the country level based on subsidiarity

The above discussion points to some possible policy steps that could be taken beyond the reach of in country donor offices working with the recipient under Paris agenda guidelines. These all impinge on what is misleadingly called the ‘international aid architecture’ – suggesting conscious design and designers – or less dramatically, the way different parts of the official aid system, managed independently under sometimes incompatible principles, interact.

To try to work bottom-up from country level to identify minimum necessary changes at the cross-country, cross-donor and global levels that can seriously enhance aid effectiveness on the ground is a variant of the ‘subsidiarity’ principle. It is not a grand re-design of global governance for its own sake, and tries to economise on the scarce energies and goodwill countries – even powerful ones like the G8 – can afford to invest in the latter.

To give a pertinent example, the fragmentation among agencies of the UN system, and their obvious overlap and coordination burden at country level, is a serious, legitimate concern for UN reformers. But to bring even a single small recalcitrant body under the aegis of another, let alone close it, could consume enormous time and political attention with only modest net benefits at country level. The same applies to the very smallest bilateral donors, especially in relation to the EU collective, where they are EU members.

However, if recipient countries can impose ground rules that limit their share of transaction costs of dealing with this 'tail end', as discussed above, and the relevant anchor institutions (UNDP and Commission, in tune with the World Bank) perform tolerably well, there is no urgent country-level problem to be addressed from a Paris agenda perspective. If, conversely, the overlap and friction centres on the *larger* multilaterals or bilaterals – the handful instantly recognisable in a country even without statistics to hand – we have a quite different problem to solve.

So what kinds of problems are likely to prove to be beyond both the Paris agenda and laissez-faire? There are five singled out here:

A. Cross-country balancing of aid allocations

The problem was discussed in Section 3. A multilateral solution would be to use the International Financing Facility to focus on correcting such imbalances, if and when it comes on stream, by giving more weight, not just to needs and performance, but to the size of the financing gap relative to the existing donor pool.

Meanwhile, some or all existing multilaterals, and particularly the MDBs, could be directed, and their funding share increased, so as to give similar added weight to the relative availability of other aid sources. This shift from an absolute selectivity bias to one which explicitly recognises these agencies' role as balancing wheel is not without political and methodological problems. For example, an unconstrained performance-based allocation system, which crowds in multilateral funds into relatively well-endowed donor-darlings, arguably pulls more people out of poverty per million dollars than a constrained one, by definition. However, this is assuming there are not diminishing returns and congestion costs to aid in such environments.

Also, actual PBAs are already heavily constrained – for example very low per capita ceilings that have been placed on funding the Indian subcontinent, or reserved minimum shares for Africa, are raising the average cost of poverty reduction very significantly, even among donors formally committed to selectivity. Multilateral formulas leading to better geographic balance could therefore actually improve targeting in this sense.

By the same token, however, large-scale rebalancing could lead to serious political concerns, just as achieving the MDG at the global level, mainly through progress in Asia, is not a sufficient response so long as so many countries in Africa risk failure. Not all poor, in a cross-country sense, are equal. Moreover, other objectives are at stake. If the EU hypothetically shifted a few hundred million euro from its Mediterranean program into India, for example, it would immediately leap from laggard status to the head of the class, in strict pro-poor allocation effectiveness ratings. This does not in itself make such a move politically feasible.

This general avenue of potential improvement nonetheless needs to be explored using all available channels, including competitive pressure via the IFF as it nears the launch phase. At the very least, multilaterals' performance ratings and the resulting effect on country allocations should be put in the public domain and made subject to scrutiny, along with other aid flows to the country. This should be part of a wider framework of mutual accountability monitoring.

B. Expanding long-term, large-scale recurrent cost financing instruments linked only to specific development outcomes

Recipients, as we have seen, badly want longer-term predictability of aid commitments, not just of disbursements against existing commitments. This is especially true for budget support (or aid that is effectively budget support) linked to the funding needs of health and education services, which usually account for the bulk of the state payroll.

General budget support to qualifying countries fills part of the need for fungibility, but has an inherently shorter-term focus, no longer than an IMF program and its associated (usually 3-year) Medium Term Expenditure Framework (MTEF). Moreover it is subject to policy (*ex ante)* and outright political conditionalties that introduce considerable short-term instability, especially if adopted by several donors symmetrically.

