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'The Aid Effectiveness Agenda: The benefits of going ahead' - A commentary on the final report

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Contents

1) Introduction

'The Aid Effectiveness Agenda: The benefits of going ahead' [2] estimates the monetary gains deriving from the implementation of the Paris Declaration (PD) and the Accra Agenda for Action (AAA) by the EU and EU member states[3]. The aim is to help donor agencies to weigh the costs and benefits of implementing this agenda. This is an important exercise given that the EU contributes more than half of all DAC ODA[4].

The study finds that total benefits of implementation of the PD and AAA by the EU could amount to **€ 5 billion**, or almost **6 % of EU aid**. Of this total, € 3.2 billion comes from *direct gains* and € 1.8 billion from *indirect gains*. Further gains of € 7.8 billion (9 % of EU aid) could be realised if aid were reallocated across countries so as to maximise the impact on poverty reduction. However, the authors consider this to be politically unlikely and so do not include these gains in their overall estimates.

In this short note, we present the key findings of the study and provide a commentary on the methodology used. In summary, we find that:

- The estimates provided on the direct benefits of implementing the PD (€ 3.2 billion) are broadly robust, although with some caveats.
- The estimates on the indirect benefits (€ 1.8 billion) should be treated with caution, due to weaknesses in the model used.
- The large hypothetical gains from aid reallocation to maximise poverty reduction (€ 7.8 billion) provide a broad 'rule of thumb' on the magnitude of potential benefits, although with some caveats.
- The study only covers a narrow sub-set of the PD and AAA commitments. As a result, the direct benefits are probably significantly under-estimated.

This commentary proceeds as follows. Section 2 summarises the main five issues covered by study and provides a brief outline of the methodology (Annex 1 provides a more technical overview.) Section 3 reviews the methodology used to quantify the benefits under these five headings. Section 4 provides a more general critique of the paper. Section 5 concludes. A comparison with some previous studies is included as Annex 2. Finally, Annex 3 invites two of the original authors - Sven Tengstam and Arne Bigsten - to respond to the questions raised in this paper with their 'Comments on the Commentary'.

2) Summary of main findings of the study

The paper quantifies the benefits of the implementation of the PD and AAA agendas by the EU and its Member States. It covers five issues:

[2] This study has been commissioned by the Directorate General for Development and Cooperation (EuropeAid) and implemented by the Unit A3 (Coherence of EU Policies for Development and EU Aid Effectiveness) to a group of independent consultants: *Arne Bigsten* (University of Gothenburg), *Jean Philippe Platteau* (Centre de Recherche en Économie de Développement (CRED) (Center for Research on Economic Development) Facultés Universitaires Notre-Dame de la Paix, Namur) and *Sven Tengstam* (University of Gothenburg).

[3] Unless otherwise stated, 'EU aid' refers to aid from the EU Institutions and Member States.

[4] Figure for 2009. Only includes ODA contributed by DAC EU members, plus the EC, as a share of all DAC ODA.

1) Savings in **transaction costs** associated with
   a) Reducing the number of countries covered by each donor; and
   b) Moving from project to programme support
2) The benefits of **untying aid**
3) Reduction of the costs associated with **volatility and unpredictability of aid** flows
4) The impact on recipient growth of a shift to **budget support** (so-called 'indirect effects')
5) The benefits of **reallocating aid** so as to maximise the impact of EU aid on poverty reduction.

As shown in Table 1, overall gains from implementing points 1-4 above are estimated at **€ 5 billion in 2009,** or approximately **6% of total EU ODA.** The benefits of aid reallocations (point 5) above are considered to be politically infeasible, and so are not included in the headline figures. However, if included this would dwarf the other benefits (€7.8 billion.)

Table 1 – Summary of the benefits of an EU implementation of the Paris Agenda

Type of effect	**Estimate (€ billion)**
Savings on transaction costs	0.7
Gains from the untying aid	0.8
Gains from reducing aid volatility	1.7
Total efficiency gains excluding indirect effects	**3.2**
Indirect effects	1.8
Total efficiency gains including indirect effects	**5.0**
Hypothetical gains from a full coordination of country allocation	7.8

Source: *The Aid Effectiveness Agenda: The benefits of going ahead'* in millions of Euro in 2009 prices

The methodology applied by the authors is as follows:

Savings in transaction costs. This element is conducted in two parts:

a. The authors run a regression analysis to estimate the relationship between administrative costs and the number of countries a donor is active in. They calculate that reducing the number of countries by 37% (one standard deviation) would reduce administration costs by 20%. This 20% saving, when compared with the total EU administrative costs, leads to total savings of € 461 million.

