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**Research Report**

## Assist those most in need, or most of those in need? The challenge of allocative efficiency for aid effectiveness

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## Assist Those Most in Need, or Most of Those in Need? The Challenge of Allocative Efficiency for Aid Effectiveness

### Summary

Against the current backdrop of declining aid budgets, the efficient allocation of aid is of crucial importance for its effectiveness. Allocative efficiency (aid is allocated where it has the largest impact) has become at least as important as operational efficiency (aid is used in a way that maximises results per unit of spending). Donors have committed in international forums in Paris (2005), Accra (2008), and Busan (2011) to improve allocative efficiency by increasing coordination among donors and avoiding duplication. However, implementation of this aspect of the aid effectiveness agenda has been slow and is currently stalling. Moreover, it remains unclear what principles should guide aid allocation across recipients and sectors.

In principle, cross-country aid allocation can be based either on recipients' needs or on performance. There are valid theoretical arguments for both of these conceptual approaches, and the empirical evidence is insufficient to assess their relative merit. While needs-based approaches would direct aid mainly to the neediest countries, performance-based approaches would target well-governed countries where aid is more likely to reach many people in need. Donors face difficult choices because institutional quality tends to be lower in the neediest countries. Also, many people in need nowadays live in middle-income countries but these are not the countries where those most in need live. There is often a trade-off between assisting many people in need and those most in need, making it difficult to identify an optimal allocation under both approaches simultaneously.

In practice, donors allocate according to many different

criteria, including geostrategic interests that divert aid from where it has the highest impact. Moreover, lack of coordination leads donors to concentrate on the same countries while neglecting other recipients that also have relatively high needs and performance. Thus, while trade-offs and lack of evidence make it difficult to define clear guidelines for an "optimal allocation", inefficiencies in overall aid allocation can be identified.

Multilateral donors whose allocations are presumably less biased could partly balance overall aid allocation by directing larger shares of aid to bilaterally underfunded countries. But it is also important to improve coordination and transparency in allocations by all donors.

The Global Partnership for Effective Development Cooperation (GPEDC), which brings together all main development actors, is in a good position to engage in overcoming the political obstacles that hinder donor coordination. Coordination will be insufficient and difficult to achieve if geostrategic interests continue to influence aid allocations, but increasing transparency is a good step forward. Donors should adopt transparent allocation formulas based on performance and/or needs and factor in each other's allocations in their own formulas. The Organisation for Economic Cooperation and Development (OECD) could play an important role in fostering this ex-ante coordination by continuing to push for a full disclosure of donor-specific indicative forward spending plans. Moreover, the Development Assistance Committee (DAC) peer review could focus more on allocation decisions in its assessment of bilateral donors' development cooperation systems, increasing the peer pressure on its members to adopt transparent allocation criteria.

### Why does allocation matter for aid effectiveness?

Falling aid budgets make the efficient use of scarce aid resources an increasingly pressing concern. Aid efficiency has two dimensions: allocative efficiency (aid is allocated where it has the largest impact) and operational efficiency (maximal results per unit of spending). The aid effectiveness agenda focuses predominantly on operational efficiency (improving aid modalities to increase value for money) whereas the equally important dimension of allocative efficiency tends to be neglected.

Despite donors' commitments at international high-level forums in Paris (2005), Accra (2008), and Busan (2011) to improve the overall allocation of aid resources, implementation of this last aspect of the aid effectiveness agenda has been slow and is currently stalling. Moreover, commitments to increase allocative efficiency have focused on improving donor coordination and avoiding duplication of efforts, while it remains unclear what principles should guide resource allocation across recipients and sectors.

Achieving allocative efficiency requires comparing the impact of aid across countries and sectors and allocating aid where it promises the highest returns. However, such comparisons are theoretically and empirically extremely challenging. In the absence of a known "optimal allocation", different approaches to cross-country aid allocation coexist, based either on recipients' needs or on performance.

### Needs-based allocation principles

Besides normative arguments based on equity considerations, allocating aid according to needs reflects the idea that the expected impact of aid is maximised where recipients exhibit the greatest need for it. However, it is not clear what type of need should be considered.

**Country-based needs:** Donors could allocate according to different degrees of need across countries. There are several arguments for directing larger shares of aid to countries with the highest needs (in terms of income poverty, but also other dimensions of human development). First, the poorest countries do not have sufficient domestic resources to achieve development goals on their own. Second, reaching the Millennium Development Goals (MDGs) might require focusing on countries that are farther off from MDG targets. Third, the most deprived recipients can offer the greatest scope for large improvements through cost-effective interventions. Activities in better-off recipients are likely to be more costly on average because often the most cost-effective interventions have already been implemented.

