Powerful donors and foreign policy: The role of multilateral financial institutions

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WP 2004: 12

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Chr. Michelsen Institute *Development Studies and Human Rights*

CMI Working Papers

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Price: NOK 50

ISSN 0805-505X
ISBN 82-8062-096-6
This report is also available at:
www.cmi.no/publications

Indexing terms
Foreign policies
Conditionality
Unilateralism

JEL: F35, F37, D74, D78

Project number
22065

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> "The United States has played a leading role in shaping the World Bank's agenda, and Bank projects often support US foreign policy goals. ... However, insofar as the United States can ensure that Bank projects support US foreign policy goals, US contributions are multiplied many times over by those of other member countries."
>
> *United States General Accounting Office (1996)*[1]

1. Introduction[2]

The empirical literature on donor-recipient relations emphasizes the fact that donors' foreign policy objectives are important motivations for giving foreign aid. In a joint report, the IMF and the World Bank suggest that the recent increase in foreign assistance probably arises from strategic considerations - the war on terrorism, conflict and the reconstruction of Afghanistan and Iraq (World Bank 2004). Moreover, Alesina and Dollar (2000) find that France, Great Britain and Japan favor their former colonies when disbursing aid, and that they, together with the US and Germany, allocate more aid to recipients that vote with them in the UN. The US targets more than one third of its total assistance on Egypt and Israel for political reasons, and it is evident that many of the recipients that receive the most aid per capita, such as Israel, Jordan, Egypt and Poland, do so because of their strategic importance (Cassen 1994). However, the opportunity for a powerful donor country to use a multilateral financial institution (MFI) strategically to promote its own foreign policy goals has received far less attention.

The gain to an influential donor which is able to make the World Bank or other similar multilaterals adopt this donor's view on an issue can be substantial. In that case, all the contributions from the other member nations will also stand behind the multilateral organizations' stance on the particular issue, and recipients may feel compelled to comply with this massive counterpart. As a result, influencing the multilaterals may give much more leverage to a donor's foreign assistance in the foreign policy arena than pursuing the same goals bilaterally with the same amount of aid. The US General Accounting Office (1996) is particularly illustrative when it states that about $2 billion in US paid capital generated the potential for political influence over World Bank loans of nearly $286 billion through co-financing with other donors and the private sector. It follows that, **f** the GAO is right in

[1] The General Accounting Office has now changed its name to the Government Accountability Office (GAO). GAO is an agency that works for Congress to study the programs and expenditure of the federal government, and is commonly called the investigative arm of Congress. It studies how the federal government spends its resources, and advises Congress and the heads of executive agencies (such as the Environmental Protection Agency, EPA, the Department of Defense, DOD, and Health and Human Services, HHS) on ways to make government more effective and responsive. GAO evaluates federal programs, audits federal expenditures, and issues legal opinions. See http://www.gao.gov.

[2] A preliminary version of this paper was presented at the NEUDC 2004 and at the Cornell-DPRU-Tips 2004 conference, and I thank the participants for valuable comments. Thanks also to Magnus Hatlebakk and Karl Rolf Pedersen.

asserting that the US, with its 22 % of the total donor support to the World Bank, is able to take the leadership in setting the bank's agenda, there is little doubt that this strategic behavior can be effective for the US in achieving its own foreign policy goals.

As indicated by the above quote, using this channel of influence may yield substantial payoffs to powerful donors which act strategically in international relations. However, it is evident that not many donors have the ability to play such a game. To exemplify this pattern, we focus on a few big influential donors, with the US influence over the World Bank elaborated in US GAO (1996) as our starting point. Given the strategic behavior of other large donors, it is also tempting to scrutinize Japan's behavior vis-à-vis the Asian Development Bank, or French agenda-setting in the African Development Bank, along these lines. However, our mission here is to provide the theoretical framework for understanding the driving forces that come into play in these settings.

Even if the principal-agent framework is the workhorse of the theoretical literature on foreign aid, and seems useful in explaining such behavior, this literature does not address the question of how some powerful donors are able to use the multilaterals to influence recipients. This gap in the literature is unfortunate, since this type of strategic behavior raises several important questions. Firstly, under which circumstances can strategic play of this kind be rewarding for a donor, and what are the mechanisms that allow for such interaction? Secondly, how will the resulting influence change the aid allocation of the other donors? Thirdly, what implications can we draw with regard to improving the efficiency of the multilateral infrastructure in general?

This paper attempts to answer these questions with a model in which the powerful donor's effort to influence a multilateral to put pressure on a recipient to comply with the foreign policy interests of the donor is endogenously determined. This game-theoretic multi-agent model with one donor, two multilaterals and one recipient illustrates the virtue of using the multilateral as an instrument in foreign policy as seen from the powerful donor's point of view. One implication of such strategic behavior is that it is damaging for the development of the recipient country and it is not difficult to see that the outcome may cause other donors to reduce their contributions below what would be optimal without such behavior. Most models of foreign aid are dyadic, which means that all the agents interact in pairs. Our model is triadic, which implies that an agent *i* (the donor) not only takes account of its relationship with agent *j* (a multilateral), but also of its own and agent *j*'s relationship with a third agent *k* (a recipient).[3]

Our model also sheds light on the question why the development operations of different donors seem to overlap in many countries, a practice that has raised concern about a possible duplication of effort and unhealthy competition for "development business" (Kanbur 2002). Our model suggests one reason as to why bilateral donors have programs in a poor country at the same time as they are financing the overlapping programs of a multilateral organization in the same country. The economies of scale and the economies of scope that are associated with pooling resources in multilaterals are balanced by the costs for an individual donor of having the multilateral institution's policies being influenced in another direction (by an influential donor) than what is optimal from this particular donor's point of view. So when the preferences of the donor differ from the multilateral with regard to policy, then it is worthwhile for some donors to diversify between their own and multilateral projects.

[3] See Basu (2000) for a discussion of dyads and triads.

The particular channels that multilateral organizations may use to influence recipient countries differ not only across organizations, but also between the issues that are fronted. It is well known that the World Bank specifies a detailed set of conditions, which the recipient must implement before it receives aid, a practice which is often referred to as "buying reform". Less is known, however, of what is actually agreed upon in the negotiations between the top officials during the implementation process. There appears to be some room for maneuver, since it is frequently found that the World Bank disburses almost 100% of the aid, even if only 50% of the conditions are implemented (World Bank 1992). We propose an explanation for the partial success of conditionality that is complementary to those suggested by Svensson (2002) and Villanger (2004). Our results suggest that when the multilaterals must include foreign policy in their recommendations to the recipient, then the multilateral has to accept some slippage in the recipient's implementation of the conditions in order to make the recipient accept the total aid conditionality/foreign policy package. Moreover, we show that making the recipient adhere to the foreign policies of the donor always has priority, and thus, the implementation of conditions levied by the multilateral will be partly crowded out.

This paper is organized as follows: the empirical background is presented in section 2, and the model of an extended triadic structure involving two donors, two multilaterals and one recipient is presented in section 3, while a few comments and tentative policy implications are discussed in section 4.

2. Institutional background

The literature on international relations offers anecdotal evidence of a number of triadic institutions in the world economy, and in this section we briefly provide some examples of how donors can use a multilateral to achieve their goals. It is evident, as Basu (2000) notes, that triadic relations occur in interactions at the international level, especially in situations where sanctioning is an issue.