b. The authors assess the savings from moving from project to programme aid. They use a literature review (SIDA, 2011) to underpin an assumption that programme aid costs only 33.5 % as much to administer as projects. They then assume that the EU and MS increase the share of programme aid from its 2009

level of 43.7%, to 66% (the Paris Declaration target.) This would save an additional € 283 million in administrative costs.[5]

The benefits of reduced untying. The estimate of benefits is based on a literature review[6], which indicates that tying aid increases the cost between 15-30%. The study takes the middle of this range (22.5%.) The share of flows lost to tying then becomes 18.4%. This figure is then applied to the tied share of EU aid in 2009, to give a total cost of € 800 million.

The benefits of reducing aid volatility. A Capital Asset Pricing Model (CAPM) is used to assess the benefits of eliminating the volatility of aid flows, based on a 2008 study by Kharas. This estimates the amount of EU aid that countries would be prepared to sacrifice (the 'deadweight' loss) in order to have a more stable (*i.e.* non volatile) flow of aid. This is found to be on average almost 15 cents per dollar in 2009[7]. Assuming that volatility could be eliminated, the authors add up the deadweight loss for each country that could be saved. This leads to a total saving of € 1.7 billion.

The impact on recipients' growth of the implementation of the PD. The impact of changes in the aid relationship on recipients' growth is calculated using a regression analysis. Three aid modalities are correlated with recipient growth (aid fragmentation, share of budget support, and the share of tied aid.) Of these, only budget support is found to be statistically significant. Using the results of the regression analysis, the authors calculate that increasing the share of budget support by 11% (one standard deviation) would increase the GDP of recipients by € 1.8 billion.

The benefit of reallocating aid so as to maximise the impact of EU on poverty reduction. Expanding on Collier and Dollar (2002), the study estimates the overall benefits of reallocating EU aid across countries in ways which will maximise poverty reduction. The Collier Dollar model estimates that aid should be allocated on the basis of poverty levels and governance, with more aid going to countries with higher levels of poverty and better governance. The authors calculate the benefits of the EU and MS reallocating aid to those countries which currently receive less aid than they should do under this model. They find that more than € 19.3 billion of the € 27 billion allocated by the EU to countries should be reallocated. They further estimate that a dollar spent in currently 'over-aided' (or 'darling') countries is only 15.2% as effective as a dollar spent in currently under-aided ('orphan') countries. This leads to a potential overall saving of € 7.8 billion if aid were fully reallocated according to the Collier Dollar model.

A more detailed and technical summary– *i.e.* assumptions and estimation techniques – is provided in Table A.1 in the Annex.

3) Review of the methodology used to calculate direct and indirect benefits

[5] Note that these calculations are based on the assumption that administrative costs associated with country programmable aid are 73.3% of total administrative costs. This second step of the assessment of savings in transaction costs considers administration costs already net of savings from a 37% reduction in the number of recipient countries, as carried out in the first part of this analysis.
[6] Jepma, 1991; EC, 2009; Clay *et al.* 2009; OECD, 2010.
[7] This figure is taken for Country Programmable Aid (CPA) only.

In this section, we provide a commentary on each element of the methodology applied by the authors.

3a: Reducing transaction costs by reducing the number of countries

We consider the regression analysis undertaken on transaction costs to be using a broadly appropriate methodology. This is particularly true in light of the paucity of existing literature quantifying transactions costs. However, there are two caveats. Firstly, the analysis would benefit from a more nuanced understanding of administration costs. Figures on administrative costs for the are taken from the OECD-DAC database. However, so-called administration costs in this case can include a wide variety of functions, not simply the costs of managing programmes. For example, policy work undertaken by donors at HQ level is generally included. In contrast, in some donors, admin costs associated with project preparation, monitoring, and so on, may also be reported as programme costs. The analysis would be stronger if the authors had only included in the regression the specific admin costs associated with project and programme preparation in country, which would therefore be sensitive to a reduction in the number of partner countries. In addition, the analysis of administration costs – based on the number of recipient countries and the Country Programmable Aid (CPA) amount – does not take into account the fact that projects also differ in terms of size. Savings in transaction costs could therefore also be achieved by increasing project size, but this is not factored into the model.

