



# Multilateral Organisations: Instruments for Donors' Foreign Policy?

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## **Multilateral Organizations: Instruments for Donors' Foreign Policy?**

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**Preliminary version**

”The United States has played a leading role in shaping the World Bank’s agenda, and Bank projects often support U.S. foreign policy goals. For example, the Bank is providing resources to assist in the transition of central Europe and the countries of the former Soviet Union from communist to market-based systems. The Bank has also directed significant resources to crisis areas where the United States has strong interests, such as Bosnia, Haiti, and the West Bank and Gaza. Compromise is sometimes necessary in the Bank as in any multilateral organization. For example, the United States favored immediate graduation of China from eligibility for IDA credits but agreed that new IDA lending to this country should end in 1999 after other members, particularly Japan, opposed the U.S. position. However, insofar as the United States can ensure that Bank projects support U.S. foreign policy goals, U.S. contributions are multiplied many times over by those of other member countries.”

*United States General Accounting Office (1996)*

## **1. Introduction**

The empirical literature on foreign aid emphasizes that foreign policy objectives are important motivations for giving multilateral aid (Cassen 1994, Alesina and Dollar 2000). Some of the recipients that receive the most aid per capita do so because they are favored in bilateral aid relationships due to their strategic importance. However, the opportunity for a donor country to use a multilateral organization strategically to promote its own policy goals has received far less attention. The gain to a donor that is able to make the World Bank or other multilaterals 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 multilateral organizations' stance in the particular issue, and recipients may feel compelled to comply with this massive counterpart. Thus, influencing the multilaterals may give much more leverage to a donor's foreign assistance on the foreign policy arena compared to pursuing the same goals bilaterally with the same amount of aid. The U.S. General Accounting Office indicates the potential for increased influence when they state that about \$2 billion in U.S. paid capital had supported World Bank loans of nearly \$286 billion through cofinancing with other donors and the private sector. So, if the GOA is right in asserting that U.S. with its 22 % of the total donor support to the World Bank is able to take the leadership in setting the bank's agenda, then there is little doubt that this strategic behavior can be effective in achieving U.S. foreign policy goals.

As indicated by the above quote, this channel of influence seems attractive for some donors. However, even if the principal-agent framework is the work-horse of the theoretical literature on foreign aid, this literature does not address how some donors' can be able to influence the objectives of the multilaterals in order to achieve their aims for the recipient. This gap in the literature is unfortunate since this type of strategic behavior rise several important questions. First, which mechanisms allows for this type of interactions? Second, how will this type of influence change the aid allocation of the other donors? Third, what implications can we draw with regards to improving the efficiency of the multilateral infrastructure in general?

This paper attempts to answer these questions with a model where the 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 two donors, two multilaterals and one recipient illustrate the virtue of using the multilateral as an instrument in foreign policy as seen from the mighty donor's point of view. Similarly, I show how this strategic behavior is damaging for the recipient and how it causes the 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 pairwise. Our model is triadic, which implies that an agent  $i$  (the donor) does not only take account of his relationship with agent  $j$  (a multilateral), but also of his own and agent  $j$ 's relationship with a third agent  $k$  (a recipient).<sup>1</sup>

Our model also shed light on the question of why development operations of different donors seem to overlap in many countries, a practice that has rised the concern of possible duplication of effort and unhealthy competition for "development business" (Kanbur 2002). Our model gives a straightforward answer to why bilateral donors have programs in a poor country at the same time as they are financing a multilateral organisation to have overlapping programs 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 regards to policy, then it is worthwhile for some donors to diversify between own and multilateral projects.

The particular channels that multilateral organisations may use to influence recipient countries differ not only across organisations, but also between the particular issues that are fronted. It is well known that the World Bank specify a detailed set of conditions for which the recipient must implement before it receives aid. Less is known, however, of what actually is agreed upon in the negotiations between the top officials during the implementation process. There appears to be quite some room for

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<sup>1</sup> See Basu (2000) for a discussion of dyads and triads.

manoeuvring, 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). Selectivity and Burnside and Dollar (2000).

