

## Measuring Official Development Assistance. Why and how to change

Matthieu BOUSSICHAS

Patrick GUILLAUMONT

➔ Matthieu Boussichas, PhD In Economics, is Programme Manager for Ferdi since 2012.

➔ PATRICK GUILLAUMONT is President of the Ferdi. He is also Professor Emeritus at the University of Auvergne, member of CERDI (Centre d'études et de recherches sur le développement international) that he founded in 1976, and director of the Revue d'économie du développement.

The concept of official development assistance (ODA), used for forty-five years, has been criticised for just as long, and increasingly so (see in particular Severino & Ray, 2011). At the High Level Meeting of the Development Assistance Committee (DAC) in December 2012, the OECD publicly opened the debate. A new measure of development aid is to be proposed by the DAC at the High Level Meeting of December 2014.



.../... The concept of ODA has undergone few changes since its inception and has been maintained despite the growing chorus of criticism. Used both politically, to assess the share of national income that developed countries spend on development assistance, and scientifically, in econometric research into aid effectiveness, a clear factor in the continued use of ODA is its widespread adoption. In particular, the adoption in 1971 of an international ODA target of 0.7% of developed countries' GNI, renewed on numerous occasions since – a target with a dubious basis but considered untouchable nonetheless – ensures the concept's survival, while at the same time necessitating its reform (see background in Guillaumont, 2009). To change the ODA concept radically would mean changing the target (which does not depend on the same decision-making circle).

The official measure of ODA has attracted two types of criticism, which centre on two questions. Do the financial terms of a flow justify it being considered «aid»? Does a flow's purpose justify it being considered development aid? The first question involves determining whether or not to include some «concessional» loans along with grants and, if so, how. The second concerns the range of activities for which flows qualify as ODA. A third question, rather than criticism, has recently been raised in connection with the other two: should all the flows that can qualify as development aid be recorded, whatever the recipient's level of development?

The first question is linked to criticism of the current practice which sees loans with a «grant element» of over 25% recorded together with grants. The grant element, which is supposed to represent the share of a grant that loans contain, is defined using a benchmark discount rate of 10%. This rate has remained untouched from the start despite wide fluctuations in market rates, and is unique regardless of the cost at which aid providers borrow, or at which aid recipients can borrow.

The second question covers as many subjects as there are activities funded by so-called development flows. Should these include, for example, school fees, hosting refugees and certain administrative expenditures, which are currently included, and certain security-related spending, which is not?

The third question – which countries are eligible to receive ODA – means determining whether only flows to those countries should be recorded as ODA. This question is linked to the geographical allocation of flows that qualify as ODA. Must these flows be reserved for a certain category of developing countries, such as those with a per capita income below a given level, or the countries classified as least developed countries?

In view of improving the concept of aid, the answers to all these questions differ depending on whether we are trying to measure developed countries' effort to support the development of other countries, or what countries receive for their development under more favourable terms than the market would provide. Effort can itself be understood in several ways. This difference in perspective, apparent since the aid concept was first discussed (see, for example, Guillaumont, 1968), suggests that at least two concepts are needed, one to measure official «effort», the other to measure «support» from the same source. The treatment of flows through multilateral aid agencies, which benefit from the efforts of developed countries and at the same time provide support of a different level to developing countries, reinforces this view.

## 1. How should loans be valued? An ambiguous concessionality

This question addresses two other issues, which are partially linked. In what form should loans be valorised next to grants? If a discount rate is used, what should it be?

### Cash flow, budgetary cost or grant equivalent?

A loan is currently considered aid (in the somewhat inelegant jargon, it is said to be «Dachable») if its grant element, as determined at the time it is committed to, is over 25%. Nonetheless, it is disbursements and not commitments that are recorded in the valuation of both aid efforts of developed countries or inflows to developing countries<sup>1</sup>; these disbursements include grants and loans with a grant element of over 25%. According to the current measure, or «cash flow» method, ODA is measured «net», i.e., the total amount disbursed in a given period less repayments during the same period.

Two alternatives are being considered to measure aid effort, both of which avoid classifying loans based on the arbitrary threshold of a 25% grant element. One is to valorise the loan for only as much as its grant element, as determined when the loan is extended. The other, which no longer requires the use of a discount rate, is to record the loan at the level of its budgetary cost. Beyond their technical aspects, both these solutions, just like current practice, reflect different views on what we are trying to measure.

