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Company interests and foreign aid policy: Playing donors off against one another

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Abstract

The evidence on conditionality indicates that this instrument sometimes works, and sometimes does not work. We suggest that third parties to the donor–recipient relationship influence the aid disbursement. The halt in aid that should follow non-compliance could trigger the recipient to cancel contracts with companies from donor countries, which creates incentives for the companies to put pressure towards aid disbursement. We use a multi-agent triadic model of the relationships between a recipient and two donors and two companies to illustrate that recipients may act strategically to make third parties (like companies and others) influence the disbursement decision. Failing to take account of third parties' role yields the opposite result; conditionality becomes successful.

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1. Introduction

"... as the representative of the World Bank on the ground, I came under pressure from several sources, some of them quite surprising, to release the tranche [loan] with

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minimal attention to conditionality. There was a steady stream of private sector representatives, domestic and foreign, arguing for the release of the tranche ... because some of them had specific contracts with the government which were unlikely to be paid on time if the government did not get the money from the World Bank and other donors. Next in line, were the bilateral donors—even those who had tied themselves to the presumably greater discipline of the World Bank by co-financing. Some of these had "fiscal year" concerns—they feared the consequences within their agencies of not releasing the funds in the fiscal year for which they were slated." (Kanbur, 2000)

Can third parties like companies, other donors, private banks, or for example NGOs play a role when donors make their aid disbursement decision, and can recipients of foreign assistance make use of such a link? Ravi Kanbur's (2000) experience from Ghana, where the loan tranche was in fact released, indicates that the pressure towards disbursement created by companies and other donors may be decisive. Even so, the literature on foreign aid has ignored these forces, and formal modeling of aid conditionality has almost been absent (Drazen, 2000).[1] We develop a model where companies are used to illustrate that third parties with a relationship to both the donors and the recipients can have an important impact on the success or failure of conditionality.

Even though conditionality is viewed as a necessary instrument for the donor community to achieve the goals of aid (Summers and Pritchett, 1993; Kanbur, 2000), several authors claim that conditionality is a failure. An overview of this line of thinking can be found in some of the papers presented at the World Bank ABCDE 2000 Washington conference, where Collier (2000) argues that conditionality as a general proposition is dysfunctional, and Gunning (2000) states that "There is overwhelming evidence that such conditionality does not work". However, the most important source of the assertion that conditionality is a failure seems to be Burnside and Dollar (1997).[2] They find that aid does not induce good policy environments to emerge on average, which is contrary to what one would expect if all aid was given conditioned on good policy and if conditionality usually worked.[3] So while the World Bank and others spent the 1980s and most of the 1990s trying to show that conditionality always worked, it now seems like the debate has gone to the other extreme where one argues that it never works.

A main challenge of evaluating conditionality is that it depends on the counterfactual. The problem is to reveal ex post whether the reforms would have

[1]See Svensson (2000) for a principal–agent model that illustrates how altruistic donors end up in the Samaritan's dilemma because the recipient has no incentives to implement conditions to reduce poverty when the amount of aid is determined by the level of poverty. Mosley et al. (1995) model the relationship between the donor and recipient as a bargaining game and find that there will always be some slippage on the conditions even if the recipient has agreed to their implementation in the first round.

[2]See for example Collier (1997) or Kanbur (2000).

[3]The result that donors are unable (on average) to affect the implementation of a reform in a recipient country is supported by Dollar and Svensson (2000). In an empirical study of 220 Word Bank reform programs supported by conditionality lending, they find that there is no correlation between donor behavior and the probability of successful reform.