The US GAO evaluation, which was quoted in the introduction to this paper, gives us a glimpse of one mechanism that enables donors to use multilaterals as instruments of their foreign policy. It states that what leverages the US funds is that obliging the World Bank to adopt the US's foreign policy goals makes it more likely that the recipients will adopt these policies since the developing countries perceive the bank to be neutral:

> "The Bank's perceived neutrality helps to further increase the potential impact of these funds. Developing country officials generally perceive the Bank - a multilateral institution counting their own governments as members - as a neutral institution that provides objective advice. Bank officials, developing and donor country officials, and private sector representatives commented that Bank advice is less likely to be viewed as motivated by self-interest than advice offered by private businesses or bilateral donors and is therefore more likely to be acted upon, particularly in cases where proposed changes are costly and politically difficult."

Even though the GAO report seems to exaggerate the extent to which developing country officials perceive the World Bank to be neutral, their main point is still important: the World Bank is perceived as being much more neutral than the US government, and its advice is more

likely to be acted upon than if the US had given that advice. One reason why we do not find many similar stories for other influential donors could be that many governments would not publicly disclose their strategies, since openness about the pressure would make the neutrality position crumble. Moreover, openness about such behavior may also encourage other donors to resist such pressure. As a result, it is in the strategic donors' own interest to keep such indirect pressure as confidential as possible.

The US GAO also gives a telling example of how the three-party structure comes into play. At the beginning of the 1990s, the US opposed grants of concessional World Bank IDA loans to China, despite the fact that China's low level of per capita income made it eligible for these types of loan. US government officials argued that China's high level of foreign currency reserves and high credit rating would secure other sources of finance. However, there is little doubt that the attempt to deny China further IDA funds was one of several ways of putting pressure on the Chinese government to reduce its balance of payments surplus vis-à-vis United States. Other motives for forcing the World Bank stop giving IDA loans to China have also surfaced. Some argue that the US wanted to punish China for misconduct in Tibet, while others assert that the US aim was to give the loan to other recipients.[4] However, the actual motive for making the World Bank put pressure on China is of less interest here, as long as the motive was to promote the US's own foreign policy.

Another example of donors putting pressure on the World Bank in order to achieve the donors' own goals can be found in Kanbur (2000), who reports his experience of the World Bank assessment of whether or not to release a loan tranche to Ghana:

> "In fact, as the representative of the World Bank on the ground, I came under pressure from several sources, some of them quite surprising, to release the tranche with minimal attention to conditionality. There was a steady stream of private sector representatives, domestic and foreign, arguing for release of the tranche, both because of fears of what macroeconomic disruption would do to the business climate in general, and also because some of them had specific contracts with the government which were unlikely to be paid on time if the government did not in turn get the money from the World Bank and other donors. Next in line were the bilateral donors - even those who had tied themselves to the presumably greater discipline of the World Bank by co-financing. Some of these had "fiscal year" concerns - they feared the consequences within their agencies of not releasing the funds in the fiscal year for which they were slated. Others worried about a meltdown of the economy if the tranche was not released. Yet others found their projects slowing up because government counterpart funds were not available, and many project agreements stipulate that donor money flows in a fixed relationship to government contributions."

This illustrates the potential gain to a donor of strategically influencing multilaterals to act in accordance with the donor's interests.

[4] There was a lively debate at the 2004 Cornell-DPRU-TRIPS conference about the US motives for making the World Bank refuse the IDA loan to China. Americans who followed this incident very closely at the time argued that the motive was more to punish China for serious violations of human rights in Tibet and to give IDA loans to others, than it was to reduce the Chinese balance of payments vis-à-vis the US. The US Department of State Country Reports on Human Rights in China 1993-1996 indicate that the situation in Tibet was of particular concern to the US, so we do not dismiss this motive.

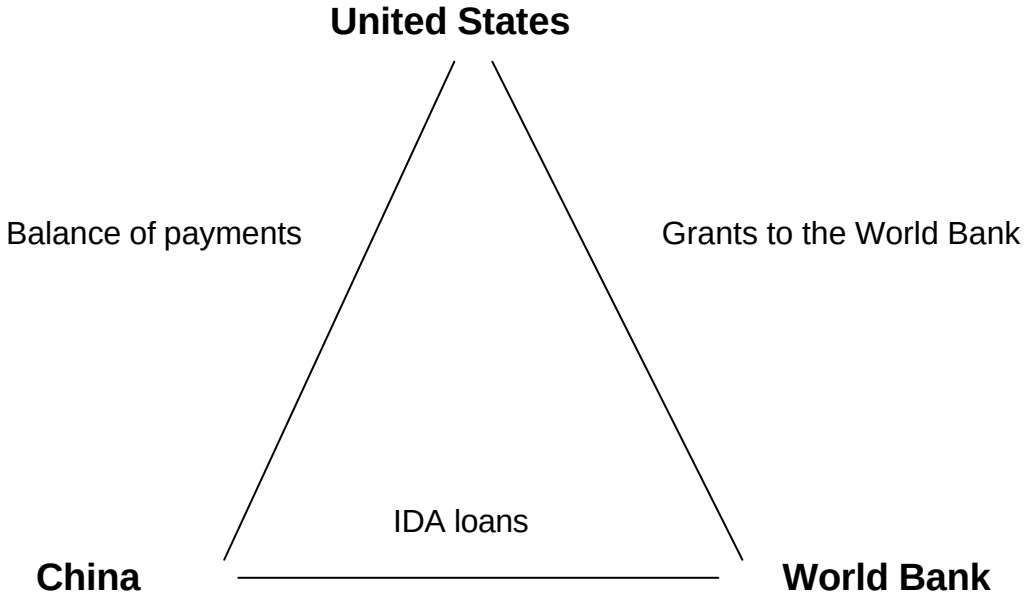
The three-party relationship that arises from the nature of poor countries' debt problems may serve as another illustration of triadic relationships. Take a situation where a developing country, Brazil for example, has a large debt burden and is negotiating with the World Bank for new finance to manage the repayment of maturing loans. Then it will be in the interest of the creditors to Brazil, such as the private banks, to put pressure on the World Bank to disburse the loan even if the conditions for disbursement are not fulfilled, since this will increase the probability that they will get their money back. Thus, powerful donors may put pressure on the World Bank to disburse new loans in order to support the donor's own private banks.

3. The model

3.1 The structure and behavioral assumptions

Take as a starting point the US attempt to refuse an IDA loan to China due to China's high level of foreign currency reserves. If the US tacitly threatens to reduce its contribution to the World Bank unless it cuts off the IDA loans to China, then figure 1 can illustrate the three-party relationship in this setting.