The current practice measures the volume of net official flows to countries under favourable financial terms, that is, the aid inflow they receive year after year, matters for their conduct of policy. Rather than a measure of “aid effort”, the current practice tends to measure an «aid

inflow.» But used as a measure of effort, due to the arbitrary grant element threshold, it leads donor countries to adapt the portfolio of their interventions to fit the threshold rather than to ensure the most appropriate financial conditions for each operation.

The budgetary cost (budget appropriations included in the finance act for grants and loan subsidies), instead faithfully reflects donor countries’ current (or ex post) official effort, unaffected by any threshold or choice of discount rate. Loans are only counted for the interest subsidies they entail. These are recorded when they happen, i.e., at the time the loans are disbursed (and not upon commitment), unless the amount needed for future subsidies is paid into a dedicated account and immediately recorded as aid<sup>2</sup>. This is a simple, easy to understand solution that can be taken on board by public opinion.

The alternative of recording the value of the grant element contained in loans – their «grant equivalent» – reflects an expected (or ex ante) effort, as the cost for the lending countries will be felt only when the loan is disbursed and interests are paid. But this of course means choosing a relevant discount rate, which raises several problems.

### Discount rate. For whom? And when?

The choice of a grant equivalent measure, just like the grant element threshold for a loan to be considered aid, entails using a discount rate. This rate is currently fixed and unique, regardless of who is lending and borrowing. Let’s suppose the use of such a rate is retained. Should it remain fixed? Should it be uniform?

2. See Cohen, Guillaumont-Jeanneney, & Jacquet, 2006. Pierre Jacquet (see speech and discussion at <http://davidroodman.com/blog/2014/02/06/undue-credit-are-france-germany-and-japan-subverting-the-definition-of-aid-with-pricey-loans/>) would like to see the budgetary cost recorded in all countries when a national aid-specific fund receives the disbursement, but the question of the measure of aid can be separated from the management of aid funds by each country through a dedicated fund, which incidentally has the advantage of allowing the best combination of aid resources in grants, subsidies, guarantees, etc.

1. There is often a lag between the year of commitment and the year of disbursement.

While it has not always been so, the discount rate (set from the beginning at 10%) is now overvalued in light of the borrowing conditions of the major donor countries, what artificially inflates the grant element and the grant equivalent, as well as the current measure of ODA, to a variable extent over time.

There are several conceivable options. If one wants to keep a fixed and uniform rate, it is of course possible to maintain the current rate of 10%. This is obviously debatable, but ensures a clear continuity with previous statistics. Another proposed solution is to use a rate of 5%, more consistent with the current level of OECD countries' treasury bills and with the rate adopted by the IMF and the World Bank in October 2013 to assess the concessionality of loans to low-income countries. But if interest rates rise in the future, this rate may in turn become unsuitable and lead to most loans being excluded from aid figures. If the principle of a single rate is maintained, then it must be a rate that varies from year to year based on average market conditions and global inflation. If the rates fluctuate, this may cause instability in the measure of aid, which could be mitigated by defining the rate using a multi-year rolling average.

An alternative preferred by some DAC experts is to differentiate the benchmark discount rate according either to lenders or to borrowers or, better yet for some experts, according to both at once.

Adopting a different rate for each donor country, as the OECD already does to assess the concessionality of tied aid using a Differentiated Discount Rate (DDR), aims to reflect the opportunity cost of money for the lending country. This option is problematic on two counts. First, for a loan under given financial terms, the poorer the lender's rating, the higher its aid is considered to be. For the same loan, and therefore the same type of flow, a donor whose economic policy has earned it easy access to financial markets sees a lower loan effort recorded than a donor whose market access reflects a more lax

economic policy. In other words, the lax developed country receives a premium in the valuation of its ODA<sup>3</sup>. Second, while this measure may reflect an effort, it bears no relation to the value of the flows received by the developing country. Yet the value of a loan in terms of development aid chiefly depends on the type of flows obtained by the receiving country. Differentiating the discount rate by donor means that two strictly identical loans, granted by two different countries, are recorded differently, whereas for a given recipient country they should be counted in the same way.

