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Bringin' Home the Curry and Givin' it away:

Commercial Ventures of NGOs in Bangladesh*

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Abstract

From handicraft shops to cyber cafés, more and more NGOs in developing countries are moving toward investment in revenue-generating business ventures. This paper explores the motivations behind such investments and their impact the donor-NGO relationship. First, a case study of NGOs in Bangladesh provides evidence of NGOs' commercial earnings in the country. Then, a simple theoretical model underlines three determinants of an NGO's decision to invest in business: the uncertainty of future donor funding; the lack of funds available; and the need to finance expenditures that donors do not value. Furthermore, facing uncertainty regarding their ability to renew future commitment, donors might prefer NGOs with business ventures. Finally, the analysis shows that having an independent income does not necessarily make NGOs better off.

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1. Introduction

I remember visiting a small fair trade store in France, and asking one of their dedicated volunteers if they had any local partners from Bangladesh. She showed me a few wallets made of jute, and after checking the store's records, explained that they came from a local cooperative of women producers, BRAC. Having visited BRAC a few months before, I wondered what this woman would think if she had a chance to walk in the fully air-conditioned nineteen-story building, and took the elevator up to the panoramic restaurant where business looking customers enjoy the finest Bangladeshi dishes. BRAC's 193 million dollar annual budget is an extreme example, but more and more NGOs in developing countries are moving toward investment in revenue-generating business ventures. Such strategies have often been the cause of misunderstanding, engendering controversy about NGOs' altruism and putting into question their commitment to their missions. The present paper provides a simple theoretical framework to explore the motivations behind NGOs' investments in commercial activities and the ways in which they may impact the donor-NGO relationship in an environment of uncertainty about future funding.

Related literature

There is a lively debate in some rich countries on whether humanitarian organizations have turned into businesses. This kind of remark usually bears a very pejorative connotation. Aspects like the increasing wages of organizations' managers or the use of marketing methods similar to business firms cast doubt in the public on whether humanitarian professionals remain truly committed to their social missions. Sylvie Brunel (2002) blames "the emergence of 'supply side economics' or the trend towards favoring profitable markets rather than responding to the real need of people in distress." She also points out that NGO workers themselves disagree with strategies that make their organizations look like businesses.

Such criticisms are not surprising. Indeed, NGOs are usually considered a subset of the private sector called the "third sector", to emphasize one of their major differences with private

firms, namely, their not-for-profit status. Economics papers that deal with NGOs assume what is widely acknowledged as a key characteristic of these organizations: they care about their social missions or, in other words, they are altruistic. For example, Azam and Laffont (2003) analyze foreign aid as a contract in which a rich country gives aid to a developing country in return for poverty reduction, regarded as an international public good. There, NGOs are modeled as a more altruistic type of rich agent. They argue that the aid contract must take into account the contributions of both the government and NGOs; otherwise free riding of one party on the other may occur. In addition, Azam (2003) studies the relative roles of the government and the civil society in poverty alleviation. There, the agents are assumed to be averse to poverty. Besley and Ghatak (2001) use an incomplete contracting approach to compare government and private ownership of public goods. The authors show that ownership should be given to the party that has the highest valuation for it. This improves investment incentives of both parties and yields the highest possible level of joint surplus. The paper suggests that if NGOs care more about development projects' outcomes, they should own their project. Hopkins and Scott (1999), in their contribution to the altruistic NGO approach, develop a model to explain the conditions under which NGOs dominate other types of firms. They argue that NGOs' potential superiority comes from their ability to attract altruistic workers and to develop efficient development technologies.¹ A departure from purely altruistic considerations can be found in Shatuverdi (2004) who models competing NGOs with different degrees of commitment to social welfare.

In the economics literature, Glaeser and Shleifer (1998) propose a model in which entrepreneurs may choose the non-profit status to signal that they care about producing high-quality products. In their paper, commitment to the non-profit status softens incentives to take actions that are detrimental to customers, such as cost reductions that lead to a deterioration of quality. This commitment is valuable since total quality is non verifiable and cannot be part of a contract. Moreover, the authors show that an important reason why donors prefer non-profits is that the risk

¹ In addition, Jack (2001) is another interesting paper analyzing public policies towards NGOs.

of diversion of funds is much smaller. Thus, Glaeser and Schleifer (1998) provide microeconomic foundations that rationalize the “negative stereotypes” that the nonprofit sector and its donors may have about for-profit firms.

Given the deeply-grounded cultural opposition between nonprofits and business firms, NGOs running commercial enterprises are likely to be criticized. Ahmad (2001) denounces the huge business investments undertaken by the Bangladeshi NGO, BRAC (Bangladesh Rural Advancement Committee), arguing that they are “contrary to its charitable status”. Stiles (2002) points out that some private firms in Bangladesh complain that NGOs running businesses have an unfair competitive advantage. Further skepticism can be found in Reddy (2003) in its comparative study of two South African NGOs. The author compares the efficiency of ACCORD (African Center for the Constructive Resolution of Disputes), a local NGO that has adopted commercialization, with the IBR (Institute of Black Research) which has remained non commercial. He argues that “commercialization has changed the mindset of NGOs from being guided by a social mission... to becoming a for-profit entity”.

In the United States, it is common for non-profits to generate large revenues from commercial activities. Some estimations suggest that nation-wide, such profits amount to more than US\$ 60 billion a year, which raises the question of how to tax the profits of non-profits (Strom, 2002).

The most important contributions to the subject of nonprofits’ commercialization can be found in the book « To Profit or Not to Profit » edited by Burton Weisbrod (1998). The authors (mostly economists but also two sociologists) focus on the nonprofit sector in the United States and while the context is far from that of NGOs in developing countries, the issues raised are very similar to the present paper.

Weisbrod (1998) proposes a theoretical framework wherein the main idea is to consider the nonprofit organization as a firm producing three kinds of goods:

- A preferred collective good that is difficult to sell in private markets, such as health care for the

poor;

- A preferred private good which can be sold but for which the organization has distributional concerns, i.e. an aim to make the good widely available;
- A non-preferred private good, whose only purpose is to generate revenue by selling it in private markets.

Weisbrod (1998) suggests further research to take into account uncertainty about each source of revenue. In the present paper, however, the uncertainty is only about donations while the returns from a business venture are certain. Allowing for uncertainty about commercial profits would give rise to an additional trade off.

Outline

As a precursor to the theoretical analysis, section 2 presents a case study of NGOs in Bangladesh, based on my field research in Dhaka between March and May 2004. This case study sheds light on important aspects of NGO self-financing and provides real world examples of the main intuitions derived from the theoretical framework.

