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Enhancing Knowledge
for Renewed Policies against Poverty

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Content

Abstract

This task deals with "Aid effectiveness and its impact on poverty" mainly seen from the side of the donors. Aid effectiveness also depends on how it is allocated by donor.

The paper proposes an approach centred on the concept of need-adjusted aid effectiveness. This means that the donor's objective function explicitly takes into account the trade-off between considerations of needs and considerations of governance. Moreover, the donor is willing to exert external discipline on the recipient countries. To the extent there is a negative correlation between the extent of needs and the quality of governance, we expect that the donor would bring more discipline to bear upon the poorer countries with the consequence that they would not be excluded from aid programmes. Working within a one-donor-two-recipient framework, in which one recipient country is relatively poorer and worse-governed than the other, we are able to show that many intuitions regarding effects of parametric changes are too simple. In particular, the improvement in the governance of the poorer country does not necessarily induce the donor to raise its aid share.

I. A new approach to the role of development aid for poverty reduction: Trading-off needs against governance[1]

1. The equity problem: aid darlings and aid orphans

A criticism that is frequently levelled against the current pattern of aid allocation is the coexistence of 'aid darlings' and 'aid orphans' among recipient countries. It subsists in spite of the coming to the fore of a new approach to development cooperation that emphasized policy dialogue, country ownership and the need to get rid of conditionalities and reform overload or high transaction costs. Heralded by the Paris Declaration (March 2005) and the Accra Agenda for Action (September 2008), this approach also privileged new aid modalities, General Budget Support (GBS) in particular, is considered to be especially suitable to meet the above objectives. Yet, results proved rather disappointing and ex post conditionalities were soon re-introduced, leading to suspension or disruption of GBS in countries such as Nicaragua and Honduras. Donor agencies that are well-known for their rigour, such as SIDA (Sweden) and DFID (United Kingdom), have even decided to give up budget support and return to aid modalities -programmes and projects- that better lend themselves to monitoring and sanction in the event of non-compliance with set conditions.

Because conditionalities associated with GBS are more politically sensitive, arguable and hard to enforce than those associated with project and programme aid (although, as a matter of principle, they should be determined by the recipients' own development priorities), they also tend to cause more frustration among donor agencies with the attendant risk of eventually dropping out the failing countries (Dijkstra, 2013). Not only does such a situation give rise to the aforementioned phenomenon of 'aid darlings' and 'aid orphans', but also, to the extent that the worse-governed countries are generally poorer, it creates a serious equity problem. This is particularly evident in the case of the "zero tolerance for corruption" approach advocated by some in reaction to the uncovering of massive frauds in using aid money in some countries. The fact of the matter is that the number of poor in fragile states where governance problems are the most serious has stayed flat at about 500 million since 1990, and is likely to remain so until 2025 according to a recent study (Sunner, 2012). Since the number of poor in 'non-fragile' states falls quickly −from almost 2 billion people in 1990 to around 500 million now−, countries with weak states will weigh more and more in donors' aid allocation decisions (Kharas and Rogerson, 2012).

2. A new approach integrating needs and governance considerations

Together with François Bourguignon, previously vice-president of the World Bank, I propose an alternative approach that departs from the above setup. By advocating the need for external discipline imposed by donors in addition to internal discipline inside the recipient country, this new approach aims at increasing the possibility of rescuing of poor but badly governed countries from neglect. Its advantage lies in the fact that the rescue is effected without going as far as the need-based approach defended by Thirlwall (2011), for example. According to him, indeed, aid assistance should be distributed on a per capita basis according to some target level of per capita income (a principle "which would operate rather like an international negative income tax" (p. 476)). By definition, therefore, the need-based approach does not lend any attention to governance aspects.