**Number of people in need:** Rather than considering the needs of countries at aggregate level, donors could allocate according to where people in need live. This approach might result in large aid shares for middle-income countries, which have high absolute numbers of people in need, but also more domestic resources to tackle poverty on their

own. However, this depends on which needs are considered. For example, in 2005 Sub-Saharan Africa (SSA) received 23 % of total ODA and East Asia (EA) 15 %. Were allocations derived from the number of people living on less than US\$2 a day in each region, SSA should have received 17 % and EA 31 %. Shifting the poverty line to \$1 daily would have resulted in 26 % for SSA against 23 % for EA. Allocating according to the number of people without access to health or education would have resulted in yet another distribution.

**Density of people in need:** There is an argument for directing aid where people in need are concentrated, in order to exploit economies of scale. It might be cost-effective to allocate aid to countries with densely populated areas where many people in need live close to each other.

**Exceptional needs:** Aid can have a large impact in countries that have exceptionally high needs due to special circumstances. There is evidence that aid is particularly effective in promoting growth in countries recovering from war due to the large financial resources needed for reconstruction. Aid is also expected to have a large impact in countries facing exogenous shocks in exports or in agricultural production. Here, aid can lower the risk of a shortfall of resources. However, the evidence points merely to a positive impact of aid on economic growth in these contexts, whereas its effect on human development is less clear. Moreover, these might not be the only circumstances that increase the potential impact of aid.

### Performance-based allocation principles

The alternative approach is to allocate according to performance, assuming that the impact of aid will be larger if it is allocated to countries that use it efficiently. In allocating according to performance, donors might consider:

**Institutional quality:** There is evidence that aid is more effective in promoting development in good institutional contexts. The literature emphasises different aspects of governance, notably the rule of law; corruption; governments' aversion to inequality; and the quality of economic policies and budgetary systems. Donors may want to allocate larger shares of aid to countries that fare better in one or all of these dimensions, or even focus exclusively on a small selection of countries with strong institutions.

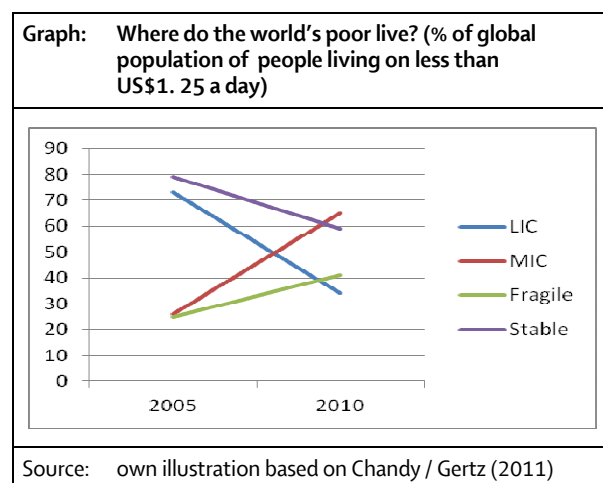
**Results achieved:** Instead of selecting recipients based on institutional quality, donors could direct aid to countries where good results have been achieved. Allocating according to past outcomes is still likely to result in larger aid shares for countries with good institutions. However, this approach avoids underestimating the potential of countries that might use aid efficiently despite having weak institutions. For example, recent evidence shows that countries with weak institutions such as Nepal and the Central African Republic made the fastest progress on MDG targets. The downside of this approach is that outcomes do not necessarily indicate good use of aid resources, but

can be the result of unrelated external factors. Moreover, a good past performance record is no guarantee that recipients will use future aid receipts efficiently.

### Trade-offs between approaches

There are valid theoretical arguments for both needs- and performance-based approaches, and the empirical evidence is insufficient to assess their relative merit. While needs-based approaches would direct aid mainly to the neediest countries, performance-based approaches would target well-governed countries where aid is more likely to benefit a larger number of people in need. This often produces a difficult trade-off because institutional quality tends to be lower in the neediest countries. There can be trade-offs also between different needs-based approaches, since countries with many people in need are often not those where the most in need live. Both these trade-offs boil down to the question: Should aid assist many people in need, or those most in need?

This is particularly relevant because poor people are increasingly concentrated in fragile states with bad institutions and in middle-income countries (see graph).



