

privatesector

Aid Agency Competition

A Century of Entry, but No Exit

Critics of the aid industry have accused it of acting like a cartel (Easterly 2002). The accusation has some bite—globally the industry remains somewhat concentrated, and for the typical recipient country, highly concentrated. Yet the most striking fact about the industry is how relentlessly competitive pressures are building. There has been a constant stream of new entrants, a steady fall in global and local concentration, and a clear tendency for donors to break out of historical patterns of aid and compete with one another. Could greater competition improve the efficiency of the aid system?

The postwar wave of modern aid agencies included the U.S. Agency for International Development (USAID), some export credit agencies, and the Bretton Woods institutions, all in response to the world's needs after World War II (figure 1).

The second wave, arriving between 1955 and 1980, had a different character. True, the World Bank agencies established—the International Development Association (IDA) and the International Finance Corporation (IFC)—were apparently a response to previously unmet needs. But many of the other agencies seemed to appear because there was money to spare rather than in response to a change in the world's needs. The new agencies included Japan's huge Overseas Economic Cooperation Fund (OECF), the regional development banks in booming Europe and Asia, and several agencies funded by oil windfalls.

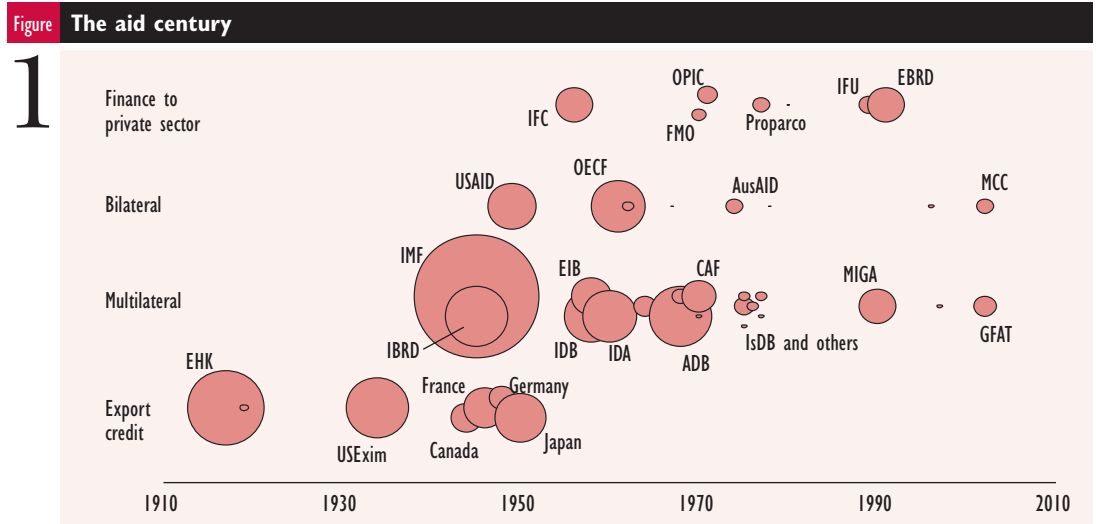
Entry to the market is continuing as new agencies find new business models—or new recipient countries, in the case of the European Bank for Reconstruction and Development (EBRD). EBRD serves private sector clients, as do its large contemporary, the Multilateral Investment Guarantee Agency (MIGA), and France's Proparco and Denmark's Investment Fund for Central and Eastern Europe (IFU). Recently two new agencies—the Global Fund to Fight AIDS, Tuberculosis, and Malaria (GFAT) and the Millennium Challenge Corporation (MCC)—started operations. They are expected to expand quickly in the next two or three years. In addition, emerging economies such as China and Slovenia have moved to set up aid agencies. The prospects for continued innovation and new entry seem good. Despite this, there has been very little exit. All the agencies created since 1945 still exist.

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This Note is part of a series exploring trends in the aid industry, including patterns of aid flows, competition, and the effectiveness of different types of aid.





Note: Agencies are shown in year of creation, with the area of the circles proportional to their most recent annual aid commitments in U.S. dollars. ADB is Asian Development Bank; CAF, Corporación Andina de Fomento; EHK, Euler Hermes Kreditversicherungs; EIB, European Investment Bank; FMO, Netherlands Development Finance Company; IDB, Inter-American Development Bank; IMF, International Monetary Fund; and OPIC, Overseas Private Investment Corporation. "IsDB and others" includes the Islamic Development Bank, the OPEC Fund, and the Arab Monetary Fund. For others, please see the text. Some organizations with annual commitments less than US\$1.75 million are not labeled. Source: OECD Development Assistance Committee; authors' compilation.

