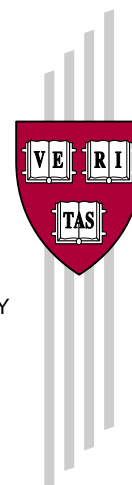


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## **G-24 Discussion Paper Series**

# **Governance-related Conditionalities of the International Financial Institutions**

**Devesh Kapur and Richard Webb**

*No. 6, August 2000*

**UNITED NATIONS CONFERENCE ON  
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**Research papers for the Intergovernmental Group of Twenty-Four  
on International Monetary Affairs**



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## PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Macroeconomic and Development Policies Branch, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising the awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research carried out under the project is coordinated by Professor Dani Rodrik, John F. Kennedy School of Government, Harvard University. The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums. Previously, the research papers for the G-24 were published by UNCTAD in the collection *International Monetary and Financial Issues for the 1990s*. Between 1992 and 1999 more than 80 papers were published in 11 volumes of this collection, covering a wide range of monetary and financial issues of major interest to developing countries. Since the beginning of 2000 the studies are published jointly by UNCTAD and the Center for International Development at Harvard University in the *G-24 Discussion Paper Series*.

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# **GOVERNANCE-RELATED CONDITIONALITIES OF THE INTERNATIONAL FINANCIAL INSTITUTIONS**

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**G-24 Discussion Paper No. 6**

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## ***Abstract***

*This paper examines the new found enthusiasm for governance-related conditionalities in the International Monetary Fund (IMF) and World Bank lending. This new agenda has focused in particular on legislative and institution-building efforts by borrowers to increase accountability, transparency, the rule of law, and participation. The paper attempts to document this trend by analysing a sample of 25 upper-tranche arrangements in 1999.*

*A review of past efforts to impose conditionality in related areas provides a discouraging background to this even more ambitious attempt by the international financial institutions (IFIs) at governmental and social re-engineering. Critical weaknesses in the new agenda are highlighted, particularly the complexity and potential conflicts that follow from a multiplication of goals, and also the distortions and ineffectiveness that result from a narrow focus on borrower governments, to the exclusion of private actors and civil society, who are also part of the problem. A brief account of some alternatives to conditionality, as currently practised, are also examined. Finally, the paper raises some troubling implications of this new agenda for the IFIs themselves, especially with regard to their operational effectiveness, their legitimacy and their fairness.*

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# GOVERNANCE-RELATED CONDITIONALITIES OF THE INTERNATIONAL FINANCIAL INSTITUTIONS

Devesh Kapur and Richard Webb

## I. Introduction

This paper looks at the current trend towards governance-related conditionality in lending by international financial institutions (IFIs). Section II focuses, in particular, on legislative and institution-building efforts by borrowers to increase accountability, transparency, the rule of law, and participation. The trend is difficult to document because statistics drawn from loan contracts do not clearly distinguish between exhortative or best-effort requirements and *sine qua non* conditions. The data also miss crucial up-front and side-letter conditions which do not appear in loan contracts.

Section III reviews past efforts to impose conditionality – especially those related to institutional development and civil service reform (CSR) – which provides a discouraging background to this new and even more ambitious attempt by the IFIs at governmental and social re-engineering. Section IV discusses some difficulties that are inherent to governance-related conditionalities (GRC), particularly the complexity and potential conflicts that follow from a multiplication of goals, and also the distortions and ineffectiveness that result from a narrow focus on borrower governments, to the exclusion of private actors and the civil community as a whole, all of whom are part of the governance problem.

A brief account of some alternatives to conditionality as currently practised is presented in section V. This is followed in section VI by a more detailed

review of the way in which the GRC agenda is likely to affect the IFIs themselves, especially with regard to their operational effectiveness, their legitimacy and their fairness.

## II. Evolving conditionality

International agreements or collaborations, such as those between IFIs and their borrowers, must deal with the risk of non-compliance which could arise by accident or opportunism. Different mechanisms have evolved for managing that risk. One consists of *ex ante* demands on borrowers. By requiring prior concessions, a party to the agreement may improve the expected outcome by enough to compensate for the risk of a breach. A second approach is to structure the agreement itself in ways that reduce the level of risk, often through stipulations that restrict a party's freedom of action. This paper revisits and builds on the analyses carried out in two earlier essays, one by Devesh Kapur and another by Aziz Ali Mohammed (Kapur, 1997; Mohammed, 1997).

Financial markets resort to a combination of higher risk premia, greater collateral and shorter duration agreements to address the risk of non-compliance, but none of these alternatives are available to IFIs, whose broader public purpose would be vitiated by such restrictions and additional charges. In the absence of such market mechanisms, it is argued that IFIs have no alternative to conditionalities as a way to overcome borrower incentives that lead to



commitment failure (Fafchamps, 1996).<sup>1</sup> IFI conditionalities (especially those of IMF) have also been viewed as screening devices which enable a creditor to discriminate between debtor countries willing to use IMF resources to invest and repay and countries which are not (Marchesi and Thomas, 1999: 454).