Conversely, differentiating rates by recipient country would make it possible to factor in the advantage gained by each borrower in view of its own terms of market access. It may seem logical to take these terms into account in determining the extent to which an official flow represents aid for the country. However, from the lender's point of view, the justification is quite different. Differentiation is supposed to reflect the borrower's default risk (consequently, in combination with differentiation based on the cost of borrowing for the lending country, is it called «risk-adjusted», as opposed to differentiation based solely on the cost of borrowing to the lender, called «risk free»)<sup>4</sup>. Furthermore, adjustment according to the financial position of the borrowing country has the advantage of

3. This differentiation, originally introduced in the OECD Arrangement on Export Credits to avoid a distortion of competition, draws on a specific rationale. As the differentiated rates are substantially lower than the discount rate of 10% used to calculate the grant element of loans, it has been used in parallel to restrict the inclusion of tied loans in the measure of ODA. Yet it may seem paradoxical to calculate the grant element based on discount rates that rise along with the rate at which the lending country borrows on the market. It reflects a political tolerance of tying the aid based on the lender's position, whereas what is important for the measure of tied aid is the level of price premiums resulting from the tie, which is likely to be higher the more difficult the lending country's balance of payments situation. Moreover, tied aid is now limited to non-LDCs. In short, the consensus on the use of a differentiated discount rate under the Arrangement on Export Credits cannot be interpreted (as does Roodman, 2014) as a consensus for its widespread adoption in the measure of aid.

4. A corollary to this solution is that it would become pointless to add to the measure of aid any decrease in annual repayments which may occur later on in the event of ODA debt cancellation (in fact, current rates are poor predictors of long-term default risk).

being applicable to loans and credits from both bilateral and multilateral agencies.

While this option is more defensible than differentiation by lender, is not without its drawbacks. When reassessing aid depending on the borrowing country's level of access to capital markets, adjustment, if it is involved in measuring an aid effort, may encourage lenders to lend more to riskier countries, since they can record «more aid» with the same resource<sup>5</sup>. Another argument is to add to the debate: the riskiest countries are also countries where the cost of preparing projects is higher, and differentiation would be a way to make the allocation of development loans between countries neutral from the donors' perspective. In fact there is no obvious relationship (country by country) between the country's debt risk and the cost of preparing projects that are carried out there<sup>6</sup>.

Ultimately, if differentiation by borrower encourages more to be lent to the riskiest countries, this is sometimes presented as an advantage since it would result in more aid going to countries that need it most. However, while these countries need more aid, it is not necessarily needed in the form of loans. Yet adjustment simultaneously results in artificially inflating the share of aid flows to these countries, giving the illusion of an allocation in their favour. More generally, this option amounts to partially addressing two problems at once: how aid is measured and how well it is allocated geographically, what is known as selectivity. It may be legitimate to weight the measure of aid by its selectivity<sup>7</sup>, but the size of financial difficulties cannot be the only criterion for selectivity (the choice of which is another issue). In short, the

measure of aid should remain independent of its geographical allocation, so that both factors can be assessed transparently.

Finally, it is clear that measuring aid in loan form using its grant equivalent inevitably gives rise to a problem of consistency. The grant equivalent is calculated for commitments using the discount rate at the time, but it is recorded as aid when the disbursements corresponding to this commitment are made, over a period extending beyond the year of commitment. «Differentiated» lender or borrower rates are changing and will probably cease to be relevant for measuring the lenders' current efforts, or the current benefits for borrowers<sup>8</sup>. This is the same problem as that encountered above: are we seeking to measure aid flow ex ante or ex post, which applies as much to effort (intentional or actual) as to support (expected or actual)? While the DAC countries, through the grant element, seem more interested in intentions, recipient countries appear more concerned with actual inflows.

As for the option of combining both differentiations of the discount rate, according to lenders and according to borrowers, it is certainly appealing in that it is able to include in the measure of aid commitments an assessment of both the relative effort of lenders and the relative advantage for borrowers. But seen as an exclusive measure of ODA flows, it combines the aforementioned disadvantages of both forms of differentiation, and adds an unavoidable arbitrariness in the technical choice of how the differentiations are combined. Ultimately, basing the measure of ODA disbursements on a discount rate matrix where each borrower-lender pair has a different rate (approximately 4000 rates!), and will probably become no longer relevant, risks making the measure of aid seem complicated, always questionable and of little use in political debate. Let us not forget that the aim of reforming the measure of official devel-

5. This is true even if lenders submit to the IMF debt management framework, which incidentally is not implemented in all borrowing countries, or respected by all lenders.

