

The Policy Implications of Evolving Aid Modalities

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1 Executive Summary

This policy paper examines two main issues. The first is how CIDA can realize the benefits of untying aid more effectively. CIDA has made substantial progress towards untying aid in the last few years. However CIDA may be able to increase the benefits of this shift if it pays closer attention to the informal or de-facto barriers that can negate the formal untying of aid. CIDA also needs to be aware that there is a significant grey area into which a number of its practices and policies may fall. In particular, there is a potential conflict between CIDA's commitment to untie all aid by 2012-2013 and CIDA's responsibilities under the Government of Canada's *Corporate Social Responsibility Strategy for the Canadian International Extractive Sector* (the CSR Strategy).

While it may not, strictly speaking, fall into the category of tied aid, the CSR Strategy could easily be portrayed as an indirect way of tying aid and has the potential to undermine confidence in Canada's commitment to untying aid. There are several steps that CIDA could take in order to reduce this potential conflict. This includes clearly situating CIDA's support for CSR in relation to its primary themes, particularly the promotion of sustainable economic growth, and prioritizing projects which have a clear plan for facilitating the use of local goods and service providers.

The second issue addressed by this paper is that of outcome-based conditionality. Due to disillusionment with policy conditionality, now widely regarded as being ineffective, political scientists and policy makers have sought to identify new, more effective forms of conditionality. One option is outcome- or performance-based conditionality. While this form of conditionality promises to avoid many of the pitfalls of policy conditionality, it also comes with its own potential problems. This new aid modality warrants closer consideration from CIDA. While CIDA should be cautious in its adoption, existing evidence suggest that careful implementation on a 'pilot' basis could help to improve aid effectiveness in selected contexts.

2 Policy Brief

Policy goal and significance

This policy brief addresses how CIDA can achieve the policy goal of improving aid effectiveness by more effectively realizing the benefits of untying of aid and adopting outcome-based conditionality. This issue is significant for several reasons:

- OECD-DAC donors have made prominent commitments to untying aid in order to increase its effectiveness, including the 2008 *Accra Agenda for Action*. Realizing the benefits of untying aid will make an important contribution to the achievement of the Millennium Development Goals.
- The use of outcome-based conditionality is growing. Prominent donors, including the European Commission and the Global Fund for AIDS, Tuberculosis and Malaria, have adopted it. More recently DFID has launched a series of pilot projects that will implement Results Based Aid.¹

Canada's position on the issue

In 2008 Canada committed to fully untying its bilateral development aid by 2012-2013. This is a central part of CIDA's policy on aid effectiveness. CIDA aims to implement conditionality in a manner that is consistent with the goal of aid effectiveness. It has not yet taken an explicit position on outcome-based conditionality.

Policy recommendations

1. **Take steps to reduce the de-facto barriers to non-Canadian firms and NGOs' involvement in CIDA projects.** CIDA should improve the accessibility of information regarding projects and funding for which they are eligible to apply. Simple steps in this direction include updating CIDA's website to clearly identify which CIDA funding avenues are open to non-Canadian organizations, and making greater use of the MERX and OECD DAC Untied ODA websites.
2. **Improve its ability to detect and monitor de-facto barriers that negate the formal untying of aid.** In line with the International Aid Transparency Initiative data standard, to which Canada has recently become a signatory, CIDA should amend the publicly available *Project Browser Data Set* to include a new field which indicates the nature of the executing agency or partner.
3. **Ensure that its policy on Corporate Social Responsibility (CSR) include clear guidance on the extent to which CIDA's support of CSR projects will be open to participation by non-Canadian firms and non-governmental organizations (NGOs).** To the extent that non-Canadian firms and NGOs are excluded, there is potential to undermine the objectives of untying aid. CIDA may be able to minimize this problem by requiring projects funded under the CSR strategy to promote the use of local goods and service providers and/or prioritizing projects which have clear plans to do so. CIDA should also clearly situate its support for CSR in relation to its primary themes, including sustainable economic development.
4. **Consider using outcome-based conditionality on a 'pilot' basis.** CIDA should approach it as one tool, among many, that can help to increase aid effectiveness. CIDA should ensure that its use of outcome-based conditionality takes into account the lessons learnt so far.
5. **Find ways to link these pilot projects to its existing projects in statistical capacity building, including the *Strengthening National Statistical Systems in Developing Countries* project.**

¹ Results Based Aid is the term used by DFID to refer to outcome-based conditionality.

3 Background: The International Policy Framework and CIDA's Current Position

(i) Realizing the benefits of untying aid

The OECD defines *tied aid* as aid which requires recipients to procure goods and services in the donor country or in a limited number of countries. In contrast, *untied aid* is aid "for which the associated goods and services may be fully and freely procured in substantially all countries."² Contributions to NGOs based in the donor country are conventionally regarded as untied aid. However, this remains a grey area in which some degree of tying can often be found in practice.

