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HWWA Discussion Paper

Project Aid or Budget Aid? The Interests of Governments and Financial Institutions

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HWWA Discussion Paper 309

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ABSTRACT

The paper compares different aid policy instruments and their effect on the target group. Starting from a situation where interest groups compete for the resources of the government, international financial institutions aim to change the policy outcome. They can either directly support one group or condition their financial help to the government on its policy. Apart from a normative analysis which policy is more adequate to help one group, the paper also asks what happens if the IFI is driven by bureaucratic self-interest, and whether this distorts policies.

Key words: aid policy, conditionality, international financial institution, interest groups.

JEL-Classifications: D73, F35, O23

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1. Introduction

There is now a wide spread consensus that just giving aid to governments in order to promote development does usually not work (Boone 1996). Even the international financial institutions (IFI), like the IMF, the World Bank, and the regional development banks themselves conclude that aid is only effective in the appropriate political environment (World Bank 1998, Burnside and Dollar 2000). Otherwise, corruption and self-interested government ensure that most of the money that foreign donors allocate to development purposes will not reach the target groups. Corrupt bureaucracies will divert money to themselves and governments support only some groups. These groups will in most cases not be the “poor” since these are not influential enough politically.

Therefore IFIs often tie their financial aid to some conditions, like a certain share of spending going to certain projects or groups. This conditional budget aid is the alternative to direct involvement of the IFIs where they support projects and NGOs that are considered to help the poor, so-called project aid. The question is which of the two instruments is more effective in reaching the goal to help the underprivileged.

I develop a simple model that compares project aid with budget aid to see which of the two instruments allocates more resources to the poor. There are two groups in the recipient country, the “rich” and the “poor”. The government leans toward one of the two groups, the “rich” and allocates less resources to the “poor” than it would do in a politically undistorted situation. Not surprisingly, unconditional aid given to governments cannot result in benefiting the poor if the difference between the relative weight that the government puts on the well being of the poor is much lower than that of the IFI.

The international community would thus aim to change the policy of the government. Compared with a situation of unconditional aid to the government, where most of the

resources would be flowing to the rich, the IFI can either stop the payments and allocate project aid to the poor, or they can attach conditions to financial aid to the government.

Both policies, however, are not without caveats. Project aid will result in a readjustment of government policy. Realizing that the poor receive direct support from the international community, the government feels free to allocate more of its discretionary payments to the rich. The poor will thus lose some in compensation for increased funds from the IFIs because project aid crowds out other forms of support. In the end, the additional amount of money that the poor receive is much lower than what the IFI spends on the project in direct aid.

Budget aid in turn is accompanied by a considerable increase in the amount of money that the IFIs have to spend on development aid to the government. In order to force the government to accept the IFI's conditionality, aid has to increase. The result is that, again, the government will use the additional resources to allocate part of them to the rich.

The sobering conclusion from the model is that both instruments can lead to an increase in the resources of the poor, but that part of the additional resources will benefit the rich. Only a closer alignment between the government's preferences and those of the IFI can avoid the conflict that money is being channeled to the rich. Conditional budget aid or project aid are thus no alternatives to government "ownership" of policies.

I also allow for a distortion of preferences of the IFIs. It has been argued that IFIs are mainly interested to handle as many projects and as much money as possible, because this is important for the internal career concerns of the desk officers (Vaubel 1991, Willett 2000, Easterly 2002). Moreover, it is often the case that the IFIs themselves are under pressure from donor governments to support politically important countries, or because some interest groups in the donor countries push their governments into a particular direction (Fleck and Kilby 2004, Dreher and Jensen 2004). Because of these additional influences, the policy choice of the IFI can be distorted.

The paper most closely related to this is a paper by Cordella and Dell' Ariccia (2003). These authors also compare project aid and budget aid in a theoretical model that allows for differences between donor agency and recipient government. There as well, the size of the relative weight being put on two conflicting objects matters for what is the better instrument, and that the amount of resources available is comparison to the government's funds is important. In their paper, however, there is no discussion about own interests on the part of the IFI. They are completely benevolent there, thus missing an important factor in international aid.