Secondly, the monetary benefit of reducing the transaction costs is estimated on the basis of a one standard deviation reduction in the number of countries (37%), starting from the assumption that the average number of partner countries is 100. This choice from a policy perspective seems rather arbitrary. There is no commitment within the PD or AAA agendas to reduce the number of countries by 37%. It would have been more appropriate for the authors to assess what might be an appropriate reduction in the number of countries, based on political feasibility (for example by reviewing recent experiences of donors attempting to make such reductions) or through extrapolation from existing aid effectiveness commitments (for example the EC Code of Conduct on Division of Labour, which provides guidance on how many donors should be involved in each sector at country level.)

3b: Reducing transaction costs by shifting to budget support

The second part of the analysis on transaction costs considers the savings generated from shifting from project to programme aid. This calculation is also helpful as a broad 'rule of thumb.' However, the basis for the estimate that the admin costs of programme aid are only 33.5% of those of project aid is only one study (SIDA, 2011). While there is no reason in principle to suggest that this figure is not accurate, (or at least in the right ballpark) the analysis would have been strengthened by a further testing of this figure in a wider set of contexts.

- **The benefits of untying**

The analysis on untying seems appropriate and the assessment of the benefits realised is in line with other studies.

- **Reducing the volatility and unpredictability of aid**

The analysis uses a model by Kharas (2008) to assess the benefits of reducing aid volatility. The Kharas model has been widely accepted as an appropriate way of measuring volatility, and as such is a good starting point. The authors are also correct to apply this model on a donor-by-donor basis, unlike other studies (EC, 2009). However, it should be noted that this model assesses the benefits of **reducing volatility** (the extent to which flows vary from year to year), **not necessarily improving predictability** [8] (the extent which aid actually disbursed is in line with commitments). In fact, improving predictability is considered a higher priority by partner countries, and could therefore be expected to generate higher benefits. Moreover, the analysis does not consider (or even mention) the benefits of improving medium term predictability, a particular priority of developing countries and an AAA commitment.

The authors could also do more to distinguish between the causes of volatility. As they note, some volatility can be explained by changes in policy and governance in developing countries: if governance deteriorates, it is arguably right that aid flows should be cut. One way of correcting for this might be to correlate volatility with changes in indicators of performance, such as the World Bank's CPIA or the Worldwide Governance Indicators. This would further strengthen the analysis.

- **The impact on growth of a shift to budget support**

We are concerned that the relationship established between budget support and growth may not be robust, and that this finding should be approached with a great deal of caution.

The main reason for this concern is that the initial regression correlating growth with budget support may be subject to reverse causality. That is, countries with a higher rate of economic growth may attract budget support rather than the other way round[9]. Alternatively, it is very likely that a third factor, namely the quality of governance and institutions, is impacting on both budget support and growth (with countries with better governance both growing faster and receiving more budget support.) If this is the case, then increasing the share of budget support, in the absence of any changes in policies, would not have the predicted impact on growth. The authors do point out this risk: however we

[8] On the differences between aid volatility and aid predictability see Celasun and Walliser (2007).

[9] In technical terms, we could consider that the OLS model is generating upward biased estimates. This particular model is usually affected by **endogeneity**- where an independent variable of the model is correlated to the error term. In the specific case of the equation reported on p.116 this could derive from omitted variables and reversed causality, as explained in the text. In this case the OLS model determines an upward biased coefficient, *i.e.* the indirect efficiency gains are overestimated, as well as it invalidates inference. Furthermore, it would have been helpful to specify the reduced-form equation (e.g. type of function, unit of analysis) to fully understand the model applied.

believe that it is sufficiently serious to call the findings into question. To deal with this problem, the authors could have controlled for the quality of policies and governance in their initial regression: appropriate indicators could have included the Kaufmann, Kraay& Mastruzzi Worldwide Governance Indicators, the International Country Risk Guide (ICRGE) or the CPIA index.

The analysis is also potentially subject to problems of multicollinearity: that is, variables are not only correlated with the dependent variable but also with each other. We might well expect, for example, that aid fragmentation would be correlated with the share of budget support, while budget support would, by definition, be correlated with a lower share of tied aid. While this potential problem does not affect the value of the coefficients, this could potentially imply that the other variables of interest - namely aid fragmentation share of tied aid on GDP - may in fact be statistically significant.

It is also unclear as to why budget support should be increased by one standard deviation (11%.) This is an arbitrary number. As with the discussion under point 1a above, it would have been more appropriate for the authors to assess what increase in the share of budget support might be realistic from a policy perspective. Moreover, the authors only calculate a one-off increase in growth in one year as a result of the proposed shift. Long-term impacts on growth performance are not taken into account.

In summary, we believe that there is considerable uncertainty about the robustness of the findings under this element. Due to the potential reverse causality in the model, the estimates are likely to be upwardly biased. We would suggest considering alternative econometric techniques such as the Two Stage-Least Squares (2SLS) or the Generalized Method of Moments (GMM), which would have helped to control for the potential reverse causality.

