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Strategic Aid Financing

Donor countries often face a Samaritan's dilemma when trying to implement political conditionality in bilateral aid. Giving through multinational organizations can mitigate this problem: Recipient nations are de-facto competing for funds, which restores their incentives to comply even with non-enforceable conditions. Donor nations might therefore find it useful to set up multinational aid funds, rather than to disseminate aid bilaterally, even if they have to give up control over where the money is spent.

In the last decade, global challenges like climate change or the fight against epidemics have become the focus of aid projects. In order to make progress on these large-scale issues, donor nations increasingly recognize that simply giving money to a developing region does not ensure success. Instead, the impact of aid spending depends crucially on efforts undertaken in the partner countries. Reforms of the local economic and judicial system, fighting corruption and general good governance are just a few of the demands on donor countries' wish lists.

However, many of the conditions set by donating governments are hard to enforce, especially since they nowadays often fall in the category of "political conditionality," aiming at broader political improvements rather than simple, measurable economic indicators (see for example Molenaers et.al., 2015). The crucial question for aid giving countries therefore remains how to strategically structure aid, so that recipient governments can be incentivized to cooperate also on intangible or non-enforceable conditions.

The Samaritan's Dilemma

Indeed, the theoretical literature on aid conditionality finds that optimal contracts should be self-enforcing, i.e. the threat of aid sanctions should be large enough to ensure that the recipient government has an interest in fulfilling the conditions (see for example Scholl, 2009). That, however, might be easier said than done: Svensson (2000) argues that the threat of cutting aid in case conditions are violated is hard to credibly sustain, at least for individual donor countries. They often face political constraints to spend a certain amount of money on aid. This opens the possibility for a classic hold-up problem: If the donor country cannot commit to giving aid only conditional on reform efforts, the recipient country, knowing it will receive assistance in any case, has no incentive to implement costly reforms. From the donor's perspective, this is also known as the Samaritan's dilemma.

Multinational Funds Can Help

Svensson goes on to argue that transferring the responsibility of allocating aid to a multilateral organization might solve the Samaritan's dilemma outlined above. He notes that if donors are lacking a commitment technology (that helps them to actually implement aid sanctions in case a recipient government shirks on the agreed aid conditions), "delegation of part of the aid budget to an (international) agency with less aversion to poverty will improve welfare of the poor." Such organizations will have less of a commitment problem and should therefore better be able to enforce aid conditionality.

Competition Restores Incentives

There is, however, no a priori reason to think that multilateral organizations have a different objective than individual donor countries in terms of eliminating poverty and achieving growth and prosperity for developing countries. After all, these organizations' founding principles are set by the donor countries that fund them. An international organization's objective, as represented by how it actually allocates funds across causes and recipient countries, should reflect an aggregation of the individual preferences of donor nations.

In a new study, Simon and Valasek (2016) argue that precisely this stage of preference aggregation enables multilateral organizations to better implement aid conditionality. How non-earmarked funds given to multilateral organizations are allocated is determined in a bargaining process between representatives of the different donating nations. Individual preferences might differ; the bargaining outcome thus has to reflect a compromise between them. The bargaining position of each donor will in part depend on intrinsic values, but importantly also on the reform efforts and willingness to cooperate of the potential recipient nations. Intuitively, the better the government of an aid receiving country behaves, the better the bargaining position of donor countries lobbying on its behalf.

This constitutes a new strategic reason for pooling resources in large aid funds rather than implementing aid bilaterally: When resources are pooled, recipient nations have to compete for their share of aid. It is precisely the heterogeneity of donor country preferences that induces (or enhances) such competition. Bilateral aid relations thus cannot replicate the effect to the same extend. This competition restores incentives to invest in costly reforms and circumvents the hold-up problem.

Conclusion

Donor nations should consider pooling their resources in multinational funds when they fear that their partner governments are reluctant to implement political reforms. This is especially relevant for aid aimed at common global issues like climate change or disease control.

Simon and Valasek show that the payoff from joining an aid fund is especially high when donor nations represented in the fund have relatively homogenous goals for their foreign aid programs, but differ in terms of where in the world they would like to send their aid money. Then the disadvantage from losing the direct say over which recipient nations get the most funds is far outweighed by the gain from inducing investment and reform incentives in the aid receiving nations.

References

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