Section 3 presents a two-period model of an NGO facing uncertainty about future donor funding. The NGO receives an aid flow in the first period to implement a development project for a group of beneficiaries. However, the donor's budget in the second period can be either positive or zero. Therefore, aid in the second period will only come with some probability. Without an alternative source of funds, the project will become infeasible in the event that aid is cut. To anticipate this situation, the NGO can invest in a business activity. It has a cost in terms of beneficiaries' utility in the first period since it drives energy away from project implementation. However, the profits generated will help finance the development project if the donor does not participate in period 2. A key assumption in the model is that the NGO is not allowed to spend any of the aid flow on its private consumption. It is shown that the NGO invests in business if the probability of getting aid in the future is low enough. In other words, one important reason why NGOs invest in commercial ventures is that it provides self-insurance against the uncertainty of

future donor funds. Bennett et al. (2003) provide a similar argument in the case of US nonprofits. Another related contribution is Fisman and Hubbard (2005)'s study of nonprofits in the United States, where organizations hold precautionary savings to smooth expenditure. However, the present paper is better suited to analyzing NGOs in developing countries, where donor funding applies to specific projects and NGOs face tough constraints regarding the use of the aid received. Then, assuming that aid can only be spent on the specific project for which it has been disbursed, the model shows that NGOs' needs to finance their private consumption acts as another determinant of their choice to start a business.

Furthermore, it is argued that donors often face uncertainty regarding their future ability to renew their commitments. Then, assuming that the donor still derives utility from the development project in the event that it ceases to participate, it is shown that it may prefer to hire an NGO that makes profits from an additional activity, provided the business investment is not too large.

Finally, section 4 shows that an NGO's independent income does not necessarily make it better off in all situations. Once the NGO has its own money from a business venture, the donor has to decide whether to provide aid to this NGO or to another project. Indeed, the NGO could now be functioning independently, even if it would always prefer to receive funds. Then, the donor may have an incentive to free ride either because it feels the NGO can achieve the same result on its own, or because a new partner's project is preferred.

2. NGO self-financing in Bangladesh

Uncertainty for NGOs and donors

« Bangladesh is the land of NGOs », local NGO workers like to say. Indeed, the ADAB directory of NGOs listed more than a thousand in 2004 but the actual number working in the country is above 22,000 (Ahmad, 1999). Many villages host the four major organizations, BRAC, Proshika, Grameen Bank and ASA, as well as other small organizations.

Most NGOs are dependent on donor funding for their operations. With such a high number of NGOs in the country, competition for donors' assistance is fierce and uncertainty about future aid

is a concern for all NGOs. In 1990, the government set up the NGO Affairs Bureau to regulate the NGO sector, including foreign organizations (Ahmad, 1999). Any NGO working with foreign funds has to submit the project to the NGO Bureau and receive its approval for the funds to be disbursed. Once a donor and an NGO have agreed upon assistance for a project, the latter goes to the NGO bureau with a letter of recommendation from the former, and starts filling out all the necessary documents. The delays for approval range from a couple of weeks to more than six months, and sometimes the disbursement of funds is not even allowed. The example of PRIP, an important consultant NGO based in Dhaka, shows how donors may have to withdraw their funds, not because they want to, but simply because the NGO bureau turns down the NGO's request. PRIP provides services to other NGOs including management system development, research reports and information technology services. Until 2002, the organization was 100 percent donor-funded. A new project, «Towards a just society», was supposed to start in January 2002, with the financial assistance of the Swiss Development Cooperation, the Netherlands Embassy and DANIDA (Denmark). The agreed upon budget was about \$US 4 million. However, because of the government's suspicion that PRIP was undertaking political activities, namely, supporting the opposition, the NGO was denied the disbursement of all the funds. Donors gave up since they were not able to channel the money. Although services to local NGOs were provided free of charge until 2002, since then, the organization survives by charging fees for its work. In 2004, a new project funded by the European Union was submitted to the NGO Affairs Bureau. This project called «Small initiative by local innovative NGOs» was endowed with more than 2 million Euros and is supposed to help 100 local NGOs. However, PRIP is still waiting for the NGO Bureau approval.

This example sheds light on the fact that not only NGOs but also donor agencies themselves face uncertainty of future contributions. Moreover, PRIP is not the only example of an NGO whose donor funds were blocked by the NGO Bureau. One of the four major NGOs, Proshika, was suspected of political activities and was under investigation in spring 2004.

Small and medium NGOs

The first part of this section deals with NGOs that can be said to have a normal size. I wish to make this distinction clear since the final NGO examined in this case study will be BRAC, an organization that now has a larger budget than many American nonprofits. Before moving on to this very advanced model of local NGO, it is useful to examine what small and medium NGOs do to improve their financial sustainability.

One of the most obvious ways to recover part of the cost of a program is to charge the beneficiaries for the services provided, a device known as user fees. This form of cost recovery has been widely debated in the development literature. The advantages of user fees in development programs are twofold. First, as mentioned above, they generate revenue, and second, they regulate consumer demand and help to avoid congestion. However, charging poor beneficiaries may crowd out those who cannot afford to pay.

Steinberg and Weisbrod (2005) show that nonprofits make some consumers pay less than the marginal cost, while charging other consumers above marginal cost, and preventing some people from consuming the good at any price. They argue that nonprofits have « concerns about reaching certain target populations » which make them use different pricing rules than those taking place in for-profit firms. In Bangladesh, NGOs often charge fees for the services they provide, but most of the time their distributional concerns keep these fees very low and the revenues generated usually remain small. For example, the Voluntary Association for Rural Development, a 7 year-old organization involved in programs including agriculture, education and health, has a service charge for all of its programs allowing it to cover around 15 percent of the costs, while it remains donor dependent for the rest. Organizations that focus on health care often use the kind of need-based price discrimination formalized by Steinberg and Weisbrod (2005). The Bangladesh Women's Health coalition charges user fees that include a registration card to become a beneficiary, the sale of medicines and a payment for the service provided to each patient. The organization recovers 50 percent of the costs of programs based in urban areas, serving both poor people in slums and middle

class Bangladeshis. However, in rural areas, cost recovery only amounts to 15 percent. There, the opportunities for charging a higher price to some relatively richer people are less available. Therefore, an interesting avenue for self-sustainability is to increase cost recovery in urban areas, by serving a richer class of patients who can afford higher fees, in the hope that rural beneficiaries as well as slum inhabitants may eventually be cross-subsidized. However, caution is required since increased efforts to serve a richer population may divert the organization from its social mission.