We advocate an intermediate approach, labelled "the need-adjusted aid effectiveness" approach. The idea is that the donor's objective embodies a trade-off between needs and governance considerations:

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acting as a coordinated body (think of the whole community of donors acting through the UN to meet the MDGs), the donors are concerned not with the amount of aid given to this or that country according to assessment of their needs, but with the amount of aid that actually reaches the poor, which depends on the quality of their domestic or internal governance. This is a satisfactory approach because needs and governance jointly determine which share of the available aid fund should accrue to each potential recipient country.

The donor agency thus faces a choice problem: it must allocate a given amount of aid money between countries heterogeneous in terms of needs and governance. In a two-country setup, this means that one country is relatively poorer and worse-governed than the other. It is because it is sensitive to the share of aid that effectively reaches the target group (the poor) that the donor agency is unavoidably confronted with the aforementioned trade-off between governance and needs when it makes its inter-country allocation decision. The decision criterion that we use is based on the concept of "need-adjusted aid effectiveness", which precisely reflects such a trade-off. A second essential feature of the new approach is that, when deciding how to allocate aid, the donor allows for the possibility of improving governance in recipient countries, at least with respect to the projects it helps to finance, particularly in the poorer and worse-governed one. Opening up such a possibility through the use of appropriate disciplining instruments −monitoring and punishment− is expected to increase the likelihood that the poorer country will be included in the aid programme.

This expectation is confirmed by our theoretical analysis yet with an important caveat: the disparity in initial governance levels ought not to be too large. In other words, if the quality of governance in the poorer country is too bad relative to that prevailing in the richer country before the donor agency applies its disciplining strategy, then our optimal allocation formula suggests that the poorer country should be denied development aid. If that unfavourable condition is not satisfied, the donor agency distributes a positive amount of aid to both (types of) countries, and the bad governance of the poorer country will be somewhat mitigated by the donor's efforts. On the other hand, if the richer country is too rich compared to the poorer one (the extent of its needs is too small in relative terms), and provided that the quality of governance in the poorer country is not comparatively too bad before the donor agency applies its disciplining strategy, the optimal aid allocation policy requires that only the poorer country receives aid.

Another result that is rather unexpected and again attests to the key role of the initial disparity between the countries' governance levels is the following: the aid share of the poorer and worse-governed country does not necessarily fall when the cost of external discipline increases. Whether it does so or not hinges upon the gap between the countries' initial governance levels. And it is only when such disparity is not too large that allowing the donor's discipline to bear upon inter-country aid allocation has the effect of raising the share of the poorer and worse-governed country.

Inter-country difference in initial governance levels is not the only pivotal variable influencing optimal aid allocation. The behaviour of the costs of external disciplining is equally important. It is thus found that, all other things being equal (including the characteristics of the other recipient country), an improvement in the governance of one country does not necessarily induce the donor to raise its relative share of aid accruing to that country. A key role is actually played by the intensity of the donor's response in terms of external discipline, more precisely by how intensively the donor substitutes better internal governance by less external discipline, possibly over-compensating the gain in internal discipline. The characteristics of the disciplining technology, in particular the monitoring technology available to the donor, matter a lot here: the less sensitive is the cost of that technology to increases in external disciplining the more likely that the intuitive outcome will prevail: a poorer and worse-governed country is rewarded by a larger share of aid when it has improved its internal governance (irrespective of the donor's efforts toward that end). The intuition is straightforward: if costs are too sensitive, it becomes excessively costly for the donor to improve the governance of the poorer country and to make it a worthwhile recipient of development aid. The policy implication of this result is extremely important: if the technology of monitoring of aid uses by recipient countries is rather ineffective or costly, efforts of the donor community should be directed to innovating this technology in such a way as to make it cheaper and less sensitive to the degree of external discipline desired.

