Multilateralism under stress

Homi Kharas ■ Senior Fellow and Co-Director, Global Economy and Development, Brookings Institution

The multilateral development system, led by the United States, has guided development cooperation by Organization for Economic Cooperation and Development (OECD) countries, evolving gradually through new institutions and new norms since World War II. Organized by a small group of like-minded countries, multilateralism has been a way of managing burden-sharing among donors and of delivering public goods. These functions are now under stress.

According to a poll conducted in December 2016 by the Program for Public Consultation at the University of Maryland, most Americans (59.3 percent) support the statement that "when giving foreign aid, it is best for the U.S. to participate in international efforts, such as through the United Nations. This way it is more likely that other countries will do their fair share and that these efforts will be better coordinated." However, a majority of Republican voters disagree, believing that it is better for the U.S. to provide aid on its own, to ensure control over how money is spent and to gain recognition for its generosity.

This America First sentiment is most concerning because multilateral institutions are uniquely equipped to respond to today's development challenges. They can coordinate among multiple development actors; conduct a coherent policy dialogue with government; build partnerships with non-state actors; blend aid and loans with private capital; play an honest broker role, especially in government-business dealings; ensure transparency, consultation, and the application of best-practice safeguards in projects; and provide accountable administrative structures on finance, data, and results-evaluation.

There are two categories of multilateral institutions. One depends on grants from donor budgets, replenished every year or on a regular cycle. The U.N. agencies, various development funds like the International Development Association and African Development Fund, and vertical funds like the Global Fund, the International Fund for Agricultural Development, and Gavi, the Vaccine Alliance fall into this category. Multilateral development banks (MDBs), which constitute the other category, include the International Bank for Reconstruction and Development (IBRD), African Development Bank, and the Asian Development Bank. With MDBs, initial paid-in capital comes from donor budgets, but most financing comes from borrowing on capital markets.

The share of aid passing through multilateral institutions has been steady at around 30 percent, but a growing number of donor countries also make voluntary contributions (about 12.5 percent of aid flows) to multilateral entities, giving them "trust funds" to implement their own programs. The U.S. is one of the largest users of multilateral institutions; 36 percent of its aid disbursements pass through multilaterals, with 16 percent channeled via core contributions, and the remaining 20 percent extended in the form of voluntary contributions designated for specific projects and programs (called "multi-bi" aid).

Multilateral institution detractors worry about high overhead cost, creep and waste, and cumbersome bureaucracy. Major shareholder countries accordingly assess multilaterals through two lenses: First, the degree to which their activities align with the national interest and, second, the effectiveness and efficiency of the agency in carrying out their mission.

Improving the effectiveness of the 192 multilaterals receiving aid today is not an easy process. Many are facing issues that in some cases may be existential. While no multilateral has been closed in the post-World War II era, U.S. leadership will determine the outcomes with consequences resonating for many years.

U.N. agencies and development funds

President Donald Trump's budget for fiscal year 2018 proposed one of the largest declines in discretionary funding in U.S. history, with only $37.6 billion (-29.1 percent) for the State Department and other international programs. Only the Environmental Protection Agency fares worse (-31.4 percent). The budget document outlines the administration's strategy:

> "Remaining engaged with the United Nations and other international organizations while pressing for key reforms that promote transparency, accountability, efficiency, effectiveness, and a more fair distribution of the funding burden. Significant savings can be found by improving peacekeeping missions and spending wisely on U.N. agencies, and encouraging other member states to increase their contributions."

The key issues are burden-sharing and effectiveness and efficiency in implementation.