The paper also relates to the growing literature that acknowledges that domestic governments are under the pressure of interest groups who lobby the government (Lahiri and Raimondos-Moller 2000a, Drazen 2000, Boughton and Mourmouras 2002). Using the model developed by Grossman and Helpman (2001), Lahiri and Raimondos-Moller (2000b) show that because of interest group pressure, fungibility is a major problem which explains why funds are diverted, while Mayer and Mourmouras (2002) view the government as a common agent of interest groups and a benevolent IFI that puts conditions on its aid in order to correct domestic political distortions. All these papers analyze the conflict of different interest groups in recipient countries and how governments use the support they receive to help mainly their constituents.

Moreover, I build on elements of the literature that analyze in detail the interest of aid bureaucracies (Easterly 2002). Bureaucratic structures could imply that IFIs place more value on handing out and administer major aid projects than on the effectiveness of aid, even if countries continuously do not fulfill conditionalities (Easterly 2005). This builds on the standard bureaucratic motive of maximizing the budget (Niskanen 1971, Moe 1997). Closely related are works that show that IFIs are not free in setting their policies but are under pressure from donor governments. Dreher and Jensen (2004) show this for the IMF and Fleck

and Kilby (2004) present similar evidence for the World Bank. Hence, not only is bilateral aid distorted (Alesina and Dollar 2000, Berthelemy 2004) but multilateral aid is distorted and influenced by political aims as well (Nunnenkamp et al. 2004).

Finally, the paper is among the very few that looks at distortions on the side of the donors and on the side of the recipient governments at the same time (Azam and Laffont 2003, Hefeker and Michaelowa 2003).

2. The Model

Consider the following utility function for the government in the recipient country

$$W = \alpha u_1 + (1 - \alpha) u_2 \quad (1)$$

where u_i are the utilities of the two interest groups. For simplicity and without loss of generality, I assume that one of the interest groups represents the “poor” (group 1) and the other the “rich” (group 2). The government assigns the weights α and $1 - \alpha$ to the interests of the two groups. If those weights adequately reflect the size of the two groups or if $\alpha = 1/2$ with equal sized groups, the government maximizes an utilitarian welfare function. I assume, however, that the relative weights of the two groups follow political considerations.

There are several ways to interpret the relative weights α and $1 - \alpha$. They could either be determined through lobbying expenditures of the two groups, where the weights would reflect the relative lobbying contributions of the two groups. Alternatively, the weights could reflect the political power of the two groups in the sense of a political support function.¹ The more votes a group can credibly commit to the government, the more the government will take the group’s preferences into account when setting policy.

¹ For a survey of these models, see Drazen (2000).

The utility of the two groups

$$u_i = -(g_i - g_i^*)^2, \quad \text{with } g_i < g_i^* \quad (2)$$

shows they are suffering if the amount of public resources they obtain deviates from a target level of resources they wish to receive. g_i is the amount of (net) public resources the two groups receive from the government in the form of subsidies, income support or direct payments. These payments g_i are realistically assumed to be lower than the amount of resources the interest groups would like to receive g_i^* .

The government's budget constraint is given as

$$g_1 + g_2 \leq g + \delta A, \text{ where} \quad (3)$$

$$\delta = \begin{cases} 1, & \text{if aid is granted} \\ 0, & \text{otherwise} \end{cases}$$

and A is the amount of official aid from the IFIs and g is the per period government revenue spend on the two interest groups.²

I assume that g is a fixed revenue that the government has at its disposal. To sharpen the results of the model, I also assume that $g_i^* = g$, that is, every interest group would like to receive the full discretionary funds from the government.³ I assume that the two interest groups do not take into account that there may be external financial support for the government. One reason why this is could be is that those payments are uncertain and not predictable in size, because they are conditional and in the discretion of the IFI.⁴

² I abstract from other expenditures, which are constant from the point of view of this model. These would only be an additive constant and can be ignored.

³ This assumption is for convenience only. All that is necessary to have a conflict between the two groups would be $g_i^* > g/2$. Nothing would qualitatively change if one would assume that $g_i^* = g + \delta A$.

⁴ Nothing would qualitatively change if one would assume that $g_i^* = g + \delta A$.