As mentioned in section 4 above, some donors, notably the European Commission, are experimenting with *ex post* conditionality, relying in particular on externally verifiable outputs and outcomes such as progress on vaccination coverage, school enrolment or completion rates, etc. These have several advantages from the donor perspective also. First, the link to results is clearer for domestic audiences sceptical of general budget support, often seen as a technocratic 'B2B' (bureaucrat-to-bureaucrat) deal with its negative connotations. Whilst reformulating such instruments as a 'Universal Education Program' or other specific MDG-related program, funding large-scale recurrent costs, is to a large extent about repackaging, improving public perceptions of tangible results is essential for greater aid stability. And these outcomes are not just more visible to, but monitorable by, civil society critics in both countries.

On the recipient side, the potential advantage sought is twofold. First, aim to strip out a substantial portion of net aid flows with a longer commitment horizon (say a minimum of seven years). Second, remove all conditions for continued disbursement for this portion that are not entirely derived from the recipient's goals, as framed in the PRSP or related sector plans. This does not eliminate the risk of suspension, but this risk for this strip is no longer co-variant with that of general budget support, and indeed it depends entirely on actions under government control. (Well, not entirely, as there is a demand side for uptake of services, etc, and this is affected by exogenous shocks of different kinds – but these mitigating factors can be assessed on their merits and allowed for in the design of the instrument).

There remains, as discussed above, the issue of credible commitment mechanisms – the ability of donors to enforce outcome-based conditions transparently and firmly. This will also be linked to measurement lags: the phasing of ex-post reviews will need to be staggered every three years or more, so that progress (or the lack of it) and its attribution is transparent. All the more reason to give up micro-management on an annual or more frequent basis.

The obvious danger is that when major MDG objectives are missed, even absent mitigating factors, donors using these instruments will flinch from suspending funds (*ex post* equivalent: not entering into a new phase) which explicitly support progress towards that outcome. There is an element of moral hazard here. Donors would however be better positioned with this type of program than with conventional instruments to seek civil society backing for a harder line. A softer line, if it came to that, could lead to effectively unconditional support, as is arguably the case now: but it could at least make it more stable over time.

A lesser objection could be that external arbiters of general budget support, in particular the IMF, would lose leverage if a big part of the budget funding pool – in reality if not in name – escaped their purview. Again, this is also true for much clumsier basket funding mechanisms at sector level, whereas the proposed new instruments would at least try to tackle recurrent costs and their fiscal sustainability head-on.

For obvious reasons the design and general pace of expansion of such instruments needs to be co-ordinated at both the cross-country, single-donor policy level, and in the wider aid community. Thereafter its roll-out in individual countries depends on country-level joint processes under the Paris agenda.

C. Reconciling the overall country aid envelope with aspirational MDG plans

The Millennium Project Report, cited above, has drawn attention to the need to build aid programs up from technically feasible, but firmly aspirational expressions of national development goals, inspired by the MDG. It rejects today's situation whereby national strategies – especially the PRSP – are effectively 'self-censored' on the basis of some largely external assessment of what resources may be available to augment domestic savings. At that rate, it says the MDG may not be achieved in some countries for many more decades (Sachs *et al*, 2005).

In practice, country aid envelopes are determined by individual donors, hence the donor collective, independently of the current PRSP, based on the set of factors discussed in section 3. Over time, progress in each PRSP cycle of course influences allocations, but the adjustment is slow and partial. In the meantime macro frameworks discussed with the IMF, and their growth, exchange rate and inflation parameters in particular, largely drive the space available for extra public expenditure. Some assumptions are made on grant- and concessional-loan financing and their sustainability, based on current donor opinion. Within some restrictions (related to e.g. Dutch Disease), these can expand the growth and public finance targets. Increasingly, alternative incremental expenditure scenarios are discussed, contingent on securing more grant aid at the margin, and a larger above-the-line deficit. But these also tend to come in incremental steps.

What's wrong with this process, apart from its innate conservatism in terms of MDG timescales, is that it is nether neither transparent nor legitimate in terms of country ownership. Outsiders' views of external financing tend to close down the resource envelope discussion too soon, without sufficient exploration of alternatives. Short-term funding imperatives, such as conclusion of a successful Fund program review, push the horizon for non-marginal change further away.

There is no perfect way to resolve this tension. The Millennium Project suggests ‘fast tracking’ selected countries through some multi-donor exercise (a kind of supercharged Consultative Group) to break through such logjams. The chosen few would reach a different plateau of funding, based on radically more ambitious, needs-driven series of PRSPs within a ten-year MDG planning framework. It is not yet clear how this would succeed where other attempts have failed, relying as it does on the same set of institutions.