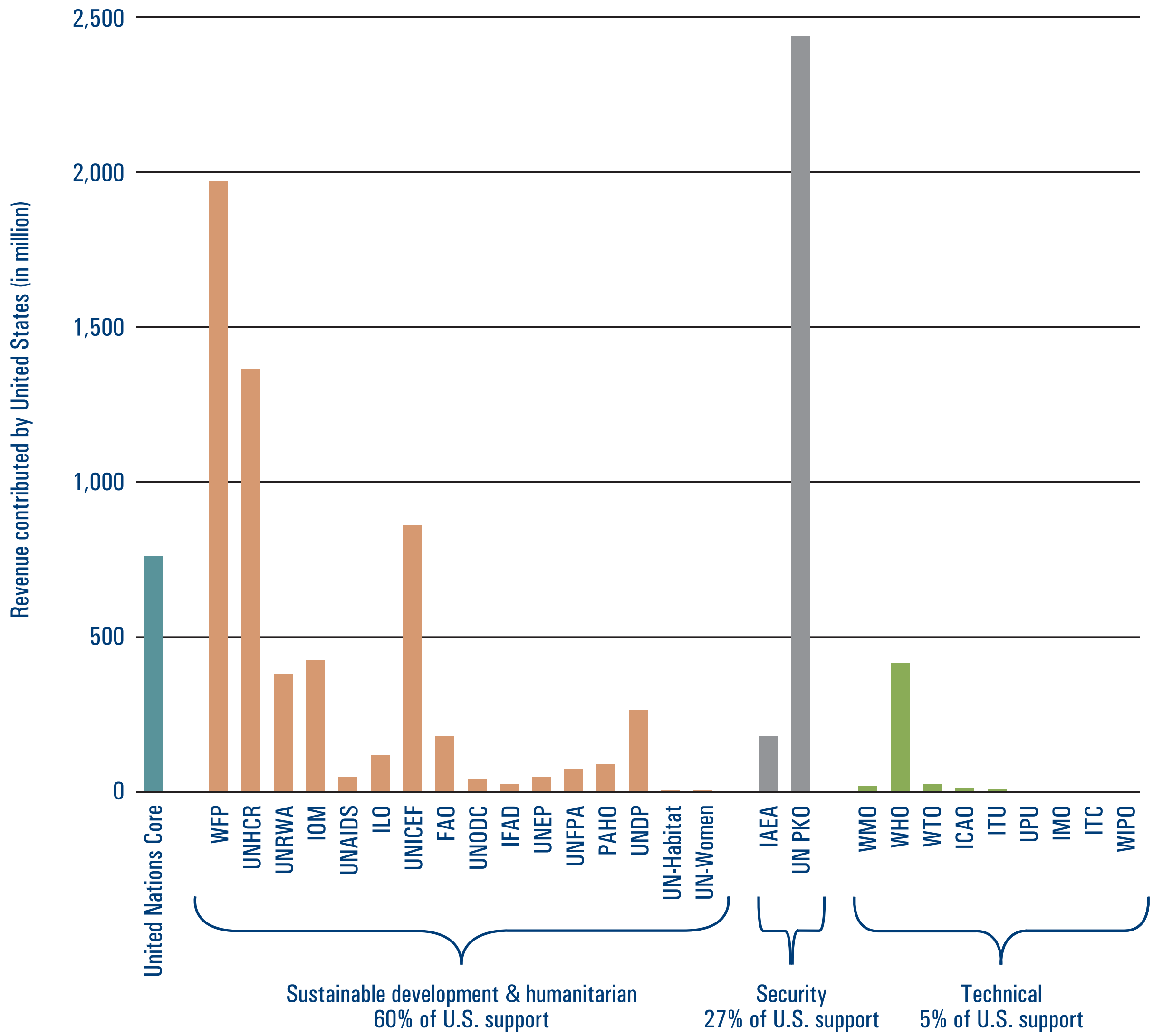
Figure 1 shows U.S. contributions to U.N. agencies in 2015. The majority of U.S. funding (60 percent) goes toward programs that can be classified as "development or humanitarian." A further 27 percent goes toward "security" programs. Little goes to technical agencies or administration.

Five organizations/areas account for three-quarters of all U.S. funding of the U.N.: peacekeeping, the World Food Program, the U.N. High Commission for Refugees, UNICEF, and core funding for the U.N. Secretariat, including the functioning of the General Assembly.

Figure 2 illustrates the question of burden sharing. It shows three definitions of a "fair" distribution: (i) the U.S. share of OECD donors' income; (ii) the U.S. share of the world economy; and (iii) the U.S. share of world population. The burden carried by the U.S. is only excessive in respect to the third yardstick. In aggregate, the U.S. contribution to all U.N. entities is slightly less than its share in the global economy. Moreover, this is highly differentiated by agency. The U.S. provides more than its global economy share to peacekeeping, the World Food Program, the U.N. High Commission for Refugees, and some smaller programs. It provides far less than its proportional share of the global economy to the core administrative functions of the U.N. and to smaller U.N. agencies.