Another assumption I make pertains to the amount of money that the poor will actually receive of the money that is allocated to them. It is well known that corruption and other factors diminish the net-receipt of support to the poor. Government bureaucracies might distract part of the funds to their own accounts, or it may end up in Swiss bank accounts. However, this problem is not unique to budget aid. Project aid as well might suffer from this problem. Depending on the character of the agents with whom the IFIs implement projects, this share of the money being distracted may be smaller than if allocated through the government bureaucracy.

The share of resources distracted under budget aid is given as ε , so that $A(1-\varepsilon)$ reaches the target groups. The share of project aid lost is denoted by η , so that $T(1-\eta)$, where T denotes the amount of project aid, reaches the destination. If the government is relatively uncorrupt and has an efficient bureaucracy, one might assume $\eta > \varepsilon$ because the use of external consultants is expensive. In case of a corrupt government, we have of course $\eta < \varepsilon$. In that case, it might seem promising not to rely on the services of the government and its bureaucracy to administer increased funds. However, the IFIs and (often also) the governments cannot be sure about the actual amount of money being lost when they decide about what policy to implement. I therefore assume that ε and η are stochastic, with $E[\varepsilon]=0$ and $E[\varepsilon^2]=\sigma_\varepsilon^2$, as well as $E[\eta]=0$ and $E[\eta^2]=\sigma_\eta^2$.

2.1. The Benchmark Case

Before seeing how the international community can try to influence the amount of resources the poor receive, it is necessary to establish how the government would allocate resources in the benchmark case. I neglect diversion of funds for simplicity.

If the government follows its own interest when optimizing the relative shares of government spending on the two interest groups, the relative shares that the two groups receive are

$$\alpha(g_1 - g) = (1 - \alpha)(g_2 - g). \quad (4)$$

Using the budget constraint of the government, the relative shares can be specified as

$$g_1 = \alpha g + (1 - \alpha)\delta A \quad (5a)$$

$$g_2 = (1 - \alpha)g + \alpha\delta A \quad (5b)$$

The amount of resources that go to the poor and rich respectively are corresponding to the marginal utility that the groups have from obtaining these resources. Since both marginal utilities must be equal in equilibrium, g_1 's share must correspond to that of the rich and vice versa. Both groups receive their relative share α and $1 - \alpha$ of the government's budget, and the opposite share of any additional resources that the government receives.

2.2. The Interests of the IFI

Let the (for now) benevolent IFI's objective function be given as

$$V = \beta u_1 + (1 - \beta)u_2 \quad (6)$$

where $\beta > \alpha$. That is, the IFI cares more for the interests of the poor than the national government does. In the limit, one might assume $\beta \rightarrow 1$, while $\alpha \rightarrow 0$ in the government's objective function. The difference $\beta - \alpha$ will be of crucial importance below.

The IFI is aware that the government will use any increase in resources to spend it on the two interest groups in the same relation it spends its "normal" resources. The more distorted the government's policy is, the more this distortion is increased through unconditional aid to the government. The question is thus, what effect would conditionality have on budget aid and how could this result be possibly changed if the IFI would be using project aid?

What the IFI would view as optimal amounts of money flowing to the two interest groups differs from that what the government is prepared to give. Assigning a larger weight to the poor results in

$$g_1^{\text{IFI}} = \beta g + (1 - \beta)\delta A \quad (7a)$$

$$g_2^{\text{IFI}} = (1 - \beta)g + \beta\delta A \quad (7b)$$

as the preferred choice of the IFI. $g_1^{\text{IFI}} > g_1$ if $(\beta - \alpha)(g - \delta A) > 0$ which is obviously fulfilled if $\beta > \alpha$ because external support will certainly not be larger than the government's budget, thus $g > \delta A$.

The IFI will hence look for ways to increase the spending share on the poor and it can use two instruments to achieve this goal: by directly supporting projects or by conditioning the aid it gives to governments.