Furthermore, some NGOs use their specific expertise to generate income. Such activities are more difficult to put in Weisbrod (1998)'s classification. Indeed, depending on one's point of view, they can be seen as preferred private goods or non-preferred private goods. At the same time, they are related to the organization's mission. Such income generating activities include mission-related services to for-profit clients, the production of surveys, research reports, and the design of various materials for other organizations. The environmental NGO Prodipon offers a good example of such initiatives. Its core mission included raising awareness of poor villagers on forest management issues. It encourages forest preservation and attempts to provide appropriate livelihood options. In addition, it runs a safe water and sanitation program in urban slums. Prodipon has two kinds of profitable activities. First, it has a waste management program. Customers pay for their solid waste to be collected at their door. The materials collected are then used to make composed fertilizers which are sold. Second, the NGO works as a consultant on waste management issues for various national and international organizations. These two commercial activities are part of the NGO's environmental protection core mission and the profits are saved in a reserve fund that can be used to cover program costs when donor funding is momentarily interrupted. In April 2004, this reserve fund was worth US\$ 0.5 million, while the NGO's annual budget was US\$ 1 million.

A giant local NGO: BRAC

BRAC started in 1972 as a small relief organization to help refugees after Bangladesh's war of independence from Pakistan. Its founder, Fazle Hasan Abed, is a former company executive for Shell Oil. It has now become one of the largest NGOs in the world, with over 100,000 people on the

payroll and the BRAC center in Dhaka looks more like the headquarters of an oil company than an NGO (Phinney, 2002). The organization has three core programs: the Economic Development Program, the Education Program, and the Health, Nutrition and Population Program. It is present in more than 60,000 villages all around Bangladesh (BRAC, 2002).

BRAC is a very advanced example of the kind of NGO that has motivated this paper. The organization has adopted various activities to generate profit and as a consequence, its financial sustainability has dramatically increased over the last fifteen years. In 2003, BRAC generated 80% of its US\$ 193 million budget.

BRAC has three kinds of profit-generating activities. First, the Microfinance Program is self-reliant and generates surplus. In 2003, the net income was about 10 million US dollars (Kairy, 2004).²

Second, BRAC has “program support enterprises” (BRAC, 2002). By providing microcredit, BRAC encourages self-employment and people engage in a number of small enterprises. The aim of program support enterprises is to provide these small businesses with good quality inputs (seeds, etc.) and market opportunities.

Third, BRAC has set up various commercial ventures, some of which can be considered as development programs. This is the case of Aarong sales centers, which were created in 1978 to help rural handicraft producers to sell their products. Other commercial investments are private companies involved in different sectors. These include a BRAC internet service called BD Mail, a BRAC Bank, and two real estate companies, Delta BRAC Housing Finance Corporation, and BRAC Concord Lands Ltd. There is even a BRAC University (BRAC, 2002).

As a consequence of these numerous investments both in development projects and in business ventures, it is difficult for anybody visiting Bangladesh to pretend he or she has never heard of BRAC. Indeed, like famous commercial brands, the NGO can be seen everywhere in

² In Bangladesh, most NGOs are involved in microfinance. Stiles (2002) reports that “it has come to be seen as a means of empowering the organization” rather than the borrowers. And the higher the interest rate charged, the larger the profits.

Dhaka, at the branches of BRAC Bank, on the signboards of Concord Lands Ltd, and on people's business cards when their e-mail addresses are hosted at "bd-mail.net". It even finds its way in the average grocery bag in the form of such products as Aarong mango juice or milk (products of the dairy and food project).

If donors keep providing huge amounts of aid to BRAC even as it generates more and more profit by itself, part of the money is likely to implicitly subsidize the creation of new businesses rather than development programs for the poor. To ensure the efficiency of aid to such a rich NGO, it would be interesting to estimate what BRAC could achieve in development programs without aid. It depends on the extent of moral hazard problems inside BRAC for the use of profits from its business ventures.

However, giving money to BRAC does not mean supporting BRAC only. In addition to implementing its own programs, BRAC channels funds to smaller NGOs, especially in its famous Non Formal Primary Education Program. Therefore, for international donors, BRAC is not only an NGO that can implement a wide range of programs, it is also a kind of local donor agency that can channel money to a network of small local NGOs.

According to M. Kairy (2004), BRAC's head of finance and accounts, donor funding will be necessary in the future for the education program, because it would be difficult to keep it free for the beneficiaries otherwise and service charge would drive children from "bottom poor" families out of the schools.

Remarks

An important issue raised by the case study is the difficulty to interpret NGOs' private consumption concerns. Of course, this is related to the ethical debate presented in the introduction. One may argue that having office facilities that look like those of the most important private sector companies might damage the image of an NGO working for the poorest segments of the local population, but such initiatives aim at improving the organizations' visibility and signaling the efficiency of a business-like management. Good working facilities may also attract some highly

qualified workers who would otherwise rather work in the private business sector.

Furthermore, important NGOs like BRAC like to point out their contribution to the Bangladeshi economy. Indeed, NGOs' business ventures create jobs in the private sector, the development of which is an important issue in developing countries. Critics argue that they are in fact a source of unfair competition with non-NGO firms, because NGOs benefit from foreign funding and various tax exemptions (Stiles, 2002).

Finally, some NGO businesses also contribute to a better work environment for the private sector, by improving access to communication devices such as cell phones and the Internet, and by investing in renewable energy.

In the next two sections, a theoretical framework is presented to tackle some of the important issues highlighted by the case study.

3. The model: self-financing NGOs

There are two agents, an NGO and a donor, indexed by n and d , respectively. For the sake of simplicity, a two-period setting is used, which is enough to study the impact of uncertainty of future donor funding on the NGO's behavior.

The NGO problem: to profit or not to profit?

The NGO would like to start a development project using a donor's financial assistance. The project consists of choosing the level of service provision to the beneficiaries in each period, which we denote by q_1 and q_2 . Their utility at each period i is then given by the increasing and concave function $v(q_i)$, with $v'(0) > 1$ and $\lim_{q_i \rightarrow \infty} v(q_i) = 0$. Degenbol-Martinussen and Endberg-Pedersen (2003) argue that the project is the most common form of aid because it allows financing well-defined activities and targeting populations. Indeed, it is then easier to show that money and effort are spent on sectors that politicians, taxpayers, and individual contributors at home care about. For this reason, the financing of a specific project is the focus of the model.