- **The benefit of reallocating aid so as to maximise the impact of EU aid on poverty reduction**

Even if the authors consider this estimate separately and outline a series of caveats, [10] the analysis of the benefits of reallocating aid flows solely on the basis of poverty reduction is one of the major innovative parts of the study and provides a basis for further discussion on the implications of aid allocation on poverty. The analysis finds that Afghanistan, Turkey, India, Morocco, China, Indonesia and Vietnam would be the major losers (in absolute terms) compared to current allocation. On the other hand major gainers would be Bangladesh, Ethiopia, Nepal, Madagascar, Kenya and Uganda. While some of the assumptions could have been refined (*i.e.* arbitrary choices on the aid saturation point, constant growth elasticity to poverty, cut-off points for governance index), this exercise has the merit to provide some rough estimates and the order of magnitude of the gains potentially achievable from a different allocation of aid flows from Member States.

[10] *We show this item separately, since we think that the political support for such a dramatic change in country allocation is not there. The fact that aid is not allocated in this way indicates that donors have also other aims than poverty reduction* (p. 12).

The disadvantage of the approach used by the authors is that, as they note, a full reallocation of country aid in line with the Collier Dollar model is unlikely to be politically realistic. However, rather than underplaying this potential benefit on that basis, the authors could instead have assessed the benefits that might be accrued through a more moderate, partial reallocation. This could have been an important exercise given the potential scale of the benefits calculated, which dwarf those of the other issues.

4) General comments on the methodology and scope for further work

As well as the specific comments on the methodology applied we also have two broader comments on the methodology:

- The need to broaden the interpretation of the Paris agenda and consider a wider range of issues in assessing the benefits of aid effectiveness;
- The need for further information on the econometric regression analysis

This section considers each of these issues in turn.

4a: Narrow interpretation of the Paris agenda

Although the study claims to be assessing the benefits of a full implementation of the PD and AAA agendas, in reality only a small sub-set of the Paris and Accra commitments are included in the analysis. As shown in Table 2, **of the 8 Paris Declaration targets which donors have responsibility for implementing, at most half are covered by this analysis.** Targets on aligning aid flows on national priorities; co-ordinating capacity development support; use of country systems; and using shared analysis are not covered at all. Arguably the target on predictability is also excluded, because, as noted above, the analysis focuses instead on volatility. Even if they are perhaps more challenging to measure, these areas should have at least been considered in the text, and 'orders of magnitude' could have been included. As noted in Annex 2, some areas (such as use of country systems) have been included in the EC (2009) study and the authors could have considered adopting a similar methodology (see Table 2)**.**

Table 2: Paris Declaration targets

No.	Target
1	*Partners have operational development strategies*
2	*Reliable country systems*
3	Aid flows are aligned on national priorities
4	Strengthen capacity by co-ordinated support
5a 5b	Use of country PFM systems Use of country procurement systems
6	**Strengthen capacity by avoiding Parallel Project Implementation Structures (PIUs)**
7	**Aid is more predictable**
8	**Aid is untied**
9	**Use of common arrangements or procedures (Programme Based Approaches)**

10	Encourage shared analysis
11	*Results oriented frameworks*
12	*Mutual accountability*

Text in italics: primary responsibility is from partner countries: reasonable to exclude from this analysis

Text in bold: Covered (fully or partially) in the analysis

Other text: not covered.

Moreover, the Paris targets themselves only represent a small sub-section of the full range of commitments made in Paris and Accra. As noted above, for example, donors made commitments in Accra to improving medium term predictability, yet this is not covered in the paper. As a result of these omissions, we consider that the benefits are probably significantly underestimated.

4b: The need for further information on the econometric regression analysis

The paper would be strengthened if additional information on the econometric analysis was provided as the lack of information makes it difficult to assess the robustness of the methodology. This issue becomes relevant, because the results of the regression analysis largely determine the final estimates of the benefits and cost savings.

In particular, the authors have not assessed the sensitivity of the models used to changes in specification, which would be normal practice in such econometric analysis[11]. This is particularly important given that there are large variations in the findings from the econometric analysis based on the assumptions used (see Table A.2 in Annex 2). For example, under administrative costs, the maximum potential savings are shown to be almost seven times as high as the minimum, depending on the assumptions used. This wide variation in estimates should lead us to interpret the findings with caution.