The introduction and growth of GRC in the IFIs is part of the evolution of the institutions themselves and the changes in their environment. The original rationale of conditionality was to protect the financial integrity of the Bretton Woods institutions. It was particularly suited to IMF's role in policing global systemic stability. IMF's conditionalities had a narrow focus on monetary-fiscal macro issues. In the case of the World Bank, conditionalities had a similar narrow focus, in its case concentrating on micro, sector-specific, financial issues. For IMF, the importance of conditionality began to grow in the 1970s. The gradual erosion of quotas – relative to world trade – was met by allowing countries to borrow greater percentages of their quotas. This softening of credit discipline was balanced, in turn, by increasing conditions. The move to stiffer conditionality was facilitated by the virtual disappearance of industrialized countries as IMF borrowers by the mid-1970s. Conditionality in IMF operations took on a central role in 1979, after the introduction of new guidelines which made it possible for IMF to move from being a lender of last resort only to becoming a lender of first resort. At about the same time, the IFIs raised their attention to structural measures that would enhance supply-side responses, spawning a corresponding new set of lending conditions (de Vries, 1985, chaps. 25 and 26).

In the World Bank's case, overt "Fund type" conditionalities were introduced through structural adjustment lending that commenced in 1980. During the 1980s the scope of these conditionalities both widened and deepened as they embraced the liberalization agenda encapsulated in the "Washington Consensus". Traditional fiscal and monetary conditions began to be increasingly fine-tuned as sub-criteria (both ceilings and floors) proliferated. Additionally, new macro conditions, with their own sub-criteria, were created, for instance, on debt ceilings and arrears. The IFIs were scrambling to plug what seemed to be ever increasing leaks in the ship of the state. The micro-managing was evident in the increasing number of conditions. In IMF's case, through 1982, less than 5 per cent of upper tranche arrangements contained more than 11 or more performance criteria. By the end of the decade, more than two thirds of such arrangements had 11 or more

criteria. The average number of criteria rose from about six in the 1970s to ten in the 1980s (Boughton, 1999). In the Bank's case the average number of conditions rose from 32 in 1980–1983 to 56 by the end of the decade.

## A. Governance

Although governance issues had come to the fore in the World Bank's thinking by the end of the 1980s, especially as a consequence of its repeated failures to bring about development in Africa, their current importance is a reflection of deep changes in international political culture. Governance was thrust into prominence with the end of the cold war and the resulting need to recreate civil societies in former communist states. Even more broadly, international political culture has changed, making state sovereignty far less sacrosanct in international discourse. One aspect of globalization has been to change international rules and norms in ways that weaken the "sovereignty" defence against intervention. The setting up of the International Criminal Court and international conventions that allow crimes against humanity to be tried in countries where they were not committed are examples of this shift. If the Pinochet case became the trend-setter, the indictment in a Senegalese court in early 2000 of former Chadian dictator, Hissène Habré, for "torture and barbarity" has broken a taboo on sovereignty in African countries as well. The extraordinary reaction in EU over the inclusion of Jörg Haider's Freedom Party in the Austrian ruling coalition exemplifies the degree of this shift. The United Nations Secretary-General, Kofi Annan, has made it clear that its members can no longer hide behind protestations of national sovereignty when they flagrantly violate the rights of citizens, arguing that "nothing in the [United Nations] Charter precludes a recognition that there are rights beyond borders" (*New York Times*, 21 September 1999).

Other factors that have contributed to the rise of GRC in IFI lending are "aid fatigue", civil society pressures from borrowing countries, and epistemic changes driven by new research findings in political economy. The World Bank, in particular, has put considerable resources into the effort to demonstrate that "governance matters" for sustainable development, and a large literature has grown in recent years on this subject (Kaufmann et al., 1999).<sup>2</sup> In September 1997, the World Bank adopted a policy statement that "corruption should be explicitly taken into ac-

count in country risk analysis, lending decisions and portfolio supervision if it affects project or country performance". Since the 1980s, IDA (International Development Association) replenishments have been the mechanism used by civil groups and donor parliaments to push through changes in the World Bank as a whole. The Twelfth Replenishment of the IDA, negotiated in 1998, became the means for extending the inclusion of GRC on the Bank's agenda. The agreement stated unambiguously that "good governance is *critical* to the development process and to the effectiveness of development assistance; this is a *key* concern of the IDA Deputies" (italics added; IDA.12, 1998). The changing reality has not been lost on African finance ministers (whose countries bear the brunt of GRC), who recently agreed to meet loan conditions set by foreign donors and eliminate corruption as long as the countries were given an opportunity to fully discuss the conditions. "In the face of declining official development assistance, there is a realization and acceptance among African countries that individual countries will have to justify their case for additional assistance. This must be on the basis of high performance on the issues of good governance, observance of the rule of law and zero tolerance for corruption."<sup>3</sup>

In the Fund's case, the sharply enhanced role of private capital markets for developing countries has led to a new rationale for conditionality – giving confidence not only to IMF but to private creditors as well. To attract private capital, countries need to establish credibility, a reputation for predictable behaviour. Conditionality is the bridge to close the "predictability gap". By this logic, conditionality is less an imposition by the IFIs than a desirable instrument sought by governments to signal the predictability of their policies to private creditors. For these purposes, conditionality is interpreted as implying a substantially "far-reaching extension in the scope of needed reforms", especially a "strengthening of the whole civil administration, in particular the judiciary" (Dhonte, 1997).