The NGO receives a level a_1 of aid to implement the project in the first period. However, at

the time the agreement is signed, the agents know the size of the second-period aid flow, a_2 , but it will only occur with some probability λ . Indeed, the project aid form has a “clear time perspective” (Degnbol-Martinussen and Endberg-Pedersen, 2003). NGOs usually get their projects funded for one or a few years and do not know whether or not donors will renew the partnerships. In addition, donors’ future priorities and budgets are subject to their countries’ changing context, including foreign aid and politics for government agencies such as CIDA (Canadian International Development Agency), or people’s willingness to make donations for private donor foundations.

In the first period, in addition to its core mission, the NGO can invest in a business activity. This activity is simply the production of a quantity b of a good or service and it yields certain profits Rb at period 2. The present model focuses on a discrete choice of the NGO between $b > 0$ and $b = 0$.

However, the NGO’s business investment decreases the beneficiaries’ utility by ωb , where $\omega > 0$. This non-monetary cost means that the NGO does a better job if it focuses on the development project. The business venture drives effort away from the NGO’s core activity, and it seems reasonable to assume that the larger the business, the higher the loss of focus.³ In addition, this cost is assumed to be only incurred at period 1.

ω could be interpreted either as the rationing of some poor beneficiaries or as the loss due to the distraction from the NGO’s core mission.⁴ Then, the general interpretation of an NGO’s business venture is an activity that causes current negative utility but generates future income. Of course, one could argue that in some cases, going commercial may hurt the NGO for a long time. For example, some experienced NGO staff could disagree with their organization’s new strategy. Although NGOs have become more and more professional for efficiency reasons, the idea workers have of their NGO’s corporate culture is important. Besley and Gathak (2003) point out that

³ Of course, it is a rather simplistic way to capture this idea. The allocation of effort between different tasks can be studied in a multi-task principal-agent model as in Holmstrom-Milgrom (1991), but it is not the aim of this paper.

⁴ However, the latter interpretation seems more convincing in the present paper, since the cost disappears in the second period, following the assumption that the NGO has had time to learn how to manage both development and business activities efficiently. User fees, on the other hand, are likely to be charged in the second period as well, thereby still excluding the poorest beneficiaries.

matching principals' and agents' mission preferences increases efficiency in organizations such as private non-profits. The present paper does not address organizational issues and simply assumes that by the time business becomes profitable, the NGO will have solved them and will be running at no cost in terms of efficiency in the development project.

The NGO chooses the level of service for the beneficiaries and its private consumption at each period. Private consumption can have different interpretations but it is assumed that neither the donor nor the beneficiaries derive any utility from it. For example, the money can be used to increase the employees' wages, or it can be invested to reach new beneficiaries elsewhere. The profits can also be saved in a reserve fund which will be useful in bad times. In addition, they can be used to start new business ventures to become more independent of donors.

The NGO's expected utility is assumed additively separable and is simply given by

$$u_n = c_1 + v(q_1) - \omega b + \beta_n [\lambda (c_2^g + v(q_2^g)) + (1 - \lambda)(c_2^b + v(q_2^b))] \quad (1)$$

where q_2^g and q_2^b are the levels of service provision at period 2 when the NGO gets a_2 (i.e. in the good state of nature) and when it does not (bad state of nature), respectively; c_1, c_2^g and c_2^b are the associated levels of private consumption; β_n is the relative importance the NGO gives to period 2.

Note that for simplicity, it is assumed that at each period, the NGO's utility is quasilinear in its private consumption and concave in the service produced for the poor. This means that the model does not allow for income effects. Of course, introducing income effects would just make the NGO more willing to invest in business, since it generates income which can be used to improve both private consumption and consumption of the poor. However, here, a donor agency provides funds for the project, and the present model aims to emphasize what the NGO can do with business profits that the donor does not allow it to do (enjoying private consumption which can have various interpretations such as topping up a low aid flow, and above all, self-insurance in the event that donor assistance becomes unavailable.)

The NGO chooses q_1 , q_2^g , q_2^b , c_1 , c_2^g and c_2^b to maximize its expected utility subject to the following budget constraints:

$$c_1 + q_1 = a_1 \quad (2)$$

$$c_2^g + q_2^g = a_2 + Rb \text{ (good state of nature)} \quad (3)$$

$$c_2^b + q_2^b = Rb \text{ (bad state of nature)} \quad (4)$$

In addition, the NGO has to abide by the following constraints imposed by the donor:

$$q_1 \geq a_1 \quad (5)$$

$$q_2^g \geq a_2 \quad (6)$$

This simply means that the NGO is not allowed to spend aid on private consumption. Note that $c_1 + q_1 = a_1$ and $q_1 \geq a_1$ imply $q_1 = a_1$.

Note that it is implicitly assumed that the NGO is not allowed to transfer part of the first period aid flow to the second period. Indeed, such transfers are not observed in practice primarily because donors have to monitor how their money is being used, and they may not allow NGOs to save part of the money to use it once they are not partners anymore.

To investigate whether the NGO invests in business or not, both cases will be examined and compared. Note that when $b=0$, q_2^b and c_2^b are equal to zero, meaning that if it chooses not to generate its own revenue through business, the NGO shuts down at period 2 in the event that no aid is disbursed. In other words, for the NGO, a business venture is an investment in financial self-sustainability.

Although the present paper argues that uncertainty about future donor funding is a major determinant of an NGO's decision to invest in a commercial venture, this is not the only factor. First, the NGO may simply want to top up the agreed-upon donor contribution. Second, here, unlike in Weisbrod (1998), the assumption that a nonprofit's unrelated commercial venture is a « non-preferred » good is relaxed. Indeed, not only does it generate a current utility loss and a future

income, but also a potential future utility gain through *private consumption* of some or possibly all profits. Therefore, the case without uncertainty will be analyzed in a first step, and it will be shown that the NGO might invest in business even when future donor funding is provided with probability one. Then, the case with uncertainty will be examined.

The case with no uncertainty: $\lambda = 1$

The following exercise brings out two motives for an NGO to start a business: future private consumption and insufficient donor funding.