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. A few tentative policy implications are discussed in section 4, and section 5 provides some concluding remarks.

## **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 its 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 U.S. General Accounting Office (U.S. 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 in their foreign policy. They state that what leverage the U.S. funds is that making the World Bank adopt the U.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.”

One reason why we do not find many similar stories for other influential donors could be that many governments would not publicly express their strategies since openness about the pressure would make the neutrality position crumble. Thus, it is in the strategic governments' own interest to keep the aims confidential.

The U.S. GOA also gives a telling example of how the three-party structure comes into play. In the beginning of the 1990s, the U.S. opposed grants of concessional World Bank IDA loans to China, despite the fact that China's low level of per capita incomes that makes it eligible for these types of loans. U.S. 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 their on their balance of payments vis-a-vis United States.

Another example can be found in Kanbur (2000) where he reports his experience in 1992 when the World Bank assessed 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 melt down 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.

The three-party relationship that arises from the nature of poor countries’ debt problems may serve as another illustration of triadic relationships (Villanger 2004). Take a situation where a developing country, Brazil for example, has a large debt burden and is negotiating with the World Bank in order to get new finance to manage the repayment of mature loans. Then it will be in the interest of the creditors to Brazil, like 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 these creditors will have their money back. Thus, Brazil can use the private banks as a third party and indicate that they will postpone the repayment to the banks unless these banks put pressure on the World Bank to disburse the new loans.

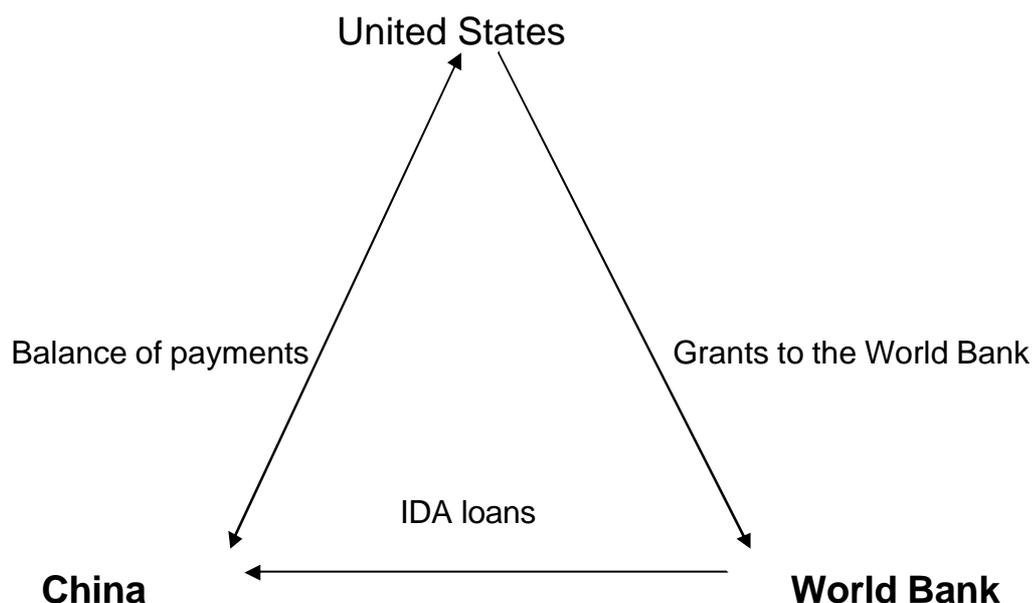
### **3. The model**

Assume initially that there is one donor, two multilateral organizations,  $M_i$ ,  $i=1,2$ , and one recipient,  $R$ . In this game, it is common knowledge that the donor will link its grant to the multilaterals according to whether or not the multilaterals have influenced the recipient to comply with this donor’s foreign policy objectives. No threat is explicitly stated, but the agents know that if the recipient does not adopt the foreign policies of the donor, then the donor’s intention is to refuse to give any resources to the multilaterals unless the multilaterals withhold the aid to the recipient. This implicit triadic threat is meant to mobilize a more harsh punishment for the recipient of non-compliance than merely losing the bilateral aid from the donor.