3. The hard challenge of making the aid allocation formula operational

In the new approach to the role of development aid for poverty reduction, the donor agency has an objective that is defined not only in terms of the intrinsic importance it attaches to the money that effectively reaches the poor but also in terms of the cost of external disciplining. The formula of optimal aid allocation is rather easy to implement as far as the first component of the donor's objective is concerned. Indeed, we only need to collect proper measures of the extent of poverty and quality of governance in potential beneficiary countries. These measures are typically available from international datasets. This is true even for indicators of governance quality. For example, one can use the so-called CPIA indicator which is a Country Policy and Institutional Assessment index that accounts for various aspects of policies and institutions: quality of macro-economic management and policies for social inclusion, quality of institutions and public sector management, and performances of the portfolio of aid projects managed by the World Bank.

The real problem is cost measurement. As a matter of fact, there are no systematic data on the behaviour of the cost of monitoring aid uses and sanctioning bad aid recipients. Till such data become available, we are compelled to simulate different scenarios on the basis of varying assumptions regarding such costs.

Finally, the need-adjusted aid effectiveness approach has important implications with regard to the Performance-Based Allocation (PBA) formula actually used by some multilateral donors to allocate aid. This formula appears to be in agreement with theory in the sense that the allocation depends positively on needs and governance, although the latter seems to be excessively dominant. However, when governance is allowed to be influenced by the donors through conditionality and disciplining, the 'need' component of the formula is called to play a more prominent role. This is precisely the aim of the new approach proposed in this policy brief.

II. Empirical cross-country analysis of aid allocation: The role of aid channels[2]

1. Introduction

After a period of general pessimism regarding the effectiveness of foreign aid, the World Bank's much-cited 'Assessing Aid' study (World Bank 1998) marked a turning point, suggesting that donors could contribute to economic growth in developing countries, but only if they focused their engagement on recipients with reasonable levels of governance. Even though the empirical results that underlie the World Bank's conclusion were later shown to be fragile (Roodman 2007), the donor community has recurrently stressed the importance of good governance for effective development cooperation. Yet, a core result of the aid allocation literature is that the quality of governance in recipient countries has hardly affected the amounts of aid actually committed and disbursed (e.g., Hoeffler and Outram 2011). This appears to hold most robustly for corruption, the element of governance that has been given particular attention by donors (e.g., Nunnenkamp and Thiele 2013). Alesina and Weder (2002) even provide evidence that corrupt governments receive more aid.

The most common explanation for the fact that aid flows do not seem to reflect recipient countries' quality of governance is that considerations of recipient merit are dominated by other donor motives. There is ample evidence, for example, that donors pursue a variety of political self-interests when giving aid. These range from preserving ties with former colonies (Alesina and Dollar 2000) to influencing the voting behaviour in the Security Council or General Assembly of the United Nations (Kuziemko and Werker 2006; Dreher et al. 2008) or the outcome of specific elections (Faye and Niehaus 2012). Foreign aid is also used to further trade links with recipient countries (Berthelemy 2006).

An alternative explanation, from which our analysis in the NOPOOR project departs, is that donors may hesitate to withdraw support from badly-governed countries as a result of a dilemma they face: exactly those countries most in need of assistance also tend to lack proper institutions. One way of trying to resolve this dilemma is to bypass recipient governments and deliver aid through non-state actors. While a sizeable share of aid by OECD donor countries is indeed channelled through non-state actors, the reasons underlying this pattern are not well understood. We explicitly investigate the role of recipient governance for donors' decisions to channel aid through state or non-state actors. In addition to providing an explanation of why donors channel aid through non-state actors, we also contribute to the debate on donor motives. Specifically, we interpret bypassing as evidence that donors are not as selfish as the aggregate relationship between aid and governance would imply. The rationale is that bypassing at a sizeable scale is hardly plausible without donor altruism because self-interest can best be pursued through direct state-to-state interactions.

2. Data

Data on the channel of delivery come from the OECD's Development Assistance Committee (DAC). Through its Creditor Reporting System (CRS), DAC documents all flows of Official Development Assistance (ODA) of DAC member countries (as well as some non-DAC countries and multilateral organizations) to developing countries. The CRS offers donors the option to report the channel of delivery for every aid transaction to a recipient country. The available channels of delivery include (i) the public sector of the recipient government, (ii) national and international NGOs, (iii) multilateral organizations such as UNDP or the World Bank, and (iv) other development actors such as private contractors.