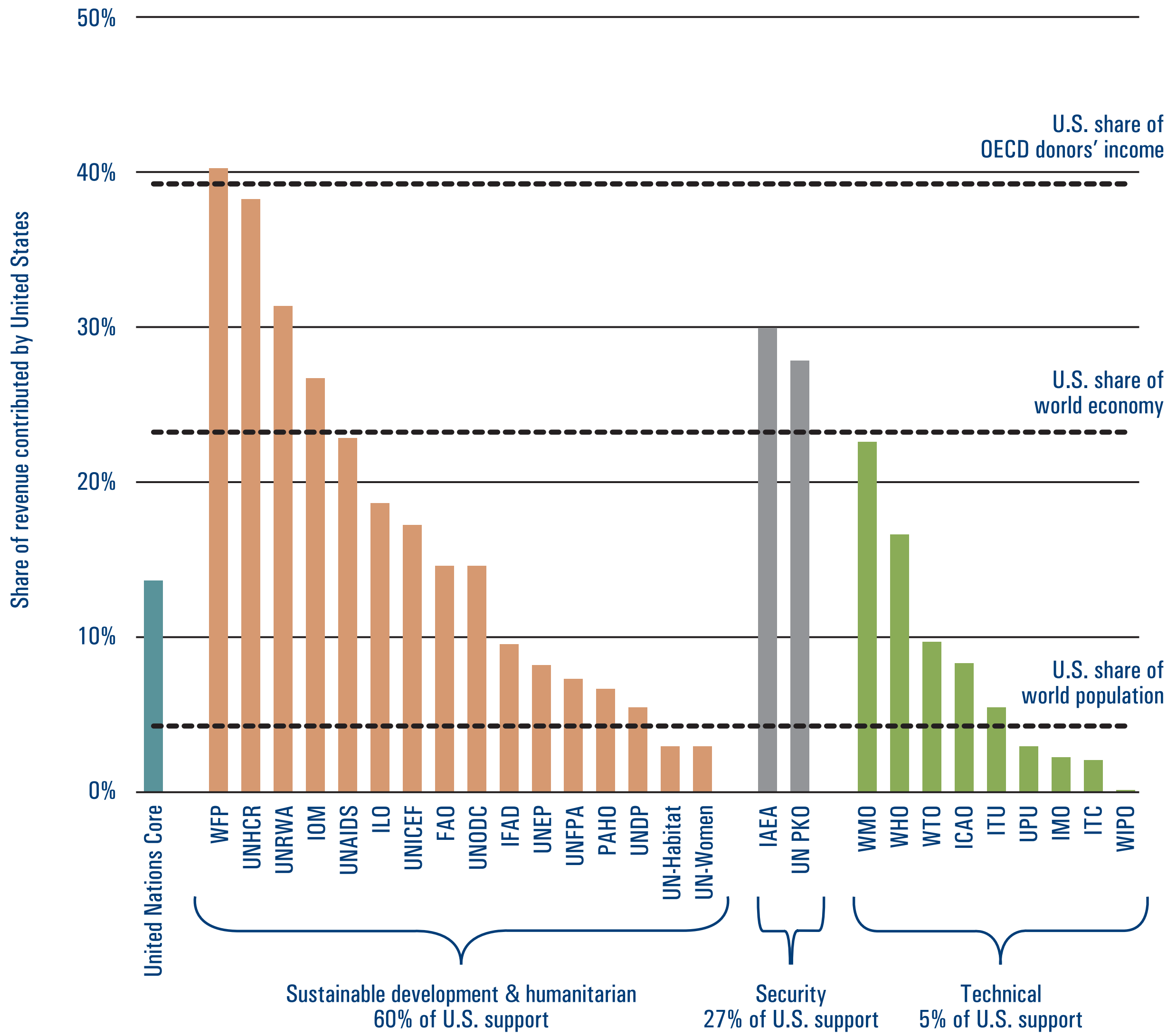
One of the systemic issues facing the U.N. is the small share of core funding, both for the Secretariat and for individual agencies. The U.N. is a forum for establishing norms and technical standards for effective behavior—but the technical agencies get a small fraction of resources. Within the development agencies, too, underfunding of core standards limits their ability to provide a coherent overarching framework within which others can work. (A case in point is the Food and Agriculture Organization's Principles for Responsible Investment in Agriculture and Food Systems). Instead, donors earmark resources toward specific projects and programs they wish to see implemented. Over half the resources of the U.N. development system is now earmarked, a practice that undercuts burden-sharing and restricts flexibility in resource allocations.

Figure 1: U.N. organizations' revenues provided by the U.S. in 2015



Source: McArthur and Rasmussen calculations based on data from https://www.unsceb.org/content/un-system-financial-statistics, downloaded 2-May-2017

Figure 2: Share of the U.N. organizations' revenues provided by the U.S. in 2015



Source: McArthur and Rasmussen calculations based on data from https://www.unsceb.org/content/un-system-financial-statistics, downloaded 2-May-2017

Figure 2 shows that the U.S. already has great discretion to fund agencies of which it approves and to withhold funding from those of which it disapproves. In 2014, the U.S. did not fund five agencies: UNESCO, the Office for Project Services, the U.N. University, the Institute for Training and Research, and the World Tourism Organization. Ironically, if the U.S. cuts its U.N. contributions, it will almost certainly have to cut funding to organizations where it currently has most control; for example, two institutions with the largest U.S. funding—the World Food Program and UNICEF—have always been led by Americans.