Proposition 1:

- i) If $a_2 > q = v'^{-1}(1)$, the NGO invests in business if $\beta_n R \geq \omega$.
- ii) If $a_2 < q$, the investment in business takes place if

$$\beta_n R \geq \omega - \beta_n \frac{[v(q) - q] - [v(a_2) - a_2]}{b} \quad (7)$$

Proof:

First, if the NGO has no business venture, its expected utility is simply given by

$$v(a_1) + \beta_n v(a_2) \quad (8)$$

However, if the NGO invests in business, it maximizes the following objective function

$$v(a_1) - \omega b + \beta_n (c_2^g + v(q_2^g)) \quad (9)$$

$$\text{s.t. } c_2^g + q_2^g = a_2 + Rb \text{ and } q_2^g \geq a_2$$

The first order condition is given by

$$v'(q_2^g) \leq 1 \text{ with equality if } a_2 < q_2^g. \quad (10)$$

Let $v'^{-1}(1) = q$. This may be interpreted as the NGO's preferred second-period project size.

The constraint imposed by the donor, $q_2^g \geq a_2$, makes the results depend on the size of a_2 .

Therefore, two cases must be considered: $a_2 > q$ (part i of proposition 1) and $a_2 < q$ (part ii).

- i) First, if $a_2 > q$, $q_2^g = a_2$ and $c_2^g = Rb$. In this case, the NGO's expected utility is

$$v(a_1) - \omega b + \beta_n(Rb + v(a_2)) \quad (11)$$

Therefore, the NGO invests in business if

$$v(a_1) - \omega b + \beta_n(Rb + v(a_2)) \geq v(a_1) + \beta_n v(a_2) \quad (12)$$

that is, if

$$\beta_n R \geq \omega \quad (13)$$

ii) Now, if $a_2 < q$, $q_2^g = q$ and $c_2^g = Rb + a_2 - q$. In this case, private consumption is lower since the NGO spends part of its business profits to supplement the donor's low contribution. The NGO's utility is then

$$v(a_1) - \omega b + \beta_n(Rb + a_2 - q + v(q)) \quad (14)$$

This yields a different condition under which the NGO invests in business:

$$v(a_1) - \omega b + \beta_n(Rb + a_2 - q + v(q)) \geq v(a_1) + \beta_n v(a_2) \quad (15)$$

which can be rearranged as

$$\beta_n R \geq \omega - \beta_n \frac{[v(q) - q] - [v(a_2) - a_2]}{b} \quad (16)$$

Since the function $v(x) - x$ is increasing in x for $x \leq v'^{-1}(1) = q$, and given that $a_2 < q$, the second term on the right hand side of this inequality is positive.

Part i) of proposition 1 says that when a_2 is high, the NGO spends it on the project and privately consumes all its business profits. In this case, the NGO invests in business whenever the second-period benefit in terms of private consumption outweighs the first-period cost on beneficiaries' utility. This is a pure private consumption motive. Of course, the NGO's private consumption in the model can have various real world interpretations. It may be higher wages for the managers, a nicer head office, or a new commercial venture whose profits do not contribute to financing development programs. For example, the biggest Bangladeshi NGO, BRAC, owns an impressive nineteen-story building with air-conditioning everywhere. They also run a four-star hotel

with conference facilities and a panoramic restaurant. BRAC's reports of income and expenditures are very detailed and transparent, and this lucrative business is not reported to contribute to development programs. By contrast, the Grameen Bank building only has air-conditioning in the conference room and in the managing directors' offices. ASA (Association for Social Advancement), a very profitable microfinance NGO, has experienced an impressive growth in the last ten years, and although its current headquarters are modest, they will soon be moving to a brand new BRAC-like building.

According to part ii), when a_2 is low, the NGO undertakes business more often. Indeed, it will not only allow it to enjoy private consumption, but also to top up the low donor's contribution to the development project.

In what follows, it is assumed that $\beta_n R < \omega$, so that the private consumption motive is not sufficient to make the NGO invest in business.

Indeed, then, if aid at period 2 is large ($a_2 > q$), the NGO does not start a business in the absence of uncertainty about future funding, since $\beta_n R \geq \omega$ does not hold.

On the other hand, if $a_2 < q$, at least part of the motivation of the NGO to invest is its willingness to improve the development project. In this case, when $\beta_n R < \omega$, the condition

$$\beta_n R \geq \omega - \beta_n \frac{[v(q) - q] - [v(a_2) - a_2]}{b} \text{ only holds if } a_2 \text{ is far enough below } q.$$

The case with uncertainty: $\lambda < 1$

Having assumed that $\beta_n R < \omega$, the private consumption motive cannot be operative for its own sake, even when λ approaches 1. Now, risk aversion on the part of the NGO might motivate its decision to start a business. This is a self-insurance motive.

Proposition 2:

- i) If $a_2 > q$, the NGO invests in business if

$$\lambda \leq 1 - \frac{(\omega - \beta_n R)b}{\beta_n [v(q) - q]} \quad (17)$$

ii) If $a_2 < q$, the investment in business takes place if

$$\lambda \leq \frac{v(q) - q}{v(a_2) - a_2} - \frac{(\omega - \beta_n R)b}{\beta_n [v(a_2) - a_2]} \quad (18)$$

Proof:

First, if the NGO does not run a business, its expected utility is

$$v(a_1) + \lambda \beta_n v(a_2) \quad (19)$$

Now an NGO with business is considered. Since a_2 only occurs with probability λ , the NGO maximizes the following expected utility

$$v(a_1) - \omega b + \beta_n [\lambda (c_2^g + v(q_2^g)) + (1 - \lambda)(c_2^b + v(q_2^b))] \quad (20)$$

subject to the constraints below

$$c_2^g + q_2^g = a_2 + Rb$$

$$c_2^b + q_2^b = Rb$$

$$q_2^g \geq a_2$$

The first order conditions are given by

$$v'(q_2^b) = 1 \quad (21)$$

$$v'(q_2^g) \leq 1 \text{ with equality if } a_2 < q_2^g \quad (22)$$

Again, let $v'^{-1}(1) = q$. When aid is not disbursed at period 2, $q_2^b = q$ and $c_2^b = Rb - q$. Here, it is important to point out that this only makes sense if $Rb > q$, i.e., if the business opportunity is lucrative enough. This is assumed in the rest of the paper.