[2] By Rainer Thiele, Kiel Institute for the World Economy

The amount of ODA delivered via different channels to a given recipient country is based on the bilateral aid commitments of all DAC member countries in 2008. For almost a third of the 181,852 bilateral aid transactions recorded by the CRS in 2008, the channel of delivery is not readily coded. This is because the channel of delivery is not a mandatory item in the CRS. We code these missing cases by determining whether the implementing organization (whose name is mandatory to provide) belonged to the public sector, was an NGO, a multilateral organization or another non-state development actor. The focus of our analysis is on whether aid is channelled through state or non-state actors. We therefore only distinguish between aid channelled through the public sector (state-to-state aid) and aid channelled through NGOs or multilateral organizations (state-to-non-state aid).

Overall, 75 percent of aid committed in 2008 was in the form of state-to-state aid. There is considerable variation across donors. The share of state-to-state aid exceeds 90 percent for donors such as Germany, Japan, and France, but is only between 40 and 60 percent for the Netherlands, Sweden and Norway, who all belong to the group of donors that are considered to be driven more by recipient need and less by economic or political self-interest than other donors. The share of state-to-state aid varies considerably over aid sectors, too. Humanitarian assistance stands out as being predominantly channelled through non-state actors. Among the remaining sectors, the share of state-to-state aid ranges from 55 percent for governance, via 77 percent for health and education to almost 95 percent for infrastructure.

Does the quality of governance in the recipient country matter for a donor's decision to choose state or non-state actors as implementing partners? To answer this question, we consider four measures that aim to capture different dimensions of governance. Our first measure is the conventional control of corruption index. The other three measures cover more specific dimensions of the quality of governance: (i) a government's respect for internationally recognized human rights; (ii) the size of the powerless population defined as the percentage of the population who belong to an ethnic group whose representatives hold no political power at the national or regional level; the size of military expenditures.

3. Methodology

Within a multivariate regression framework, we use different dependent variables to capture both the relative and absolute importance of state and non-state channels of aid delivery. Our first dependent variable is the share of state-to-state aid that recipient country i received from donor j. Donors may not only reduce the proportion of aid that is given through state actors to bypass the government of a recipient country. They may also lower the absolute amount of overall (state-to-state and state-to-non-state) aid to that recipient country. To consider this possibility, our second set of dependent variables includes the absolute amount of (i) overall, (ii) state-to-state and (iii) state-to-non-state aid that recipient country i received from donor county j.

In choosing our control variables, we follow the aid allocation literature and distinguish between recipient need and donor interest. To proxy recipient country i's need, we include its GDP per capita, population size and the number of people who died as a result of natural disasters in the preceding period (2000-2008). It should be noted, however, that this interpretation only applies for the specification using aid amounts as dependent variable. When it comes to explaining aid shares, recipient country i's GDP per capita and population size rather signal its economic importance. Donors can be expected to favour direct engagement with governments, i.e. to distribute a high share of aid through state channels, in recipient countries they regard as economically important. The number of deaths from natural disasters controls for the exceptional role of non-state actors in humanitarian assistance (see above), with more deaths giving rise to a higher share of state-to-non-state aid.

To proxy donor country j's self-interest, we include the amount of exports from donor j to recipient country i, the amount of proven crude oil reserves in country i, and a dummy indicating whether donor j and recipient country i have had a colonial relationship in the past. We also control for how "close" donor j and recipient country i are by including the geodesic distance between the two countries and the number of migrants from recipient country i who live in donor country j as a share of country j's population. We expect a donor to deliver more aid, and also a larger share of its aid budget, through state channels when its self-interest and "closeness" to the recipient country is high as government-to-government transfers may be more effective in reaching non-development goals of the donor.