Take as a starting point the U.S. attempt to deny an IDA loan to China due to China’s high level of foreign currency reserves. So if the U.S. tacitly threatens to reduce

their contribution to the World Bank unless it will cut off the IDA loans to China, then figure 1 can illustrate the triadic relationship in this setting.

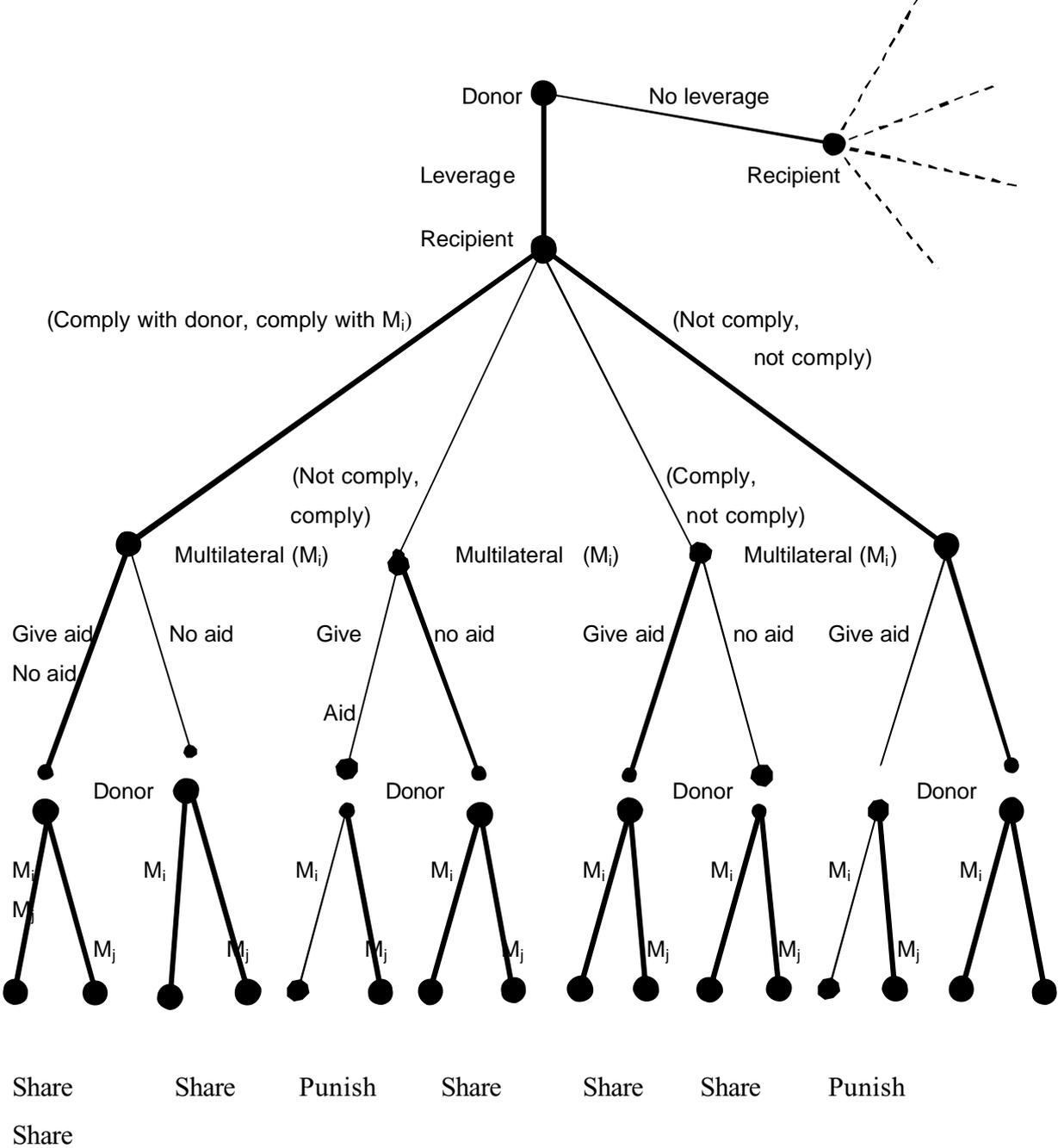
**Fig. 1. The triadic relationship.**



Since these actions are sequential, it is necessary to analyze the relationships in a dynamic framework. Since we will model the influential donor's strategic use of multilateral organizations in general, we now denote the agents in general terms. At stage one, the donor decides whether to pursue a strategy where 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 and the recipient. Figure 2 illustrates the sequence of the actions, but note that the figure does not show the option for the donor to give aid to the

recipient at stage 4. This is, however, only for dispositional convenience, which is also elaborated on in the text.

Figure 2: The game-tree under the leverage strategy



Now, assume that the donor is indifferent in how its aid is allocated as long as it goes through a multilateral and ends up in a poor country. Another option would be to

channel the aid directly to the recipient, but assume for now that this is less efficient compared to using the multilateral.<sup>2</sup> Thus, the donor prefers to allocate aid to the two multilateral organizations. Assume further 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 between two actions, it will choose the action with the worst result for a multilateral if this particular multilateral does not comply with the donor’s aim of punishing the recipient for not adopting the donor’s foreign policy. Experiments indicate that many individuals are willing to take on a cost in order to punish non-cooperators, and this type of behaviour has been labelled as “strong reciprocity” (Bowles and Gintis 2000). See Villanger (2004) for an overview of the empirical basis for the assumption of weak reciprocity.