6. If it is considered important to take account of this cost in the discount rate, an acceptable differentiation would be in favour of a group of countries where the costs of project preparation are higher, for example LDCs. However, this option would have the disadvantage of introducing a threshold effect to the valuation of loans.

7. As is the case in the Center for Global Development's Commitment to Development Index

8. The same criticism certainly applies to the measure of concessional loan disbursements defined on the basis of a discount rate set at the time of commitment.



opment assistance is to enhance its credibility and transparency.

### Two or more concepts rather than one?

In short, it makes little sense to use the same concept or indicator to measure two different things, on the one hand the official aid effort that developed countries provide in a given year, and on the other the official aid inflows that developing countries actually receive that year.

The simplest and most transparent measure of the year's actual effort is no doubt the budgetary cost of the grants and interest subsidies extended that year. Of course, it is also conceivable to record the sum of grants and the grant equivalent of loans, which is more a measure of anticipated effort and applies better to commitments than to disbursements. In the case of a grant equivalent measure, the discount rate required for this purpose should be regularly reviewed according to the borrowing conditions of donor countries. The rate must be the same for all donors, as two loans with identical characteristics should be recorded in the same way regardless of the lender. One solution would be to set an annual discount rate commensurate with average market access conditions for developed countries. In order to take into account the risk to lenders of their development assistance in loan form, a risk premium would be added to the above rate.

The discount rate would not be differentiated by donor, but only and possibly by borrower. The only conceivable differentiation would be for LDCs alone, on the basis that these countries, because of their specific structural handicaps, require more work in preparing operations (rather than the fact that they involve a higher risk)<sup>9</sup>.

9. Another solution would be to develop a separate measure of risk associated with each loan transaction to distinguish each loan based on risk, so that each donor can communicate on the risk it is taking for the borrower in lieu of the market. This could be done by calculating a «risk equivalent» that would account for the monetary gain derived by the borrower thanks to the

When measuring the official development support received by developing countries in a given year – an important concept both for their policy management and for aid effectiveness analysis – it is the inflows that enter the country over the year that must be considered, either the official «concessional» disbursements (grants and concessional loans) net of amortization, or the total official flows measured as a net transfer, i.e. minus both amortization and interest payments. If the focus is on net concessional inflows, as is currently the case, the clearest method is to identify them using a single, moving discount rate corresponding to the average market access conditions for developing countries and a threshold which, for the sake of continuity, would remain at 25%.

However, if in a spirit of compromise a single summary measure was sought, or another, more forward-looking or ex ante measure, based on the sum of grants and the grant equivalent of loans, it would be better to use only a single moving rate corresponding to the average market access conditions for developing countries, rather than on access conditions for developed countries. This, so as to include in the rate the average additional cost of lending to these countries, whether because of the risk they represent or the specific costs of preparing the loans. To take the spirit of compromise even further, if differentiated rates were sought according to recipient countries, care should be taken to avoid using multiple country categories, which would create multiple threshold effects and would obscure the meaning of the aid measure.

These two (or three) measures should naturally be complemented by the measure of total official finance (concessional or non-concessional) aiming at sustainable development, as well as by a measure of private finance of various types. It then becomes a question of the eligibility of flows according to their purpose.

lender's concessional transaction. As such, the lender could communicate on the cost it accepts in lieu of the market and distinguish the risk effort made between a loan to a safe country and a loan to a risky country.

## 2. What should aid include? Contents of variable legitimacy

Some spending recorded as ODA is regularly criticized for its ambiguous contribution to development, while other major expenditures are currently neglected. For each of these, two questions are raised: should they be counted? and if so, how?

The answer to both questions depends in part on whether the aim is to measure effort or support flows. Here again, we cannot avoid distinguishing between the donor perspective (what corresponds to an «effort») and the recipient perspective (what constitutes actual inflows received for development). The answer also depends on how countries' contributions to global public goods (GPG) are measured. A clear measure of these flows, the purpose of which sometimes overlaps with that of ODA, should enable a stricter measure of aid. This measure could also be accompanied by a target, which would be added to and combined with the ODA target to cover ODA and global public goods.