Fig. 1. The relationship



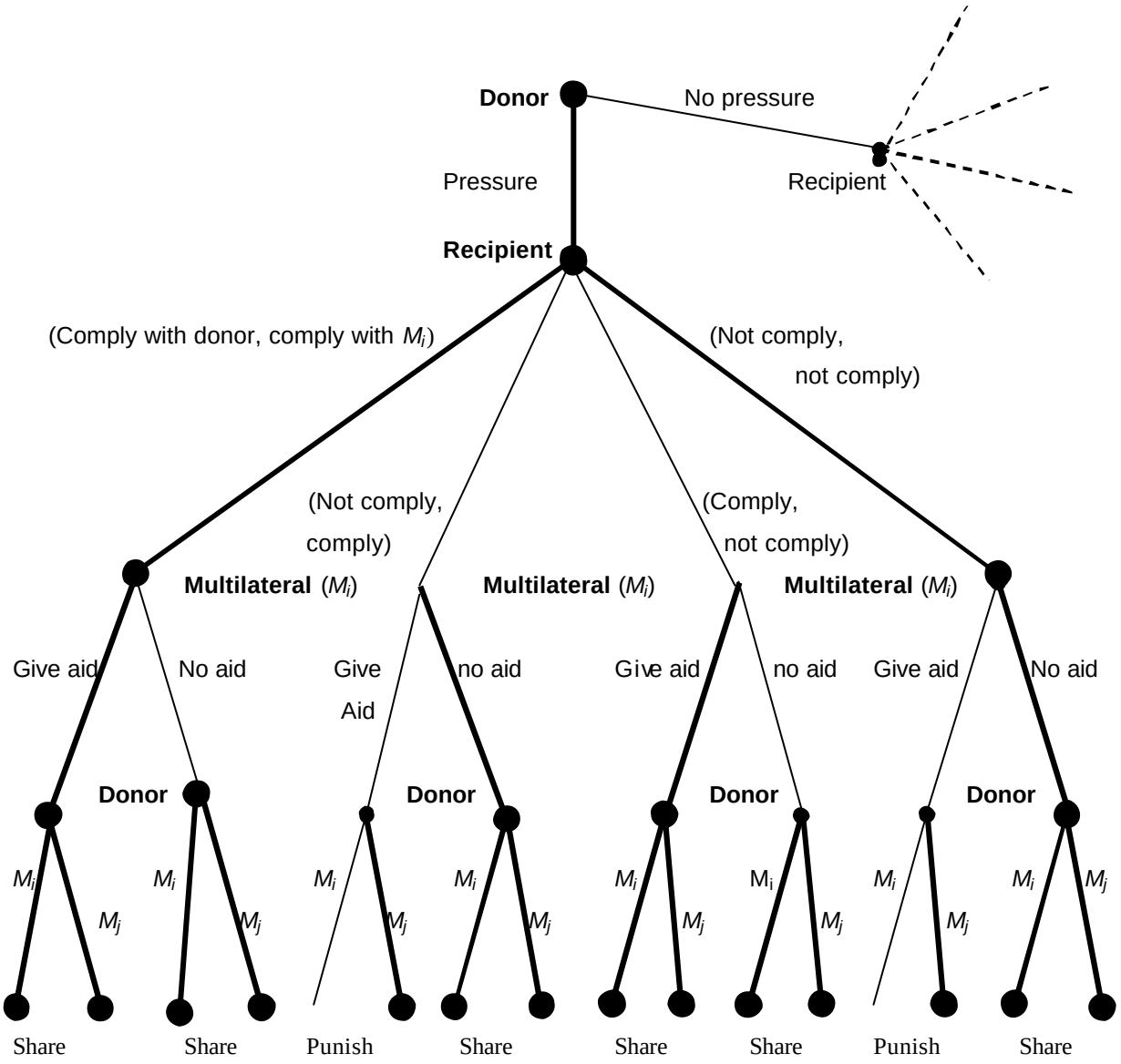
Assume now that there is one powerful donor and one recipient where the donor is a Stackleberg leader maximizing its utility by choosing the level of aid and the extent of economic reforms that the recipient is to implement before getting aid, given its knowledge of the recipient's (follower) reaction function along the aid-reform parameters.[5] Assume also

[5] It is important to note that we follow strictly the standard way aid conditionality is modeled in the literature, which is an accurate description of so-called performance-based aid. For aid conditionality models with this structure, see Svensson (2000) and Villanger 2004. See also Kanbur (2000).

that there are two multilateral organizations, M_i, $i=1,2$. It is common knowledge that the donor will link its grant to M_i according to whether or not M_i influences the recipient to comply with the donor's foreign policy objectives. No threat is explicitly stated, but the agents know that if the recipient does not adopt the foreign policy of the donor, then the donor's intention is to refuse to give any resources to M_i unless M_i withholds the aid to the recipient. This implicit threat by way of a third agent is meant to mobilize a harsher punishment of R for non-compliance than merely losing the bilateral aid from the donor.

These actions are sequential, and thus, it is necessary to analyze the relationships in a dynamic framework. At stage one in the game, the donor decides whether to pursue a strategy whereby it tries to influence the foreign policy of the recipient via the multilateral organization. At stage two, the recipient decides which policies to adhere to, and this decision regards both foreign policy and structural and economic reforms as specified in the conditions that the multilaterals set for giving aid. At stage three, the multilateral decides whether or not to give aid to the recipient, and at stage four the donor decides how to allocate its aid to the multilateral organizations. Figure 2 illustrates the sequence of the actions.

Figure 2: The game tree under the leverage strategy



Now, assume that the donor is indifferent to how its aid is allocated, as long as it goes through a multilateral and ends up in a poor country, and that it is less efficient to give aid to the recipient than to give it to the multilateral. Another option would be to channel the aid directly to the recipient, or give the aid to some other poor country if the multilateral and the recipient do not comply with the donor's demands. However, our assumption is only to avoid drawing attention to the fact that the donor could threaten to disburse the aid directly to the recipient, or to another poor country, if the multilateral does not comply. In the former case, the recipient will get aid from the donor if the multilateral does not punish the recipient in a situation where the multilateral does not comply with the donor. This donor behavior

undermines the donor's own aim of making the recipient comply, and is thus rather unrealistic. The latter case, where the donor's strategy would be to threaten to give the aid to another poor country, is more realistic. Note, however, that in both cases it can be shown that the main result of the model may be unaltered if we use these alternative threats. In the case of only one multilateral, the only assumption needed is that it must be costless for the donor to give the aid to some other agency or purpose if the multilateral does not comply with the donor's demand.

The required assumption for illustrating our main point in a model with only one multilateral seems very realistic. However, the drawback of using only one multilateral is that we do not get the interesting result that similar multilaterals can be played off against one another and find themselves in a "prisoner's dilemma". This structure illustrates an additional argument for why strategic behavior may be very rewarding for powerful donors. Taken together, our set-up, where the powerful donor's threat is to give the aid to another multilateral, seems like a more fruitful approach.

Assume also that the donor acts according to the following "weak reciprocity" rule:

> The donor will give the aid to M_j if M_i gives aid to the recipient in a situation where the recipient does not comply with the foreign policy of the influential donor. Otherwise, the aid is shared between the multilaterals.

We term this rule "weak reciprocity" because it specifies that if the donor is indifferent to the choice between two actions, it will choose the action with the worst result for a multilateral if it does not comply with the donor's aim of punishing the recipient for not adopting the donor's foreign policy. Our weak reciprocity assumption gets increasing support from experimental economics, where one frequent finding is that people are inclined to punish those who do not co-operate, even if this punishment does not imply higher payoff in subsequent periods (in contrast to trigger strategies in repeated games). Moreover, this literature suggests that many individuals are willing to go much further than what is implicit in our weak reciprocity assumption. These experiments reveal that people may take on a cost in order to punish non-co-operators, even if this does not lead to a higher payoff in subsequent periods (Fehr and Gächter 2000; Ostrom, Walker and Gardener 1992).

In particular, experiments with "ultimatum games"[6] reveal that substantial positive offers are turned down. Proposals of less than 20% in these games are often rejected (Güth and Tietz 1990; Roth, Prasnikar, Okuno-Fujiwara and Zamir 1991; Camerer and Thaler 1995; Henrich 2000), which implies that people are willing to lose 20% of the money in the game as long as the player that proposed the "unfair" share gets nothing.[7] Bowles and Gintis (2000) interpret these results as reflecting "strong reciprocity": a behavioral rule to reward co-operators and punish those who deviate from norms of acceptable behavior. Our assumption of weak reciprocity does not go so far as implying that a player is willing to incur a net cost of punishing, only that a player who is indifferent to the choice between two actions chooses the action that gives the worst outcome for the deviator and the best outcome for the co-operator.

[6] In an ultimatum game, two players (usually unknown to each other) decide on how to share an amount of money between them. One is chosen to propose a share, the "proposer", and the other one, the "responder" decides whether or not to accept that share. If accepted, the proposed share is allotted to the responder while the proposer will have the remainder. But if the offer is rejected, neither of the players gets anything.