### 3.1 The payoff functions

A realistic representation of  $n$  countries’ optimal positions on a set of  $k$  foreign policy

issues can be set up in a matrix  $P^*$  where  $P^* = \begin{bmatrix} p_{11}^*, p_{12}^*, \dots, p_{1k}^* \\ p_{21}^*, p_{22}^*, \dots, p_{2k}^* \\ \vdots \\ p_{n1}^*, p_{n2}^*, \dots, p_{nk}^* \end{bmatrix}$ . Thus,  $p_{ij}^*$  denotes

country  $i$ ’s optimal stance in foreign policy issue  $j$ , and  $i$  can be either a donor country

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<sup>2</sup> This assumption is only to avoid drawing attention to the fact that the donor could threaten to disburse the aid directly to the recipient if the multilateral does not comply. The results of the model are unaltered if we use this alternative threat, but I think my set-up is more realistic since it appears that donors do not

or a recipient country. To simplify the notation, assume that the foreign policy positions  $(1, \dots, k)$  can be compiled into an index so that each country can be ranked accordingly. This could for example be to which extent the countries support the ongoing “war against terror”. Let the vector  $p^*$  represent the countries’ rank on the index, where  $p^* = (p_1^*, p_2^*, \dots, p_n^*)$ . Thus,  $p_i^*$  indicates country  $i$ ’s rank when country  $i$  adhere to its optimal position. However, should country  $i$  abstain from its preferred positions, and for some reasons or another adopt some other country  $j$ ’s positions, then let this country’s new position be denoted  $p_i^j$ .

To simplify the disposition, let the upper-case letters of the aid variable indicate the recipient of foreign aid, and the lower-case letters indicate which agent disburses the aid. Thus,  $a_{US}^R, a_{Mi}^R$  indicates the amount of aid given by the donor to the recipient, and the amount of aid given from the multilateral to the recipient, respectively.