Finally, the expansion of IFI conditionalities is a logical extension of their "mission-creep", expressed for instance in the widening agenda of IMF's Surveillance and Article IV consultations (IMF, 1999a). We shall return to this point later.

"Good governance" has thus become enshrined in the commandments that rule the IFIs, yet the term eludes operational precision. There are frequent references (as in IDA.12, 1998) to the "four pillars" of good governance: accountability, transparency, the

rule of law, and participation. Indeed its imprecise, elastic meaning works in favour of general acceptance. At the same time, unsurprisingly, IFIs rarely use the term "governance" in their negotiations or agreements. Consequently, GRC remains, to a considerable extent, a matter of interpretation.

Despite the ambiguities that surround the term, one cannot overemphasize the importance that has been acquired by "good governance", whether measured in terms of the way in which IFIs now define themselves, or the priorities of the ever-widening circle of the stakeholders of those institutions. In addition, the issue now has a great deal of resonance within developing countries, particularly with respect to the problems of corruption and accountability, where, despite their external nature, the IFIs have tapped into a deep well of discontent.

The rationale for the IFIs concern with good governance is therefore clear. But the move from desirability to action, specifically in the form of GRC, poses three questions: (i) do the IFIs have the mandate, the comparative advantage, and the competency to justify GRC? (ii) given the vast terrain and range of issues that "governance" potentially covers, do the IFIs have their priorities right? and (iii) is the manner in which the IFIs are addressing the problem of governance appropriate?

## **B. Documenting conditionalities**

There are two principal problems in measuring GRC. First, what constitutes a "conditionality" and, second, what constitutes "governance"? A strict interpretation of traditional IMF conditionality, would restrict itself to traditional IMF quantitative "performance criteria", including "prior actions", "quantitative targets" and "structural benchmarks". But programme documents go much farther: these have numerous "programme objectives" and lay out "strategies and measures" to meet them. The language in the latter is awash with governments promising to "adopt", "assess", "authorize", "build upon", "complete", "continue", "discontinue", "define", "ensure", "expand", "establish", "examine", "fill", "introduce", "improve", "increase commitment to", "mobilize", "organize", "prepare", "pursue", "redefine", "reform", "reverse", "streamline", "strengthen", "study", "support", "update", "upgrade", all sorts of worthy objectives. Sticking to the narrowest definition would be misleading because it would amount to saying that all of these other criteria mentioned in

IFI documents are simply nonsense and no more than a Keynesian programme to provide employment to their bureaucracies; if not, we should take them at face value.

However, including these criteria creates other problems of interpretation. In most cases they are dated covenants but, unlike quantitative performance criteria, they are not explicitly tranche release conditions. A government may promise to do a, b, c, etc., but the consequences of not doing so are unclear. There are many subjective elements in interpreting what constitutes a conditionality. If the Government of Mali agrees to organize a sectoral round-table on housing, what would this mean in practice? What does one make of a condition that the same government should “ensure the coordination and the convergence of macroeconomic and sectoral policies” in pursuit of regional integration objectives (IMF, 1999a)? When Senegal agrees to “pursue the development of animal production”, Tanzania to “support the ‘Water for Life’ campaign”, Madagascar to “generalize the use of impact studies for sustainable development” and “mobilize decision-makers and the population to devise a joint communication plan”, or Guinea to “continue rationalizing management of human resources in the agriculture sector”, are these conditionalities or simply banalities?

Furthermore, an omnibus condition can be interpreted as a single condition or several conditions depending on how one breaks it up, temporally and by subissue. The numbers may give a sense that the conditions are all of equal importance and weight, which is obviously never the case. Critically, some of the most important conditions are not reflected in these numbers at all; they are to be found in “side letters” and “pre-programme” conditions, the latter being particularly important in the case of the poorest aid-dependent countries where these are put in place in consultative group meetings.

Tables 1–5 attempt to give numerical estimates of conditionalities based on IMF *Letters of Intent*, *Policy Framework Papers* (PFPs) and *Memorandum of Economic Policies* (MEPs). We restricted our selection to countries that had programmes in 1999.

The exception was East Asia (Indonesia, Republic of Korea and Thailand), where we looked at programmes that commenced in late 1997, following the onset of the crisis in East Asia. The reason is that later programmes (in 1998 and 1999) in these countries were essentially a continuation of the programmes that were initiated in 1997. While tables 1 and 2 are based on a strict and narrow interpretation of conditionality (“quantitative performance criteria”), tables 3 and 4 are based on a more loose interpretation of conditionality drawn from PFPs and MEPs.

Table 5 summarizes the burden of conditionality by region. The unequal sample sizes drawn from each region, as well as the fact that the countries chosen are not drawn randomly in the strictest sense, means that the numbers should be interpreted with caution. We are, however, confident that the numbers are broadly representative of recent trends in IFI conditionality.