During the 1990s, evidence emerged indicating that tied aid had a number of adverse effects. Economists found that tying aid effectively reduced its value, generally estimating that tying aid led to the overpricing of goods and services by between 15 and 30%. Tied aid was also found to have a number of indirect costs, potentially leading to the procurement of lower quality goods and services, the supply of products unsuited to local conditions and delays in delivery. Others noted that by excluding local goods and services providers, tying aid stifled local economic development. It was also thought to have a number of negative effects on policy making and governance because it undermined local ownership of development projects.

In light of this evidence, members of the OECD's Development Assistance Committee (DAC) recommended in 2001 that development aid to Least Developed Countries (LDCs) be untied to the greatest extent possible.³ Special provision was made for technical co-operation and food aid, both of which remained tied to a higher degree than other forms of aid. The commitment to untying aid was reiterated in both the OECD's 2005 *Paris Declaration on Aid Effectiveness* and the 2008 *Accra Agenda for Action*. In the Paris Declaration DAC members committed to increase the percentage of bilateral aid that is untied over time. The Accra Agenda is more specific, and more ambitious, committing members to:

- Extend coverage of the 2001 Recommendation to non-LDC Highly Indebted Poor Countries (HIPC).
- Improve their reporting on the 2001 Recommendation.
- Elaborate individual plans to further untie their aid to the maximum extent.
- Promote the use of local and regional procurement by ensuring that their procurement procedures are transparent and allow local and regional firms to compete.
- Respect international agreements on corporate social responsibility.

Most recently, at the Fourth High Level Forum on Aid Effectiveness in Busan, South Korea (29 November - 1 December 2011) delegates reiterated their commitment to untying aid in order to increase aid effectiveness. The Busan Partnership for Effective Development Co-operation, which provides a framework for development co-operation that embraces traditional donors, South-South co-operators, the BRICS, civil society organizations and private donors, states that:

Pursuant to the Accra Agenda for Action, we will accelerate our efforts to untie aid. We will, in 2012, review our plans to achieve this. In addition to increasing value for money, untying can present opportunities for

2 OECD, "Untied Aid," *OECD Glossary of Statistical Terms*, 2002, <http://stats.oecd.org/glossary/detail.asp?ID=2817>.

3 OECD, *DAC Recommendation on Untying Official Development Assistance to the Least Developed Countries*, 2001.

local procurement, business development, employment and income generation in developing countries. We will improve the quality, consistency and transparency of reporting on the tying status of aid.⁴

Canada's commitment to untying aid is now a central part of CIDA's policy on aid effectiveness. In CIDA's September 2002 *Policy Statement on Strengthening Aid Effectiveness*, CIDA committed to untying its aid to LDCs, excluding food aid and programming in the Partnerships With Canadians Branch. CIDA also committed to seeking a number of amendments to its contracting regulations in order to allow greater access to CIDA projects and tenders by non-Canadian firms and organizations. In 2008 the Government of Canada went further, with the Minister of International Cooperation announcing that Canada would fully untie its aid, including food aid, by 2012-2013. The rationale for this decision was clearly linked to aid effectiveness. CIDA stated:

Moving to global procurement for bilateral development assistance will increase efficiency by ensuring Canada gets the best value for money with its aid dollars. Untying aid will also give developing countries greater opportunities to be suppliers of goods and services and, in that way, generate economic growth within their local markets.⁵

Canada's progress towards the goal of fully untying aid has been significant. In 2010 Canada reported total bilateral aid commitments of \$US 1,192.23 million to the OECD. Of this, \$US 1,183.9 million - 99.3% - was untied.⁶ While this represents substantial progress, Canada has not sought to expand its commitment to untying aid outside the context of bilateral aid. As such, certain areas in which CIDA works remain more prone to tying. The main areas where CIDA still ties aid are technical cooperation, education and support for governance and civil society, as well as emergency assistance and reconstruction. Projects managed through the Partnerships with Canadians Branch, which accounts for a relatively small proportion of the international assistance delivered by CIDA, are open only to Canadian organizations.⁷

(ii) Outcome-based conditionality

In the 1980s and 1990s the disbursement of large amounts of development aid was made conditional on policy reforms. However, policy conditionality (as it has become known) became increasingly subject to criticism. In a significant number of cases aid continued to be provided, or loans granted, even when recipients failed to implement the policy changes required by donors. In other cases questions were raised about the extent to which donors were able to identify the policies that would be appropriate or effective in recipient countries. As in the case of tied aid, policy conditionality also raised issues of governance. Policy conditionality appeared to encourage recipient governments to direct their accountability towards donors rather than their own citizens, while the fragmented nature of the policy requirements of different donors created significant administrative burdens for aid recipients.

4 OECD-DAC Working Party on Aid Effectiveness, "Busan Partnership for Effective Development Co-operation," *Fourth High Level Forum on Aid Effectiveness*, 1 December 2011, para. 18(e), <http://www.aideffectiveness.org/busanhlf4/en/component/content/article/698.html>.