Experience of similarly inspired efforts on a smaller, sectoral scale, such as the Education for All Fast Track Initiative (FTI), show that gaps can be closed, in principle, through such concerted action when they are quite small in absolute terms, falling within some ‘high case’ envelope for single donors applying conventional allocation rules, or drawing on the donor’s current reserve funds. When quantum increases are needed, however, for many countries simultaneously, this far exceeds the scope for discretion at the country level, and may require new mandates from the donor legislature.

The aid system, in other words, is neither ‘liquid’ nor flexible enough for Sachs-type large-scale gap-filling across many countries simultaneously. It is geared to considering one country, or sub region, at a time under *ceteris paribus* assumptions of only marginal (say, 10%) overall flexibility at donor level. More importantly, it implicitly projects, from past experience, a high possibility of offsetting decreases in programs elsewhere, due to exogenous shocks and governance problems. It is largely these ‘business as usual’ savings – on failing but not failed states, for the most part – that finance the large surges of aid needed to fund large recovery situations and emerging successes. In addition, a number of donors (for example Millennium Challenge Corporation and Global Fund to fight AIDS) now finesse country allocations altogether by asking countries to compete for funds, across countries, one project at a time, making it much harder to ‘fit’ funding to any country’s PRSP-MDG framework, aspirational or otherwise (see the recommendation on this point below).

Bearing in mind such systemic constraints, just launching a large set of simultaneous MDG-driven negotiations at multi-donor, multicountry, multisector level is unlikely to be sufficient, and could create false expectations. A complementary approach would be to create a large enough ‘reserve fund’ at multilateral level to be responsive to opportunities on several fronts simultaneously. This would in effect be a ‘synthetic donor’, or ‘silent partner’ at gap-filling discussions, but could only come in with the agreement of the resident donor community and after they had made their own best efforts. This is the model being tested on a modest scale, for example, by the FTI Catalytic Fund. It could of course be closely related to the ‘balancing fund’ concept discussed above.

Once again, the obvious candidate for a world-class synthetic donor is the IFF, with actual implementation divided over relevant existing donor agencies. It also fits with the IFF’s mission to accelerate aid, i.e. improve the liquidity, not underlying solvency, of aid budgets. But even absent the IFF, a temporary reserve facility could be constituted on a rolling basis at, say, the World Bank or IMF, like an overdraft designed to bridge spikes of aid commitments that exceed individual donor budget limits for short periods. Its carrying costs should not prove insurmountable.

Obviously, governance arrangements would need careful design – as they will for the IFF anyway. And in particular, moral hazard issues need to be addressed, so that existing donors do not free-ride on the new facility, an issue faced already by the FTI Catalytic Fund. But these are not insoluble problems, as demonstrated for example by how the HIPC debt reduction initiative was organised.

D. Credible Mutual Accountability Devices with effective sanctions

One inherent asymmetry of the Paris agenda, and of the aid system in general, is that if recipients do not match agreed performance, donors can (in principle anyway) apply clear sanctions: however if donors underperform, no such remedies are available to the recipient. Incentives are skewed accordingly. How might this be changed?

Part of the difficulty lies in defining clear donor behaviour standards, and here the Paris agenda is instrumental. Moreover in some countries, such as Mozambique, a parallel ‘performance assessment framework’ applicable to donors, with specific indicators (on, e.g. timely disbursements) has been agreed. A number of observers (Oxfam 2004, Johnson *et al* 2004) have recently suggested useful batteries of monitorable indicators that would help clarify and codify such behaviours. Some of these involve financial reporting used by recipient governments, in addition to open-source information. Some involve a measure of subjective scoring or opinion surveys, including baseline surveys carried out for the DAC and others as part of the Paris process.

Such initiatives serve several purposes. At the country level, they allow for greater transparency in confronting different views of the same interactions, and a support for problem-solving, even though power relations remain unequal and there is no guarantee of redress for the recipient. The possibility of ‘naming and shaming’ as well as emulation and rivalry at country level affects donor group incentives towards better performance. Also, local representatives know that such ratings can strengthen the recipient’s hand in appealing over their heads to other levels of donor management or political oversight.

However, it is at the international level, where they should also operate, that these incentives are much weaker, especially when donor behaviour is dictated by arrangements beyond the discretion of the country office. This is for several reasons, but two stand out. First, the ratings do not yet carry the authority of a respected, and widely published, independent assessment source comparable, say, to Transparency International. And second, compared to the analogy of ratings agencies in bond markets, such signals do not generate significant financial costs and rewards along with moral suasion.