[7] Low offers are often perceived as "unfair" by both the proposer and the responder; see, for example, Henrich's (2000) interviews of the players in Los Angeles and Machiguenga, Peru.

3.2 The payoff functions

Assume that there is only one foreign policy issue that the countries must decide on in this model: the trade policies in the US-China-World Bank situation referred above, for example, or to what extent the countries support the ongoing "war against terror". To keep it as simple as possible, assume that p_i^* denotes country i's optimal stance on this foreign policy issue, and let p_i^j denote the event that country i has adopted country j's foreign policy stance. Let the two countries' favored positions differ, $p_i^* \neq p_j^*$, and assume that each country can only choose p_i^* or p_i^j, so that no combinations of policies are possible.

To simplify the presentation, let the superscript of the aid variable, a, indicate the recipient of foreign aid, and the subscript indicate which agent is giving the aid. Thus, a_{US}^{Mi}, a_{Mi}^{R} indicates the amount of aid given by the donor, *US*, to M_i, and the amount of aid given from M_i to the recipient, *R*, respectively.

Let the utility function of the donor be

(1) $US(p, a_{us})$.

Assume that the donor achieves a higher utility level if the recipient adopts the donor's foreign policy positions, compared to the situation where the recipient adheres to its own foreign policy stance. Note, however, that the donor does not derive any utility directly from the positions that any multilateral may take on these issues. Thus, ceteris paribus, the donor is indifferent to the multilaterals' stance on foreign policy.[8] Assume further that the donor believes that giving aid is in itself a good thing to do, and its utility therefore increases in proportion to the amount of aid disbursed to the multilaterals. This assumption reflects the empirical finding that one of the motives for most donors in giving aid is usually that aid spurs economic growth, or reduces poverty, but can also reflect other altruistic objectives like achieving the Millennium Development Goals.[9] Let $\hat{a}_{US}$ be the donor's total amount of aid, and assume that this amount is exogenously determined and constant.[10]

Assume further that each multilateral is funded by several other exogenous donor countries so that the multilateral is able to give the specified aid to the recipient even if the donor should cut off its grants to this multilateral organization. The multilateral organizations have identical preferences, and the utility function of multilateral i is assumed to be

[8] Clearly, it is abstracting from reality to suggest that donors are indifferent as to which multilateral to fund, and we thus return to this issue in section 3.7. However, assume for now that the donor is indifferent in the choice between giving aid to similar multilateral financial institutions, and it is sufficient to have a donor that is indifferent between giving aid to the World Bank compared to giving aid to the IMF. Similarly, it is sufficient to assume that the donor is indifferent between giving aid to different regional multilateral financial institutions like the African Development Bank, the Asian Development Bank and so on.

[9] Empirically, this motive is also important for the influential donors we are investigating here. See, for example, details on the criteria for being eligible for grants from the US Millennium Challenge Account of $5 billion per year (http://www.whitehouse.gov/infocus/developingnations/millennium.html).

[10] It is usually assumed that the total amount of aid is determined by agents other than those that execute the aid policy. For example, it is often the congress or national assembly that determines the sum of foreign assistance. Aid will be endogenously determined in the extension of the model in section 4.

(2) $M_i(a_{Mi}^R, a_{US}^{Mi}, g_i c_i)$ where $i = 1,...,k,$

and where the multilateral has an increasing utility in the amount of aid received from the donor a_{US}^{Mi}. Let c_i be the conditions or reform program that multilateral i levies on the recipient, and let g_i be the recipient's degree of implementation of these conditions.[11] Then let $g_i \in [0,1]$ define the degree of the recipient's implementation of the conditions levied by M_i, where $g_i = g_i^0 = 0$ indicates that none of the conditions are implemented, and then the degree of implementation increases up to $g_i = g_i^1 = 1$, which indicates that all of the conditions are implemented. We assume that M_i has an increasing utility in g_i, and an increasing utility in giving aid to the recipient up to a cut-off level determined by the degree of the recipient's implementation of the conditions, and a decreasing utility in giving aid above this threshold:

$$(3) \qquad \frac{\partial M_i}{\partial a_{Mi}^R} \begin{cases} > 0 & for\ a_{Mi}^R < \tilde{a}_{Mi}^R \\ = 0 & for\ a_{Mi}^R = \tilde{a}_{Mi}^R \\ < 0 & for\ a_{Mi}^R > \tilde{a}_{Mi}^R \end{cases}$$

where

$$(4) \qquad \tilde{a}_{Mi}^R = f(g_i),\ \frac{\partial f}{\partial g_i} > 0,\ \tilde{a}_{Mi}^R \le \hat{a}_{Mi}$$

Hence, the higher the degree of implementation, the more aid will be disbursed from the multilateral. Note also that the multilateral decreases its utility in giving more aid than $\tilde{a}_{Mi}^R$. It is thus a loss for the multilateral if more aid is given than the actual implementation record of the recipient should imply. This assumption stems from the "aid-for-reform" nexus, or buying reform: donors believe that improving the macroeconomic environment in the recipient country will increase aid's impact on growth and that giving aid to a recipient with a bad environment will be a waste of aid. Hence, giving more aid than the amount justified from the recipient implementation record is to waste the aid, and this will, in addition, also undermine conditionality.[12]

Let the recipient's utility function be denoted

$$(5) \qquad R(p, a_M^R, g\ c)\ \text{, where } a_M^R = \sum_{i=1}^{k} a_{Mi}^R$$

where c represents the vector of conditions $c = (c_1, \ldots, c_k)$ that the multilaterals impose on the recipient. Let g be the corresponding vector that indicates the degree of implementation of

[11] The multilateral financial organizations typically condition their aid on the recipient implementing reforms or policies that are conducive to economic growth and development, such as good macroeconomic policies that create low inflation, balanced budgets and openness to trade.

[12] See Burnside and Dollar (2000) for more on this argument.

the conditions for the k different multilaterals: $g = (g_1,...,g_k)$. It is assumed that the recipient derives utility from the foreign policy stances of the other countries in the same manner as the donor. Thus, the recipient increases its utility if other countries take the same stances in foreign policy as the recipient's stances, and reduces its utility if it is compelled to abandon its own foreign policy in favor of some other country's stance in these matters. Assume also that the recipient has an increasing utility of receiving aid, and has a decreasing utility in the degree of implementation of the conditions.[13]

The sequencing implicit in conditionality implies that M_i demands that the recipient implement at least g_i before a_{us}^R is disbursed. However, the recipient will demand that the offer is at least as good as its reservation payoff, namely not to implement the conditions and not have any aid: $R(p, \bar{a}_{Mi}^R, g_i^0 c_i)$, where $\bar{a}_{Mi}^R = 0$. The multilateral's decision on the amount of aid to disburse for an ex post implementation, $\breve{g}_i$, is thus found by solving the following maximization problem:

$$(6) \qquad \underset{a_{Mi}^R}{Max}\, M_i(a_{Mi}^R, a_{US}^{Mi}, \breve{g}_i c_i) \quad s.t. \quad R(p, \bar{a}_{Mi}^R, g_i^0 c_i) \le R(p, a_{Mi}^R, \breve{g}_i)$$
$$a_{Mi}^R \le \hat{a}_{Mi}.$$

It follows that the donor can set some conditions c_i where for every degree of implementation, $\breve{g}_i > 0$, there exists an optimal amount of aid, $\breve{a}_{Mi}^R$, that will be disbursed, ceteris paribus, to the recipient, as long as this amount is less than the total aid budget of the multilateral, $\breve{a}_{Mi}^R \le \hat{a}_{Mi}$. Then let

$$(7) \qquad (\breve{g}_i, a_{Mi}^{\breve{g}i}), \ \breve{g}_i \in [0,1]$$

represent the aid implementation pairs that maximize the multilateral's utility function, and note that each of these pairs satisfies the constraint with equality:

$$(8) \qquad R(p, \bar{a}_{Mi}^R, g_i^0 c_i) = R(p, a_{Mi}^{\breve{g}i}, \breve{g}_i c_i).$$

Thus, the recipient is always, ceteris paribus, made indifferent by the multilateral between implementing the conditions and receiving the aid, and not implementing and not getting aid. To induce the recipient actually to choose to implement the conditions, however, the multilateral offers the recipient a very small reward for full implementation, $g_i = 1$, and this reward decreases with smaller g down to zero for no implementation, $g_i = 0$.