Let the utility function of the donor be

$$(1) \quad US(p, a_{us})$$

This donor derives utility of the other countries’ foreign policy positions, and the more they resemble the influential donor’s own positions, the higher is its utility. 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 in the multilaterals stance in foreign policy. Assume further that the donor believe that aid will be good for the poor in the recipient country, and its utility is therefore increasing in the amount of aid disbursed to the recipient or to the multilaterals. This assumption reflect the empirical finding that the motivation for many donors giving aid is usually that aid spurs economic growth, or reduces poverty, but can also reflect other altruistic objectives. Let  $\hat{a}_{US}$  be the donors’ optimal amount of aid, and assume that this amount

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perceive multilateral aid and bilateral aid to be perfect substitutes. Thus, threatening to give the aid to another multilateral seems like a better approach.

is exogenously determined and constant.<sup>3</sup> The amount of aid disbursed to the multilaterals can then be denoted  $\hat{a}_{US}^{Mi}$ , while the aid given bilaterally can be denoted  $\hat{a}_{US}^b$ .

The multilateral organizations have identical preferences, and the utility function of one multilateral is assumed to be

$$(2) \quad M_i(a_{Mi}^R, a_{US}^{Mi}, \gamma_i c_i) \quad \text{where } i = 1, 2, \dots, k.$$

+   +   +

Further,  $a_{Mi}^R, a_{US}^{Mi}$  is the amount of aid that the multilateral  $M_i$  disburses to the recipient and the amount of aid the same multilateral receives from the donor, respectively. Note, however, that each multilateral is assumed to be 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 the multilateral organization. Let  $c_i$  be the conditions or reform program that multilateral  $i$  levies on the recipient: following the practice of conditionality, we assume that  $M_i$  demand that the recipient implement these requirements before aid is disbursed. Then  $\gamma_i \in [0,1]$  can denote the degree of the recipient's implementation of the conditions levied by  $M_i$ . Let 0 indicate that the conditions are not implemented, and then the degree of implementation is increasing up to 1, which indicates that the conditions are perfectly implemented.

The multilateral organizations typically condition their aid on the recipient implementing reforms or policies that are conducive to economic growth and development. The multilateral finance institutions, for example, condition a large

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<sup>3</sup> 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.

amount of the lending on good macro economic policy like low inflation, balanced budgets and openness to trade. Thus, we assume that  $M_i$  has an increasing utility in the recipient's degree of implementation of the conditions. Assume also that  $M_i$  has an increasing utility in the amount of aid received, and thus also in the amount of aid disbursed.<sup>4</sup>

Let the recipient's utility function be denoted

$$(3) \quad R(p, a^R, \gamma c) \text{ , where } a^R = \sum_{i=1}^h a_{Mi}^R + a_{US}^R$$

+ -

where  $c$  represents the vector of conditions  $c = (c_1, c_2, \dots, c_k)$  that the multilaterals imposes on the recipient. Let  $\gamma$  be the corresponding vector that indicates the degree of implementation of the conditions for the  $k$  different multilaterals:  $\gamma = (\gamma_1, \gamma_2, \dots, \gamma_k)$ . 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.

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<sup>4</sup> Note that the multilateral organization's utility of giving aid to the recipient is not affected by the recipient's degree of implementation of the conditions. In situations where the lack of implementation would cause the aid to have no effect on the parameters of interest, this representation of the multilateral organization's preferences may be too simplistic. This could be the case when the conditions are macroeconomic stabilization and when the sole purpose of aid is to increase economic growth. Then it is easy to visualize a preference structure of the multilateral where it would be better off by not giving aid if the recipient did not implement the conditions and created a stable macroeconomic environment, since there is a widespread belief that aid does not increase growth when macroeconomic policies are poor (Burnside and Dollar 2000). See Villanger (2004) for a model where the donor's preferences have this structure. To focus on the main points in this paper, however, we confine ourselves with the simpler version of the multilateral organization's utility function.