2.3. Project Aid

This section derives how the IFI could directly help the poor by supporting projects and how the government would react to this. The main finding is that the government will partly negate the consequences of the direct help, because it will cut back on its own payments to the poor. An increase in project aid for the poor would prompt the government to reconsider its policy towards the two groups, because the utility of the poor is exogenously increased, making the poor better off while the rich are not affected directly. The government will thus reoptimize the amounts of money it gives to poor and rich. The amount of money allocated to the two groups is then

$$g_1^{\text{GOV}}|_{\text{PA}} = \alpha(g - T(1 - \eta))$$

resulting in $g_1|_{\text{PA}} = \alpha(g - T(1 - \eta)) + T(1 - \eta)$, or

$$g_1|_{PA} = \alpha g + (1 - \alpha)T(1 - \eta) \quad (8a)$$

and

$$g_2^{GOV}|_{PA} = (1 - \alpha)g + \alpha T(1 - \eta). \quad (8b)$$

This confirms the standard result that aid is fungible and that an increase in direct support for one group will lead to a crowding out of government support for the poor (Lahiri and Raimondos-Moller 2000b, Cordella and Dell' Ariccia 2003).⁵ The government anticipates that the IFI supports the poor and will itself adjust its own contributions accordingly. From the point of view of the government this amounts to the same effect as if the IFI had increased its unconditional support to the government.⁶

The poor would benefit from project aid only if project aid is larger than what the IFI is willing to give to the government alternatively. However, the IFI must also be aware that the rich interest group would benefit from an increase in project aid to the same relative amount that the poor benefit.

Moreover, because the absorption capacity of the poor in the form of relevant projects is in general restricted, the usefulness of project aid is constrained by the absorption capacity of the recipient country. If there are not enough sensible projects, the maximum amount of useful project aid is constrained. Moreover, direct budget aid is much faster to disburse because project aid is less flexible and needs more time for preparation. In addition, the IFI

⁵ The strong result obtained here, of course, is due to complete fungibility, that is, the government can redirect financial flows at its discretion. If governments cannot completely redirect those flows, the result would be less extreme than obtained here.

⁶ This is a result similar to those that show that an exogenous increase in resources, either because of windfall profits or an increase in aid, would lead to more lobbying and thus potentially increase distortions in the recipient country (Lane and Tornell 1996, Svensson 2000a).

must be aware of the relevant losses of resources due to the fact that it needs to rely on NGOs and external consultants to implement project aid.⁷

2.4. Conditional Aid

Let us now assume that the IFI is willing to give budget aid, but only under the condition that the government ensures that enough money is reaching the poor. The IFI's condition for handing over money to the government will be some minimum amount of money that is allocated to the poor. How large would this amount from the point of view of the IFI be and thus be made a condition? The optimal amount of resources going to the poor would follow from optimizing the IFI's objective function with respect to g_1 . This, as (7) has established, would be $g_1^{\text{IFI}} = \beta g + (1 - \beta)\delta A$. Comparing the desired share for the poor from the perspective of the IFI with that of the government has also shown that $g_1^{\text{IFI}} > g_1^{\text{GOV}}$ is equivalent to $\beta > \alpha$. From the point of view of the IFI it is thus always desirable to impose conditionality on the government to ensure that g_1 increases.

The IFI would thus require that the government allocate some share $\hat{g}_1 > g_1^{\text{GOV}}$ to the poor in order to ensure that the poor receive a larger amount of the governments resources. This conditionality, however, will not be costless to the IFI because the recipient government can always reject conditionality and give up the financial support from the IFI. The government will not (and maybe even cannot) simply change the structure of the financial flows to the interest groups. Doing so would distort the political equilibrium in the receiving country and could push the government out of office in the next elections or by a coup d'etat.

⁷ Heller and Gupta (2002) show more generally that governments often have problems with the absorption of large external help.

To bring the government to allocate a certain share of resources to the poor requires that the government's participation constraint under conditional aid is fulfilled. The government must be indifferent between obtaining more aid from the IFI with conditionality and receiving lower aid without conditionality.

At the same time, it is unrealistic in most cases to assume that the IFI could completely set transfers to the government to zero, even if the government refuses to accept conditionality. Because of exogenous shocks or simply because of political pressure on the IFI it might be forced to support the government to a certain extent regardless of government policy. It is well established that governments continue to receive support, even if implementing "bad" policies and renegeing on promises to change policies (Svensson 2003, Easterly 2001, 2005).