How much has competition increased?

Even when studying a profit-making private industry it is not easy to measure the intensity of competition. But it is possible to track concentration, the measure of how much market share is in the hands of a few large players. Concentration is not perfectly correlated with a lack of competition but is highly suggestive of it.

Industrial economists measure concentration using the Herfindahl index, which ranges from 0 (perfect competition) to 1 (monopoly).¹ Under U.S. competition policy a Federal Trade Commission (FTC) investigation would regard an index of more than 0.18 as meaning “highly concentrated”—not proof of an uncompetitive industry but certainly reason to be suspicious.

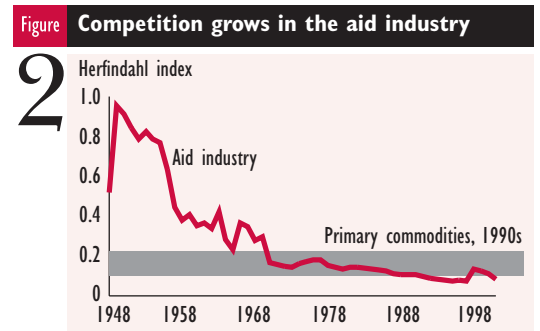
Had the FTC been asked to investigate the international aid industry in the 1950s, it would have discovered an index of more than 0.5 (figure 2). At the time the aid industry was dominated by U.S. postwar aid flows. Now it has a Herfindahl index of around 0.1—“mildly concentrated” by FTC standards.

For comparison, figure 2 shows the range of concentration of primary commodities in the 1990s as estimated by Verleger (1993), with each producing country treated as a single entity. The range is from 0.208 (rubber) to 0.085 (oil). Over the years the aid industry has moved from well above this range to near the bottom of it.

Competition between bilateral donors

Competition may take place between aid agencies but also between donor countries. The inherent competitiveness of the aid industry seems to be increasing on both levels, because besides establishing new agencies without closing down old ones, donor countries seem to be moving in on one another’s “turf.”

That bilateral donations show geographical patterns and historical persistence is well known. For example, France and the United Kingdom send aid to former colonies; Australia concentrates on Asia, Oceania, and the Pacific islands; and Japan’s major beneficiaries are large East Asian economies. One effect of such patterns is to limit competition. Just as cartels always seek ways to divide up the market in a stable fashion, donors might stick to historical part-



Source: OECD Development Assistance Committee; authors' calculations; Verleger 1993.

ners if they were attempting to suppress competition in the aid industry.

Yet the historical patterns are changing faster than in the past. Donors' lists of favorite recipients changed more in the 1990s than in the 1980s. For the major donors that make up the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD), only 5 new entrants made it to the list of the top 15 recipients in 1982–92, but 7 new entrants did in 1992–2002 (figure 3). The more rapidly shifting patterns of aid do not support the contention that aid is increasingly cartelized.

Donors are also spreading their aid more thinly across the world. For nearly three-quarters of donors (14 of the 19 DAC members for which data were available) the share of aid flowing to the region that received the most declined between 1982 and 2002. Thus the market is less segmented, allowing more opportunity for competition.

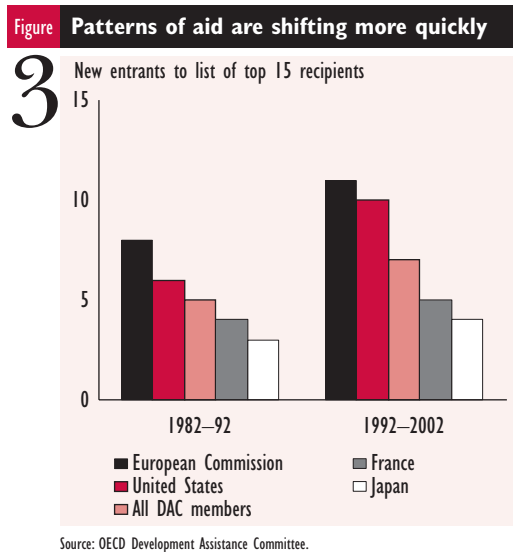
The corollary from the point of view of recipient countries is that they receive aid from more donors. The World Bank (2004, p. 172) recently published an index of donor fragmentation for recipient countries, which rose from an average of 56 in 1975 to 67 in 2002. But while fragmentation at the country level is rising, it is still quite low. An index of 56 would be produced by three donors alone, one providing 60 percent of aid flows and the other two 20 percent each. An index of 67 would be produced by three equal donors.