### **Circumscribing expenditure that represents an «effort» for development without necessarily resulting into inflows to developing countries**

The ODA components most criticized for their dubious contribution to eligible countries' development are essentially those spent in the donor country: refugee assistance, school fees and administrative costs. While there is a debate on each of these types of spending (see Roodman, 2014 and Severino & Ray, 2011), it should be possible to find a consensus for evaluating a country's effort. In short, when these expenditures have a real cost for the donor and are intended for development, they can be incorporated into a measure of its effort. However, if they do not correspond to a transfer to recipient countries, they cannot be considered an inflow.

Let us look briefly at the various expenditures. Currently, the cost of hosting refugees is counted for their first year, and the arbitrary one-year cut-off point satisfies no one. Some stakeholders justifiably argue that refugee support is not development aid, while others are equally justified in wanting to count the entire period that the person has refugee status (it is a contribution to international mobility). Tuition fees for students from poor countries, who have no obligation to return to their countries, may seem far removed from ODA, but if higher education is not free and grants are awarded to those students to cover these costs, it makes sense to include them in school fees. Including administrative expenses in the measure of aid appears incongruous to some, as they finance the bureaucracy of rich countries, while others believe they represent a contribution by donor countries to the quality of operations financed by aid. Why not retain a fixed share of total aid, supposed to represent a "normal" contribution to the preparation of operations?

### **Specifically treating some key development and GPG spending that has so far been neglected in or excluded from ODA**

Two categories of expenditure that are currently neglected in aid measures should be better addressed in terms of their contribution to development: risk coverage instruments and spending in support of peacekeeping.

Coverage of a risk by specific instruments – such as government guarantees from a donor country on a private loan to a developing country – is an important and innovative contribution to the development of the recipient country. It entails an «effort» on the part of the donor in that the donor assumes a potentially costly risk. In a measure of donor effort, it could be assessed as the monetary valuation of the risk assumed by the organizations providing the guarantees, based on their exposure and

the probability of default – in short, by the provisions established for this purpose. Is risk coverage a real contribution to countries' development? It facilitates the granting of a loan, and as such is beneficial to recipient countries. Should all the extra funds obtained or just the provision be counted as aid flows for the recipient? What is not counted as «aid» must in any case be recorded in the «other official flows or state supported flows for development» category.

More controversial is expenditure for peacekeeping. A country's security is increasingly recognized as an essential condition for development. Some expenditures of this type are currently included in ODA<sup>10</sup>; their scope could be extended, particularly to expenditure to support the training of armed forces for national defence. Recording peacekeeping operations themselves as development aid is obviously more strongly disputed, whatever justification could be given in a broad development sense. The sheer magnitude of the sums involved could change the scale and nature of the object being measured. In order not to distort the object, but to take into account the development contribution of a country intervening unambiguously with the aim of restoring the peace in a partner country, which may be the case in operations conducted under a UN mandate, the corresponding expenditure, if it is not included in the aid concept, could be included in an expanded concept of official efforts for development and GPGs and, on the side of the recipient countries, in an expanded concept of official flows received for development.

### **Beyond development assistance, measuring contributions to global public goods**

10. Currently, only the following security spending is recorded as ODA: supervision of elections; rehabilitation assistance to demobilised soldiers; rehabilitation of basic national infrastructure; monitoring or retraining of civil administrators and police forces; reform of security systems and other activities related to the rule of law; training in customs and border control procedures; training in fiscal or macroeconomic stabilization policy; repatriation and demobilization of armed factions, and disposal of their weapons; and explosive mine removal.

The above example shows that a dividing line between what is and is not recordable as aid lies between expenditure to fight poverty and expenditure on global public goods (besides peace and security, these include the preservation of the environment, and the response to climate change). Given the close proximity between these two types of expenditure, spending for global public goods should be accounted for just like aid spending is, with the same rules applied to the treatment of grants and loans, both for measuring the effort of financing countries and for measuring the inflows to receiving countries; the cursor that separates ODA and GPGs would relate exclusively to the purpose of the expenditure. The targets for aid and GPGs would then need to be jointly defined. The uncertainty of the split between ODA and finance for the response to climate change is particularly obvious for aid aimed at adaptation, but is also apparent in some mitigation projects in poor countries.