5 CIDA, "Canada Fully Unties Its Development Aid," *CIDA*, 5 September 2008, <http://www.acdi-cida.gc.ca/acdi-cida/ACDI-CIDA.nsf/eng/NAT-9583229-GQC.fi>

6 OECD, "Development Database on Aid Activities: CRS Online," *OECD*, 2012, http://www.oecd.org/document/0/0,2340,en_2649_34447_37679488_1_1_1_1,00.html.

7 In the 2010-2011 Fiscal Year, the Partnerships With Canadians Branch was responsible for just over 6.3% of the international assistance delivered by CIDA; *CIDA Statistical Report on International Assistance 2010-2011*, Government of Canada, 2012.

In order to strengthen developing country ownership of reforms and improve the predictability of aid flows, donors agreed to streamline and align conditionality requirements as part of the Accra Agenda. Generally, this is to be done by drawing conditions from developing countries' own development policies. More specifically, under the Accra Agenda, donors committed to:

- Work with developing countries to agree on a limited set of mutually agreed conditions based on national development strategies.
- Jointly assess donor and developing country performance in meeting commitments.
- Regularly make public all conditions linked to disbursements.
- Work together with developing countries at the international level to review, document and disseminate good practices on conditionality with a view to reinforcing country ownership and other Paris Declaration Principles by increasing emphasis on harmonized, results-based conditionality.

The last point indicates that donors, who are subject to their own accountability requirements to domestic populations, have not abandoned conditionality, but rather have sought to develop new, more effective forms of conditionality. One of these is results- or outcome-based conditionality. Outcome-based conditionality represents an attempt to extend results-based management practices, which have become best practice within donor organizations, to their relationships with aid recipients. It differs from traditional conditionality by linking the disbursement of funds to defined developmental outcomes - such as reductions in infant mortality rates - rather than specified policy changes. This new form of conditionality is closely linked to the Millennium Development Goals (MDGs), which are focused on results and measurable performance targets. For example, the goal of improving maternal health, has been linked to the target of reducing by three quarters, between 1990 and 2015, the maternal mortality ratio.

Outcome-based conditionality can take a number of forms. It can be imposed in an all-or-nothing manner, with failure to meet targets on time being the trigger for all aid disbursement to be halted. Concerns about the negative effects of aid volatility mean that a more moderate approach is generally taken in practice. Most commonly, projects that employ outcome-based conditionality split funding into two tranches: one fixed and one variable. The fixed tranche is disbursed in full providing that minimum criteria of eligibility are satisfied, while a proportion of the variable tranche is disbursed based on the extent to which performance targets are met at a set point in time. These targets are generally agreed after consultation between donors and aid recipients. Outcome-based conditionality can also be implemented by conditioning successive disbursements on performance in preceding periods. This differs from the split-tranche approach by delaying the disbursement of aid until targets are met, rather than reducing the total amount of aid to reflect the extent to which performance targets have been achieved at a fixed point in time.

Great hopes are attached to outcome-based conditionality. It has been cast as a means of accelerating progress towards the MDGs. It is also generally thought that outcome-based conditionality will support recipient ownership of reforms, avoid arbitrary judgements about policy, reduce conflicting conditionality requirements and support better coordination between donors. These hopes are based on the fact that while outcome-based conditionality specifies what is to be achieved, it - in theory - affords recipient governments flexibility in terms of the policies that they adopt in order to achieve those goals.

Despite these hopes, the spread of outcome-based conditionality has been relatively limited within donor agencies. The European Commission is the only major donor to implement it on a significant scale. More recently, progressive donors like Sweden and Switzerland have begun to trial outcome-based conditionality in Mozambique. The Millennium Challenge Corporation (MCC) established by the United States also includes limited elements of outcome-based conditionality.⁸ Movement towards outcome-based conditionality has been more pronounced among non-government donors, with a number of large NGOs and charitable foundations using forms of outcome-based conditionality. This includes the GAVI Alliance and the Global Fund for AIDS, Tuberculosis and Malaria. The shift towards outcome-based conditionality has been greatest in the health sector, where performance targets are easier to identify and measure. Greater use of this form of conditionality has been advocated by a number of groups, including the Center for Global Development. The Center has proposed a form of outcome-based conditionality which it terms 'Cash on Delivery Aid' and has demonstrated how it could be applied to primary education.⁹ Partly in response to this, DFID has launched a £30,000,000 (\$48,000,000) pilot project which will trial Results Based Aid (DFID's terminology for outcome-based conditionality) in the education sector in Ethiopia between 2012 and 2015.¹⁰

The limited implementation of outcome-based conditionality by donor agencies is due to a number of factors. One factor which has already been foreshadowed is the difficulty of identifying and measuring appropriate performance indicators. Outcome-based conditionality has been easier to apply in certain sectors, such as education and health, where measurable targets and reliable data are more readily available. Government donors have also been wary of adopting this new form of conditionality. Full implementation of outcome-based conditionality would represent a substantial shift in how aid agencies operate, moving their focus to monitoring and assessing progress against key development indicators. While such a shift has been recognized as desirable by donors, it would require them to implement changes to standard practices and to invest in training or recruiting staff with new skill-sets. Another important barrier to the spread of outcome-based conditionality is the fragmented nature of empirical research in the area. Donors have been reluctant to invest time and resources in shifting to outcome-based conditionality in the absence of clear evidence that it is, in fact, more effective. However, as will be discussed in section 4, below, the evidence that is available suggests that further experimentation with outcome-based conditionality is warranted. It also highlights a number of practical issues that will need to be addressed if the potential benefits of outcome-based conditionality are to be realized.