Finally, even if the authors provide this caveat in the text, it is worth stressing that the summary of effects of an EU implementation of the Paris agenda (see Table 1 in this commentary as reported from the study) should be carefully read and interpreted. Figures reported in Table 1 are not directly comparable and focus on different scales and beneficiaries. Direct efficiency gains of € 3.2 billion (*i.e.* savings on transaction costs, gains from untying aid and reducing aid volatility) are assessed for the year 2009 and they could translate into higher aid volumes. On the other hand, indirect effectiveness gains of € 1.8 billion (rather than efficiency gains as reported) concern with the long-term effects on recipient countries.

5) Conclusions

In this note we briefly summarized major findings and the methodology of the EC 2011 study on the benefits of a fully implementation of the Aid Effectiveness Agenda. We welcome this study as it quantifies the potential gains of making aid more effective. The efficiency gains estimated in this paper are not negligible – in principle they account for 6% of the total EU aid flows in 2009.

[11] Only a basic measure of fit like the R-square is indicated in the study.

We have found the assessment of the direct benefits of the PD uses a broadly appropriate methodology, with some caveats. However, there is considerable uncertainty about the rigour of the econometric analysis which estimates the indirect benefits of the PD agenda, and we believe that this means that the benefits are probably over-estimated. However, we feel that the document overlooks some relevant dimensions of the aid effectiveness debate, meaning that the direct benefits of the PD agenda are probably under-estimated. Because the direction of bias is different as between the direct and the indirect effects, we are not able to assess whether the gains are in, aggregate, under or over-estimated. We suggest further analysis, as outlined in the paper, to seek to further strengthen these findings.

Annex 1: A summary of main findings, assumptions and methodology

Table A.1 summarizes the PD principles and indicators covered in the study, the main assumptions underlying the methodology as well as the monetary benefits and cost savings from the implementation of the PD by EU member states and EU Institutions. It considers both direct efficiency gains (along – but partially – the principles of *harmonisation* and *alignment*) and indirect efficiency gains for recipients' growth performance by increasing the share of official development assistance delivered as General Budget Support (GBS) and by reducing both aid fragmentation and the share of tied aid. The study also estimates the efficiency gains deriving from the reallocation of ODA flows from EU member states and EU institutions to 'aid orphan' countries – by modifying aid allocation exclusively on the basis of aggregate poverty reduction effects where political costs of aid coordination are not taken into account. Estimates are of about € 7.8billion. Given the political constraints, the same authors report these figures separately.

Table A.1: Main findings and methodology

PD principle	Dimension	Methodology	Estimates
		Direct efficiency gains	
Harmonisation	Better aid coordination measured by administrative savings	*Savings on administrative costs by reducing the number of partner countries* of one-standard deviation (by 37%). • Reduced-form equation (log-transformation): Administrative costs as dependent variable, independent variables include number of recipients, CPA and year dummy • OLS pooled regression analysis for the period 2000-09. *Savings by changing aid modalities: increase in the proportion of CPA that is programme-based aid from 43.7% in 2009* (actual value) *up to 66%* (PD target). Assumptions: • PD target for overall ODA also applies to CPA; • Administrative costs of CPA are twice as high as bilateral ODA that is not included in CPA.	€ 461 million
Alignment	Benefits of untying EU aid	• Calculations of costs related to tied aid are considered on the basis of a *mid-point cost estimate of 22.5%* according to OECD (2010) [whose figures are between 15%	€ 800 million

		and 30%]; • EU-12 countries contribution estimated at 1.6% of total EU15+European Commission costs (no data available on tied aid) assuming that 'tying' patterns are identical; • EC does not report any tied aid for 2009. • Disbursement data calculated on the basis of available data for commitments for both tied technical assistance and non-technical assistance.	
Alignment	Benefits of reducing the unpredictability and volatility of EU aid	• Estimation of the *deadweight loss* of volatility on the basis of the Capital Asset Pricing Model equation [following the methodology as in Kharas (2008)] • Values are normalized by the value of CPA for 2009 for all EU states and EU institutions	€ 1,681 million
		Indirect efficiency gains	
Development effectiveness	Estimation of the potential effects of PD measures on growth	• Standard augmented Solow growth model equations (human and physical capital variables, controls for initial GDP per capita and population) considering different 'measures' of the PD (*GBS, tied aid, aid fragmentation*), ODA (also its square value to take into account non-linearities), time dummies and a lag structure for the ODA variable (the point estimate considered for the quantitative assessment is on the basis of the 4-year lag structure). • Estimation technique: pooled OLS. • Among the three different PD measures only GBS presents a significant point estimate (at 5%	€ 1,808 million

