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The Hard Challenge of Aid Coordination

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Summary. — Aid coordination is a constant theme of discussion among national and international aid agencies in their search for more effectiveness and efficiency in delivering development assistance. This paper seeks to clarify some of the arguments currently made in support of aid coordination, and to precise unavoidable trade-offs born of the existence of political costs. It is anchored in the available literature on aid delivery while focusing on the implementation problems of aid coordination among donor countries. In particular, it deals with: (a) the issue of consistently and collectively handling possible governance failures in recipient countries; and (b) the impact of heterogeneity of donor countries on the effectiveness of aid coordination.

Key words — development aid, coordination, aid efficieny

1. INTRODUCTION

The need for aid coordination has become a recurrent theme in the discussions and strategic thinking of national and international aid agencies. The Paris Declaration (March 2005) and the Accra Agenda for Action (September 2008) thus mentioned aid coordination as one of the key mechanisms to be mobilized with a view to enhancing aid effectiveness. The signatories, indeed, made a commitment to eliminate duplication of efforts and rationalize donor activities so that they become as cost-effective as possible. The European Union (EU), in particular, has enshrined the importance of aid coordination with other donors in several policy documents: Consensus on Development (2006), the Code of Conduct on Division of Labour (2007), and the Operational Framework on Aid Effectiveness (2009) based on the international aid effectiveness agenda. Among the ambitious goals featured in these documents are the following: a better alignment of donor priorities with partner countries' development strategy, the donor harmonization of conditionalities, improved mutual accountability and transparence, management for results, the delegation to a leading donor of the responsibility of managing aid to a particular country, co-financing arrangements, and even joint programing and the pooling of aid resources destined for recipient countries. [1]

The gains of aid coordination from the standpoint of donor countries can be usefully thought of as belonging to the categories of cost savings and governance benefits. Cost saving effects are expected to result from a substantial reduction in the individually borne transaction costs accompanying the various steps involved in the aid delivery process: exploratory missions, negotiations, delivery, monitoring, follow up, and evaluation. As for the governance effects, they are caused by a more effective implementation of conditionalities and better monitoring of aid uses, on the one hand, and higher levels of aid ownership and transparence, on the other hand. The poor in the recipient countries ought to be better off as a consequence of those improvements of governance and the more rational use of their scarce human capital resources. For donor countries, the main shortcoming of aid coordination is the loss of national sovereignty and the impeded ability to pursue national objectives through aid programs. For recipient countries, it is their diminished independence owing to reduced competition among donors.

Given the variety of effects likely to result from aid coordination schemes and the serious obstacles in the way of their realization, which add to their uncertainty, efforts to quantify the benefits of such schemes are extremely perilous (see the contribution of Bigsten in this issue for a recent attempt to assess the benefits of aid coordination among European countries). Our purpose in this paper is rather to clarify some of the arguments in support of aid coordination in the light of the unavoidable trade-offs born of the existence of political costs. Our discussion is anchored in the available literature but also proceeds by delving into the implementation problems. In particular, it sets about highlighting (1°) the difficulty of carrying out punishment against lapsing recipient governments, and (2°) the impact of heterogeneity of donor countries on the effectiveness of aid coordination.

The outline of the paper is as follows. In Section 2, we review the scant economic literature that touches on the issue of aid coordination on a theoretical level, either directly or indirectly. In Section 3, we analyze the issue of aid coordination as a n-player coordination game in which multiple equilibria exist. We also highlight the trade-off between the poverty reduction motive and the political sovereignty of donors and lay the grounds for an analysis in those terms. In Section 4, we examine the case of homogenous donor countries assuming that their number is pre-determined and they are free to choose the intensity of their coordination efforts. In Section 5, we turn to the more interesting case of heterogeneous countries and attention is focused on the role of their size and preferences, and the manner in which these factors affect the feasibility and effectiveness of aid coordination

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programs. In Section 6, we discuss the case of Mali, which was selected by the Committee for Development Aid of the OECD as pilot country to initiate a review of aid effectiveness in 1996. This case study material brings into light a number of hurdles against effective aid coordination that were not addressed in the preceding analysis. Section 7 concludes the paper.

2. AID COORDINATION AS A MECHANISM OF INCENTIVE ALIGNMENT

In the following, we start by reviewing two theoretical papers which directly address the problem of aid coordination by assuming the existence of multiple donors. Thereafter, we look at a number of papers which use a single donor framework to analyze aid delivery but conclude that aid must be coordinated to align incentives in the recipient countries with those of the donor.

