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

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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, 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,

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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).

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

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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

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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.

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 used 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.

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To find out more:

- ➡ → Bourguignon, F., and J.P. Platteau, “Optimal Discipline in Donor-Recipient Relationships –Reframing the Aid Effectiveness Debate”, CRED and PSE, 2014.
- ➡ Bourguignon, F., and J.P. Platteau, “Aid Effectiveness Revisited: The Trade-Off Between Needs and Governance”, CRED and PSE, 2014.

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