How to spend it

Smart procurement for more effective aid

An updated summary of the report published on September 2011

Summary

Procurement is a keystone in development finance. Eurodad estimates that US$ 69 billion of aid money is spent on procuring goods and services annually either by donors or by recipient countries, more than 50% of total Official Development Assistance (ODA). Procurement practices are, therefore, key to ensure that aid delivers the best development results. More than ten years after initial agreements to untie aid, two thirds of contracts awarded by bilateral donors still go to firms from Organisation for Economic Cooperation and Development (OECD) countries.

Aid untying is essential for smart procurement as well as the use of country systems, which increases ownership and domestic accountability, and improves the chances for local firms to win contracts. Much more can and must be done to fully exploit the potential of targeted and well-regulated procurement, which can yield a double dividend for poverty eradication and sustainable development.

Key figures about aid and procurement:

- **Public procurement accounts for 14.5% of GNI for developing countries.**
- **US$ 69 billion of aid is used for procurement each year.**
- **Tied aid increases cost of supplies by 15% to 40%.**
- **Two thirds of contracts awarded by bilateral donors still go to firms from the North.**
- **More than half of World Bank-funded contracts in the case study countries went to foreign firms.**

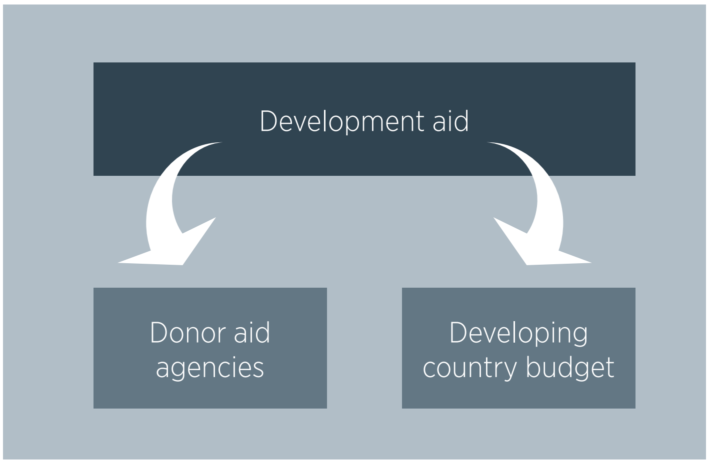
Introduction

In the last decade, the international community has made important efforts to increase the quantity and quality of development aid. Official Development Assistance has increased from US$ 54 billion in 2000 to US$ 133.5 billion in 2011, although it is still far from the United Nations target of 0.7% of donors' Gross National Income (GNI).

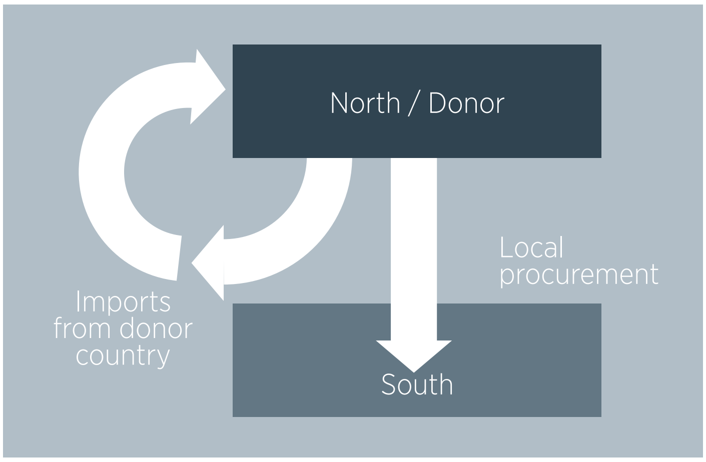
The Paris Declaration (2005) and the Accra Agenda for Action (2008) laid out the main commitments to ensure aid effectiveness, which include developing countries' ownership of development strategies and the use of recipient countries' procurement systems as the first option. These commitments were restated at the fourth High Level Forum on Aid Effectiveness held in Busan in late 2011, which also added a new commitment on improving aid transparency. However, ineffective practices by donors and recipient countries continue to constrain the full potential of aid to deliver development outcomes and to enable poor countries to become independent from aid in the long run.