Even if conditionality is interpreted narrowly, its burden on borrowers has grown significantly. The average number of criteria for a sample of 25 countries, with programmes initiated between 1997 and 1999, is 26. This compares to about six in the 1970s and ten in the 1980s. Although, under a narrow definition of conditionality, the burden is most acute in Central Asia and East Europe, a broader definition of conditionality, however, places the largest burden on sub-Saharan Africa. The region also stands out in the number of GRCs, which are more than half of all conditionalities (loosely defined) in all regions, and nearly three fourths in sub-Saharan Africa. Although there is little doubt that some GRCs (for instance those related to “transparency”) are new, quantitative precision is rendered difficult by the plasticity of the concept, as well as the repackaging of some earlier conditionalities (such as those related to bank mergers as a prelude to privatization, or dismantling import monopolies which have fiscal consequences) but with a different intent (and rhetoric). Moreover, a number by itself does not distinguish between conditions that are written into agreements from those which have the most weight in determining whether or not agreements are signed and money disbursed.

Table 1

IFI CONDITIONALITY STRICTLY DEFINED: EAST ASIA, CENTRAL ASIA, EAST EUROPE, AND LATIN AMERICA							
Country	Total	Prior actions	Quantitative targets	Structural benchmarks	Of which governance-related		
					Total	Institutional	Financial
<b>East Asia</b>							
Cambodia	30	11	8	11	9	4	5
Indonesia	18	--	8	10	8	4	4
Rep. of Korea	10	--	4	6	4	3	1
Thailand	9	--	9	--	--	--	--
<b>Central Asia</b>							
Kazakhstan	27	4	10	13	17	8	9
Kyrgyz	37	10	14	13	23	8	15
<b>East Europe</b>							
Albania	43	12	7	24	33	17	16
Latvia	28	--	8	20	20	10	10
Romania	43	11	12	20	25	14	11
<b>Latin America</b>							
Brazil	38	--	7	31	21	12	9
Bolivia	32	--	5	28	21	16	5
Nicaragua	29	--	7	22	18	11	7

*Source:* IMF: *Letters of Intent*: Republic of Korea, 12/03/97; Indonesia, 10/31/97; Thailand, 08/14/1997; Romania, 07/26/99; Albania, 12/21/99; Latvia, 11/10/99. *Policy Framework Papers*: Cambodia, 10/06/99; Kazakhstan, 11/22/99; Kyrgyz, 12/27/99; Bolivia, 08/25/99; Nicaragua, 08/23/99. *Memorandum on Economic Policies*: Brazil, 11/12/99.

Table 2

IFI CONDITIONALITY STRICTLY DEFINED: SUB-SAHARAN AFRICA							
Country	Total	Prior actions	Quantitative targets	Structural benchmarks	Of which governance-related		
					Total	Institutional	Financial
Cameroon	15	0	7	8	7	5	2
Djibouti	29	6	18	5	8	4	4
Gambia	20	0	11	9	5	4	1
Ghana	23	4	9	10	13	9	4
Guinea	17	0	11	6	5	3	5
Madagascar	30	7	13	10	11	7	4
Mali	26	5	10	11	13	10	3
Mozambique	22	0	8	14	12	5	5
Rwanda	25	1	14	10	7	4	3
Senegal	27	0	10	17	9	6	3
Uganda	22	3	8	11	12	7	5
United Rep. of Tanzania	29	0	7	22	13	6	7
Zambia	18	3	10	5	6	5	1
Average	23	2	10	10	9.3	5.7	3.6

*Source:* IMF: *Letters of Intent*: Cameroon, 08/09/99; Djibouti, 10/02/99; Gambia, 11/08/99; Ghana, 04/13/99; Guinea, 12/07/99; Madagascar, 06/28/99; Mali, 07/12/99; Mozambique, 06/10/99; Rwanda, 11/02/99; Senegal, 06/04/99; Uganda, 11/19/99; United Republic of Tanzania, 07/13/99; Zambia, 03/10/99.

Table 3

**IFI CONDITIONALITY LOOSELY DEFINED:  
EAST ASIA, CENTRAL ASIA, EAST EUROPE, AND LATIN AMERICA**

Country	Total	Of which governance-related		
		Total	Institutional	Financial
<b>East Asia</b>				
Cambodia	83	65	44	21
Indonesia	81	48	26	22
Rep. of Korea	114	44	25	19
Thailand	56	37	18	19
<b>Central Asia</b>				
Kazakhstan	114	69	33	36
Kyrgyz	130	97	61	35
<b>East Europe</b>				
Albania	72	47	25	22
Latvia	65	28	16	12
Romania	82	34	18	16
<b>Latin America</b>				
Bolivia	89	45	31	14
Brazil	95	44	23	19
Nicaragua	50	34	24	10

*Source:* IMF: *Letters of Intent*: Indonesia, 10/31/97; Republic of Korea, 12/03/97; Thailand, 08/14/1997; Albania, 12/21/99; Latvia, 11/10/99; Romania, 07/26/99. *Policy Framework Papers*: Cambodia, 10/06/99; Kazakhstan, 11/22/99; Kyrgyz, 12/27/99; Bolivia, 08/25/99; Nicaragua, 08/23/99. *Memorandum on Economic Policies*: Brazil, 11/12/99.