### 3.2 Some assumptions about the payoffs

The following assumptions will focus the analysis on the interesting situations, i.e. the situations where it is possible for donors to influence multilaterals strategically in foreign policy issues. First, assume that the donor's aid is not large enough to "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 this should imply that it would lose the bilateral aid  $\hat{a}_{us}^R$  from the donor, compared to receiving  $\hat{a}_{us}^R$  in exchange for adopting the donors foreign policy,  $p_R^{us}$ :

$$(4) \quad R(p_{-R}, p_R^{us}, \hat{a}_{us}^R + \hat{a}_M^R, \gamma c) < R(p_{-R}, p_R^*, \bar{a}_{us}^R + \hat{a}_M^R, \gamma c)$$

where  $\hat{a}_M^R = \sum a_{Mi}^R$ , i.e., the sum aid from the multilateral organizations, where  $\hat{a}_{Mi}^R > 0, \forall i$  and where  $\bar{a}_{us}^R = 0$ .

Second, assume that the total aid from the multilateral organizations is large enough to make the recipient adopt the influential donor's foreign policy stance:

$$(5) \quad R(p_{-R}, p_R^{US}, \hat{a}_M^R, \gamma c) > R(p_{-R}, p_R^*, \bar{a}_M^R, \gamma c)$$

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

Assume also that one single multilateral is not able to influence the recipient to comply with the donors' foreign policies:

$$(6) \quad R(p_{-R}, p_R^{US}, a_{-Mi}^R, \hat{a}_{Mi}^R, \gamma c) < R(p_{-R}, p_R^*, a_{-Mi}^R, \bar{a}_{Mi}^R, \gamma c)$$

Thus, equations 5 and 6 imply that the combined aid from both multilaterals is large enough to make the recipient adopt the donor's foreign policies if such a trade is proposed.<sup>5</sup>

Assume for the moment that the recipient has declined to adopt the donor's foreign policies, 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 disburse aid to the recipient and, in turn, lose the funding from the donor. This condition will be elaborated on below, and is stated as

$$(7) \quad M_i(\bar{a}_{Mi}^R, \hat{a}_{us}^{Mi}, \gamma_i c_i) > M_i(a_{Mi}^R, \bar{a}_{us}^R, \gamma_i c_i)$$

Finally, note that the donor is indifferent in 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 that the donor do not care which of the countries will have the aid from the multilateral organizations.

In order to simplify the disposition initially, we assume initially that the recipient's degree of implementation is given. In line with the empirical evidence on the poor performance of conditionality as an instrument to make the recipient reform, we assume that the recipient does not implement the conditions perfectly. Thus,

$$(8) \quad \gamma = \bar{\gamma} = (\bar{\gamma}_1, \bar{\gamma}_2, \dots, \bar{\gamma}_k) \text{ where } \bar{\gamma}_i < 1$$

The implications of this restriction and the results when it is relaxed are topics of section 3.5. In the next section, we explore the subgame perfect equilibrium when the

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<sup>5</sup> Note that it could well be that the donor's aid plus the aid from one of the multilaterals would be a sufficient amount for the trade to go through. However, as we show later, such a constellation is not attractive from the donor's point of view.

multilaterals are not used as tools for foreign policy, and this is followed by the more realistic setting in section 3.4 where such strategic influence is an option for the donor.

### 3.3 The subgame perfect equilibrium under bilateral interactions

It is illustrating 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 pair-wise. Thus, the donor does not try to use the multilateral organisation in order to compel the recipient to adapt 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 policies, 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 between 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 specify that the aid will be shared between the multilaterals in this situation, we let that be the disbursement outcome in this situation. Thus, if  $a_{us}^*$  is the donor's 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 pursue the recipient to change its foreign policies, then it is also evident that both the donor and the recipient will adhere to their preferred foreign policy stances, which is represented by  $p^*$ . Thus, the donor's utility in this equilibrium is

$$(9) \quad US(p^*, a_{US}^*) = US(p^*, a_{US}^M)$$

Following the weak reciprocity rule, then, implies that each multilateral organization gets  $\frac{a_{US}^*}{k}$ . Further, recall that the recipient's implementation of the conditions is exogenously determined. The multilaterals, in turn, disburse the amount of aid that is associated with this particular implementation record. Let the multilateral's optimal amount of aid to the recipient be  $\hat{a}_{Mi}^R$  when  $\gamma_i = \bar{\gamma}_i, \forall i$ , is given. Hence, each multilateral will have a payoff of

$$(10) \quad M_i(\hat{a}_{Mi}^R, \frac{a_{US}^*}{k}, \bar{\gamma}_i c_i^*)$$

where  $c_i^*$  is the multilateral's optimal choice of conditions to levy on the recipient.