As in the case with no uncertainty, two cases must be considered, depending on the size of a_2 . Indeed, the constraint $q_2^g \geq a_2$ binds when $a_2 > q$.

i) If $a_2 > q$, $q_2^g = a_2$ and $c_2^g = Rb$. Therefore the NGO's utility is

$$v(a_1) - \omega b + \beta_n [\lambda(Rb + v(a_2)) + (1 - \lambda)(Rb - q + v(q))] \quad (23)$$

Then, when a_2 is large ($a_2 > q$), the NGO invests in business if

$$v(a_1) - \omega b + \beta_n [\lambda(Rb + v(a_2)) + (1 - \lambda)(Rb - q + v(q))] \geq v(a_1) + \beta_n \lambda v(a_2) \quad (24)$$

which can be rearranged to get the following condition:

$$\lambda \leq 1 - \frac{(\omega - \beta_n R)b}{\beta_n [v(q) - q]} \quad (25)$$

ii) In the case where $a_2 < q$, $q_2^g = q_2^b = v'^{-1}(1) = q$, and $c_2^g = Rb + a_2 - q$. Then, the NGO's expected utility is

$$v(a_1) - \omega b + \beta_n [\lambda(Rb + a_2 - q + v(q)) + (1 - \lambda)(Rb - q + v(q))] \quad (26)$$

Then, the business investment is undertaken if

$$v(a_1) - \omega b + \beta_n [\lambda(Rb + a_2 - q + v(q)) + (1 - \lambda)(Rb - q + v(q))] \geq v(a_1) + \beta_n \lambda v(a_2) \quad (27)$$

i.e. if the following condition holds:

$$\lambda \leq \frac{v(q) - q}{v(a_2) - a_2} - \frac{(\omega - \beta_n R)b}{\beta_n [v(a_2) - a_2]} \quad (28)$$

Part i) of proposition 2 simply means that the NGO invests in business if the probability of getting future donor funding falls below some threshold. Hence, by having a business venture, the NGO self insures against the risk of fall in aid. The role of risk aversion is clearly brought out by analyzing the impact of a mean-preserving spread. Figure 1 shows that starting from a point where the NGO does not undertake business, decreasing λ while keeping λa_2 constant triggers the move to business as soon as λ falls below the point defined by equation (17). As shown in Mas Colell et al (1995), moving down along the constant λa_2 curve amounts to shifting to an unambiguously more risky distribution. Thus, the graph shows that the NGO's decision is affected by an increase in risk.

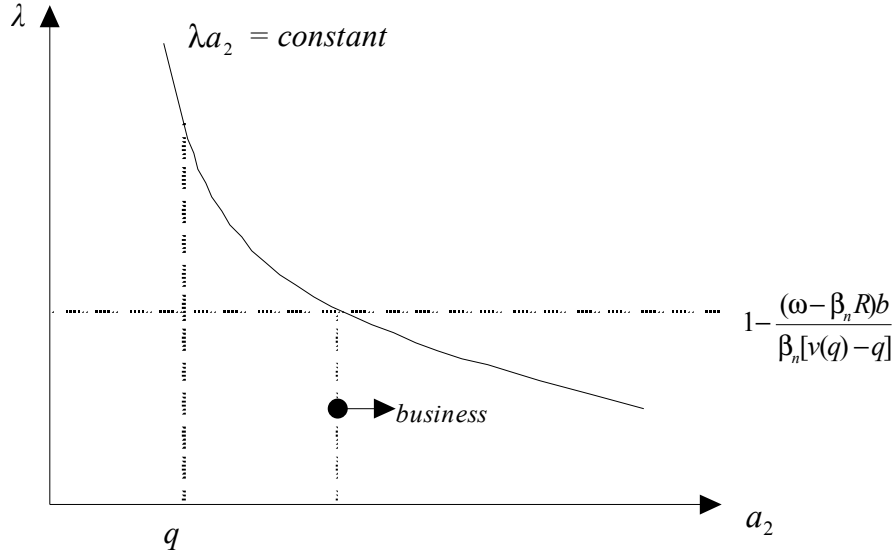


Figure 1: a mean-preserving spread along the constant λa_2 curve.

As business increasingly hinders efficiency in the development project (i.e. as ω increases), the threshold decreases, making it less likely that the NGO invests in business. An increase in β_n , which happens if the NGO cares more about the future, has the opposite effect.

Note that this threshold is less than zero if $b \geq \frac{\beta_n[v(q) - q]}{(\omega - \beta_n R)}$, which defines an upper bound on acceptable levels of business. The NGO will never invest more. Too large a business venture is not worth the cost in terms of first period utility.

In part ii), a_2 is low which makes the NGO willing to top up this low contribution. Since the function $v(x) - x$ is increasing in x for $x \leq v'^{-1}(1) = q$, and given that $a_2 < q$, the first term on the right hand side of condition ii) is greater than 1. Therefore, if a_2 lies sufficiently far below q , the NGO's willingness to top it up becomes the main reason why it will invest in business, even if there were no uncertainty, as seen in the previous case. Indeed, if the right hand side were greater than 1, condition ii) would always hold.

In addition, note that condition ii) never holds if the right hand side is less than zero, that is,

if the business investment is greater than $\frac{\beta_n[v(q) - q]}{(\omega - \beta_n R)}$.

Neither does it hold when the threshold is greater than 1, that is, the business investment would never be less than $\frac{\beta_n\{[v(q) - q] - [v(a_2) - a_2]\}}{(\omega - \beta_n R)}$. This upper bound is higher the larger the gap between a_2 and q .

To sum up, the above analysis brings out the key role of uncertainty about the future disbursement of donor funds. In the case of NGOs in Bangladesh, the probability λ may be determined by the government's NGO Affairs Bureau, whose regulation of the sector may facilitate or hinder the transfer of foreign funds to NGOs. This probability is likely to be NGO-specific. For example, NGOs involved in politically sensitive sectors may have more trouble getting the NGO Bureau's approval.

The donor's taste for self-sustainable NGOs

In the present model, the donor's objective is assumed to be the maximization of beneficiaries' welfare. That is, it does not only derive utility from a "warm glow" but also from a "general altruism".⁵ Then the donor's expected utility is given by

$$v(q_1) - \omega b + \beta_d [\lambda v(q_2^g) + (1 - \lambda)v(q_2^b)] \quad (29)$$

Let a_i denote the exogenous donor's budget available for the project at period 1. Aid disbursement at period 2, a_2 , will only occur with probability λ . However, assume as before that the size of a_2 in the event it occurs is known to both the NGO and the donor.

In other words, the donor faces uncertainty about its future ability to contribute. This assumption seems quite realistic. First, the local office of a donor agency may not be able to

⁵ is the "personal and direct satisfaction" derived from providing aid for a development project, and the general altruism is the utility derived from the improvement in the beneficiaries' welfare.

anticipate the organization's future worldwide policy in terms of preferred countries and sectors of intervention. Second, Section 2 provides examples where donors had to withdraw their assistance from an NGO not because they wanted to but because the necessary government approval of the projects was not received.

Then, since it derives utility from the implementation of the development project at period 2 even if it does not contribute, it may be interested in financing an NGO whose business venture ensures financial self-sustainability.