Table 4

**IFI CONDITIONALITY LOOSELY DEFINED: SUB-SAHARAN AFRICA**

Country	Total	Of which governance-related		
		Total	Institutional	Financial
Cameroon	92	77	56	21
Djibouti	134	106	77	29
Gambia	121	91	65	26
Ghana	80	61	42	19
Guinea	125	88	61	27
Madagascar	137	103	81	22
Mali	105	67	45	22
Mozambique	74	58	36	22
Rwanda	135	99	73	26
Senegal	165	99	72	27
Uganda	74	54	28	26
United Republic of Tanzania	150	104	67	37
Zambia	87	59	43	16
Average	114	82	57.4	24.6

*Source:* IMF: Cameroon, LOI and PFP, 08/09/99; Djibouti, LOI and PFP, 10/02/99; Gambia, LOI and PFP, 11/08/99; Ghana, LOI, 04/13/99 and PFP, 04/14/99; Guinea, LOI, 12/07/99 and PFP, 12/08/99; Madagascar, LOI, 06/28/99 and PFP, 07/13/00; Mali, LOI and PFP, 07/12/99; Mozambique, LOI and PFP, 06/10/99; Rwanda, LOI, 11/02/99 and PFP, 11/04/99; Senegal, LOI and PFP, 06/04/99; Uganda, LOI and PFP, 11/19/99; United Republic of Tanzania, LOI, 07/13/99 and PFP, 01/19/99; Zambia, LOI and PFP, 03/10/99.

Table 5

THE BURDEN OF CONDITIONALITY						
Region	Total conditionality		Governance-related conditionality		Governance-related conditionality as percentage of	
	Strictly defined	Loosely defined	Strictly defined	Loosely defined	Strictly defined conditionality	Loosely defined conditionality
Africa	23	114	9	82	39	72
Asia	17	84	4	49	24	58
Central Asia and East Europe	36	93	24	55	67	59
Latin America	33	78	13	41	39	53

**Source:** Data based on IMF *Letters of Intent and Policy Framework Papers* (PFPs) between 1997–1999: *Africa*: Cameroon, Djibouti, Gambia, Ghana, Guinea, Madagascar, Mali, Mozambique, Rwanda, Senegal, Uganda, United Republic of Tanzania, Zambia; *Asia*: Cambodia, Indonesia, Republic of Korea, Thailand; *Central Asia and East Europe*: Kazakhstan, Kyrgyz, Albania, Latvia, Romania; *Latin America*: Bolivia, Brazil, Nicaragua.

### III. Does the past record inspire confidence?

In considering the benefits likely to accrue from GRC, it is helpful to look at past IFI experience, first with conditionality in general and, second, with efforts to improve public management and institutions. How effective has conditionality been in inducing behavioural change and accomplishing its earlier, more narrowly defined objectives? And, given the significant intersection between GRC and the goals of earlier efforts to improve public management and institutions, does the past record of the IFIs in these admittedly difficult areas inspire confidence? The historical record should suggest which areas of governance can be tackled more easily by the IFIs, a conclusion that could then be contrasted with the current scope of IFI conditionalities.

Numerous studies have sought to examine the effectiveness of IFI conditionality. The World Bank conducted several internal evaluations of its structural adjustment operations. These studies, as well as a number of external evaluations, all conclude that the effects of these operations have been modest.<sup>4</sup> Structural adjustment lending by IMF was found to be equally modest, even though conditionality plays a more central role in IMF operations. Thus, an internal IMF review in the late 1980s of 149 standby and extended arrangements by IMF found that the

performance criteria and overall external objectives had been met in a quarter of the cases. In another 36 per cent neither category was satisfied; in 17 per cent performance criteria had been met but not the external goals; while in the remaining 21 per cent the opposite was true (IMF, 1988, table 4: 28). Tony Killick's extensive evaluation of IMF programmes found an "over-reliance" on conditionality, as well as a proliferation of conditionality in Fund programmes leading to heightened non-compliance (Killick, 1995).

An even more negative view that conditionality has had perverse effects, has been put forward by some analysts, including senior World Bank officials. Joseph Stiglitz, the former Chief Economist of the World Bank, recently argued: "There is increasing evidence that [conditionality] was not [effective] – good policies cannot be bought, at least in a sustainable way. Equally critically, there is a concern that the way the changes were effected undermined democratic processes" (Stiglitz, 1999: 591). Since "good governance", as understood by the IFIs, clearly implies better democratic processes – as underlined by the emphasis on accountability, transparency and participation – undemocratic means of implementation contradict the objective. In a series of articles, Paul Collier, Director of Research in the World Bank, has been even more categorical; he writes: "The extension of the practice of conditionality from the occasional circumstances of crisis management to

the continuous process of general economic policy-making has implied a transfer of sovereignty which is not only unprecedented but is often dysfunctional". Collier adds that donor conditionality has "low credibility" and "was incredible since its inception", in three respects: the penalties inflicted by the conditionality regime "lacked moral legitimacy"; the punishment was excessive relative to the "crime"; and "the imposition of penalties was not in the financial interest of the donors" (Collier, 1999: 319–320).

Most of these studies agree that attaching conditions to aid can strengthen the arm of governments that are trying to push through necessary but unpopular measures. It would seem intuitively obvious that reforms rarely succeed unless a government shares the conviction that they are essential, rather than agreeing to measures with reluctance, merely to meet a deadline for the release of a life-saving tranche. Taken to an extreme, the importance of "ownership" would imply that conditionality is unnecessary, but realities are more complex because opinions differ within governments, and power alignments shift over time. An incumbent government might "own" a programme but its successor might not; a government might genuinely believe in the need to abolish agricultural subsidies but its farmers might not; technocrats may "own" programmes that many other members of society do not.