3.3 Some assumptions about the payoffs

The following assumptions will focus the analysis on the interesting situations, i.e. those where it is possible for donors to influence multilaterals strategically in foreign policy issues. First, we simplify the presentation by assuming that the donor's aid is not large enough to

[13] If the donor and the recipient have the same preferences regarding the economic reforms, then there is no need to condition the aid on reform. Conditionality is thus often referred to as buying reform, i.e. the multilateral financial institutions specify an economic reform that the recipient must implement before it gets loans (see for example Collier, Guillaumont, Guillaumont and Gunning 1997, and Kanbur 2000).

"buy" a redirection of the recipient's foreign policy stances in a bilateral exchange. Thus, the recipient would rather adhere to its own foreign policy even if it were offered $\hat{a}_{US}$ in compensation for adhering to the donor's foreign policy, p_R^{US}:

$$(9) \qquad R(p_{-R}, p_R^{US}, \hat{a}_{US}^R + a_M^R, gc) < R(p_{-R}, p_R^*, \bar{a}_{US}^R + a_M^R, gc)$$

where $\bar{a}_{US}^R = 0$.

Second, assume that the total aid budget of all the multilaterals, $\hat{a}_M^R > 0, \forall i$, is large enough to make the recipient adopt the influential donor's foreign policy stance:

$$(10) \qquad R(p_{-R}, p_R^{US}, \hat{a}_M^R, gc) > R(p_{-R}, p_R^*, \bar{a}_M^R, gc)$$

where $\bar{a}_M^R = \bar{a}_{Mi}^R = 0, \quad \forall i$.

In order to illustrate the subtle mechanism that the donor can utilize under these circumstances, assume also that if one single multilateral abstains from giving aid, then the rest of the multilaterals are not able to make the recipient comply with the donors' foreign policy:

$$(11) \qquad R(p_{-R}, p_R^{US}, a_{-Mi}^R, \bar{a}_{Mi}^R, gc) < R(p_{-R}, p_R^*, a_{-Mi}^R, \bar{a}_{Mi}^R, gc).$$

Thus, equations 10 and 11 imply that the combined aid from all the multilaterals is necessary in order to make the recipient adopt the donor's foreign policy if such a trade is proposed.[14] Assume for the moment that the recipient has declined to adopt the donor's foreign policy, and recall that the donor will not give funds to a multilateral that gives aid to the recipient in this situation. Now, if the multilateral is to follow the donor's demand and not give aid to the recipient, then it must be more important for the multilateral to get the funding from the donor and withhold aid from the recipient, compared to ignoring the donor's demands and disbursing aid to the recipient and, in turn, losing the funding from the donor. More generally, we assume that it is always more important for the multilateral to get aid from the donor than to maintain conditionality:

$$(12) \qquad M_i(a_{Mi}^R, \hat{a}_{US}^{Mi}, g_i c_i) > M_i(a_{Mi}^R, \bar{a}_{us}^R, g_i c_i), \quad \forall i, \forall(g, a_{Mi}^R),\ k < K$$

where K is the number of multilaterals that makes each share of the donor's aid so small that the multilaterals become indifferent between the two scenarios in equation (12):

$$(13) \qquad M_i(a_{Mi}^R, \frac{\hat{a}_{US}}{K}, g_i c_i) = M_i(a_{Mi}^R, \bar{a}_{US}^R, g_i c_i), \quad \forall i, \forall(g, a_{Mi}^R).$$

Recall that $\hat{a}_{US}$ denotes the entire amount of the donor's aid, and thus, $\hat{a}_{US} / K$ is the amount disbursed to each multilateral if there are K multilaterals. Assume also that

[14] Note that it could well be that the donor's aid plus the aid from one of the multilaterals would be sufficient for the trade to go through. However, as we show later, such a constellation is not attractive from the donor's point of view.

(14) $$M_i(\bar{a}^R_{Mi}, \hat{a}_{US}, g_i c_i) > M_i(\hat{a}^R_{Mi}, \frac{\hat{a}_{US}}{k}, g_i c_i) \quad , \forall i, k \geq 2$$

is satisfied. Thus, the multilateral would rather have the entire amount of aid for itself even if this implies that it must abstain from disbursing aid to the recipient, compared to, ceteris paribus, giving aid to the recipient and sharing the donors' funds with the other *k* multilateral organizations. Note that this condition must hold even in the situation where the recipient has implemented all the conditions and is thus eligible for the maximum disbursement of aid from the multilateral. We return to this issue in the discussion of the dynamic game below.

Finally, note that the donor is indifferent to whether the multilateral disburses aid to the recipient or not. This feature of the donor's payoff function stems from the nature of the multilateral aid organizations in that the funds available will be disbursed to some countries in need. The donor's payoff function reflects only the fact that the donor does not care which of the countries will receive the aid from the multilateral organizations.

In order to simplify the presentation, we start out by assuming that the recipient's degree of implementation of the conditions is given. In line with the empirical evidence on the poor performance of conditionality as an instrument for forcing the recipient to reform, we assume that the recipient does not implement the conditions perfectly. In this situation, we assume that the multilateral disburses either the full amount of aid, or nothing at all.[15] Thus,

(15) $$g = \bar{g} = (\bar{g}_1, \bar{g}_2, ..., \bar{g}_k), \text{ where } \begin{array}{ll} \bar{g}_i < 1 & \Rightarrow a^{\bar{g}_i}_{Mi} = a^{g^*}_{Mi} \text{ where } g^* = 1, \\ \text{or} & \Rightarrow \bar{a}^R_{Mi} = 0 \end{array}.$$

The implications of this restriction, and the results when it is removed, are topics of section 3.6. In the next section, we explore the subgame perfect equilibrium when the multilaterals are not used as tools of foreign policy, and this is followed by the more realistic setting in section 3.5, where such strategic influence is an option for the donor.

3.4 The subgame perfect equilibrium when the donor is not influencing the multilateral

It is illuminating to display the subgame perfect equilibrium of the model when the influential donor does not exert leverage on the multilateral organizations. The situation where the donor does not interlink foreign policy with aid policy can serve as a benchmark, and assume for now that all agents interact in pairs. Thus, the donor does not try to use the multilateral organization in order to compel the recipient to adopt the donor's goals. In this case, the donor evaluates aid by standard motives for giving aid, as specified above.

Since the total amount of aid from the donor is too small to make the recipient change its foreign policy, and since we have assumed that multilateral aid is more efficient than bilateral aid, it is straightforward to show that it is optimal for the donor in this setting to give all its aid to the multilateral and nothing bilaterally. Since the donor is indifferent as to how much each multilateral gets, we cannot say anything about the share that accrues to each when there is no strategic behavior. However, since the weak reciprocity rule specifies that the aid will be shared between the multilaterals in this situation, we let that be the disbursement outcome

[15] See the World Bank 1992 for details of such an implementation-disbursement pattern.

here. Thus, if $\hat{a}_{US}$ is the donor's total amount of aid to be disbursed, then let a_{US}^{M} indicate that each multilateral gets an equal share of the donor's aid.