CIDA does not have an explicit policy on conditionality, but aims to implement conditionality in a manner that is consistent with the goal of aid effectiveness. In light of this, CIDA attempts to limit conditionality to terms agreed upon with partner countries and, when multiple donors are involved, to harmonize conditionality requirements as much as possible. While CIDA has a strong commitment to results-based management internally¹¹, it has not yet taken a clear position on outcome-based conditionality nor sought to implement it in the projects which it funds. An adoption of outcome-based conditionality could complement and support CIDA's internal implementation of results-based management.

8 The eligibility of countries for MCC funding is based on past performance against a number of indicators, but this is arguably a form of selectivity rather than true outcome-based conditionality.

9 Birdsall, Nancy, William D Savedoff, Ajah Mahgoub, and Katherine Vyborny. *Cash on Delivery: A New Approach to Foreign Aid*. 2nd ed. Washington D.C.: Center for Global Development, 2011.

10 See <http://projects.dfid.gov.uk/project.aspx?Project=202989>.

11 CIDA, "Results-based Management Policy Statement," *CIDA*, 2008, <http://www.acdi-cida.gc.ca/acdi-cida/acdi-cida.nsf/eng/ANN-102084042-GVJ>.

4 Recent research: Implications for CIDA

(i) *Realizing the benefits of untying aid*

Policy makers, practitioners and academics expect that untying aid will produce significant benefits in terms of aid effectiveness. As well as avoiding the artificial inflation of prices for goods and services and reducing delays in their provision, untying aid is expected to contribute towards sustainable economic development by opening up more opportunities to local businesses. On the governance side, untying aid is expected to improve local ownership of development projects and to support stronger relationships between donors and aid recipients.

Yet the process of untying aid is not as straightforward as it first appears. A number of issues arise that have the potential to undermine or negate the potential benefits of untying aid. Recent studies funded by the OECD have identified a number of ways in which this can occur.¹² A number of aid agencies sought to examine this issue. DFID, for example, has used a field study in Nigeria to analyze the practical barriers which can prevent local organizations from taking up the opportunities created by untied aid.¹³ This section summarizes the general findings of existing research with respect to the impact of untying aid before identifying some specific problems which have arisen in the context of CIDA's own efforts to untie aid.

Evidence: The impact on cost-effectiveness

Evidence suggests that while untying aid has had benefits in terms of cost-effectiveness, these benefits have been contingent on a number of factors. In the majority of projects assessed by researchers untying aid and local competitive sourcing were cost effective in terms of securing goods and services at market prices. However, untying aid did not always lead to cost-savings. This has most often been due to the 'normal' problems associated with public contracting. In light of this, researchers noted that the increased use of country procurement systems has created a demand for capacity building in this area. The extent to which untying aid has led to cost-saving has also been dependent on the level of competition for tenders, which has sometimes been reduced by the size of projects being tendered. The projects assessed so far have generally been those undertaken in favourable circumstances (i.e. in contexts of relatively good governance, reasonable economic stability and good donor-recipient relationships) so, at present, it is unclear whether untying aid will have the same impact on cost-effectiveness in less favourable contexts.

Evidence: The impact on sustainable economic development

While the developmental impact of untying aid has been difficult to trace, recent research provides grounds for cautious optimism. Studies of several projects have suggested some link between untying aid and increased local employment and incomes. However, evidence has generally been insufficient to attribute these increases directly to the untying of aid.

12 Dirk Willem te Velde, Ed Clay, and Matthew Geddes, *The Developmental Effectiveness of Untied Aid*, London: Overseas Development Institute, October 2008, <http://www.odi.org.uk/resources/>; Clay, Ed, Matthew Geddes, and Luisa Natali. *Untying Aid: Is It Working?* Copenhagen: Danish Institute for International Studies, December 2009. <http://www.odi.org.uk/resources/>.

13 DFID, *Development: Making it Happen, 2008 Annual Report*, London: DFID, 2008, para. 5.9.

Untying aid does appear to shift the balance towards sourcing goods and services from local suppliers. However, the impact of this is constrained by the undeveloped nature of local economies (many local companies still rely primarily on imported goods). Research, including surveys conducted by DFID with local businesses in India, Bangladesh, Nigeria and South America, points towards several factors that have prevented local firms from winning tenders even when aid was untied.¹⁴ The most important of these are:

- A lack of information. Local goods and services providers are often unaware of opportunities to become involved in development projects.
- A lack of skills and capacity. Local goods and services providers are often confronted by complex terms of reference and bidding documents, which are rarely tailored to local conditions.
- Financial constraints, including limited access to credit. This makes it harder for local firms to meet pre-qualification requirements, manage exchange rate risks, maintain cash flow and provide bid security.
- A lack of reputation outside their own country. Even well established and experienced local firms have struggled to be recognized by donors.