In their own defence, IFIs argue that it is precisely in response to the criticisms of their programmes that they waded deeper and deeper into structural issues, moving from economic to political structures and processes. They agree that their programmes did not work well in the past (the Bank is readier to criticize itself than the Fund) in part because they ignored issues of power – the interests and political processes that shape and subvert public institutions – but argue that the obstacles to development are finally understood. Thus, the Bank has "discovered" a new approach to development: the "Comprehensive Development Framework" (CDF), whose "comprehensive" and "holistic" approach is to replace both "the old approach of an exclusive focus on growth" and the "trickle-down approach".<sup>5</sup>

How much of this is "new" is debatable. Development economists and the World Bank itself have always known that there is no magic bullet behind development, although at various times primacy has been given to particular factors – physical capital in the 1950s and 1960s, poverty in the 1970s, trade and structural adjustment in the 1980s, human capital and the financial sector in the 1990s, and, more recently,

governance. The cycles and lags between ideas, projects and expertise limit the duration with which the institution stays with any single idea (see figure below). T.N. Srinivasan, one of the pioneers of development economics, comments:

It takes one's breath away to read that "we now see the centrality of issues of governance, both in the public and private sector". Pray, what took so long to see this? "Governance", to use the buzz-word, is not a new issue – one already knows that rampant corruption is deleterious, or for that matter that openness to foreign trade and technology, macro-economic stability, investment, etc., are all important! What do Wolfensohn and Stiglitz mean precisely by "democratic, equitable and sustainable increases in living standards provide the right focus for policy makers"? What is the meaning of "democratic" increases? Equitable in what sense? ... Some of us, at least, believe that five decades of development experience since the end of the second world war has shown that policies for poverty alleviation are not mysterious or new, but mundane, tried and tested. They are policies that bring about rapid and labour-intensive growth based on a better educated and healthier labour force, participatory democracy and fuller integration with the world economy.<sup>6</sup>

These observations are borne out to a considerable degree in many of the PFPs we examined, particularly in the poorest countries. Conditionalities in the PFPs often demonstrate a slavish bent to faddishness rather than a sense of priority on the use of scarce resources. Does a country like Mozambique, which has one of the lowest per capita incomes in the world, really need to "complete provincial poverty profiles" at this stage? Even more troubling are conditions that ask Rwanda to "fill gap left by genocide by strengthening vocational, technical, and management training", along with 134 other conditions ranging from being asked to "complete the household living conditions survey in urban and rural areas" and "develop a vision for Rwanda's public service to guide the next stage of reforms of public administration". Given the unfortunate reality of that country one wonders whether the PFP is simply a Potemkin Village, a classic bureaucratic document that blithely sacrifices realism at the altar of "comprehensiveness".

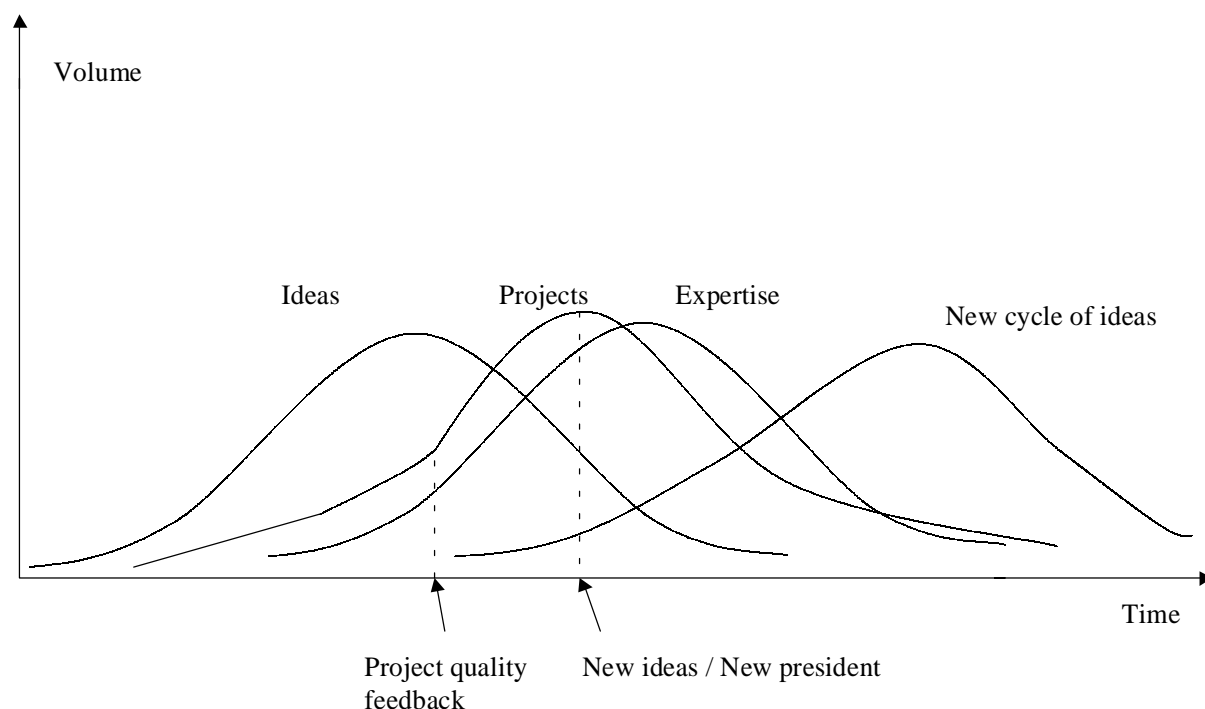
The experience with public sector management projects provides a more direct indicator of the likely performance of GRC. Admittedly, the emphasis is now being placed on issues, such as transparency,