Since it follows directly that there is no scope to press the recipient to change its foreign policy, then it is also evident that both the donor and the recipient will adhere to their preferred foreign policy stances, a situation which is represented by p^*. Thus, the donor's utility in this equilibrium is

(16) $US(p^*, \hat{a}_{US}) = US(p^*, a_{US}^{M})$

Following the weak reciprocity rule, then, implies that each multilateral organization gets $\frac{\hat{a}_{US}}{k}$. Further, recall that the recipient's implementation of the conditions is exogenously determined. The multilaterals, in turn, disburse the entire amount of aid to the recipient, as assumed in (15). Hence, each multilateral will have a payoff of

(17) $M_i(a_{Mi}^{\bar{g}}, \frac{\hat{a}_{US}}{k}, \bar{g}_i c_i^*)$

where c_i^* is the multilateral's optimal choice of conditions to levy on the recipient.
It follows that the recipient will achieve

(18) $R(p^*, \sum_i a_M^{\bar{g}}, \bar{g}c^*)$

3.5 The subgame perfect equilibrium

Now we turn to see whether the influential donor can use its foreign assistance to the multilateral organization in such a way that it can exert leverage on the recipient's foreign policy. Thus, we do not restrict the players to interacting bilaterally, but let them freely engage in influencing a third party in order to put pressure on an opponent.

Recall the aid allocation rule that specifies that the donor will give the aid to another multilateral organization if the first organization gives aid to a recipient that does not adopt the foreign policy of the donor. Thus, the main aim for the donor is to create a crossfire from the multilaterals in order to induce the recipient to adopt the donor's foreign policy. The backward induction yields the following result:

Stage 4
If the recipient did not adopt the donor's foreign policy goals at stage 2 and M_1 disbursed the aid anyway, then the donor will give all its aid to M_1 as long as M_2 did not disburse the aid to the recipient. All other histories in this game will imply that each multilateral organization gets half of the aid each.

Stage 3
All possible actions at stage 3 for different histories can be represented as follows:

The recipient adopted the donor's foreign policy goals at stage *2*.

In this case, all multilateral organizations will have an equal share of the aid, no matter which action they take. Then their optimal choice at stage 3 follows directly from (15): they disburse the full amount of aid to the recipient. Formally, the multilaterals' game at stage 3 can be represented as:

		M_2	
		Aid	No aid
M_1	Aid	$M_1(a_{M1}^{\bar{g}}, \frac{\hat{a}_{US}}{2}, \bar{g}_1 c_1^*)\ M_2(a_{M2}^{\bar{g}}, \frac{\hat{a}_{US}}{2}, \bar{g}_2 c_2^*)$	$M_1(a_{M1}^{\bar{g}}, \frac{\hat{a}_{US}}{2}, \bar{g}_1 c_1^*),\ M_2(\bar{a}_{M2}^{R}, \frac{\hat{a}_{US}}{2}, \bar{g}_2 c_2^*)$
	No aid	$M_1(\bar{a}_{M1}^{R}, \frac{\hat{a}_{US}}{2}, \bar{g}_1 c_1^*)\ M_2(a_{M2}^{\bar{g}}, \frac{\hat{a}_{US}}{2}, \bar{g}_2 c_2^*)$	$M_1(\bar{a}_{M1}^{R}, \frac{\hat{a}_{US}}{2}, \bar{g}_1 c_1^*),\ M_2(\bar{a}_{M2}^{R}, \frac{\hat{a}_{US}}{2}, \bar{g}_2 c_2^*)$

B) The recipient did not adopt the donor's foreign policy goals at stage *2*.
In this case, M_i knows that if M_j gives aid to the recipient at stage 3, then the full amount of aid from the donor will accrue to M_i if M_i does not give aid to the recipient, while M_j will not get any aid. Further, if both M_i and M_j take the same actions, then they will share the aid from the donor. Formally:

		M_2	
		Aid	No aid
M_1	Aid	$M_1(a_{M1}^{\bar{g}}, \frac{\hat{a}_{US}}{2}, \bar{g}_1 c_1^*), M_2(a_{M2}^{\bar{g}}, \frac{\hat{a}_{US}}{2}, \bar{g}_2 c_2^*)$	$M_1(a_{M1}^{\bar{g}}, \bar{a}_{US}^{R}, \bar{g}_1 c_1^*),\ M_2(\bar{a}_{M2}^{R}, \hat{a}_{US}, \bar{g}_2 c_2^*)$
	No aid	$M_1(\bar{a}_{M1}^{R}, \hat{a}_{US}, \bar{g}_1 c_1^*), M_2(a_{M2}^{\bar{g}}, \bar{a}_{US}^{R}, \bar{g}_2 c_2^*)$	$M_1(\bar{a}_{M1}^{R}, \frac{\hat{a}_{US}}{2}, \bar{g}_1 c_1^*),\ M_2(\bar{a}_{M2}^{R}, \frac{\hat{a}_{US}}{2}, \bar{g}_2 c_2^*)$

It is evident that this simultaneous move game played between the multilateral organizations has a "prisoner's dilemma" structure. Thus, both multilaterals will choose not to give aid in the situation where the recipient does not adopt the donor's foreign policy because M_i knows that it will lose all of the donor's funds to M_j if it disburses aid to the recipient in this situation, and vice versa.

The mechanism that drives the interesting results is thus that the donor is able to create incentives for the multilaterals to influence the recipient to adopt the donor's foreign policy. Since it is in both multilateral organizations' interest to withhold aid if the recipient does not comply, then the recipient will be better off by adopting the donor's foreign policy at stage two in the game. Thus, the donor's best response to this is to leverage its funds to the multilaterals and to adhere to the aid allocation rule. The equilibrium path is that the donor starts out by pursuing the leverage strategy at stage one, then the recipient complies at stage two, both multilaterals disburse the aid at stage three and get to share the aid from the donor at stage four.

The payoffs to the players illustrate the winners and losers resulting from this strategic behavior. First, note that the recipient only achieves $R(p_R^{US}, \hat{a}_M^R, \bar{gc}^*)$, which is less than it would have received if the multilateral organizations were not used as tools of the foreign policies of the donor. In this latter case, the recipient would get $R(p_R^*, \hat{a}_M^R, \bar{gc}^*) > R(p_R^{US}, \hat{a}_M^R, \bar{gc}^*)$. Further, the donor is clearly better off from this strategic behavior compared to the dyadic case. By influencing the multilateral, the donor is able to make the recipient adopt its own foreign policy, and thus achieves $US(p_{-R}, p_R^{US}, \hat{a}_{US})$, which is clearly better than the utility when not acting strategically $US(p_{-R}, p_R^*, \hat{a}_{US}) < US(p_{-R}, p_R^{US}, \hat{a}_{US})$, since it makes the recipient adopt the donor's foreign policy. Note also that the multilaterals are indifferent between the subgame perfect equilibria in the two scenarios.

3.6 When the implementation of conditions is endogenously determined

Assume now that the recipient's implementation of the conditions levied by the multilaterals is endogenously determined in the model and that the recipient chooses the degree of implementation at stage 2, together with its choice of foreign policy. Thus, the restriction in (15) no longer binds. Then, if we assume for the moment that the recipient will either choose to comply or not to comply with the demands to change its foreign policy and implement the conditions, there are four options for the recipient at this stage in the game. These options are displayed in the game tree in figure 2: comply with both; not comply with both; implement the conditions but refuse to adopt the donor's foreign policy; or, finally, refuse to implement the conditions but adopt the donor's foreign policy.