The donor has to choose between an NGO with a business ($b > 0$) and an NGO whose project will be entirely dependent on external funds ($b = 0$).

Again, uncertainty may not be the only concern for the donor. First, the donor may simply wish to reward self-help (Weisbrod, 1998), in which case, an increase in the NGO's commercial revenues would encourage donations. However, the present paper is not well suited to study this effect, since the business investment is just modeled as a binary choice.

Second, the donor may also like an NGO that can supplement its contribution when the budget available is low. For example, some donors refuse to include the NGO's office costs in the budget. Then, an NGO that can cover these costs itself may be attractive since it allows the donor to exhibit a "more efficient" aid in terms of dollar spent per beneficiary.⁶

In order to take on board such issues, like in the analysis of the NGO's decision, the case without uncertainty will be examined first, followed by the case where $\lambda < 1$.

The case with no uncertainty: $\lambda = 1$

Proposition 3:

- i) If $a_2 > q$, the donor never hires an NGO with business.
- ii) If $a_2 < q$, an NGO with a business will be preferred if

⁶ The present paper does not investigate bargaining between NGOs and donors. However, this aspect is of particular importance in determining the budget size and what the NGO is allowed to do with it.

$$\beta_d[v(q) - v(a_2)] > \omega b \quad (30)$$

Proof:

i) The donor's decision depends on the size of a_2 . Indeed, if $a_2 > q$, the NGO implements

$q_2^g = a_2$ and the donor never hires an NGO with business since the inequality

$$v(a_1) - \omega b + \beta_d v(a_2) < v(a_1) + \beta_d v(a_2) \quad (31)$$

always holds.

ii) If $a_2 < q$, then an NGO with business implements $q_2^g = q$, while an NGO with no private

income can only produce $q_2^g = a_2$. Then, the former will be chosen by the donor if

$$v(a_1) - \omega b + \beta_d v(q) < v(a_1) + \beta_d v(a_2) \quad (32)$$

that is, if

$$\beta_d[v(q) - v(a_2)] > \omega b \quad (33)$$

Proposition 3 states that an NGO with a business will be preferred if a_2 is far enough below q . To sum up, on the one hand, when the donor knows it will be able to contribute a high amount at period 2, it will never value an NGO's investment in business. On the other hand, when it knows its contribution will be low, it may prefer to make sure that the NGO is able to supplement the contribution with its own profits.

PIACT, a Bangladeshi NGO established in 1980 and working in the fields of HIV/AIDS prevention and non formal education, is one example that can illustrate the office cost interpretation mentioned above. Indeed, its donors only allow 10 percent of a project's funds to cover such fixed costs. Thus, donors only cover 50 percent of these costs and the NGO has to find the money for the remaining 50 percent elsewhere. PIACT has several income generating activities including the sale of consultant services, renting some of its office space, and a copy shop on the ground floor. In addition, part of a development project consists of helping sex workers to find alternative

livelihoods. They are provided with vocational training, during which they make products that are sold on markets. The NGO keeps 25 percent of the profits generated through these sales.

The case with uncertainty: $\lambda < 1$

Proposition 4:

The donor prefers an NGO with business if

$$\lambda \leq 1 - \frac{\omega b}{\beta_d v(q)} \quad (34)$$

Proof:

Again, using the results derived for the NGO, it is easy to analyze the donor's decision. If

$a_2 > q$, an NGO with business will be preferred if

$$v(a_1) - \omega b + \beta_d [\lambda v(a_2) + (1 - \lambda)v(q)] > v(a_1) + \beta_d \lambda v(a_2) \quad (35)$$

which can be rearranged to have the following condition:

$$\lambda \leq 1 - \frac{\omega b}{\beta_d v(q)} \quad (36)$$

Now, if $a_2 < q$, the NGO is known to implement $q_2^b = q_2^g = q$. Then, the donor chooses an NGO with a business if the following condition holds:

$$v(a_1) - \omega b + \beta_d v(q) > v(a_1) + \beta_d \lambda v(q) \quad (37)$$

i.e., if

$$\lambda \leq 1 - \frac{\omega b}{\beta_d v(q)} \quad (38)$$

This condition is the same as in the case where $a_2 > q$.

Proposition 4 is very intuitive. It simply says that the donor will choose a self-sustainable NGO if the probability of contributing to the project at period 2 falls below some threshold. Note that this threshold is always strictly smaller than 1, so the only reason why the donor would value the NGO's business activity is the uncertainty about its future ability to contribute. Indeed, recall

that when $a_2 > q$ and there is no uncertainty, the donor always chooses an NGO without business. Hence, the NGO provides the donor with some insurance by investing in a business venture. Furthermore, the fact that λ must be positive defines an upper bound on b . The donor will never

finance an NGO whose business investment is greater than $\frac{\beta_d v(q)}{\omega}$.

To sum up, an altruistic donor may hire an NGO with a business to insure that the desired development project will be implemented in the event that future aid cannot be disbursed. For example, in Bangladesh, if it becomes more difficult for NGOs to get approval of foreign funds from the NGO Affairs Bureau, forward looking donor agencies may try to support organizations that will be able to function even in the event that the government decides to prevent them from getting new foreign donors' assistance.

4. Aid for “wealthy” NGOs?

In the previous section, it has been argued that ex ante, because of uncertainty about the availability of future funds, NGOs have a reason to invest in a business venture and donors may prefer to finance such “hybrid” NGOs. Now, let the agents be in the good state of nature where the donor is able to contribute a_2 in the second period. In addition, assume that the donor has chosen an NGO with business. This section investigates the donor's decision to contribute when the NGO has generated profits and could therefore function independently. Instead, the donor could decide to finance another project. In other words, this section investigates the donor's commitment once the NGO's business investment is sunk.

The model that follows uses the basics of the previous section but is considered independently. The NGO's business investment is considered as sunk and the story is that of a donor facing a “wealthy” NGO. The present section presents a game taking place at what was period 2 in the previous section, when the donor has money and the NGO has already generated income from its business venture. The former has to choose whether to deliver aid or not and given the

amount received, the latter will implement the project and choose its private consumption.

Furthermore, assume that if the donor decides not to contribute, it spends a_2 on another project elsewhere with another partner. Of course, as stated in section 3, the donor would still derive utility from the first project. Therefore, its utility from leaving the NGO by itself is $v(q_2) + \theta z(a_2)$, where θ is a positive constant representing its relative preference for the outside option. The donor makes a decision taking into account the NGO's behavior derived above. The following proposition provides the conditions that determine the donor's decision whether to renew its commitment.