Figure

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**INSTITUTIONAL LIFE CYCLE IN THE WORLD BANK**


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accountability, participation and corruption, that are relatively new, if not for development thinking, certainly for IFI lending and advocacy. Nonetheless, there is a substantial overlap with the “old” effort to improve public sector management. When it comes to actual operations, these “new” governance objectives will necessarily translate into an agenda for broad transformation in public institutions.

The experience with institutional development (ID) has been frustrating. In a wide variety of institutional settings, public-sector management projects have historically underperformed the Bank’s portfolio average (World Bank, 1998). Out of 1,689 projects with institutional development goals approved between 1971 and 1991, only 29 per cent had a substantial impact on ID, according to evaluations by the World Bank’s Operations Evaluation Department (OED). The impact on ID was modest in 45 per cent of the projects and negligible in the remaining 26 per cent. During the 1990s, “substantial” institutional development impact was evident in 32, 31 and 39 per cent in the projects that exited the portfolio during the periods 1990–1993, 1994–1997 and 1998–1999, re-

spectively. But even in the most recent cohort, performance was a third lower in the case of IDA countries, i.e. the countries where GRC is most likely to be applied.

Further evidence is provided by the Bank’s periodic internal reviews of the effectiveness of its role in institutional development. Three reports over the past three decades reveals a considerable willingness to self-examination, yet little learning from that study (World Bank, 1980, 1999a; Paul, 1990). The reasons are structural. Institutional development is usually needed most where it is hardest to achieve. That difficulty has been met most commonly by resorting to outside experts: loans for ID have been conditioned on the acceptance of technical assistance.<sup>7</sup> Yet, numerous reports have documented the weaknesses and failures of donor-driven technical assistance, especially in Africa. Technical assistance is charged with fostering the dispensation of favours through patronage relationships, and with distorting labour markets and wage scales. The effect has been to increase dependence and rent seeking. ID projects are highly vulnerable to contextual factors, which can make or



break a project. To be successful, their design and approach must be closely adapted to prevailing culture, norms, attitudes, and behaviour patterns.

Another body of evidence that bears on experience with institutional reform draws on efforts by the World Bank and Inter-American Development Bank in the area of health reforms, as reviewed by Nelson (1999), who writes: “In most poor and middle-income countries ... better and more equitable education and health care demand far-reaching reforms in the organization, management, financing, and incentives of the sectors as a whole. Such reforms are extraordinarily difficult politically – more so even than the painful structural adjustments carried out over the past two decades in many nations. Rarely can the necessary measures be successfully imposed from the top, still less from outside the country”. Her main recommendation for such reforms is to “make haste slowly”.

This need for tailoring, however, runs into the wall of IFI institutional culture and incentives, which are inimical to the development of country-specific expertise. The Bank’s perpetual reorganizations truncate any tendency to acquire such expertise. The issue is moot for IMF, which prides itself on its universal nostrums. In both institutions, personnel incentives encourage rotation rapidly through departments, rather than to develop country- or even region-specific expertise. The traditional predominance of the economics profession in IFI staffing – the social science with the strongest claim to universality – has been another factor in the undervaluation of country-specific knowledge. However justified in the past, the economist’s (and increasingly the political scientist’s) aversion to country specificity will prove an obstacle to the IFI effort to tackle governance problems. The Bank’s recent and successful efforts to recruit large numbers of non-economist social scientists is unlikely to make a significantly rapid and large impact on its institutional culture, while IMF has made only token efforts in that direction. Unlike budget balancing, or road, dam, and school construction, IFI contributions to governance problems must build on a close familiarity with country-specific cultural, social and political knowledge. These institutional obstacles to country-specific knowledge are reinforced by the “low brow” valuation that is placed on such knowledge within the academic community from which IFI personnel is drawn, and with which the IFIs carry on a continuous and intensive interaction.

Three additional examples of IFI efforts to improve government performance – civil service, tax,

and judicial reforms – may be cited to illustrate the difficulties faced by the GRC agenda.

Over the past two decades, the World Bank has supported ambitious efforts for CSR. Initially in the 1980s, the Bank’s strategy to combat bureaucratic dysfunction turned on the notion that governments could “do more with less”. It supported downsizing measures to limit and cut civil service size, while imposing hard budget constraints on wage expenditures. Subsequently, it added capacity-building initiatives, using salary supplements in key areas, that would allow governments to “do more”, particularly to implement difficult adjustment programmes. In the early 1990s, the Bank added a third class of measures: institutional reforms, such as intra-public-sector regulatory reform and external checks and balances, directed at making governments “more transparent and accountable”, in addition to more efficient.