Choice A: Not implement conditions and decline to adopt the donor's foreign policy
Recall equation (6), which implies that the recipient is made indifferent between implementing the conditions and receiving aid from M_i, compared to not implementing and not getting the aid. Then it follows that choice A will make M_i decline to give any aid to the recipient, not only because this is in accordance with conditionality, but also because this is the action demanded by the donor in this situation. This will, in turn, trigger the donor to grant the aid to M_i. The equilibrium resulting from the recipient choosing not to comply with either demand yields the recipient its reservation payoff in this game: it can always achieve at least $R(p^*, \bar{a}_M^R, g^0 c^*)$ by adhering to its own foreign policy and refusing to implement any conditions and not getting any aid. It follows that M_i achieves $M_i(\bar{a}_M^R, \frac{\hat{a}_{US}}{2}, g_i^0 c_i)$, and the donor gets $US(p_{-R}^*, p_R^R, a_{us}^*)$.

Choice B: Implement conditions and adopt the donor's foreign policy
The recipient is brought down to its reservation payoff by the multilaterals' use of conditionality, and hence, it follows that adopting the donor's foreign policy would result in an even lower payoff to the recipient than this minimum level. Then we know that the recipient will never choose to comply with both demands. Should it do that anyway, it follows that M_i will give aid to the recipient at stage 3, both since this is in accordance with conditionality and because the donor rewards M_i with aid at stage 4 for making the recipient adopt the donor's foreign policy. Thus, should the recipient choose to comply with both demands, then the payoffs to the players will be $R(p^{US}, a_M^{g1}, g^1 c^*)$, $M_i(a_M^{g1}, \frac{\hat{a}_{US}}{2}, g_i^1 c_i)$, $US(p^*, a_{us}^*)$, where a_M^{g1} is the amount of aid that solves (6) when $g_i = g_i^1 = 1$.

Choice C: Implement conditions and decline to adopt the donor's foreign policy
If the recipient chooses to implement the conditions and refuse to adopt the foreign policy of the donor, then the multilateral will not get any aid from the donor unless it does not give aid to the recipient (reciprocity). Thus, if maintaining conditionality is less important to the multilateral than the value of the donor's funding, as assumed in equation (12), then the multilateral will punish the recipient by not giving it aid at stage 3. This will ensure that the donor disburses aid to both multilaterals at stage 4. The payoffs to the players will thus be $R(p_R^*, p_{US}^*, \bar{a}_M^R, g^1 c)$, $M_i(\bar{a}_M^R, \hat{a}_{US}^{Mi}, g_i^1 c_i)$ and $US(p_{US}^*, p_R^*, a_{us}^*)$. Note that the recipient would be better off in this situation to decline both to implement the conditions and to adopt the donor's foreign policy since $R(p_{-R}, p_R^*, \bar{a}_M^R, g^1 c) < R(p_{-R}, p_R^*, \bar{a}_M^R, g^0 c^*)$.

Choice D: Not implement conditions and adopt the donor's foreign policy
Choosing this alternative induces M_i to give aid to the recipient at stage 3, since it is more important for M_i to have the aid compared to maintaining conditionality (equation 12). This will in turn result in the donor giving aid to both multilaterals at stage 4. The payoffs to the players will thus be $R(p_R^{US}, p_{US}^*, \hat{a}_M^R, g^0 c)$, $M_i(\hat{a}_M^R, \hat{a}_{US}^{Mi}, g_i^0 c_i)$ and $US(p_{US}^*, p_R^{US}, a_{US}^*)$. Note that as long as it is more important for the recipient to get aid from both multilaterals compared to maintaining its own foreign policy, as assumed in (10), then these actions describe the subgame perfect equilibrium path of the game.

It is clearly too rigid to assume that the recipient can only choose between implementing the conditions or not. There is a lot of evidence on the partial implementation of these conditions, and we thus allow for such an implementation pattern in the following. Moreover, equation (10) states that the recipient is strictly better off by adopting the donor's foreign policy stances in return for aid from all of the multilaterals, compared to adhering to its own foreign policy and not getting aid from the multilaterals. Thus, there is scope for the multilaterals to demand that the recipient implement at least some of the conditions at the same time as it adopts the foreign policy of the donor. At stage 2 in the game, then, the recipient will now be confronted with the situation that the multilaterals demand that the recipient adopt the donor's foreign policy, but also demand that the recipient chooses the degree of implementation of the conditions that is no less than $\hat{g}_i \in \langle 0.1 \rangle$, where $\hat{g}_i$ is defined by

(19) $$R(p_{-R}, p_R^{US}, \hat{a}_M^R, \hat{g}c) = R(p_{-R}, p_R^*, \bar{a}_M^R, g^0 c)$$

Thus, the offer from the multilaterals will ensure that the recipient is indifferent between a first scenario where the recipient adopts the donor's policy, gets aid from all multilaterals and

implements some of the conditions so that the degree of implementation equals $\hat{g}_i$, and the second scenario where the recipient rejects the conditionality/foreign policy package and does not get any aid.

3.7 Heterogeneous multilaterals

There is no doubt that the opportunity to switch aid without cost between identical multilateral financial institutions plays an important role in the model when the recipient's implementation of the conditions is both endogenously and exogenously determined. Since the real world multilaterals are not identical, however, it is necessary to investigate the situation where the donor prefers one multilateral over the other. It could well be that some donors prefer to fund the World Bank rather than the regional development banks, even if these perform almost the same activities. Similarly, some donors prefer not to put all their eggs in one basket, and would thus fund several different multilaterals instead of concentrating on one. In the following two sections, we develop the model to include both types of preference.

3.7.1 When the donor prefers to give aid to several multilaterals

Let us assume for now that there are increasing benefits to the donor in dividing the aid in equal shares for the different multilaterals. Note that in this situation the weak reciprocity allocation rule will not come into play. Punishing a multilateral for not making the recipient comply implies that the donor must take the cost of giving all the aid to the other multilateral. Since the donor is not willing to take a cost in the final round if it can avoid it, it is optimal for the donor at stage 4 to give half of the aid to each of the multilaterals, irrespective of the previous history of the game.

In this case, both multilaterals will know at stage 3 that they will certainly get the aid, and will have nothing to gain from pressuring the recipient to comply with the donor's foreign policy goals. Then both multilaterals will disburse aid to the recipient, irrespective of the recipient's actions. As this is evident to the recipient at stage 2, it will know that any threat of not getting aid unless it adheres to the donor's foreign policy is not credible. Thus, it will adhere to its own foreign policy and abide by conditionality, which in turn secures the full disbursement of aid from the multilateral at the subsequent stage. Finally, the donor will see that any threat to force the recipient to adhere to the donor's foreign policy is not credible, and will therefore not use any threat. Then we will have the same payoff to the players as specified in section 3.4, where we assumed that the donor did not make use of the multilateral in foreign policy decisions.

Two interesting results emerge from this case. The first is that a preference for giving aid to several multilaterals implies that conditionality becomes successful in these circumstances.[16] The second is that there is no scope for the strategic use of the multilaterals under these conditions.

[16] However, we know from Villanger (2004) that repeating this type of game infinitely may enable the strategic player (in our case, the donor) to continue to grab the gains from this type of behavior. When there are costs of punishing the third party (in our case, the multilateral), it is necessary that the strategic player offer better terms to the third party and applies a trigger strategy to grab the gains. If the third party does not cooperate with the strategic player, then this triggers the punishment that only ordinary terms will be offered forever. The donor could probably offer both the multilaterals better terms in our game, and thus be able to use the multilateral to influence the recipient in infinitely repeated play. However, due to the usual constraints, the elaboration of this idea must be left for future research.