It follows then that the recipient will achieve

$$(11) \quad R(p^*, \bar{a}_{us}^R, \hat{a}_M^R, \bar{\gamma} c^*)$$

since it will receive the assigned amount of aid from the multilaterals, and not get any aid from the donor.

### 3.4 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 have leverage on the recipient's foreign policy. Thus, we do not restrict the players to interact bilaterally, but let them freely engage in influencing a third party in order to put pressure on an opponent. For simplicity, assume that there are two multilateral organizations.

Recall the aid allocation rule that specify that the donor will give the aid to another multilateral organization if this 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 cross-fire 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 comply with the 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:

A) The recipient complied at stage 2.

In this case, all multilateral organizations will have an equal share of the aid, and will also be able to set the conditions for granting the aid that are optimal as seen from the multilateral organizations' point of view.

		$M_2$	
		Aid	No aid
$M_1$	Aid	$M_1(\frac{a_{US}^*}{2} + \bar{a}_1, c_1^*), M_2(\frac{a_{US}^*}{2} + \bar{a}_2, c_2^*)$	$M_1(\frac{a_{US}^*}{2} + \bar{a}_1, c_1^*), M_2(\frac{a_{US}^*}{2} + \bar{a}_2, c_2^*)$
	No aid	$M_1(\frac{a_{US}^*}{2} + \bar{a}_1, c_1^*), M_2(\frac{a_{US}^*}{2} + \bar{a}_2, c_2^*)$	$M_1(\frac{a_{US}^*}{2} + \bar{a}_1, c_1^*), M_2(\frac{a_{US}^*}{2} + \bar{a}_2, c_2^*)$

B) The recipient did not comply at stage 2.

		<b>M<sub>2</sub></b>	
		Aid	No aid
<b>M<sub>1</sub></b>	Aid	$M_1(\frac{a_{US}^*}{2} + \bar{a}_1, c_1^*), M_2(\frac{a_{US}^*}{2} + \bar{a}_2, c_2^*)$	$M_1(\bar{a}_1, c_1^*), M_2(a_{US}^* + \bar{a}_2, c_2^*)$
	No aid	$M_1(a_{US}^* + \bar{a}_1, c_1^*), M_2(\bar{a}_2, c_2^*)$	$M_1(\frac{a_{US}^*}{2} + \bar{a}_1, c_1^*), M_2(\frac{a_{US}^*}{2} + \bar{a}_2, c_2^*)$

It is evident that this simultaneous move game played between the multilateral organizations has a “prisoner’s dilemma” structure. Thus, both multilaterals will chose not to give aid in the situation where the recipient does not adopt the donor’s foreign policy.

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 then 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 loser of this strategic behavior. First, note that the recipient only achieves  $R(p_R^{US}, a^*, \gamma c)$  which is less than what it would have in the situation where the multilateral organizations were not used as tools in the foreign policies of the donor. In this latter case, the recipient would have  $R(p_R^*, a^*, \gamma c) > R(p_R^{US}, a^*, \gamma c)$ . 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  $US(P_{US}^{US}, a_{US}^*)$ , which is clearly better than the utility when not acting strategically  $US(P_{US}^*, a_{US}^*)$  since it makes the recipient adopt the donor's foreign policies. Note also that the multilateral indifferent between the subgame perfect equilibria in the two scenarios.