Impact on the World Bank Group

Multilateral aid agencies² have been winning market share from bilateral and export credit agencies for the past three decades, but the World Bank Group has been losing market share since the mid-1980s (figure 4). The International Bank for Reconstruction and Development (IBRD) was smaller in 2002 than in any year since 1985, even before adjusting for inflation.

Consequences and responses

In well-functioning markets an increase in competition is almost always good news for customers and bad news for incumbents. Almost

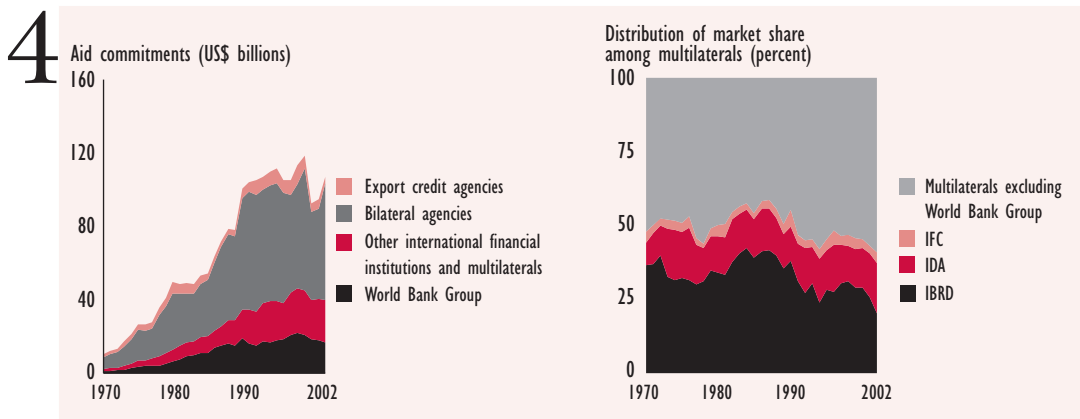


everyone has abandoned the once widespread belief that competition is wasteful and that a centrally planned economy would do much better. We now realize that any “waste” generated by the competitive process is dwarfed by its ability to push firms to innovate, cut costs, and respond to customer demand.

But the aid system is at best a quasi-market. It is not always clear who the customers are. Thus for the aid industry it is not so ridiculous to say that competition is wasteful and should be managed. For example, Stephen Knack and Aminur Rahman (2004), constructing a model in which competing donors poach the best local government staff to run projects, find that donor fragmentation is associated with lower-quality bureaucracies in recipient countries.

The aid industry has attempted to limit these costs by calling for more cooperation. Such calls have become more prevalent as competition has increased.³ But can this response be sustained in the face of continued entry? Most cartels—whether predatory or altruistic—attract entry and are not resilient when it happens.

An alternative strategy is to embrace the increasing competitiveness of the aid “market” and use it to make the market work better. There is no reason that the agencies that set priorities and donate money need to be the agencies that use the money to deliver services. Should aid agencies “make aid” or simply “buy aid?” Since competition would probably be

Figure Multilaterals grow in importance, but the World Bank Group shrinks

Source: OECD Development Assistance Committee.

much more productive between service delivery organizations than between donor organizations, this split has some attractions. There are several ways in which it might happen:

- Effective outsourcing of aid to “execution agencies” would need to be based on better monitoring and benchmarking of agencies’ performance. Donors would be able to achieve desired results more effectively if they knew which agencies deserved their money.
- Existing agencies could be split up to make such outsourcing easier. The Commonwealth Development Corporation in the United Kingdom was split into an agency that gives money and a government-owned limited liability company that delivers services. It is quite possible to conceive of a market for corporate control emerging between service delivery agencies, and for-profit companies freely entering the business.
- Going further, poor people could be given aid vouchers so they could purchase services directly, an idea floated by William Easterly (2002). Of course, both the economic and the political obstacles to this proposal are formidable.

The competitive pressures faced by aid agencies can be exaggerated, but they are real and growing. It is therefore worth exploring ways to turn this trend to the advantage of the poor. In the short term the most promising way to do so is to improve the monitoring and benchmarking of aid agencies, enabling donors to channel

funds through the agencies that produce the best results.

Notes

1. The Herfindahl index is the sum of the squares of the market shares of industry players.
2. Including the World Bank Group, the United Nations, the regional development banks, and the European Commission.
3. One way to get a sense of this trend is to survey the titles of papers presented to the Bank-Fund Development Committee since its founding in 1974. No titles mentioned *partnership*, *joint programs*, or *harmonization* before 1985, but 14 have since then, 10 of them in the past five years.

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