Handout 13: Conflicts of interest in the aid relationship

Prof O'Connell / Ec 81, Economic Development / Spring 2018

The figure below analyzes the **aid relationship** between a donor government and a recipient government. It shows how **conflicts of interest** alter the **gains from aid** and can motivate **conditionality**.[1]

The recipient government is assumed to get utility from both infrastructure spending and other spending, and to pay for these things using a combination of tax revenue and aid. The recipient's budget constraint is therefore $I + Other = \bar{R} + Aid$, where I is infrastructure spending, $Other$ is other forms of government spending, $\bar{R}$ is the recipient's tax revenue (which we will assume is fixed), and Aid is the aid provided by the donor. The diagram uses a set of conventional-looking indifference curves to depict the recipient's utility function, $U^R(I, Other)$, as we have done in similar cases earlier in the semester.

The figure shows the no-aid point (N), where Aid is zero and the recipient chooses its spending pattern subject to the budget constraint $I + Other = \bar{R}$. In the absence of aid, the highest utility the recipient can reach is U_0^R. Aid would make the recipient better off by shifting the budget constraint outwards in a parallel manner and allowing the recipient to choose higher levels of both infrastructure spending and other spending. The dashed ray from the origin through the no-aid point shows how the recipient would allocate any unconditional aid.[2]

What motivates aid from the donor's perspective? We will assume that the donor values infrastructure spending in the recipient economy but gets no utility at all from other forms of spending in the recipient economy. And the donor also incurs an opportunity cost of δ in terms of its own foregone domestic spending, for every dollar of aid that it provides. So the donor's utility function is $u(I) - \delta \cdot Aid$, where we assume that the function u displays diminishing marginal utility. Using the recipient's budget constraint to substitute in for Aid, we can derive the donor's utility function for infrastructure and other spending as $U^D(I, Other) = u(I) - \delta \cdot [I + Other - \bar{R}]$.

So there is a ***conflict of interest*** between the **principal** (the donor) and the **agent** (the recipient). They both care about aid outcomes, but because their preferences are distinct, the recipient may end up choosing actions that are not in the donor's interest. In particular, the recipient values $Other$ spending, but from the donor's perspective, $Other$ is a 'bad' rather than a 'good' (look at $U^D(I, Other)$ to confirm that when the recipient spends a dollar of aid on $Other$, the donor's utility falls by δ). Even infrastructure has a contingent status for the donor, because the marginal benefit of aid-financed infrastructure spending from the donor's perspective, $u'(I)$, may be smaller than the donor's marginal cost of δ. For low levels of infrastructure spending, greater aid-financed infrastructure spending makes the donor better off (because the marginal utility $u'(I)$ exceeds δ), while for sufficiently high levels of infrastructure, additional aid-financed infrastructure spending makes the donor worse off. The donor's indifference curves are therefore inverted-U shapes, with their maximum points lying along the vertical dotted line defined by the value of infrastructure that solves $u'(I) = \delta$. The donor's utility increases as you move *downwards* in the diagram.

The figure shows a case in which there are potential ***gains from aid***, but the conflict of interest is severe enough that unconditional aid will make the donor worse off than no aid at all. These properties depend on the shape of the donor's indifference curve through the no-aid point. To draw it as depicted, we have assumed that infrastructure at the no-aid point is below the value that solves $u'(I) = \delta$, and that the slope of the indifference curve at the no-aid point is flatter than a ray from the

[1] The analysis here comes from Adam, C. S. and S. A. O'Connell (1999), "Aid, Taxation and Development in Sub-Saharan Africa," *Economics and Politics* 11(3), November: 225-54

[2] This dashed locus is a straight line when the income elasticities of demand for both goods are equal to 1. This in turn holds when the utility function is *homothetic*, which we are assuming just to keep the diagram simple.

origin. Under these assumptions we have a striking outcome: despite the existence of potential gains from aid (given by any point *within the area enclosed by the two indifference curves through the no-aid point*) aid will collapse in the absence of conditionality. The donor will infer that the recipient will use aid to move outwards on the ray from the origin – which will unambiguously move the donor onto a lower indifference curve. The donor will therefore infer that in the absence of conditionality, it is better to give no aid at all to this recipient.

The heavy line shows the *contract curve*, which is the set of tangencies between donor and recipient indifference curves that leave both players at least as well off as in the no-aid situation. The contract curve gives the set of Pareto-efficient allocations. Each of these allocations requires (a) that the donor provide some aid, because the contract curve lies entirely outside the recpient's no-aid budget line; and (b) given the amount of aid, the recipient must deviate sharply from the spending pattern it would prefer.

If the donor could make take-it-or-leave-it offers and enforce conditions, it would choose the lowest point on the contract curve, where it would be supporting a major increase in infrastructure spending – in fact, a bigger increase than the aid inflow itself (draw a line through this point, parallel to the no-aid budget line, and convince yourself)! So conditionality is certainly alluring. But it is not obvious at all that this point – or any other point on the contract curve – is very realistic given the limited credibility of the donor to enforce conditions.

The conundrum illustrated here sheds light on the allure of conditional lending during the 1980s and early 1990s, the broad disillusionment with conditionality among donors starting in the mid-1990s, and a variety of innovations in aid design over the past decade or so, from greater selectivity (e.g., the MCC) to political convergence on goals (e.g., the SDG campaign), to greater measurability and accountability for results (e.g., various forms of PbR).

Pareto-Efficient Aid Contracts when the Donor and Recipient Value Outcomes Differently