Therefore, I assume that

$$A = \begin{cases} \bar{A} & \text{if } g_1 \geq \hat{g}_1 \\ \underline{A} & \text{if } g_1 < \hat{g}_1 \end{cases} \quad (9)$$

with $\bar{A} > \underline{A}$ and $\underline{A} \geq 0$. If the IFI can credibly commit vis-a-vis the recipient country, it might be able to set $\underline{A} = 0$. The minimum amount with which that the IFI must support the government can be arbitrarily small if the IFI is powerful and if the government in question is not able to put pressure (directly or indirectly) on the IFI.

As argued, to meet the participation constraint of the government, the budget aid with conditionality must compensate the government for the conditions attached to it. Take the extreme case that the IFI wishes to force the government to allocate

$$\hat{g}_1 = \beta g + (1 - \beta)\hat{A} \quad (10)$$

to the poor. \hat{A} is the amount of money that the IFI then has to provide to the government in order to make the government accept that \hat{g}_1 is flowing to the poor. How large must \hat{A} be to meet the participation constraint of the government? To make the government indifferent

between the two regimes, the equality between $W|_{BA} = \alpha(\hat{g}_1 - g)^2 + (1 - \alpha)(g + \bar{A} - \hat{g}_1 - g)^2$ and $W|_{NC} = \alpha(g_1^{GOV} - g)^2 + (1 - \alpha)(g + \underline{A} - g_1^{GOV} - g)^2$ must be fulfilled, with $\hat{A} = \bar{A}$ as the critical value that ensures the government's indifference. This critical value, specified in the appendix, is increasing in β and falling in α . It also rises in the amount of aid received without conditionality \underline{A} .

The participation also constraint ensures that the government would not renege on promises that it has given to the IFI. If the government can be made as well off when fulfilling conditionality as when not fulfilling, there is no reason for the government not to fulfill its commitment. Especially if the government adopts a longer-run perspective it benefits from fulfilling its promise when adequately compensated by the IFI.⁸

Another way to avoid that governments renege on promises is *ex-ante* conditionality on aid.

3. The Influence of Different Policy Solutions on the Poor

Having established the instruments the IFI can use and how the government reacts, the question is now how the poor would fare under either regime?

In the benchmark case without conditionality the poor will receive

$$g_1^{GOV} = \alpha g + (1 - \alpha)\underline{A}(1 - \varepsilon), \quad (11)$$

while under project aid their income is

$$g_1|_{PA} = \alpha g + (1 - \alpha)T(1 - \eta), \quad (12)$$

and under conditionality it is

⁸ Another way to express this would be to assume that the government “owns” the pro-poor policy when being compensated for this policy change. On ownership, see Drazen and Isard (2004) or Boughton and Mourmouras (2002).

$$\hat{g}_1 = \beta g + (1 - \beta)\hat{A}(1 - \varepsilon). \quad (13)$$

Depending on the regime, the income of the poor varies greatly. If we assume that unconditional aid is rather low, or even close to zero, (11) will certainly be smaller than (12), unless the amount of resources that “disappears” under project aid is much too large. If the difference between the amount of government expenditures given to the poor that the IFI prefers and what the government itself wishes to commit to this aim $\beta - \alpha$ is large, it is almost certain that (13) is the largest of the three expressions.

To illustrate, let $\underline{A} \rightarrow 0$. Then, the condition for $\hat{g}_1 > g_1|_{PA} > g_1^{GOV}$ becomes

$$(\beta - \alpha)g + (1 - \beta)\hat{A}(1 - \varepsilon) > (1 - \alpha)T(1 - \eta) \quad (14)$$

and equivalent to a direct comparison between project aid and budget aid. The condition states that it is obviously in the hands of the IFI whether the poor fare better under one or the other system. Budget aid is attractive for the income situation of the poor if conditionality results in a larger share of government expenditures and if the net amount of aid received (i.e. net of any losses due to corruption or otherwise) is higher. Thus, since $\beta > \alpha$ by definition, the critical question is only if $\hat{A}(1 - \varepsilon)$ is sufficiently larger than $T(1 - \eta)$ to compensate for $\beta > \alpha$. In other words, the direct impact of forcing the government to increase the spending share on the poor must be larger than the crowding out effect arising from the fact that the government lets the rich share in increased resources.⁹

The condition makes clear that the income of the poor tends to be larger under budget aid with strict conditionality, especially if g is large relative to T . Also, budget aid tends to be

⁹ Notice also that the total amount of government resources distributed g might influence the comparison. It is reasonable to assume that g is considerable larger than A or T for most countries.

more effective if the losses under project aid η are high and it is less attractive if the losses under budget aid ε are high.