### 3.5 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. Further, we follow the convention in the aid conditionality literature by assuming that the recipient's utility of receiving aid is balanced by the hardship implementing conditions and economic reforms that would not otherwise have been implemented. Thus, assume that the following condition is satisfied:

$$R(p, a_{Mi}^0, \gamma_i^0 c) = R(p, a_{Mi}, \gamma_i^1 c)$$

when  $\gamma^0 = 0$ ,  $\gamma^1 = 1$ ,  $a_{Mi}^0 = 0$ . This implies that the recipient is indifferent between, *ceteris paribus*, implementing the conditions to get multilateral aid, compared to abstaining from implementation and not get aid. So if the multilateral is to impose further requirements for the recipient to receive aid, that is, demand that the recipient adopt the donor's foreign policies, then two scenarios arise. The first is straight forward, the recipient rejects the aid-conditionality- foreign-policy-package because this yields the recipient strictly better off. The second scenario is that the multilateral offers to abstain from conditionality, and et as the sole requirement that the recipient implement

the foreign policy of the donor. In this case, the multilateral secures itself the aid from the donor and

The interesting result of the latter scenario is that the multilateral becomes soft on the economic reform programs usually set forward in the conditions that the recipient. Thus, the donor's strategic use of a multilateral does in fact crowd-out the sound economic reform programs that the multilateral usually condition its aid on. Thus, the multilateral is weakened as an instrument for development, and is clearly worse off in this situation. Moreover, if one believes that the economic reform programs would be beneficial to the people in the poor country if implemented, then these people would also be worse off in this situation.<sup>6</sup> This pattern of the recipient not implementing the conditions, but still get the aid, is also in accordance with the empirical evidence on conditionality.

It is no doubt that the opportunity to costlessly switch aid between identical multilaterals plays an important role in these relationships, both when the recipient's implementation of the conditions is endogenously and exogenously determined. Since the multilaterals are not identical, however, it is necessary to investigate the setting where one of the multilaterals is preferred over the other. It could well be that some donors prefer to fund the World Bank over other similar developing banks with almost like the African Developing Bank or the Asian Developing bank. Similarly, some donors prefer not to put all their eggs in one basket. These donors prefer to fund several different multilaterals in stead of concentrating on one. In the following two sections, we develop the model to include both preferences. First, we let there be increasing costs to the donor in the number of multilaterals it gives aid to, and in the second scenario we let there be decreasing costs in the number of multilaterals.

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<sup>6</sup> Note that we model the recipient as a government with specific preferences that are negative to the economic reform programs. This could for example be reforms that alter the income distribution in disfavour of the electorate that supports the ruling government. So even in the reform could be positive for the broad majority of the poor people, it could still be rejected by the government.

### **3.6 When the donor prefers to give aid to several multilaterals**

Some donors prefer to fund several multilateral organizations even if these organizations perform almost identical tasks (Kanbur 2003). The most illustrative case is that some donors fund the lending of the World Bank, at the same time as they fund the lending of a regional developing bank, where both banks give loans to the same countries. In this section, we assume that this type of donor behavior arise from a preference towards dispersing their total amount of aid to different multilaterals.

Thus, assume for now that there are increasing benefits to the donor of dividing the aid in equal shares to 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, then 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 have the aid with certainty, and nothing to profit 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 having 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 full disbursement of aid from the multilateral at the subsequent stage. Finally, the donor will see that any threat of making the recipient adhere to the donor's own foreign policy is not credible, and will thus not use any threat. Then we will have the same payoff to the players as specified in section 3.2 where we assumed that no strategic use of multilaterals were carried out.

Two interesting results emerge from this case. First, that a preference for giving aid to several multilaterals implies that conditionality becomes successful in these circumstances.<sup>7</sup> Second, there is no scope for strategic use of the multilaterals under these conditions.

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<sup>7</sup> However, we know from Villanger (2002) that for  $N=1$  the recipient is able to get aid without implementing the conditions when there are costs of punishing the company if we allow the game to be repeated in infinitely and if the recipient offers a favorable contract. In our game, when  $N=2$ , the recipient could offer both the companies a contract that is better than the market based contract only if they put pressure on the donor in the donor specific punishment path, and the ordinary contract if they do not. Due to the usual constraints, however, elaboration on this idea must be left for future research.

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