The first problem could be addressed by donors collectively funding, at arms’ length, a permanent platform for bidding out donor assessment contracts to independent professional analysts meeting requisite qualifications, and against agreed templates.

The platform could also collect and publish such ratings by country and donor. It could take the form of a foundation, perhaps linked to the UN, but not through its development agencies, which would themselves be subject to rating.

The second problem, of sanctions, is of course much tougher. In a more competitive set-up, where funding of aid and delivery of aid services can be unbundled and the latter outsourced based on outcome targets, as envisaged for example in Harford (2004), delivery agency ratings could be enforced by funders. For example, they might have to meet eligibility thresholds (the Millennium Challenge Account in reverse) to access funding, or they could only do so to a limited extent until ratings improved, etc.

Finally at the apex level, if constructs like the IFF, or other large new multilateral facilities as discussed above become available, donor ratings (including as financing as well as delivery agents) could similarly be used as criteria to regulate access to funding. This alone could have a profound effect in reshaping the aid system over time, even if, as one suspects, these ratings could have relatively low weights to begin with, compared to other criteria.

E. Global Public Goods and Global Thematic Agencies

An obvious category of issues falling beyond the Paris agenda but affecting aid effectiveness at country level concerns global public goods, or, as in the title of a recent working paper by the secretariat of an international task force 'international cooperation in the national interest' (ITFGPG Secretariat, 2005).

At the core of the policy response that paper suggests, in brief, is an enabling platform for tackling the root causes of the undersupply of cooperation across borders. This concerns six areas where action at the individual country level will not be sufficient: peace and security; infectious disease control; global commons; financial stability; open trade; and knowledge. The three root causes are the lack of incentives (free riding e.g.) for countries to join; differences in their ability to bear costs; and scepticism as to the effectiveness of international institutions. The enabling platform also has three mutually reinforcing pillars: better monitoring; a new financing architecture; and institutional reform, especially in the leading coordinating bodies.

This approach deserves much more attention, well beyond the scope of the present paper. It is consistent with it, however, in building up a global picture from country-level interactions and the missing institutions and resources that are needed beyond country-level approaches, whilst accepting that the latter will bear the brunt of the effort ahead.

A final thought concerns the operation of global thematic funds organised to address such public goods, especially in the health and global commons areas. The human and political appeal of highly focused special-issue funding, including the unprecedented initial growth of institutions such as GFATM and GAVI, is such that they are becoming a permanent and growing part of the multilateral landscape. Their growth is also fuelled by restrictions, such as burden-sharing formulas, on the expansion of the share of the established multi-purpose multilaterals, such as IDA.

There has however been much discussion, including within the Paris agenda, as to how in practice such institutions are to ‘align’ with a country-led vision of development. Whilst it is clearly not their aim to work at cross-purposes with national strategies and priority-setting mechanisms, there are some inherent sources of tension. Their funding is (in theory) earmarked for specific purposes (though not in the narrowest sense, as they can also fund general sector infrastructure used to deliver a wider range of services). They mostly finance specific projects, with competitive tenders at intervals that may not suit national planning, and a high degree if uncertainty as to success. They often rely on a different institutional channel to convey ‘ownership’ than that consulted by other donors – for example, one involving a mix of civil society and government voices rather than the latter exclusively. And they rely on and use, but seldom add to, scarce institutional capacity to design and manage country programs, thereby externalising part the cost of their operations onto other donors.

Some of these features can be corrected at country level without serious consequence. For example, as was shown above, if sector spending limits are fully controlled and budget and financial tracking processes work well, earmarking becomes notional and the funds become equivalent to general budget support. This holds unless the donor can monitor and enforce overall spending thresholds, which these funds generally cannot. Providing ultimate development outcomes improve as intended, and more effort is now going into monitoring them thanks to the global funds themselves, we should not be too concerned about notional earmarking from a country development perspective.

A more forthright response would be to try to move these institutions towards a programmatic approach, explicitly concerned with filling gaps in existing programs rather than generating large numbers of new project ideas. At the same time, it may be necessary to identify more clearly what resources should be mediated through government as against nongovernmental channels, and how. This is not a simple matter of changing a few procedures at the margin, going as it does to the basic principles on which these institutions were founded – which include rectifying the perceived failures of other donor agencies.

An intermediate step might be for the DAC to agree with these institutions on a ‘*code of conduct*’ relating to alignment and harmonisation at country level, starting with the features that might, if not addressed, cause serious harm, and then moving on to further improvements. In these discussions one must assume that the relevant adjustment may well be on the side of conventional donors and recipient governments, as much as in the behaviour of the global funds.

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