Smart procurement is a key part of the success, since public procurement practices determine which private firms, from which countries receive aid-funded contracts, in turn determining who reaps the benefit of the creation of decent jobs, income opportunities and productive capacities. According to the OECD, public procurement accounts for 20% of GNI for OECD countries and 14.5% for developing countries. Additionally, Eurodad calculations suggest that US$ 69 billion annually, more than 50% of total official development assistance, is spent on procuring

How aid is channelled



Boomerang aid vs. sustainable aid transfer



goods and services for development projects from external providers.

Based on examining six country case studies: Bangladesh, Bolivia, Ghana, Namibia, Nicaragua and Uganda and a literature review on procurement, this report provides a comprehensive assessment of the procurement policies and practices of both aid agencies and developing countries' governments, the developmental impact of ongoing procurement reforms, and how smart procurement could make aid a more effective instrument to drive sustainable development.

Boomerang aid: Much aid never reaches developing countries

Aid yields a double dividend when it funds not just development projects but is spent 'on locally produced goods and services. Injecting aid monies into developing countries' economies builds productive capacities, and creates jobs and income opportunities that the local population can use to lift themselves out of poverty.

Tying aid to the condition that all purchases are made from firms from donor countries is the least effective form of procurement. It turns aid into boomerang aid, that is, a financial flow only channelled to developing countries on the books, which in fact never reach them.

Thus, tied aid deprives developing countries from unleashing the full potential of aid as a driver for long-term sustainable development, and also undermines the recipient country's ownership of the development process, which is the cornerstone of the development effectiveness agenda. Furthermore, tied aid decreases value for money. As OECD Development Assistance Committee (DAC) research shows development projects funded with tied aid are 15% to 40% more expensive.

Agreements to untie aid have been instrumental in dramatically increasing the share of untied aid from 51% to 79% of bilateral ODA to all developing countries between 1999 and 2001 and between 2007 and 2009. But despite progress, at least 17% of all bilateral aid was still tied aid in 2009. This average masks a much worse performance by several bilateral donors such as Greece (67% of its aid was tied in 2009), Austria (54%), Korea (50%), Portugal (39%), Italy (38%), United States (32%), Germany (27%), and Spain (25%).

Moreover, tied technical assistance is also a frequent practice for some donor countries. In 2001, when the DAC Recommendations on Untying ODA to Least Developed Countries (LDCs) were negotiated, there was a strong pressure from some DAC member states to leave technical assistance out of the agreement. In Accra, however, donors committed to promote technical cooperation using local and regional resources, including through South-South assistance. In fact, tied technical assistance is costly, all too often inefficient, and the least effective modality of development cooperation.

Indeed, donor countries continue to mislead their own citizens and developing countries, by passing off what is essentially state support to donor country firms – and consultants –, as a genuine contribution to poor countries' effective development.

Informal aid tying also matters

Donor countries also use many informal tying practices, which tilt the playing field in favour of businesses based in their countries. These practices include:

- procurement process handled by officers in headquarters or outsourced to specialised agencies;
- advertising all tenders in a language different than the local one;
- the use of different tendering procedures and guidelines;
- tendering in large lots which implies that Small and Medium Enterprises (SMEs) do not have the capacity to bid; and
- establishing restrictive conditions and eligibility criteria for pre-select bidders.

Even when open and competitive bidding is used in donors' procurement, firms from donor countries profit most from aid contracts. Research commissioned by the OECD in 2010, entitled "Untying Aid. Is it working?" shows that in reality the majority of formally untied aid contracts from bilateral agencies also go to donor country firms. Two thirds are awarded to firms from OECD countries, and 60% to firms from the donor country that funds the project.

This report assessed the distribution of World Bank funded contracts to local and foreign beneficiaries. The results differ dramatically across the case study countries. In Nicaragua 72% of contract value went to local firms while in Uganda this share was as little as 18%. On average, half of the contract value in World Bank funded projects went to foreign firms, and the share increases with the size of a contract.

At the same time, firms in industrialised and emerging economies are significant beneficiaries of a large share of World Bank loans. In 2008, 67% of the World Bankfinanced contract amounts went to firms from just ten countries: Argentina, China, France, Germany, India, Indonesia, Italy, Russia, Turkey and the United Kingdom. This is a consequence of World Bank procurement practices that consider international competitive bidding as best practice. This has a practical effect of increasing the likelihood for the most competitive firms from higher-income countries to win contracts – to the detriment of SMEs from the borrower countries who – ironically – bear the responsibility to generate profits and tax income from their investments to be able to repay the loans.