4. The Preferences of the IFI

4.1. Bureaucratic Interests

As indicated in the introduction, some authors claim international aid agencies themselves have somewhat distorted preferences. Applying bureaucracy theory, Vaubel (1991) or Easterly (2002) point out that the internal career structures make officers in those agencies mainly interested in distributing as much money as possible, because promotion depends to a large extent on the size and number of large projects that they handle. Moreover, it is not necessarily only the IFI's self-interest that may create a spending bias in its policy. Donor governments frequently request that some funds be allocated to some countries, quite irrespective of whether governments have qualified for this aid or not. For whatever reason, the IFI may put an extra value on being able to hand out financial support to the government in question.

To consider this case, let the IFI's objective function be given as

$$V = \beta u_1 + (1 - \beta)u_2 + \gamma(A) + \chi(T), \quad (15)$$

where $\gamma(A)$ is the gain if budget aid can be distributed, and $\chi(T)$ is the respective gain of distributing project aid. I distinguish between the two forms of supporting countries because the relative gain from distributing a special form of aid might differ. The marginal gain for the IFI of doing either is $\partial\gamma/\partial A > 0$ or $\partial\chi/\partial T > 0$ respectively, where both are concave functions. Either for internal career reasons or because of pressure from donor governments or the public at large, the IFI may develop a preference for using one instrument over the other. The question is whether and how the incentives of the IFI distort its policy choice because its additional interest determines which of the two solutions is preferred.

First, however, I briefly establish when the IFI itself has an interest to engage with the government in either conditional aid or giving aid to that country. It is, of course, conceivable that the IFI, like the recipient government, has no interest at all to move beyond the standard situation where the government receives only some minimum amount of aid \underline{A} . Since the IFI has to decide about whether to use project aid or budget aid at all before uncertainties are resolved, I use expected values for this comparison. The condition for $E[V|_{PA}] > E[V|_{NC}]$ is

$$E\left[-\left\{\beta[\alpha g + (1-\alpha)T(1-\eta) - g]^2 + (1-\beta)[g - \alpha g - (1-\alpha)T(1-\eta) - g]^2\right\} + \chi(T)\right] > \quad (16)$$

$$E\left[-\left\{\beta[\alpha g + (1-\alpha)\underline{A}(1-\varepsilon) - g]^2 + (1-\beta)[g - \alpha g - (1-\alpha)\underline{A}(1-\varepsilon) - g]^2\right\} + \gamma(\underline{A})\right]$$

Using the assumptions $E[\varepsilon_t] = 0$, $E[\varepsilon_t^2] = \sigma_\varepsilon^2$ and $E[\eta_t] = 0$ and $E[\eta_t^2] = \sigma_\eta^2$, it can be rewritten as

$$2g(1-\alpha)(\beta-\alpha)(T-\underline{A}) + [\chi(T) - \gamma(\underline{A})] > \quad (17)$$

$$(1-\alpha)^2 \left[T^2(1+\sigma_\eta^2) - \underline{A}^2(1+\sigma_\varepsilon^2) \right].$$

The condition states that, in the first term of the LHS, the IFI prefers project aid because the poor receive more money under project aid if $T > \underline{A}$ and if the difference between β and α is large. Moreover, if the uncertainty of money under traditional aid reaching the poor is higher than that under project aid $\sigma_\varepsilon^2 > \sigma_\eta^2$, this also supports the use of project aid. The self-interest of the IFI to give as much money as possible is also supporting aid if project aid is higher than unconditional aid $\chi(T) > \gamma(\underline{A})$. The RHS of the condition compares the amount of money received by the rich under the alternative arrangements. It shows the problem of crowding out normal financial help from the government to the poor, because the government of the receiving country will cut back on support for the poor if the poor receive project aid.