Another major issue that arises when individual donors fund different parts of the multilateral system is that the system can become unbalanced. The U.N. spends much of its money (about 40 percent) in fragile states where humanitarian and peacekeeping costs predominate. In these countries, the share of development expenditures is low, around one-quarter. The system is heavily oriented toward dealing with symptoms of crisis (famine, conflict) and provides relatively little money to build resilience and fund prevention, something that could be five to 10 times more cost effective. The continuation of earmarking hampers any shift toward more cost effective programming. For decades, then, the humanitarian-development and peace-development divides have remained unaddressed.

Multilateral development banks

The U.S. is the major shareholder in many multilateral development institutions and has traditionally appointed the president of the World Bank, the largest institution. The five largest multilaterals operating in developing countries collectively have capital and reserves of over $800 billion. Yet they are shackled by their shareholders, both in financial and operational terms.

From a financial perspective, MDBs have been very cautious, partly because most of their capital is callable, not paid-in, and shareholders wish to limit their risk. Although MDBs often publicize their commitments, their actual net disbursements are far smaller, with the outstanding stock of loans of the five largest multilateral banks just over $400 billion. The G-20 Working Group on multilateral banks reported that there could be potential for at least doubling this amount without jeopardizing the AAA credit rating status enjoyed by all the top five development banks.

From an operational perspective, shareholders are split on two major issues. They do not agree on the role of multilateral banks in upper middle-income countries (defined as countries with per capita income levels between $3,956 and $12,236). Some shareholders believe that lending to this group dilutes focus and argue in favor of graduation at an early stage. Other shareholders, including the upper middle-income countries themselves, are in favor of continued support, in order to solve a range of global and regional problems—including knowledge sharing—as well as to improve the portfolio through diversification to low-risk countries. They emphasize the cooperative nature of the multilateral institutions. The largest demand from upper middle-income countries is for infrastructure financing and institutional support via technical assistance.

A second divisive issue surrounds the nature of engagement with the private sector and managing the risk that publicly-funded projects could crowd out commercial investors. The World Bank has adopted a "cascade" principle for infrastructure finance to crowd-in private investment and to create markets. Under this framework, the Bank will first try to mobilize commercial investors through regulatory and policy reforms to improve the private investment climate and then look at risk-sharing instruments like guarantees, only using loans when these efforts to create market solutions do not work.

The cascade principle is widely disliked by other development banks who look to the client country for guidance as to whether to pursue a project as a private or publicly funded activity. Middle-income countries, too, are concerned about the potential of the cascade to slow the speed of project processing.

With shareholders at loggerheads, the major development banks, including the IBRD and the International Finance Corporation, are operating below potential. They lack clarity on the feasibility of a capital increase. They are still experimenting with new operating modalities for blending their financing with commercial investors.

U.S. leadership

The U.S. has long been the leader of the multilateral development system, shaping its structure and funding its operations. That leadership is required now more than ever. Important decisions on funding have to be made—for U.N. agencies and for a number of funds whose three-year funding cycle is falling due, which includes the Global Environment Facility, the International Fund for Agricultural Development, and the Global Partnership for Education.

At the same time, the U.S. must take the lead in setting out a vision for the MDBs, both at the boards of these institutions and in global fora. The G-20 has commissioned an eminent persons group to look into the optimal role of the international financial institutions, with Tharman Shanmugaratnam, deputy prime minister of Singapore, as chairman, and John Taylor, former U.S. treasury undersecretary, as a member. It will deliver its final recommendations by September 2018.

In the background, but not to be ignored, is the specter of China's emergence as a major player in development finance. China has helped found two new, and now operational, development banks, the Asian Infrastructure Investment Bank and the New Development Bank. The AIIB has an initial paid-in capital pledge of $20 billion. By 2020, it will have more paid-in capital than the IBRD (although the latter has accumulated considerable reserves) and about the same lending capacity.

China's commercial banks, the China Development Bank and the China Export-Import Bank, also lend abroad. Between them, they have approximately the same total international assets—$680 billion—as all the western multilateral banks put together. China has also announced concessional funds totaling another $116 billion.

In the case of China, development financing is coupled with political support at the highest level. Chinese President Xi Jinping hosted a Belt and Road Forum in May 2017, attended by nearly three dozen heads of state (with Italy being the only G-7 participant) to lay the groundwork for a new global order.

There is a stark contrast between China's view that their One Belt, One Road initiative is the "project of the century" and the U.S. view that it is time to reduce the U.S. presence on the global stage.