Procurement through country systems: are donors honouring their commitments?

Using developing country procurement systems could do away with many of the controversial practices currently used by donors. This is why donors agreed in Accra in 2008 to "use country systems as the first option for aid programmes in support of activities managed by the public sector."

However, donors are lagging behind in the implementation of their own commitment. Official figures suggest that no progress was made between 2005 and 2007. Eurodad research shows that only Bangladesh and

Nicaragua saw significant increases, while in Uganda the use of country systems is actually decreasing.

This research shows also that there is no correlation between the donors' use of country systems and the World Bank Country Policy and Institutional Assessment, which measures, among other aspects, the quality of public financial systems. A mixture of economic interests, accountability concerns and desire for greater public recognition by donors could be telling reasons behind the lack of progress.

Country procurement systems: Strengthened by whom and for what?

Procurement policies and practices are politically sensitive as they shape the spending of developing country public budgets and taxpayers' money. For this reason, government procurement is a contested agenda item in trade negotiations, with rich countries pushing for opening up the government procurement markets in the South for their corporations.

If ownership is crucial to making aid more effective, so is defining the policies that influence how taxpayers' money is spent in poorer countries. It is key that developing governments and not foreign actors take the lead in designing procurement reforms and engage a broad range of stakeholders to shape up policies.

Using country systems:

- improves the likelihood that local business will profit from aid;
- gives the developing country more of a say on how the aid is used; and
- reduces transaction costs by doing away with the donors' numerous parallel implementation units.