There can also be a trade-off between achieving allocative efficiency in the short and in the long term. In the short term, it may be efficient to direct most resources to recipients where aid has the largest immediate impact. However, negative cross-border spillovers from neglected recipients in a range of areas including security, health, the environment, and trade might lead to such an allocation being inefficient in the long term.

### Allocation at sub-national and sector level

Similar considerations regarding the distribution of aid resources can, in principle, be applied to the allocation of aid between different sectors as well as between different sub-national entities such as regions, provinces and districts. Yet, allocation decisions at these levels become even more complex if, for instance, needs or performance are to

be compared between different sectors. At the same time, donors may have very limited influence on the actual use of aid resources at this level, due to fungibility of aid resources and to the need to respect national sovereignty.

### Aid allocation in practice

In practice, most donors apply a combination of different approaches, resulting in actual allocation patterns that diverge from pure needs- or performance-based approaches. Moreover, donors attach different importance to needs and performance respectively. For example, the United Nations Development Programme (UNDP) uses a needs-based formula that weighs population size and income per capita. In contrast, allocations by the World Bank's International Development Association (IDA) are largely determined by the CPIA score, which measures recipients' institutional quality. The European Development Fund and most multilateral development banks adopt performance-based formulas similar to IDA's.

Bilateral donors rarely have clear allocation formulas, but allocation patterns suggest that some donors (e.g. Netherlands, UK) assign more weight to recipients' institutional quality than others (e.g. France, USA).

Since the end of the 1990s, donors have been attaching more importance to the quality of recipients' institutions. However, the move towards greater selectivity based on institutional quality is not as clear as might be suggested by donors' emphasis on good governance. Needs still greatly influence cross-country distributions of aid, and there has been increasing attention for fragile states, whose aid receipts grew by half between 2000 and 2010.

Allocation patterns are not explained by recipients' needs and performance only. The emergence of "aid orphans" – i.e. countries receiving insufficient aid according to both approaches (see box) – suggests that factors other than needs and performance influence allocation patterns. A large body of evidence shows that geostrategic interests often lead individual donors to allocate larger shares of aid to political allies, commercial partners, former colonies, countries that pose security threats, etc. Global public goods such as climate change adaptation also induce donors to direct aid to countries different from those where it is expected to have the largest impact on economic and social development.

Moreover, donors rarely factor in other donors' allocations when distributing their resources, since aid allocation is considered a sovereign policy to be decided unilaterally. Uncoordinated donors tend to focus on the same "darling" countries while neglecting other recipients that also have relatively high needs and performance. However, coordinated donors might still allocate according to shared geostrategic interests, whereas increasing the development impact of aid requires coordinated allocations to be based on criteria such as needs and performance.

**Box: Aid orphans**

The OECD (2013) identifies a number of countries that are under-aided according to both performance- and needs-based approaches. Most of these "aid orphans" are fragile states located in SSA such as Madagascar and Togo. Underfunding of countries with relatively high levels of needs and performance is due mostly to neglect by bilateral donors. This can be attributed both to the recipients' relative unattractiveness for donors and to a lack of coordination that produces inefficient concentrations of donors in "aid darling" countries.

assume a balancing role by allocating larger shares of aid to bilaterally under-aided countries. However, it is also important to improve coordination and transparency in allocations by all donors.

The Global Partnership for Effective Development Cooperation (GPEDC), which brings together all main development actors, should capitalise on its inclusive character to engage in overcoming the political obstacles that undermine efforts to coordinate allocations. Coordination will be insufficient and difficult to achieve if geostrategic interests continue to influence aid allocations, but increasing transparency in aid allocations is a good step forward. Donors should adopt transparent allocation formulas based on performance and/or needs and factor in each other's allocations in their own formulas. The OECD could play an important role in fostering this ex-ante coordination by continuing to push for a full disclosure of spending plans. Moreover, the DAC peer review could focus more on allocation decisions in its assessment of bilateral development cooperation systems, increasing the peer pressure on its members to adopt transparent allocation criteria.

### Conclusions and policy recommendations

Although allocative efficiency is crucial for aid and development effectiveness, trade-offs and lack of evidence make it difficult to set clear guidelines for an "optimal allocation". In other words, no optimal allocation of aid exists. Nonetheless, inefficiencies in actual allocation patterns can be identified and possibly addressed, especially where these are caused by lack of coordination or the undue influence of geostrategic interests. Multilateral donors whose allocations are presumably less biased could partly

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