## **3. Measuring aid and its targets**

The revision of the aid concept raises the question of its relevance to the aid targets set by the international community. This question itself has several aspects.

### **Who is eligible?**

The first aspect concerns the fit between the type of flows and the nature of the beneficiaries. The uneven progression of developing countries has called the list of eligible countries into question. A review of the list would be coherent, but is politically-charged. It would be better to focus on defining commitments to countries with the greatest need for aid.



## **0.7% for ever?**

The target of 0.7% ODA/GNI has often been criticised for its lack of scientific basis, and even of utility. The fact that it has been around for so long is both its main strength and its main weakness. It would be logical, even legitimate to review this target if the measure of aid was itself significantly modified. However, abandoning it raises serious political difficulties given how strongly it symbolises a general commitment by developed countries to financing development.

## **Complementary targets: GPGs and priority to LDCs**

As it will inevitably be maintained, the 0.7% target should be supplemented with other targets in the future development agenda. One should cover combined ODA and funding for global public goods in developing countries, particularly in the area of climate change.

Another target should be designed to emphasize the priority that must be given to LDCs for aid allocation. It is doubtful, for reasons mentioned above, that the best way to indicate this priority would be to measure aid to LDCs differently by applying a specific discount rate to calculate the grant element. As already envisaged, supplementing the current target of 0.15%-0.2% for LDCs with a commitment to award half of ODA to LDCs has a good symbolic value. But the symbol has another side to it, which reveals the limited credibility left to the targets of 0.7% and 0.15-0.2%: if total ODA falls below 0.3%, adhering to the principle of half of ODA for LDCs will not enable the 0.15% target to be reached. If we accept the 0.7% target and the principle of one half at least for the LDCs, ODA for LDCs would need to increase to 0.35%. International donors should guarantee a floor of highly concessional finance to the most vulnerable countries, through formal and credible commitments. Reserving a share of ODA for the least developed countries will be an innovative solution to the

extent that donors are still committed to a total volume of ODA for developing countries such as the 0.7% of ODA/GNI.

## **Who decides?**

Behind the question of the fit between the aid measurements and aid targets appears a problem of global governance. The 0.7% and 0.15-0.2% targets, even if they apply only to developed countries, have been formulated, established and repeated in the context of the United Nations, on a worldwide scale. The measure of aid is currently discussed mainly in the DAC of the OECD, the rich countries' club. It seems difficult that a new measure of aid could be adopted by the CAD without being endorsed within the broader UN framework, which alone can judge the consistency of the concept with the objectives of the international community.

The OECD chiefly focuses on an aid concept which enables the measurement and comparison of the aid efforts of its members, and it is legitimate in doing so. Developing countries, along with the UN, are concerned with measurement of the inflows they receive, which is also a legitimate concern. The aid target, established by the international community, even if it is set as a percentage of rich countries' income, seems to be a target for inflows to poor countries, rather than effort to be provided by rich countries. Again, the need for two measures seems clear.

## Références

- **Cohen, D., Guillaumont-Jeanneney, S., & Jacquet, P.** (2006). « La France et l'aide publique au développement », Conseil d'analyse économique - La Documentation française.
- **Guillaumont, P.** (1968). « L'aide internationale au développement : note sur trois concepts principaux », *Revue économique*, pp. 974-1003.
- **Guillaumont, P.** (2009). « Faut-il abandonner l'objectif du 0,7% ? », *L'ENA hors les murs* - n°388, pp. 34-36.
- **OECD** (2014). « Options for modernising the ODA measure », DCD/DAC(2014)3.
- **Roodman, D.** (2014). « Strengthening the Measuring Stick: A 14-Point Plan for Reforming the Definition of Official Development Assistance (ODA) », CGD Policy Paper 044.
- **Severino, J.-M., & Ray, O.** (2011). « La fin de l'aide publique au développement : mort et renaissance d'une politique publique globale », *Revue d'économie du développement*, Vol. 25, pp. 5-44.





Créée en 2003, la **Fondation pour les études et recherches sur le développement international** vise à favoriser la compréhension du développement économique international et des politiques qui l'influencent.



### **Contact**

[www.ferdi.fr](http://www.ferdi.fr)

contact@ferdi.fr

+33 (0)4 73 17 75 30