4. Results

Consistent with our hypothesis, the quality of governance is significantly and positively associated with the share of state-to-state aid in all specifications. The size of the effects is substantial. A one standard deviation increase in the control of corruption index (which corresponds to the difference between Kenya and Ghana) is associated with a 4.3 percentage point increase in the share of state-to-state aid.

To further substantiate our main finding, we investigate whether there is heterogeneity in the relationship between institutional quality and the channel of aid delivery that is consistent with donors bypassing weak state institutions. As argued above, bypassing should be more prevalent in sectors in which donors have a real choice of delivery through state or non-state actors. This hypothesis is confirmed by our empirical findings: Institutional quality is of no importance at all when aid is given for infrastructure projects and of little importance for aid projects related to improving production activities or education. By contrast, it seems to matter much more for aid committed in the health or governance sector where non-state actors are relatively more prevalent. The exception from this pattern is emergency aid. By definition, it is typically granted in times when recipient countries require immediate assistance to cope with disasters and can arguably be expected to be driven by the desire to assist as quickly and effectively as possible. Compared to structural aid that follows long-term objectives, considerations of governance should hence be less relevant in case of emergency aid. Indeed, the effects of all four governance measures on emergency aid are practically zero and mainly insignificant.

Another way to detect heterogeneity in the relationship between governance and the channel of aid delivery that is suggestive of bypassing is to analyse whether aid flows vary with differences in donor motives. Bypassing should be more common if aid allocation was motivated less by strategic (self-interests), but more by consideration of recipient need and aid being effective in promoting development. Our results indeed suggest that stronger economic interests in recipient countries are associated with less bypassing of weak governments. Stronger political self-interests do not appear to be associated with less bypassing, with the exception of military expenditures.

Next, we investigate the absolute amounts of aid that are delivered through state and non-state channels. We start by using the amount of total aid including both state-to-state and state-to-non-state aid as dependent variable. In line with the previous literature, total aid increases with population size, exports and colonial relationship and decreases with GDP per capita, distance and oil reserves. Our first governance measure, control of corruption, reproduces the finding of Alesina and Weder (2002) that more corrupt countries receive more aid. However, the other governance measures, in particular the human rights score and the share of powerless population indicate that recipient governance is taken into account when determining the overall amount of aid, with better governed countries receiving more aid.

To assess whether bypassing also occurs for absolute amounts of aid, we use absolute amounts of state-to-state and state-to-non-state aid as separate dependent variables. The aggregate finding of more aid flowing to more corrupt countries appears to reflect an increasing use of non-state channels, whereas the amount of state-to-state aid is not affected by differences in corruption levels. There is thus evidence for bypassing corrupt governments even in absolute amounts of aid. Poor governance as captured by the other three measures is associated with significantly lower amounts of aid being delivered through state actors. Countries with low human rights scores and weak representation of the population also receive less aid through non-state actors, even though the quantitative importance of this effect is markedly smaller. By contrast, in countries with higher military expenditures, more aid is channelled through non-state actors, which again points to bypassing in absolute amounts.

5. Conclusion: Does bypassing improve aid effectiveness?

When assessing the different aid channels from a development perspective, it is not donor motives per se that matter but rather how aid can be rendered effective in promoting growth and poverty reduction in recipient countries. Recent research (e.g., Dreher and Kilby 2010) has provided some evidence supporting the view that aid is most likely to raise growth if it is allocated according to developmental needs. This reasoning might also apply to the particular case of funds channelled through non-state actors. Another strand of the literature stresses the detrimental effects that large amounts of aid inflows are likely to have on institutional quality, for instance by giving rise to rent seeking behaviour (Djankov et al. 2008), which would also point to a higher effectiveness of foreign aid allocated through non-state channels. Our own exploratory regressions for the health and education sector provide suggestive evidence that bypassing may have reduced infant mortality, but no conclusive evidence for primary school completion.