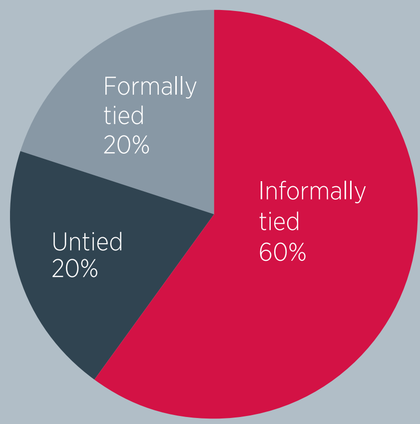
Informal vs. Formal tied aid

60%

of donor aid is informally tied to using donor firms

20%

of donor aid is formally tied to using donor firms



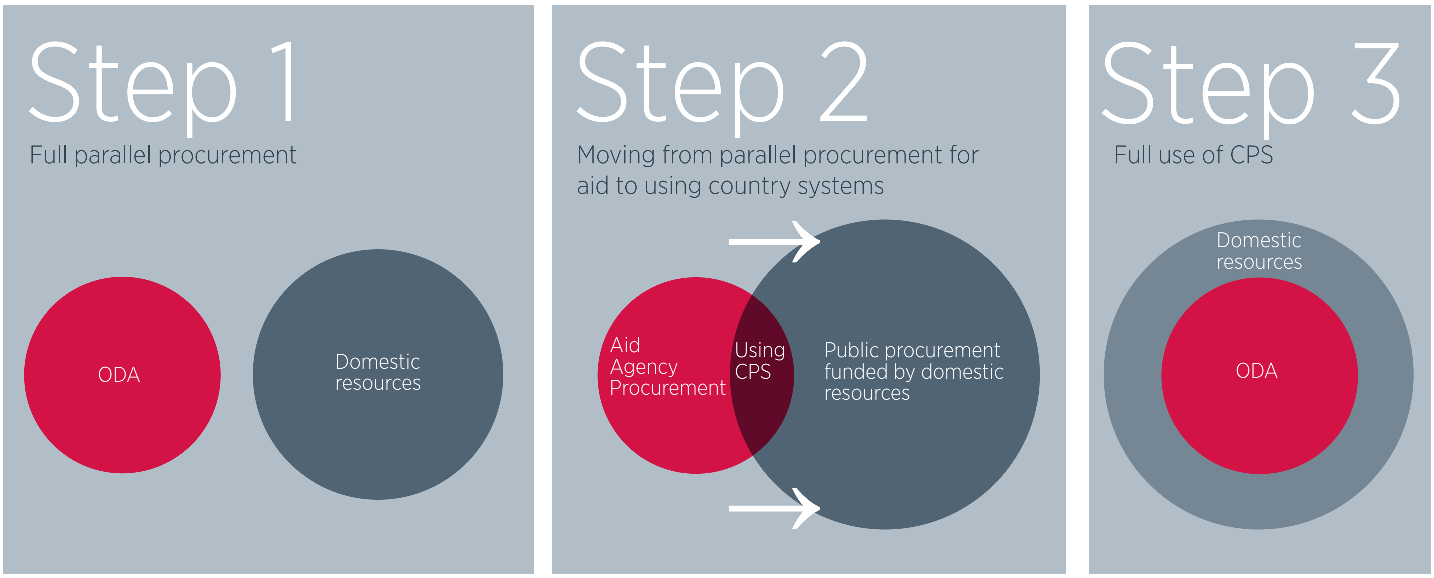
Procurement reforms are donor-led

Evidence from case study countries shows that donors, particularly the World Bank and other Multilateral Development Banks (MDBs), continue to exert a strong influence on procurement policy reform in developing countries by:

- **Attaching policy conditions to their aid and loans.** Procurement policy reforms advocated by the World Bank and other MDBs have all too often pushed for increased liberalisation of procurement systems.
- **Providing donor-driven technical assistance.** This results in procurement systems aligned with "international best practices" as defined by the World Bank and other donors, rather than to the needs of individual developing countries.
- **Conducting diagnostic reviews of procurement systems.** The diagnostic tools have been developed primarily by the World Bank, with some influence from other MDBs and bilateral donors. In practice, they are instruments to influence policy reform in developing countries in softer ways.
- **Using trade negotiations to constrain developing countries' policy space** to decide their own development strategies. Although developing countries have refused to sign the World Trade Organisation (WTO) Government Procurement Agreement, regional and bilateral agreements, such as the Dominican Republic-Central America-United States Free Trade Agreement (CAFTA-DR), increasingly play a role.

Despite promises made, reforms conducted did not necessarily result in more effective procurement systems. The case study in Uganda found that many reforms resulted in highly bureaucratic requirements and time-consuming and burdensome procurement processes. The poverty, social and environmental impacts of procurement have largely been forgotten in the reform process so far.

Using country procurement systems (CPS)



Smart procurement can make the difference

Donors and recipient countries can make the most of aid by spending every euro twice: when aid is spent on local supplies and employment for development projects, it can have enormous multiplier and leverage effects. There are at least three key ways in which procurement can be conducted to benefit the poor and other marginalized groups:

- **Pro-poor procurement** can increase the share of public spending that goes to the poor and help develop their capacities. It can promote the use of labour-intensive supplies and methods and create jobs for the poorest in society. Such practices have been mainly tested in the infrastructure and agricultural sector, namely, the World Food Program's Purchase for Progress (P4P) and the Home-Grown School Feeding (HGSF) Programs.
- **Promoting decent work, social inclusion and environmental sustainability.** Government and aid agencies can require contractors to comply with labour and environmental standards. They can also use procurement to benefit marginalised groups including women. The US-American Living Wage Law and the Black Economic Empowerment policies in post-Apartheid States such as South Africa and Namibia provide good example of this approach.
- **Driving private sector development, innovation and inclusive growth.** A long-term and predictable commitment to purchase from governments and donors can boost investment in productive capacities. Most common targeted procurement practices are:
  - granting price preferences to local bidders,
  - setting aside a share of contracts in particular for SMEs, and
  - debarring firms involved in fraud or corruption cases, and firms registered in tax havens or involved in human rights violations.

  Promoting SME development is usual practice in most developed countries, including the EU, and targeted procurement practices should also be applied in developing countries.

Recommendations

Recommendations for bilateral and multilateral donors:

Untie all aid to all countries.

End informal aid tying.

Use country procurement systems as the default option.

Support developing country efforts to strengthen procurement systems.

Give preferences to local and regional procurement.

Move towards smart procurement.

Integrate Public Procurement into the EU's Policy Coherence for Development Framework.

Include sustainable public procurement practices in the modernisation of the EU and the review of the World Bank procurement policies.

Recommendations to developing country governments:

Make procurement policies and practices smart.

Make country procurement systems work.

Make procurement policies and practices democratic.

Make the procurement process transparent and accountable.

Say no to tied aid and to tied technical assistance.

The full report is available at: http://eurodad.org/4639/

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Contact

Eurodad
Rue d'Edimbourg
18-26
1050 Brussels
Belgium

Tel: +32 (0) 2 894 4640
Fax: +32 (0) 2 791 98 09

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