Evidence: The impact on ownership and transparency

Untying aid appears to be supporting both a move away from the project-based approach and greater use of country procurement systems. However, researchers have noted a 'chicken and egg' issue: where country procurements systems are weak, donors have been reluctant to untie aid, but where aid remains tied there are fewer incentives to invest in capacity building in public procurement. Where there has been a shift towards local procurement, local ownership of development has been strengthened. SIDA, for example, has found that since formally untying its aid in 2006, its development assistance to Laos has become more closely aligned with the development priorities of the Government of Laos and, consequently, more effective.¹⁵

Research suggests that the impact of untying aid on transparency has been mixed. From the perspective of recipients, improvements in transparency have been dependent on the area or level of contracting. Areas found to be less transparent include contracting that occurs at donor headquarters and partnership arrangements. Recipients also report that donor practices remain particularly opaque in relation to technical cooperation.

Research indicates that the impacts of untying aid on ownership and transparency are closely linked. Largely due to donor concerns about transparency and accountability, untying has done little to reduce financial reporting and monitoring requirements, both for recipients and within donor agencies. As a result, untying aid has often failed to reduce administrative burdens to the extent expected.

14 See Clay, Ed, Matthew Geddes, and Luisa Natali. *Untying Aid: Is It Working?* Copenhagen: Danish Institute for International Studies, December 2009, p. 50.

15 McGillivray, Mark, David Carpenter, and Stewart Norup. *Evaluation Study of Long-Term Development Co-operation Between Laos and Sweden*. SIDA Evaluation. Stockholm: SIDA, 2012, p. 106-107.

A review of information, policies and documents available on CIDA's website suggests that CIDA's progress in untying aid has already raised some problems in practice. These problems tend to cut across the issues highlighted by the research discussed above.

Problem 1: Informational barriers to entry by local businesses

Research indicates that a lack of information is one of the most important barriers that prevents local business from making the most of the opportunities created by untied aid. This appears to be a problem for CIDA: information about CIDA funding and tender opportunities for non-Canadian organizations is much more difficult to obtain than equivalent information for Canadian firms. While the CIDA website provides very clear instructions to Canadian firms seeking tender and/or funding opportunities¹⁶, little or no information is provided with respect to non-Canadian firms. Some untied tender opportunities are listed on MERX¹⁷ and the OECD DAC Untied Official Development Assistance website.¹⁸ However, given the increasing amount of Canadian aid which has been formally untied, the relatively small number of tenders or funding opportunities listed in this way suggests that these websites may be underutilized.

Problem 2: Lack of information impedes identification of de-facto tying practices and barriers to entry by local firms

Research points to a shortage of publicly available information that allows de-facto forms of tying aid and/or barriers to entry by local firms to be identified and tracked. While most donors report their aggregate levels of untied aid, it is much harder to obtain information that would allow researchers and policy makers to assess whether the formal untying of aid is leading to changes in practice. One example of this is CIDA's *Project Browser Data Set*.¹⁹ This data set includes a field that indicates the identity of the executing agency or partner, but does not include a field that readily identifies whether such partners are Canadian, local or international. This limits CIDA's ability to quickly and easily identify countries or sectors in which non-Canadian organizations are underrepresented as project partners.

Problem 3: Nature of partnerships with national NGOs and the private sector may reduce transparency, ownership and trust

Research has indicated that certain areas of donor practice, including partnership arrangements, remained particularly opaque to aid recipients. This reflects the fact that while contributions to NGOs are conventionally regarded as untied²⁰, they remain grey areas in practice. These grey areas have become larger as the global financial crisis has accelerated the search for new aid modalities, including modalities that allow donors to leverage funds available from the private sector.

In the case of CIDA this appears to have led to a lack of clarity about how certain programs and policies interact with the commitment to fully untying development aid. Particular issues are raised by the *Corporate Social Responsibility Strategy for the Canadian International*

16 This information is provided at <http://www.acdi-cida.gc.ca/acdi-cida/acdi-cida.nsf/eng/NIC-5491045-HGA#a1>.

17 <http://www.merx.com/>.

18 <http://webnet.oecd.org/UntiedAidWeb/NotificationList.aspx?lng=en&Mnu=true>.

19 Available at <http://www.acdi-cida.gc.ca/acdi-cida/acdi-cida.nsf/eng/CAR-530122033-M6W>.

20 Since 2005, Canada has classified its aid to NGOs as united on this basis.

Extractive Sector (the CSR Strategy). The lack of clarity surrounding this interaction, and the potential for negative perceptions, is particularly high at present because CIDA's own policy on CSR is still under development.