		confidence level). • Benefits in terms of GDP increase for recipient countries are estimated only on the basis of one-standard deviation increase in the share of GBS on total ODA for EU aid.	
Effects of EU allocation of country allocation of aid			
	Estimation of gains from reallocation of EU-EU member states CPA on the basis of poverty reduction	• Maximization of a poverty reduction function on the basis of Collier and Dollar (2002) • Assumptions: Decreasing returns of aid flows on growth starting at 10% GDP Constant poverty growth elasticity across recipient countries Constant EU 2009 CPA amount Efficiency gains of shifting aid from aid darlings (*i.e.* those countries receiving more aid flows than accessed by the proposed allocation rule) to aid orphans have been adjusted to take into consideration differences in the quality of governance – (i) from 'bad darlings' – donor darlings whose average governance index is below -4.9 – to 'good darlings' considering an efficiency loss of 31% (ii) the remaining part considering an efficiency loss as twice as high 62%.	€ 7,779 million

Annex 2: Comparison with other studies

Other studies attempted to assess the overall benefits of the implementation of the PD, although they have not provided original research and/or elaborated a thorough methodology as in the case of the 2011 EC report. The 2011 report refers to the study commissioned by the European commission in 2009 (EC, 2009), which also estimates the benefits of the implementation of the PD for EU institutions and EU countries. While covering similar areas (donor proliferation, fragmentation of aid programmes, tied aid, volatility and lack of predictability in aid flows), the EC 2009 study does cover other areas, *i.e.* country ownership and the use of country systems. However, figures presented in the EC 2009 study mainly rely on a *back-of-the envelope* approach and/or on previous studies. [12]

The other study providing an overall assessment of the benefits of the implementation of the aid effectiveness agenda is Killen and Rogerson (2010). Building on previous analyses, Killen and Rogerson (2010) assess costs related to unpredictable aid flows within a range of $ 10-25 USD billion and the costs of fragmented aid flows around $ 5 USD billion. Their estimates rely on Kharas (2008) and EC (2009) respectively and relate to all DAC donors. Once we adjust these figures to reflect the size of the EU institutions and EU member states - on the assumption that their share of total DAC ODA is around 70% of total ODA in 2009 and that donor behaviour is fairly similar across countries, estimates for EU member states and EU institutions would range from € 8 to € 16.5 billion. Monetary gains reported in Table A.2 focus only on *direct* benefits from the implementation of the PD.

Table A.2: Direct gains of the implementation of the PD – A comparison

Cost	2011 EC report	2009 EC report	Killen and Rogerson (2010)
Donors	EU countries - EU Inst.	EU countries - EU Inst.	DAC donors
Currency unit	Million EUR	Million EUR	Million USD

[12] Benefits from the implementation of the PD and the AAA by EU member countries and EU institutions covered by the 2009 EC study include:

- *project preparation costs* (proxy for the costs of aid fragmentation) are on the basis of the average staff cost per project multiplied by the number of new projects;
- costs of *sector level donor proliferation* according to an educated guess along the average 8% of CPA for administrative costs (between 5 and 8%);
- costs related to *tied aid* on the basis of aid classified as tied (not partially tied) and assuming a range of costs from 15% to 30% of total aid;
- losses due to lack of aid *predictability* are assessed following Kharas (2008) assuming that costs are between a range of 10%-20% of total CPA; [12]
- savings from *direct budget support* calculated on the basis of 50% administration costs as found in Miovic (2004) as a proxy for the benefits deriving from the use of country systems.

Sector level donor proliferation		80-120	
Fragmented aid	238*– 937**	1,900-3,000	5,000
Tied aid	554 – 986	400-800	
Unpredictable and volatile aid flows	1,681	2,300-4,600	10,000 – 25,000
Use of country systems		300-400	

Notes:* Lower estimate on the assumption that the number of recipient countries decreased by half the standard deviation, by 19%. ** Sensitivity test at 95% confidence level. *** Total corresponds to the sum of the lower and upper bound estimates. The overall figure provided in EC (2009) from € 3 to € 6 billion does not coincide with the summing up of the different components. This point has also been raised in the 2011 study.

These three studies are far from being easily comparable as the set of dimensions investigated, the underlying assumptions and the time horizon do not necessarily overlap or even have been clearly specified. Nonetheless, a few points are worth stressing.