The case for bypassing recipient governments is reinforced by the poor record of past efforts to use policy conditionality as a means of initiating reforms that are deemed necessary for aid to be effective (Öhler et al. 2012; Svensson 2003). Yet, in the donor community there is a strong opinion that donors should remain engaged with local administrations in order to raise democratic accountability and strengthen administrative capacities. This is expected to be achieved by focusing on local ownership of reforms rather than relying on externally imposed conditions, but conclusive evidence that donors can indeed contribute to institutional improvements in recipient countries with weak governance is so far lacking. Given this insecurity, bypassing appears to be a rational strategy for donors who care for poor people in weakly governed countries.

III. Aid proliferation and donor fragmentation[3]

1. Introduction

Aid proliferation, donor fragmentation and lack of coordination are widely recognized as serious problems impairing aid effectiveness. Proliferation and fragmentation impose high transaction costs on the recipient countries, especially the poorest among them, with multiple donor missions, different sets of policy conditions and inconsistent reporting requirements absorbing scarce administrative resources (Acharya et al. 2006). Knack and Rahman (2007) show that aid fragmentation impairs bureaucratic quality in recipient countries. For a broad cross-section of aid recipients, Kimura, Sawada and Mori (2012) find a negative impact of aid fragmentation on economic growth.

Donors have repeatedly promised to specialize and better coordinate their aid activities, most notably in the Paris Declaration on Aid Effectiveness of 2005, which includes an explicit commitment to a division of labour based on donors' comparative advantage at sector or country level. Various OECD-DAC monitoring reports have provided qualitative evidence on the progress made since 2005. More systematic quantitative analyses are scarce, however. We contribute to filling this gap by performing a multivariate regression analysis for a broad cross-section of recipient countries that attempts to isolate the effects of the Paris Declaration on aid fragmentation and donor coordination.

Considering aid fragmentation and duplication of donor activities at the national level of recipient countries can only provide an incomplete assessment of the extent to which donors specialize and coordinate as it is not taken into account that a notable share of aid projects is sector-specific and targeted to specific locations within recipient countries. If donors specialized within recipient countries by engaging in specific sectors and regions, and if their specialization profiles within countries differed, then coordination failure would be less of a problem than cross-country studies suggest. The need for coordination within countries has been officially acknowledged by the international donor community, for instance in the Accra Agenda for Action in 2008. Until recently, little was known about the regional distribution of aid projects, but regional aid data are now available for a few recipient countries. We focus on the case of Malawi, for which information is most comprehensive.

2. Data and methodology

Our cross-section analysis covers about 140 recipient countries and 24 aid sectors over the period 1998-2010. In both steps, we make use of the rich data on aid commitments collected in the DAC's Creditor Reporting System (CRS). The sample of 19 donors includes all major bilateral DAC donor countries plus the two largest multilateral donors (EU institutions and the International Development Agency). All donors in our sample belong to the participating countries and organizations of the Paris Declaration. For the case of Malawi, we cover the sectoral aid activities of all bilateral and multilateral donors in the country's 28 provinces during the period 2000-2011, employing unique geocoded project-level information collected by the AidData initiative.

Following Aldasoro et al. (2010), we proceed in two steps and employ separate measures to assess changes in the degree of specialization of individual donors and in the degree of coordination among donors. This is in contrast to previous research which often fails to take into account that the need for coordination might decrease if donors decided unilaterally to specialize. In the first step, we employ Theil indices to evaluate whether major donors, viewed as independent actors, have reduced aid proliferation and fragmentation by concentrating in selected recipient countries and specializing in selected aid sectors, for example aid for education. In the second step, we refer to the earlier literature on the measurement of intra-industry trade. So-called trade overlaps have often been used to assess the

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empirical relevance of intra-industry trade. Analogously, we employ overlap indices to analyse the extent to which donors co-ordinate their aid efforts.