The CSR Strategy is designed to promote and support corporate social responsibility by Canadian companies, particularly those in the mineral extraction sector, operating abroad. While primary responsibility for implementation of this strategy rests with Foreign Affairs and International Trade Canada (DFAIT), CIDA will also play a role in its implementation. In September 2001, CIDA announced three pilot projects that it will fund, via the Partnerships With Canadians Branch, as part of the the CSR Strategy. Under these projects, which will be implemented in Colombia, Peru, Bolivia, Ghana, and Burkina Faso, CIDA will provide funding to Canadian NGOs which have partnered with different mining companies. World University Service of Canada will partner with Rio Tinto Alcan, Plan Canada with IAMGOLD and World Vision Canada with Barrick Gold.²¹

While CIDA will be providing funds directly to Canadian NGOs, not mining firms, the strategy is explicitly intended to improve the competitiveness of these Canadian firms. DFAIT states, "Building the Canadian Advantage will improve the competitive advantage of Canadian international extractive sector companies by enhancing their ability to manage social and environmental risks."²² While it may not, strictly speaking, fall into the category of tied aid (since goods and services required for the projects may still be sourced outside of Canada), the CSR Strategy could easily be portrayed as an indirect way of tying aid. As a result it has the potential to undermine confidence in Canada's commitment to untying aid. This is a significant issue because of what untying aid is expected to achieve: stronger local ownership of development and greater trust between donor and recipient governments.

The steps which CIDA could take to address these problems are discussed in section 5, below.

(ii) Outcome-based conditionality

While the spread of outcome-based conditionality remains relatively limited, there have been some efforts to evaluate the effectiveness of this new form of conditionality. These evaluations suggest that outcome-based conditionality may have a positive impact on developmental outcomes, though it is too early to make definitive conclusions. They also highlight a number of common problems and 'lessons learnt' that should inform future implementation of outcome-based conditionality.

Evidence: The impact of outcome-based conditionality on developmental outcomes

Existing research suggests that outcome-based conditionality can have a positive effect on developmental outcomes. Evaluations of existing projects suggest that a positive impact is more likely when:

21 CIDA, "Minister Oda Announces Initiatives to Increase the Benefits of Natural Resource Management for People in Africa and South America," *CIDA*, 29 September 2011, <http://www.acdi-cida.gc.ca/acdi-cida/ACDI-CIDA.nsf/eng/CAR-929105317-KGD>.

22 Foreign Affairs and International Trade Canada, "Building the Canadian Advantage: A Corporate Social Responsibility (CSR) Strategy for the Canadian International Extractive Sector," *DFAIT*, March 2009, <http://www.international.gc.ca/trade-agreements-accords-commerciaux/ds/csr-strategy-rse-strategie.aspx?lang=eng&view=d>.

- *There is greater certainty about the amount of aid which is linked to performance and the timing of its disbursement.* One study found evidence of increased efforts to reduce corruption immediately after the announcement of the MCC. This appeared to be linked to the fact that control of corruption was one of the most prominent eligibility requirements for MCC funding. However, this 'anticipation effect' faded over time as domestic political demands (in particular, resistance from the United States' Congress) led to a reduction in the amount of aid that would be available from the MCC and created uncertainty about the timing of its disbursement.
- *The financial incentive is more focused.* Outcome-based conditionality has been more effective in generating incentives to improve performance in sectorally targeted projects, particularly in the health sector, than in the context of general budget support. Research suggests that, since the EC is the only major donor to apply outcome-based conditionality in the context of budget support, the financial incentives created in this context are not strong enough to generate substantial change. For example, when the EC withheld 21% of its variable-tranche budget support to Burkina Faso, this represented about 4% of total EC budgetary support. This, in turn, was only about half of the EC's aid to Burkina Faso and an even smaller component of Burkina Faso's total aid. This suggests that outcome-based conditionality is unlikely to be effective in the context of general budget support unless it is adopted as part of a coordinated effort with other donors.
- *Targets are customized to the circumstances of recipient governments.* Experience indicates that outcome-based conditionality has been ineffective when the same targets are applied to all countries. Those most in need of improvement - extremely poor states and post-conflict states - have not been motivated to improve performance when they have been required to meet such targets. However, where performance measures and targets were customized to such countries, outcome-based conditionality has been more successful in providing a motivation to improve performance. Preliminary evidence suggests that, in some cases, outcome-based conditionality may also be more effective when targets are tailored at the provincial or district level.
- *Recipients have sufficient bureaucratic capacity to learn from mistakes.* Evidence indicates that outcome-based conditionality will only be effective if recipients identify why they have failed to meet targets and adjust their policies accordingly. This is not an easy task. In many cases the required bureaucratic capacity is lacking. An evaluation of the EC's use of outcome-based conditionality observed that only half of the recipient countries used their performance reports to analyze why they had failed to meet targets. An even smaller proportion made clear conclusions about how their policies could be changed in order to improve performance. In a handful of cases, a failure to meet targets has led recipients - and in some cases donors - to revise performance targets downwards. For example, when Uganda failed to meet education targets in 2001 the government responded by lowering its targets rather than implementing policy reform. While this is defensible in cases where original targets were genuinely unrealistic, it can become a means of endorsing the status quo and avoiding serious analysis of why policies have failed and how they can be

improved. In light of these problems, existing research on outcome-based conditionality is almost universal in suggesting that donors increase capacity building projects in the area of policy analysis and development.