- Estimates of the benefits from untying aid are fairly similar across the studies, as the methodology used is similar.
- Estimates of the costs of fragmentation are very different between the 2009 and 2011 studies. This is due to the different methodologies used. Estimates in the 2011 study are generated by estimating the average administrative cost per recipient country, and then assessing the savings to be made by cutting the number of countries by 37%. In addition, with programme based approaches estimated to have 33.5% of the admin costs of project aid, the authors calculate the savings to be made from increasing the share of PBAs to 66%. In contrast, the 2009 study estimates the costs of fragmentation by multiplying the cost of a single project by the number of new projects. We consider this to be a less rigorous methodology as to generate this saving, no new projects could be created: a very heroic assumption.

- The largest discrepancy is related to the measurement of the direct costs of lack of aid predictability despite the fact that all studies rely on Kharas (2008). We consider the 2011 report should provide a more accurate estimate. Both studies estimate the certainty equivalent[13], i.e. the amount of aid that partners would be prepared to give up to have greater certainty over the flows they will receive. However, while the 2009 study

[13] The evaluation of the volatility costs borrows from the financial literature – the *certainty equivalent* corresponds to the amount of money that would make the safe asset (*i.e.* predictable aid) as much as attractive and valuable as the risky asset (*i.e.* volatile flows). The *deadweight loss* measures the difference between the expected value of the risky asset and the *certainty equivalent* or in other words the amount the recipient would be willing to pay for a safe rather than a risky asset.

calculates this at a flat rate across all donors, the 2011 study breaks this down by recipient and calculates it for EU institutions and member countries only. This makes it more relevant for these purposes.

- The 2009 EC report considers benefits from reducing sector level donor proliferation and from using country systems. The 2011 study may have benefitted from also including assessments on both areas, given the point noted above about the narrowness of this analysis.

Annex 3: Comments on the Commentary: A response from Sven Tengstam and Arne Bigsten

By Sven Tengstam and Arne Bigsten

March 2012

1) Introduction

This commentary provides valuable comments, and we will try to respond to the main points.

In general: When the PA has a target, e.g. that 67 % of aid should be provided within programme-based approaches, we evaluate what the effect of reaching the target would be. In most of the cases where the PA does not have a target we evaluate what the effect of a change by one standard deviation would be. Some of the comments suggest that we should assess an "appropriate" improvement based on political feasibility or existing commitments (other than PA).

We agree that such an approach could also be used, but it is not very clear what choices to make. With this approach that the reader may question our choice of what is "appropriate", while using a standard deviation is at least an established approach in economics. This estimate shows the order of magnitude of the effects, and the reader can see how sensitive the outcome is to a change of that specific magnitude. He may then adjust our estimate downwards or upwards according to what he feels is politically feasible or desirable.

2) The Aid Effectiveness Agenda

3a: Reducing transaction costs by reducing the number of countries

"Firstly, the analysis would benefit from a more nuanced understanding of administration costs. Figures on administrative costs for these are taken from the OECD-DAC database. However, so-called administration costs in this case can include a wide variety of functions, not simply the costs of managing programmes. For example, policy work undertaken by donors at HQ level is generally included. In contrast, in some donors, admin costs associated with project preparation, monitoring, and so on, may also be reported as programme costs. The analysis would be stronger if the authors had only included in the regression the specific admin costs associated with project and programme preparation in country, which would therefore be sensitive to a reduction in the number of partner countries. In addition, the analysis of administration costs – based on the number of recipient countries and the CPA amount – does not take into account the fact that projects also differ in terms of size. Savings in transaction costs could therefore also be achieved by increasing project size, but this is not factored into the model. "

Our understanding is that it is not possible using the data we have to "only include the specific admin costs associated with project and programme preparation in country". The relevant data is not available. We agree, of course, that this issue has many dimensions,

which could be discussed in a more nuanced fashion. However, our task was to come up with an order of magnitude on these costs, which we think we have done.

To use project size might be doable.

"There is no commitment within the PD or AAA agendas to reduce the number of countries by 37%. It would have been more appropriate for the authors to assess what might be an appropriate reduction in the number of countries, based on political feasibility (for example by reviewing recent experiences of donors attempting to make such reductions) or through extrapolation from existing aid effectiveness commitments (for example the EC Code of Conduct on Division of Labour, which provides guidance on how many donors should be involved in each sector at country level.) "

This is a valid point. But using a standard deviation is established in the field, and if we use something "based on political feasibility", it might be a bit ad hoc. See introduction.

3b: Reducing transaction costs by shifting to budget support

"While there is no reason in principle to suggest that this figure is not accurate, (or at least in the right ballpark) the analysis would have been strengthened by a further testing of this figure in a wider set of contexts."

That is obviously true. But that would have to be done in future work.