Proposition 5:

i) When $a_2 > q$, the donor contributes if

$$\theta \leq \frac{v(a_2) - v(q)}{z(a_2)} \quad (39)$$

When $a_2 < q$, the donor will not renew its commitment, whatever θ .

Proof:

This simple proof consists of two steps. First, the second stage of the game (i.e., the NGO's problem) is analyzed. Then, it is used to derive the donor's decision at the first stage.

Step 1: If the donor stops providing aid, the NGO chooses the level of service q_2 and its private consumption c to maximize its utility subject to its budget constraint:

$$\text{Max } c + v(q_2) \text{ subject to } q_2 + c = Rb$$

The first order condition is

$$v'(q_2) = 1 \quad (40)$$

Let $v'^{-1}(1) = q$ denote the corresponding level of service. Then, $c = Rb - q$ and the NGO's utility is $v(q) + Rb - q$.

If the donor keeps financing the project, as in the previous sections, it is assumed that it does

not allow the NGO to spend any of the aid flow on private consumption, that is, $q_2 \geq a_2$. Now the NGO chooses q_2 and c to solve the following problem:

$$\text{Max } c + v(q_2) \text{ subject to the constraints } q_2 + c = Rb + a_2 \text{ and } q_2 \geq a_2$$

The first order condition is given by

$$v'(q_2) \leq 1 \text{ with equality if } a_2 < q_2. \quad (41)$$

As before, two cases must be examined, depending on whether a_2 is higher or lower than the production the NGO could achieve without aid, namely, $q_2 = v'^{-1}(1) = q$.

On the one hand, if $a_2 > q$, the constraint imposed by the donor on the use of aid binds, so that $q_2 = a_2$ and $c = Rb$. The idea is that when the donor provides enough aid, the NGO privately consumes all its business profits and its utility is $v(a_2) + Rb$.

On the other hand, if $a_2 < q$, $q_2 = q$ and $c = Rb + a_2 - q$. This means that the NGO uses its business profits to top up a donor's low contribution and privately consumes the remaining funds. And its utility is then $v(q) + Rb + a_2 - q$.

Remark: the NGO always prefers to receive aid whatever its size. Indeed, when aid is small, it is the case if $v(q) + Rb + a_2 - q \geq v(q) + Rb - q$, which holds for any a_2 . On the other hand, when aid is large, i.e. when $a_2 \geq q = v'^{-1}(1)$, the corresponding condition is $v(a_2) + Rb \geq v(q) + Rb - q$, which is true in this high range of aid provision.

Step 2: The question remains whether the donor will contribute.

If $a_2 > q$, $q_2 = a_2$, the donor contributes if $v(q) + \theta z(a_2) \leq v(a_2)$, that is, if

$$\theta \leq \frac{v(a_2) - v(q)}{z(a_2)}. \text{ This proves part i) of the proposition.}$$

If $a_2 < q$, $q_2 = q$, the donor will not renew its commitment, whatever θ , since the condition

$v(q) + \theta z(a_2) \geq v(q)$ always holds, which corresponds to part ii) in proposition 5.

Part i) of proposition 5 simply means that if the donor's budget is low and it can rely on the NGO to make the project work as well without aid, the donor will finance another partner while still enjoying the sight of its previous partner's success. On the other hand, when the aid budget is high, the donor's relative preference for its outside option determines its decision to remain committed to the same NGO.

The donor's commitment issue is related to Weisbrod (1998)'s intuition that "donative revenue responds to commercial activity". In the present framework, it has been shown that the donor may free ride on a "wealthy" NGO. However, one important implicit assumption made in the model is that the business profits are always large enough to cover the gap between a_2 and q in the case where $a_2 < q$. It would be interesting to introduce some risk on the commercial venture's returns so that the NGO's profit might not be sufficient and the donor would have to keep supporting its existing partner.

Furthermore, proposition 5 has some interesting implications for beneficiaries welfare. When $a_2 < q$ and the donor free rides, the beneficiaries' level of utility is $v(q)$, that is, the same as if aid continued. In words, when the donor's budget is low, the NGO can afford the same level of service to the target population whether it receives aid or not. However, the NGO would prefer to receive aid since it could enjoy more private consumption. Indeed, $Rb + a_2 - q \geq Rb - q$ for any a_2 . Therefore, since the beneficiaries' welfare is not affected in this case, the donor stops financing the NGO to avoid subsidizing the latter's private consumption, and an additional partner can be financed instead.

In the case where $a_2 > q$, if the outside option is preferred, the partnership is broken even if it makes the existing beneficiaries worse off ($v(a_2) \geq v(q)$). When the donor's budget is large, aid

allows project implementation at a larger scale than if the NGO runs on its own funds.

It is important to point out that these interpretations rely on the quasilinearity assumption. Indeed, if income effects were incorporated, the NGO would spend more than q on the development project if its profits were sufficient to do so.

Finally, this section suggests that the donor's imperfect commitment is an additional incentive to invest in business. Although this point has not been formally investigated here, the exogenous uncertainty considered in section 3.1, captured in the probability λ , can easily be reinterpreted as donors' imperfect commitment. However, the present section has shown that the NGO's income might provide the donor with an incentive to free ride. Thus, the donor's lack of commitment might also discourage the NGO's investment in business. This point is related to Weisbrod (1998)'s study of the interdependence between commercial and donative revenues. More empirical work is needed on this issue in developing countries. The example of BRAC shows that although this NGO has a significant self-generated income, it is still attracting millions of dollars of donor funding. This suggests that when it comes to important local NGOs, donors may remain committed despite high independent earnings.

5. Conclusion

This paper has proposed a theoretical framework to introduce business ventures as part of NGOs' activities. Indeed, a growing number of NGOs try to generate their own income to be more independent of donor funding. Recent papers have provided formal models of NGOs and donors, but self-financing strategies have until now attracted little attention. Yet, such investments are now part of the tool kit of development finance and they raise new issues. In particular, ethical concerns in the nonprofit sector have incited debate regarding the increasing resemblance between some nonprofit organizations and for-profit businesses. This will be an increasingly sensitive topic as self-financing becomes more widespread in practice.

NGOs' commercial activities can be a powerful strategy to ensure their survival in an environment where donors' assistance is volatile. However, NGOs' independent income sources do

not necessarily make them better off, since it might crowd out donations. The crowding out hypothesis has been studied in the case of US nonprofits, but further empirical research regarding local NGOs in developing countries is needed.

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