Evidence: Setting targets and measuring performance

Perhaps the biggest challenge that outcome-based conditionality has faced is the problem of setting targets and measuring performance against them. The fundamental idea underlying outcome-based conditionality is that of linking the disbursement of aid to progress against broader developmental objectives, such as reducing infant mortality. Yet research suggests that in many cases the indicators used to measure performance are more intermediate indicators, such as rates of vaccination. These indicators are often chosen because they are easier to measure or because data on them is readily available. Their use is problematic because they can push recipients quite strongly towards certain policies, undermining local ownership of policy-making. They can also encourage a focus on quantitative measures (the number of schools built) rather than outcomes (literacy rates). Research has noted a number of instances in which data on indicators closer to outcomes was available but was not used.

Evaluations of existing projects also highlight the issue of who is responsible for measuring performance. There has often been a tendency to outsource this, with donors requiring external audits of performance. While accountability does require an objective assessment of performance, it is important that opportunities for capacity building are not lost. In some cases, evaluations have suggested that outcome-based conditionality could be used to foster capacity building in data collection, noting that the increased focus on results that is associated with outcome-based conditionality has sometimes led national statistical agencies to become more closely involved in development projects. For example, in Burkina Faso the EC's use of outcome-based conditionality appears to have prompted closer engagement with the National Institute for Statistics and Demography.

The preliminary nature of the evidence on the effectiveness of outcome-based conditionality is a barrier to wide-scale implementation of this new aid modality. Yet it also means that there is an opportunity for CIDA to make a significant contribution through carefully designed and evaluated pilot projects. CIDA is also in a position to take advantage of existing evidence about the potential and problems associated with outcome-based conditionality. Section 5, below, notes a number of ways in which CIDA could draw on this existing evidence to design effective pilot projects.

5 Recommendations

(i) Realizing the benefits of untying aid

In order to more effectively realize the benefits of untying aid, this paper recommends that CIDA **take steps to reduce the de-facto barriers to non-Canadian firms and NGOs' involvement in CIDA funded projects.** In particular, CIDA should improve the accessibility of information regarding projects open for tender or proposals by these organizations. There are some relatively simple first steps that could be taken. CIDA should update its website to include a page which clearly identifies how non-Canadian organizations can apply for funding from CIDA and/or propose their goods and services for use by CIDA. CIDA should also evaluate the extent to which it could make greater use of the MERX and OECD DAC Untied Official Development Assistance websites to advertise untied tender opportunities. Given the relatively high percentage of aid which CIDA has formally untied, a surprisingly small number of CIDA projects are currently listed on these websites.

CIDA should also **improve its ability to detect and monitor de-facto barriers that negate the formal untying of aid.** At present, there is little publicly available information that could be used to identify sectors or countries in which local goods and service providers are under-utilized in CIDA projects or programs. One relatively simple way of increasing transparency and tracking abilities in this area would be to amend the publicly available *Project Data Set* to include a new field which indicates the nature of the executing agency or partner. This could be done using the categories and coding guidelines set out in the International Aid Transparency Initiative's (IATI) data standard, to which CIDA became a signatory to the IATI in November 2011. This standard classifies implementing actors into a number of categories, including local NGOs, national NGOs, international NGOs, public sector and multilateral organizations. In addition to increasing CIDA's ability to identify whether untying aid increases the involvement of local actors in CIDA projects, such a change would support CIDA's broader commitment to increasing the transparency of aid.

To manage the potential conflict between CIDA's commitment to untying aid and the CSR Strategy this policy paper recommends that CIDA **ensure that its policy on Corporate Social Responsibility (CSR), currently under development, include clear guidance on the extent to which CIDA's support of CSR projects will be open to participation by non-Canadian firms and non-governmental organizations (NGOs).** This may require CIDA to more explicitly address how the Partnerships with Canadians Branch (through which CIDA's CSR projects are being funded) will be affected by Canada's commitment to untying aid. While funding to national NGOs is not conventionally identified as tied, it remains a grey area. Given the stated goals of the CSR Strategy, this creates substantial scope for misperceptions regarding CIDA's goals and a consequent negative impact on trust and local ownership. To the extent that non-Canadian firms and NGOs are excluded from participation in CSR projects, it should be recognized that this has the potential to undermine some of the objectives with Canada's commitment to untying aid aims to achieve. CIDA may be able to minimize this negative effect by:

- Including requirements to promote the use of local goods and services providers in funding agreements for projects funded under the CSR strategy and/or prioritizing projects which have a clear plan for facilitating the use of local goods and service providers. Rather than imposing a strict quota for local procurement, CIDA should emphasize the need to structure projects in a way that minimizes the barriers to participation faced by local firms and organizations. This

could include steps such as breaking tender opportunities into several components, so as to encourage tenders from local businesses. Such an approach would be in line with the policies adopted by other leading donor agencies, including DFID.