By employing measures that are easy to quantify for essentially all donors and recipients, we largely miss the relevance of specific instruments, including sector-wide approaches (SWAps), common pools, and delegated responsibility to lead donors, for reducing transaction costs and coordinating donor efforts. To the extent that donors have increasingly used these instruments we therefore underestimate the progress made so far. Yet, OECD monitoring reports as well as our own experience in Malawi and Mozambique point to a rather limited rise in the use of such approaches over the period under consideration, suggesting that the account given by the aid overlaps is not seriously biased.

In contrast to Aldasoro et al. (2010) who simply portray the development of Theil and overlap indices over time, our cross-country analysis controls for various determinants of specialization and coordination, notably the heterogeneity of donors and aid portfolios as well as major recipient characteristics. For instance, the Theil index for a donor could be reduced if this donor increasingly granted general budget support, instead of project-related aid in various specific sectors. Larger aid overlaps may result if several donors shifted towards general budget support. Similarly, Theil indices can be expected to decrease and overlaps to increase if donors orchestrate major debt relief operations for a few recipient countries.

3. Results

According to our cross-country analysis, recent shifts in aid priorities, such as the rising importance of general budget support, contributed to reduced levels of aid fragmentation. Nevertheless, our results suggest that aid fragmentation persisted after the Paris Declaration and coordination among donors has even weakened. The Theil indices do not reveal an overall trend towards more concentrated and less proliferated aid. Index values declined over the period under consideration for some donors (France, Germany, the Netherlands and the UK), went up for Japan and hardly changed for several other donors (Denmark, the European Union, Sweden, IDA, Norway and the US). Comparing aid proliferation across donors, the ranking differs markedly from rankings based on indicators relating to the altruistic or selfish aid motivations of donors. Though often berated as selfish donors, France and Japan turn out to be relatively modest proliferators in the most recent period. By contrast, Norway is a strong proliferator, even though it belongs to the group of like-minded, and widely believed to be superior, donors. Our calculations of aid overlaps point to a falling degree of co-ordination for all major donors. The change is particularly pronounced among donors with low initial overlap indices (Denmark, France and Japan).

While our cross-country estimates may be biased to some extent because larger aid overlaps are not necessarily in conflict with better coordination if, for example, donors increasingly pursue sector-wide approaches, we can largely rule this out for the case of Malawi on the basis of a careful inspection of the available project-level information. Again, we do not find compelling evidence for increased aid specialization after the Paris Declaration, and the regional division of labour among Malawi's donors may even have deteriorated. Our within-country evidence thus corroborates what we found at the national level of recipient countries.

4. Conclusion

The difficulties donors face when it comes to keeping the promises made in the Paris Declaration and at subsequent high-level meetings arguably reflects the complex political economy of the international aid system. Even if donor countries and aid agencies were purely altruistic and their overarching goal was to provide effective aid, existing information asymmetries would create incentive problems. This is because the donor institutions are ultimately accountable to domestic taxpayers, who usually do not have the information required to assess the success or failure of specific aid interventions. As a result, donors might be inclined to 'plant their flag' and engage in a broad range of highly visible projects in

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order to demonstrate their engagement and secure future funding. Credible and independent evaluations may help identify successful interventions and, thereby, reduce this information asymmetry. This would be a necessary, though probably not sufficient, condition for a less fragmented allocation of foreign aid.

Furthermore, we show in a theoretical paper that problems of free riding need to be overcome, such as when donor countries consider whether to share information about development project failures with other donors which might use that information to their own advantage. And donor countries may fail to coordinate because, in the absence of a centralized decision-mechanism, they do not expect that other countries, or enough other countries, will join the coordinating group.

In reality, donors pursue a mix of altruistic and selfish goals. Big donors such as the United States and France have strong political and economic interests and are thus unlikely to adhere to an ambitious agenda that significantly restricts their room of manoeuvring. Our own estimates for a broad cross-section of donors indeed suggest that competition for export markets and political support prevents donor countries from coordinating their aid activities between one another.