Likewise, the condition for $E[V|_{BA}] > E[V|_{NC}]$ is

$$E\left[-\left\{\beta[\alpha g + (1-\alpha)T(1-\eta) - g]^2 + (1-\beta)[g - \alpha g - (1-\alpha)T(1-\eta) - g]^2\right\} + \chi(T)\right] > \quad (18)$$

$$\mathbb{E}\left[-\left\{\beta\left[\alpha g + (1-\alpha)\underline{A}(1-\varepsilon) - g\right]^2 + (1-\beta)\left[g - \alpha g - (1-\alpha)\underline{A}(1-\varepsilon) - g\right]^2\right\} + \gamma(\underline{A})\right]$$

which can be rewritten as

$$(1-\alpha)^2 \underline{A}(1+\sigma_\varepsilon^2) + g^2(\beta-\alpha)^2 + \gamma(\hat{A}) - \gamma(\underline{A}) > \quad (19)$$

$$(1-\beta)^2 \hat{A}(1+\sigma_\varepsilon^2) + 2g(1-\alpha)(\beta-\alpha)\underline{A}.$$

The condition shows, again, that the IFI is better off under budget aid with conditionality if the difference between β and α is large because conditionality ensures that the poor receive a higher share of government expenditures g . Moreover, the self-interest of the IFI makes budget aid attractive because the IFI can hand out more money than without conditionality. If, which is unlikely to be the case, $1-\beta$ is large, however, the rich receive a large share of the higher budget aid and therefore budget aid becomes less attractive (RHS of the expression).

4.2. Project Aid or Budget Aid?

Supposing that the difference between the relative weight that the IFI puts on the benefits of the poor and that of the government $\beta - \alpha$ is large, and that the self-interest of the IFI to hand out money is non-negligible, it is clear that the IFI would prefer project aid and conditional budget aid to giving aid without conditionality. Moreover, the benchmark case might not be a relevant alternative in any case, because IFIs are increasingly under pressure from NGOs and other interested parties to ensure that poor people are reached by their official money. In as much as political reasons to give money even to the non-deserving governments disappear, the relevant alternatives are project aid and budget aid with conditionality.

The question in this subsection thus is not whether conditional help should be given, but what type of conditional aid should be given. From the IFI's point of view, budget aid is more attractive if $\mathbb{E}[V|_{BA}] > \mathbb{E}[V|_{PA}]$, which is

$$E\left[-\left\{\beta\left[\beta g+(1-\beta)\hat{A}(1-\varepsilon)-g\right]^2+(1-\beta)\left[g-\beta g-(1-\beta)\hat{A}(1-\varepsilon)-g\right]^2\right\}+\gamma(\hat{A})\right]> \quad (20)$$

$$E\left[-\left\{\beta\left[\alpha g+(1-\alpha)\Gamma(1-\eta)-g\right]^2+(1-\beta)\left[g-\alpha g-(1-\alpha)\Gamma(1-\eta)-g\right]^2\right\}+\chi(T)\right]$$

and becomes

$$(1-\alpha)^2 T(1+\sigma_\eta^2)+g^2(\beta-\alpha)^2+\gamma(\hat{A})-\chi(T)> \quad (21)$$

$$(1-\beta)^2 \hat{A}(1+\sigma_\varepsilon^2)+2g(1-\alpha)(\beta-\alpha)\Gamma.$$

The IFI will prefer budget aid to project aid if this is a way to give more aid and if the difference between the IFI's weight for the poor and that of the government is large. By forcing the government to allocate the share β of g to the poor, conditional budget aid is beneficial for the poor. Moreover, the larger the amount of crowding out going on under project aid the better is budget aid and vice versa.

This positive analysis of the IFI's interests need not align with those of the earlier section that looked at how much money ends up in the hand of the poor. Career concerns or fashions in the international aid community might distort policy (see Easterly 2001), and if certain types of aid are preferred, the policy chosen by the IFI need not be the one which leaves the poor better off. If this is not the case, however, and if IFIs are really interested in the well being of the poor, it is likely that budget aid will bring more aid to the poor and that this policy instrument is indeed chosen by the IFI.

5. Conclusion

The present paper has looked at the question whether project aid or conditional budget aid is better suited to increase the income of the poor. Starting from a situation where a politically self-interested government benefits one interest group at the costs of the poor, international donors have to ask themselves how they can improve the well being of the poor in such countries. I have assumed that an IFI can either do so by directly supporting projects that benefit the poor or by attaching conditions to aid to government, which ensure that the poor receive a certain share of this aid.