- Ensuring that CIDA's support for CSR is clearly situated by reference to its primary themes, particularly the promotion of sustainable economic growth. In doing so, CIDA may be able to draw on the experiences of other aid agencies which have already adopted policies on CSR. For example, the Swedish International Development Agency (SIDA), has developed a set of guidelines for its support of CSR²³ and has recently commissioned a review of how it could become more involved in CSR projects in the future.²⁴ SIDA's guidelines make it clear that it seeks to promote CSR primarily for developmental reasons, with the expectation that CSR will to improve the competitiveness of *local* (rather than Swedish) businesses.

(ii) Outcome-based conditionality

While wholesale adoption of outcome-based conditionality would be both inappropriate and inadvisable, existing evidence suggests that outcome-based conditionality can have a positive impact on developmental outcomes in the right circumstances. In light of this, this paper recommends that CIDA **consider using outcome-based conditionality on a 'pilot' basis**. CIDA should ensure that its use of outcome-based conditionality takes into account the experience of donors who have already experimented with outcome-based conditionality. Specifically, CIDA should design its use of outcome-based conditionality so that:

- The amount of aid linked to performance, and the timing of its disbursement, is clear.
- Financial incentives are focused. This may mean piloting outcome-based conditionality in sector-specific projects, where it has tended to be more effective, rather than general budget support. The adoption of outcome-based conditionality in the context of general budget support may be appropriate if an opportunity arises for coordinated implementation with other donors.
- Targets reflect individual country circumstances, and where relevant, sub-national (provincial or district) circumstances.
- It is supported by capacity building projects in policy analysis and development, so that recipients are able to learn from mistakes.

This paper also recommends that CIDA **explore ways to link these pilot projects to its existing projects in statistical capacity building**, including the *Strengthening National Statistical Systems in Developing Countries* project. This would allow CIDA to improve the quality and range of data available to implement outcome-based conditionality, while supporting its existing projects.

23 SIDA. *Guidelines for Sida's Support to Private Sector Development*. SIDA, 2005. www.sida.se/publications.

24 Adam Smith, "Support to 'Business For Development (B4D)': A Review of New Approaches and Donor Agency Experiences", May 2009, <http://www.sida.se/English/Partners/Sida-and-the-private-sector/Ethical-business-in-developing-countries/CSR/>.

6 Further Reading

Adam, Christopher, Gérard Chambas, Patrick Guillaumont, Sylviane Guillaumont Jeanneney, and Jan Willem Gunning. “Performance-Based Conditionality: A European Perspective.” *World Development* 32, no. 6 (2004): 1059–1070.

This paper assesses the impact of the EC's implementation of outcome-based conditionality in Madagascar, Burkina Faso, Benin and Uganda. It finds that while outcome-based conditionality contributed to an increased focus on results and policy learning, there has been insufficient time for it to have a significant impact on local ownership and accountability.

Birdsall, Nancy, William D Savedoff, Ajah Mahgoub, and Katherine Vyborny. *Cash on Delivery: A New Approach to Foreign Aid*. 2nd ed. Washington D.C.: Center for Global Development, 2011.

This book proposes a form of outcome-based conditionality termed 'Cash on Delivery Aid' and demonstrates how it could be applied to the primary education sector.

Clay, Ed, Matthew Geddes, and Luisa Natali. *Untying Aid: Is It Working?* Copenhagen: Danish Institute for International Studies, December 2009. <http://www.odi.org.uk/resources/>.

This report assesses progress towards untying aid and evaluates the impact of untied aid. The authors point to tensions between the formal untying of aid and the actual practice of aid delivery. They conclude that the challenge is no longer the formal untying of aid, but the removal of de-facto tying practices which limit the impact of formally untying aid.

Haan, Arjan de, and Max Everest-Phillips. “Can New Aid Modalities Handle Politics?” In *Foreign Aid for Development: Issues, Challenges, and the New Agenda*, edited by George Mavrotas, 197–221. Oxford: Oxford University Press, 2010.

This book chapter summarizes the expected benefits of outcome-based conditionality. It also identifies the political obstacles to its use. These include a lack of trust in the capacity and will of recipient governments and inertia in aid agency practice.

Koerberle, Stefan, Jan Walliser, and Zoran Stavreski, eds. *Budget Support as More Effective Aid? Recent Experiences and Emerging Lessons*. Washington D.C.: World Bank Publications, 2006.

In Chapter 4, the Directorate General for Development of the EC provides a detailed explanation of how its outcome-based conditionality works. It identifies some of the problems that have been encountered in practice, in particular the need for sufficient bureaucratic capacity on the part of recipients to learn from mistakes.

Temple, Jonathan R.W. “Chapter 67 - Aid and Conditionality.” In *Handbook of Development Economics*, 5:4415–4523. New York: Elsevier, 2010.

This chapter provides a comprehensive review of the academic literature on development aid, including the literature on aid effectiveness. The author observes that much of the academic literature on aid relies on cross-country statistical evidence, limiting its utility to policy makers. The chapter also explains how approaches to conditionality have evolved in response to empirical evidence that has cast doubt on their effectiveness.

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