Matters are further complicated by the ever-growing number of state and non-state actors involved in development cooperation. This reduces the incentive of each single actor to engage in costly coordination processes as the individual's influence on final outcomes becomes increasingly marginal. In addition, important new actors such as China are not even fully integrated into the formal negotiation arrangements. Overall, in the foreseeable future progress towards less fragmented and better coordinated aid is likely to remain modest. What can realistically be expected are incremental steps to improve donor coordination such as an increasing use of co-financing arrangements involving several like-minded donors.

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Annex

The two papers on "Does Aid Availability Affect Effectiveness in Reducing Poverty? A Review Article" and "The Hard Challenge of Aid Coordination" are available on the NOPOOR website since the 18th September 2014.

Part I: A new approach to the role of development aid for poverty reduction: Trading-off needs against governance

1. "Optimal Discipline in Donor-Recipient Relationships –Reframing the Aid Effectiveness Debate", CRED and PSE, 2014.

2. "Aid Effectiveness Revisited: The Trade-Off between Needs and Governance", CRED and PSE, 2014.

Abstract (Paper 1): Increased attention to the issue of aid effectiveness has sparked a flurry of empirical studies attempting to measure the macro-level impact of aid flows on the performances of developing countries. These studies yield ambiguous and even contradictory results and one possible source of confusion is the fact that they are not grounded in solid theorizing. This paper tries to remedy this lacuna by proposing a principal-agent model in which the donor monitors the use of aid and metes out sanctions in the event of fraud detection. Its most original feature lies in the assumed comparability between internal (domestic) and external (donor-imposed) disciplines and the resulting possibility of studying the behaviour of aggregate discipline. We show that, contrary to intuition, an (exogenous) improvement of domestic discipline may be over-compensated by the donor so that total discipline actually decreases and elite capture paradoxically increases. This implies that the relationship between domestic and total disciplines may be non-monotonous. We highlight the crucial role of the shape of the cost functions to obtain not only the above paradox but also corner solutions in which the donor optimally chooses to refrain from imposing any external discipline. The central lesson to draw from the whole exercise is therefore that no simple general testable prediction can be inferred from economic theory regarding the impact of aid on the donors' objective even when the quality of domestic governance or the policy environment is considered.

Abstract (Paper 2): The paper proposes an approach centered on the concept of need-adjusted aid effectiveness. This means that the donor's objective function explicitly takes into account the trade-off between considerations of needs and considerations of governance. Moreover, the donor is willing to exert external discipline on the recipient countries. To the extent there is a negative correlation between the extent of needs and the quality of governance, we expect that the donor would bring more discipline to bear upon the poorer countries with the consequence that they would not be excluded from aid programmes. Working within a one-donor-two-recipient framework, in which one recipient country is relatively poorer and worse-governed than the other, we are able to show that many intuitions regarding effects of parametric changes are too simple. In particular, the improvement in the governance of the poorer country does not necessarily induce the donor to raise its aid share.

Part II & III

Project-related papers

Acht, M., T. Omar Mahmoud, and R. Thiele (2015). Corrupt Governments Do Not Receive More State-to-state Aid: Governance and the Delivery of Foreign Aid through Non-state Actors. Journal of Development Economics 114: 20-33. (also available as NOPOOR working paper)

Bourguignon, F., and J.-P. Platteau (2015). The Hard Challenge of Aid Coordination. World Development 69 (May): 86-97.

Nunnenkamp, P., H. Öhler, and R. Thiele (2013). Donor Coordination and Specialization: Did the Paris Declaration Make a Difference? Review of World Economics 149 (3): 537-563.

Fuchs, A., P. Nunnenkamp, and H. Öhler (2015). Why Donors of Foreign Aid Do Not Coordinate: The Role of Competition for Export Markets and Political Support. World Economy 38(2): 255-285.

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