3.7.2 When the donor prefers to give aid to one multilateral

There are several reasons why donors have a special preference as to which multilateral financial institution to fund within different operational areas for these organizations. The first line of reasoning is that the donor favors a particular multilateral, which could be the case if a donor believes that the World Bank is more efficient than every other international development bank. As a result, for efficiency reasons, some donors may want to channel the total amount of financial aid to the World Bank. Or one could put it the other way around and have donors that favor the African Development Bank (AfDB), because they believe that African state leaders are much more prone to follow advice if it comes from AfDB rather than from WB, since AfDB may be perceived by these leaders to be "their own" bank. Another reason for favoring a particular institution may be that the multilateral focuses on topics important to the donor, so that donors most concerned with financial stability in the world markets prefer to fund the IMF, while those that prefer investment projects favor WB.

Assuming that the donor favors one particular MFI over the other MFIs alters the game in important ways. It is evident that it is now optimal for the donor to give all the aid to the particular favored organization at stage 4, irrespective of the previous actions of the players. The donor's threat, i.e. of not giving aid to a multilateral that is not trying to get the recipient to adopt the donor's foreign policy, is therefore not credible. The subgame perfect equilibrium of the game yields the result that the donor is not able to make the multilateral influence the recipient's decisions, and hence, we have the ordinary outcome of section 3.4, where the recipient adheres to its own foreign policy, implements the conditions and receives aid from the multilateral, but with the difference that the donor gives aid only to the favored multilateral at stage 4.

The second type of argument for supporting one multilateral could be that it is more efficient from the donor's point of view to concentrate on funding one multilateral. That could be for monitoring reasons, when there are costs to the donor in tracking the multilateral's use of its money. So if we assume that the donor prefers to fund only one multilateral but is indifferent as to which multilateral this is, and that the donor can, without cost, choose one instead of the other, then we can get a different outcome of the game. A minor alteration of the weak reciprocity rule in the game is all that is needed in order to allow the donor to continue to make use of the multilateral to induce changes in the recipient's foreign policy.

The donor can now change its aid disbursement rule by stating that it will give all its aid to one of the multilaterals based on a random draw at stage 4, as long as no multilateral gives aid to the recipient in a situation where the recipient does not adopt the donor's foreign policy. If a multilateral should give aid to a recipient that does not adopt the donor's policy, then this particular multilateral will be disqualified from the random draw. As a result, those multilaterals that co-operate with the donor get a ticket in the donor's lottery where there is only one winning ticket for the total amount of the donor's aid, and where those multilaterals that do not cooperate do not get a ticket in the lottery. Then it is possible to show that there are a number of multilaterals for which the expected utility for a multilateral of co-operating with the donor is larger than the utility of declining to influence the recipient. Then the donor's threat becomes credible, and the recipient adopts the foreign policy of the donor in order to secure aid from the multilateral.

4. Policy implications and comments

First note that the driving force in the model is that the donor will carry out the punishment of the multilateral if the multilateral disburses aid to the recipient in a situation where the recipient does not adopt the foreign policy of the donor. This implies that the recipient's implementation of the foreign policy of the donor will always have priority over implementing the economic reforms. As a result, in creating the foreign policy/conditionality package, the multilateral will ensure that the recipient is indifferent between rejecting both demands and not getting aid, with the scenario that it gets aid, adopts the foreign policy of the donor and implements a subset of the initial economic reforms.

One interesting result from the sub game perfect equilibrium of the game with endogenously implementation of a continuous economic reform parameter is that the multilateral becomes soft on maintaining conditionality. Moreover, the donor's strategic use of a multilateral does in fact crowd out the sound economic reform programs that would have been implemented if there were no strategic behavior on the part of the donor. As a result, the multilateral is weakened as an instrument for development, and is clearly worse off in this situation compared to the situation in section 3.3 where no such strategic donor behavior prevails. Moreover, if one believes that the economic reform programs would be beneficial to the people in the poor country if implemented, as most economists do, then these people would also be worse off as a result of this type of strategic donor behavior.[17]

It is important to note that we do not claim that the multilateral organizations are vehicles for the donor's foreign polices. Our point is that, in some situations, some influential donors can use their power to make the multilateral put pressure on recipients on issues that are outside the recognized domain of this organization, as we believe was the case with the US pressure on the World Bank to make China reduce its balance of payments surplus vis-à-vis the US. Our model illustrates the huge gains, in terms of increased influence, in having the multilaterals promote a country's position on an issue, compared to promoting that position in a bilateral negotiation. Even if the donor's aid alone is not enough to make the recipient adopt the donor's foreign policy, the donor can still achieve this goal by putting pressure on the multilateral organizations. Given our knowledge that bilateral aid is to a large extent determined by the foreign policies of the donors, we believe it would be a little naïve to assume that donors do not also try to achieve foreign policy goals through these multilateral channels.

However, the role of other donors is clearly an issue in this game. In the long run, it might be the case that donors that have development in poor countries as a sole motive for giving aid would withdraw from funding the MFIs. This, in turn, would further weaken the role of economic reform in development, especially since those donors that are left as supporters would be of the type that, presumably, were more inclined to advance their own foreign policies through the institution. Thus, the rather pessimistic implication of this is that these types of institution are over time more likely to become instruments for selfish donors pursuing their selfish goals rather than vehicles for development.

[17] Note that we model the recipient as a government with specific preferences that are negative to the economic reform programs. These could be, for example, reforms that alter income distribution in disfavor of the electoral constituency that supports the ruling government. So even though the reform could be positive for the broad majority of the poor people, it could still be rejected by the government.

Another scenario could be that donors with the same preferences join to form new multilateral organizations that reflect more of their own policies, as for example Japan tries to do when gathering support for an "Asian IMF". Our model proposes one explanation for the puzzling structure of contemporary aid patterns, where donors prefer to fund several multilateral organizations, even if these organizations perform almost identical tasks (see Kanbur 2003 for more on this issue). It is quite illuminating that some donors fund the lending of the World Bank at the same time as they fund the lending of a regional development bank, where both banks give loans to the same countries. Such behavior may arise if funding the World Bank is more efficient, as seen from the donor's point of view, but there are increasing costs when large donors sometimes use it to achieve their own selfish political goals. As a result, altruistic donors fund the World Bank up to a certain level, and then use the rest of their aid budget to fund less efficient regional development banks.

Finally, note that the model's prediction of a pattern of partial implementation under the conditions where the full amount of aid continues to be disbursed is also in accordance with the empirical evidence on conditionality, where it is found that it sometimes works and sometimes does not. Thus, these results may also add to our knowledge of the causes of the partial success of conditionality.

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Summary

The opportunity for a powerful donor country, such as the United States, to use a multilateral financial institution (MFI) strategically in order to promote its own foreign policy goals has received little attention. The gain to a donor that is able to make the World Bank or other MFIs adapt to this donor's view on an issue can be substantial. In that case, all the contributions from the other member nations will also stand behind the MFI's stance on the particular issue, and recipients may feel compelled to comply with this massive counterpart. As a result, influencing MFIs may give much more leverage to a donor's foreign assistance in the foreign policy arena than pursuing the same goals bilaterally with the same amount of aid. We present a model where a donor tries to influence a MFI to put pressure on a recipient to comply with the foreign policy interests of the donor. This game-theoretic multi-agent model with one donor, two MFIs and one recipient illustrates the virtue of using the multilateral as an instrument in foreign policy as seen from the powerful donor's point of view. Similarly, we show how this strategic behavior is damaging for the recipient in particular and for development in general.

ISSN 0804-3639
ISBN 82-8062-096-6

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