(a) *Theories based on a multiple-donor framework*

To begin with, Knack and Rahman (2004) examine how alignment of incentives is affected by the presence of multiple donors that independently provide aid to a poor country. Their contribution, focuses on staff recruitment by donors in the recipient countries. Each donor is assumed to maximize the poverty reducing impact of its own projects, and project success is assumed to increase at a decreasing rate with the amount of skilled local staff time dedicated to the project. The authors compare the optimal level of administrator time devoted to each project when maximization takes place individually with the optimal level when donors seek to jointly maximize the poverty reduction impact of their projects. The central result is that the number of administrators to be hired declines when the concern of a particular donor for the success of the projects of other donors increases. Lack of coordination thus leads to excessive donor recruitment of administrators, thus causing unnecessary stress on the demand for scarce (staff) resources in the recipient countries.

Torsvik (2005) considers a group of rich countries that independently provide aid to a poor country, and how incentive alignment is affected by the presence of multiple donors aimed at poverty reduction. Since there are several donors, poverty alleviation in the poor country becomes a public good: if one donor provides aid, it has a positive effect on the welfare of all the other donors. As is typical in such situations, non-cooperation between the donors leads to an undersupply of aid. Cooperation or coordination between donors is therefore desirable to bring total aid amount closer to its social optimum.

The next question addressed by Torsvik is how foreign aid affects policy in the recipient country. If the donors can use enforceable conditional aid contracts to influence the recipient's policy, they are always better off with coordination than without it. When the donor–recipient relationship is not contractible, however, the recipient government has an incentive to exploit the poverty aversion of the donors to its own advantage, by reducing domestic transfers to the poor when aid for the poor is externally provided (the crowding-out problem).

Torsvik investigates this question by examining two different interaction regimes. First, if the donors are able to commit not to increase their aid in response to crowding out by the recipient government, then all of them make simultaneous moves in a non-cooperative game-theoretic setup. Donor cooperation has then the effect of increasing foreign support but also encouraging crowding-out. The incomes of the poor increase when donors coordinate their efforts and provide more aid than before, but it is not obvious that the utility of the donors increases as well. [2] In order that donor coordination proves beneficial from the donors' viewpoint, the government of the recipient country must have enough aversion to poverty to limit the crowding-out problem.

Alternatively, because of their strong aversion to poverty, donors may be unable to commit not to help the poor in response to crowding-out ("Samaritan dilemma"). Knowing that, the recipient country reduces the support for its own poor, ex-ante, in order to trigger more aid. In such a setup (donors act as Stackelberg-followers), donor coordination would again lead to increased aid flows, but not necessarily to more crowding-out. This is because, as a response to a fall in the support of the recipient country to its poor, they would increase total aid to a lesser extent when they cooperate that when each donor acts independently. Recipient governments are thus more effectively disciplined through donor coordination when the donors are unable to commit not to help the poor, that is, when they hold a weak bargaining power.

To sum up, when the recipient country's government shares the goals of the donors (it is equally averse to poverty), aid coordination is unambiguously beneficial. In the opposite case of diverging interests, however, coordination is not necessarily beneficial if contracts cannot be effectively used to align the interests of the recipient country with those of the donors, and if the latter do not face a Samaritan dilemma. According to intuition, when the recipient government is in a position to exploit the donors' generosity, its ability to do so is more effectively controlled through donors' coordination if the donors make their decisions regarding the amount of aid after it has itself decided how much of it will be transferred to the poor.

(b) *Theories based on a single-donor framework*

Let us now turn our attention to theoretical works that use a single-donor framework to study aid effectiveness. A useful point of departure is the pioneer contribution of Azam and Laffont (2003) who use a principal-agent framework to determine the optimal aid contract. This contract specifies that the recipient government will receive an aid amount (which is endogenous) linearly dependent on the level of consumption of the poor that it provides.

Azam and Laffont put emphasis on the adverse selection problem: recipient countries vary in terms of the quality of their governance, and the donor ignores these quality levels when deciding about aid flows. Their prescription is that the donor should avoid giving aid to the worst-governed countries as this would deprive its own citizen without the poor in the recipient country getting much of it. To improve the situation, the authors propose that the donor community relies on a specialized international agency that would collect information about governance levels. Donor coordination, in this instance, would increase the neglect of the poor in the worst-governed countries.

Svensson (2000) and Svensson (2003) explicitly looks at conditionality as a way to mitigate the moral hazard problem of opportunistic recipients. He analyzes a two-stage game among two recipient countries and the donor. The optimal aid contract specifies the amount of aid disbursed as a function of the good or bad state of nature that prevails and reform effort helping the poor. Yet, as reform effort is assumed to be non-observable and non-contractible, the second-best contract is such that it induces the recipient to exert higher effort through aid flows being lower in bad states and higher in good states (more likely to occur when reform effort has been higher) (p. 70).

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