The first result is that project aid, even if pushed by NGOs and other parties, does usually not only lead to an increase of the income of the poor but will benefit the rich as well. In the stylized model developed here, the government will take the project aid to the poor into account and reoptimize the amount of money channeled to the rich. Official aid thus crowds out funds otherwise given to the poor. By recognizing that part of the burden of supporting the poor is assumed by the IFI, the government is generally free to spend more on the rich.

A second result is that budget aid with conditionality might look as being a perfect alternative. It suffers from the same problem, however. Moreover, conditional aid might turn out to be a very expensive instrument to use. This is particularly the case where conditionality is most needed. The receiving government will only be willing to accept conditionality if it is accompanied by a significant increase in aid. This increase has to be larger the more distorted the government's preferences are in favor of the rich. Receiving more aid in general, the government will again use part of it to give it to the rich, thus the problem of crowding out arises here as well.

This leaves a first sobering conclusion: International financial institutions do not have much possibilities to force governments to spend more on the poor if governments do not want to so. If they put conditionality on the money they spend, this will only work if the

amount of money is sufficiently increased. There is hence no simple substitute for government “ownership” of desired policies.

Another aspect that is often overlooked in the literature is that IFIs themselves might have distorted preferences. If IFIs have an interest to spend money, either because they are pressured to do so by the donor community or NGOs, or because of internal career considerations, they will tend to choose those instruments that allow to distribute more aid. This need not be the most efficient or effective instruments. Aiming to spend more money will push the IFI towards choosing budget aid as the preferred instrument because it will imply more expenditures, if only to meet the participation constraint of the government. Therefore, congruent spending interests might give rise to an implicit coalition between government and IFI.

The present paper is only a first step toward an interesting and largely unexplored field. Preferences of governments and IFI have been roughly sketched and are certainly missing many of real world incentives and phenomena. In addition, several simplifying assumptions have been made concerning the IFI’s capability to enforce conditionality. Exploring the relative effect of relaxing these assumptions would be a promising area for further research. Another aspect would be to see if and how this simple model is supported by the data.

Appendix: Derivation of the critical level of aid to compensate the government for conditionality

The government is indifferent between an increase in budget aid and accepting the IFI's conditionality and living without the support from the IFI, if

$$\alpha(\hat{g}_1 - g)^2 + (1 - \alpha)(\bar{A} - \hat{g}_1)^2 = \alpha(g_1^{\text{GOV}} - g)^2 + (1 - \alpha)(\underline{A} - g_1^{\text{GOV}})^2$$

which is equivalent to

$$(\hat{g}_1 - g)^2 - (g_1^{\text{GOV}} - g)^2 = \lambda \left[(\underline{A} - g_1^{\text{GOV}})^2 - (\bar{A} - \hat{g}_1)^2 \right]$$

with $\lambda = (1 - \alpha)/\alpha$.

Taking the square root on both sides gives

$$\hat{g}_1 - g_1^{\text{GOV}} = -\hat{\lambda} \left[(\underline{A} - g_1^{\text{GOV}}) - (\bar{A} - \hat{g}_1) \right]$$

with $\hat{\lambda} = \sqrt{\lambda}$.¹⁰ Using $\hat{g}_1 = \beta g + (1 - \beta)\bar{A}$ and $g_1^{\text{GOV}} = \alpha g + (1 - \alpha)\underline{A}$, assuming that the government pushes the IFI to set $\bar{A} = \hat{A}$, and solving for \hat{A} results in

$$\hat{A} = \frac{1}{\left(\beta - \frac{1}{1 + \hat{\lambda}}\right)} \left[(\beta - \alpha)g + \underline{A} \left(\alpha - \frac{1}{1 + \hat{\lambda}} \right) \right].$$

The condition for this to be positive is that $(1 + \hat{\lambda})\beta > 1$ or that $\beta > 1 - \hat{\lambda}\beta$, which is the case if β is close to unity and/or if α is close to zero. Thus, if the conflict between the government and the IFI about the appropriate weight for the poor is large, the government request a considerable increase in budget aid to take the poor as much into account as the IFI wants.

¹⁰ Note that the positive solution for $\sqrt{\lambda}$ can be ruled out, because it makes no economic sense.

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