3c: The benefits of untying

"The analysis on untying seems appropriate and the assessment of the benefits realised is in line with other studies. "

3d: Reducing the volatility and unpredictability of aid

"However, it should be noted that this model assesses the benefits of **reducing volatility** (the extent to which flows vary from year to year), **not necessarily improving predictability** [14] (the extent which aid actually disbursed is in line with commitments). In fact, improving predictability is considered a higher priority by partner countries, and could therefore be expected to generate higher benefits. Moreover, the analysis does not consider (or even mention) the benefits of improving medium term predictability, a particular priority of developing countries and an AAA commitment.

The authors could also do more to distinguish between the causes of volatility. As they note, some volatility can be explained by changes in policy and governance in developing countries: if governance deteriorates, it is arguably right that aid flows should be cut. One way of correcting for this might be to correlate volatility with changes in indicators of performance, such as the World Bank's CPIA or the Worldwide Governance Indicators. This would further strengthen the analysis. "

The reason we did not study predictability was that, as we understand it, data is too weak. But it would be very nice if it was possible.

[14] On the differences between aid volatility and aid predictability see Celasun and Walliser (2007).

We agree that it would be good to try to separate out volatility that has a valid explanation.

3e: The impact on growth of a shift to budget support

We agree with most of the comments, and we have mentioned it in the report.

We agree that there are risks of reversed causality and omitted variables.

It might be worth using e.g. Governance Indicators as control variables as suggested.

That multicollinearity makes the risk to get statistically insignificant estimates of the other variables, even if they actually do matter is correct. But there is not much to do about it. This risk would be there (but a bit smaller) even if there was very little multicollinearity: *Absences of evidence is not evidence of absence.*

It is a good point to use some other realistic change than one standard deviation. But, as we discuss in the introduction, using a standard deviation is established in the field, and if we use something "based on political feasibility", it might be a bit ad hoc.

To use 2SLS or GMM is no solution if we do not have good instruments, which we do not have.

"Moreover, the authors only calculate a one-off increase in growth in one year as a result of the proposed shift. Long-term impacts on growth performance are not taken into account. "

This is true and we do already point it out, but should maybe have discussed it further.

3f: The benefit of reallocating aid to maximise the impact of EU aid on poverty reduction

"The disadvantage of the approach used by the authors is that, as they note, a full reallocation of country aid in line with the Collier Dollar model is unlikely to be politically realistic. However, rather than underplaying this potential benefit on that basis, the authors could instead have assessed the benefits that might be accrued through a more moderate, partial reallocation. This could have been an important exercise given the potential scale of the benefits calculated, which dwarf those of the other issues. "

To assess a more moderate, partial reallocation might also be useful. But the reader can play around with more limited reallocations. We show the upper limit of what can be achieved. And the discussion from the introduction is still valid.

3g: Narrow interpretation of the Paris agenda

"Although the study claims to be assessing the benefits of a full implementation of the PD and AAA agendas, in reality only a small sub-set of the Paris and Accra commitments are included in the analysis. As shown in Table 2, **of the 8 Paris Declaration targets which donors have responsibility for implementing, at most half are covered by this analysis.** Targets on aligning aid flows on national priorities; co-ordinating capacity development support; use of country systems; and using shared analysis are not covered at all. Arguably the target on predictability is also excluded, because, as noted above, the analysis focuses instead on volatility. "

“Moreover, the Paris targets themselves only represent a small sub-section of the full range of commitments made in Paris and Accra.”

All this is true. But we failed to come up with ideas about how to measure those factors that were left out. This was an attempt to see how much one could measure with some credibility.

3h: The need for further information on the econometric regression analysis

“In particular, the authors have not assessed the sensitivity of the models used to changes in specification, which would be normal practice in such econometric analysis.”

True. This analysis could have been extended further, but we at least attempted to include this analysis to get a reasonably complete picture of the factors that one can potentially measure. But it is certainly true that the estimates here are imprecise.

3i: Other

“Finally, even if the authors provide this caveat in the text, it is worth stressing that the summary of effects of an EU implementation of the Paris agenda (see Table 1 in this commentary as reported from the study) should be carefully read and interpreted. Figures reported in Table 1 are not directly comparable and focus on different scales and beneficiaries. Direct efficiency gains of € 3.2 billion (i.e. savings on transaction costs, gains from untying aid and reducing aid volatility) are assessed for the year 2009 and they could translate into higher aid volumes. On the other hand, indirect effectiveness gains of € 1.8 billion (rather than efficiency gains as reported) concern with the long-term effects on recipient countries.”

See comment at 5. **The impact on growth of a shift to budget support.**

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