An internal review of those projects commented that “despite its growing importance, CSR continues to suffer from definitional, strategic and operational ambiguities. Between 1980 and 1997, the Bank diagnosed three stylized forms of bureaucratic dysfunction that undermined the ability of governments to secure the fundamentals of adjustment and development” (World Bank, 1999b). On average, only a third of closed CSR interventions and 38 per cent of ongoing efforts achieved satisfactory outcomes. Even when desirable, outcomes were often not sustainable. Downsizing and capacity-building initiatives failed to produce permanent reductions in civil service size and to overcome capacity constraints in economic management and service delivery. There was no evidence that civil servants began to “own” and follow formal rules, such as codes of ethics in any meaningful way. As a result, institutional reforms were unable to limit arbitrary action by bureaucrats or politicians to any significant extent. The review found that the limited success of the Bank’s approach to CSR was largely due to its narrow “technocratic” character. “Rather than engaging CSRs as dynamic systems that are influenced by multiple stakeholders, Bank operations relied on small groups of interlocutors within core ministries to design and implement one-size-fits-all CSR blueprints in diverse country settings” (World Bank, 1999b).<sup>8</sup>

A review of the Bank’s record on reform of tax and customs systems in the 1990s found two principal constraints on World Bank operations. One, the theoretical basis for reform efforts in this area was rudimentary. The review found little evidence in sup-

port of the theories that had been relied on by the Bank in designing tax reform programmes. Those theories stressed the importance of institutions that harness voice and improve transparency and contestability in rendering tax administration more effective. Further, the Bank's institutional framework for accumulating knowledge from loan operations was inadequate. Institutional components of project design were biased toward organization, manpower upgrading, and procedures related to information technology, while little attention was being paid to improving accountability, administrative cost-effectiveness and anti-corruption institution-building (Barbone et al., 1999).

The Bank's foray into judicial reform is another example of the institution's approach to governance. During the 1990s, judicial reform projects were in vogue in the World Bank, regional development banks and other donor organizations. A key intellectual prop for those projects was Douglas North's thesis that the absence of low-cost means of enforcing contracts was "the most important source of both historical stagnation and contemporary underdevelopment in the Third World". This argument helped to bring about a resurrection of the "law and development" efforts which had been carried out in the 1960s and early 1970s, though with little success (North, 1990: 54). But, like other uncausal arguments, North's thesis can be criticized for overemphasis and a corresponding underestimation of the complexity that prevents or delays development. Indeed, North's history – his interpretation of England, his principal historical example – has been questioned.<sup>9</sup> But most importantly, there is little reason to believe that contract enforcement can only be done through formal systems. Most societies have informal systems of enforcement.

A review of judicial reform efforts by the Bank written in 1999 is discouraging. The report states that, after dozens of projects and more than half a billion dollars in lending by the IFIs alone, "little is known about the actual effect of judicial reform on economic performance or even about what elements constitute a sound reform project" (Messick, 1999: 117–136). Indeed, in several cases it has been found that the sudden introduction of formal mechanisms to resolve legal disputes has simply disrupted informal mechanisms, without commensurate gains. A lack of understanding of the considerable role played by informal legal and enforcement mechanisms in poor countries seems to have been a major gap in the intellectual underpinning for judicial reform projects.

Judicial reform illustrates several features of the way in which the IFIs have approached governance issues. One is a combination of impatience and a readiness to use borrowers as guinea pigs. New development doctrines are taken on board and pushed to the fore with haste, as the IFIs strive to maintain their image as founts of development savvy. Internal incentives reward risky innovation more than solid repetition. A second feature is the overwhelming dominance of US academia when it comes to calling the intellectual tune. A third is nimbleness when needed to steer around unpleasant realities. A case in point is the Bank's avoidance of criminal law and police reform – reforms that have been identified repeatedly in the Bank's country surveys as a major requirements for business and to secure the "rule of law". There is a hint of pro-foreign business bias here, in that powerful foreign investors are less threatened by local police misbehaviour than by the inability or unwillingness of a judicial system to enforce contracts. Yet the best of judicial systems is unlikely to succeed if police and prosecution are incompetent and corrupt. The Bank's General Counsel had argued that the Articles of Agreement preclude the Bank's involvement in this area, but it is undoubtedly true, also, that police reform presents severe public-relations risks for the institution.

#### **IV. Impact on the quality of the development process**

What conclusions can be drawn from the IFIs' as yet brief experience with GRC? This question poses several others: what criteria should be used to measure GRC "success"?; what assumptions lie behind the multiplication of specific, detailed governance-related conditions?; to what extent is GRC responding to the objectives of civil society in donor countries and in borrower countries?; has GRC enhanced the pace and quality of the development process?

The GRC experiment is as yet too recent for such an evaluation and, in any case, the effort would require resources well beyond the scope of this paper. In the World Bank, project proposals began to incorporate GRC only in the late 1990s, and those projects are only now reaching the Board for approval. What this paper can do, however, is to provide an advance warning of some design weaknesses in the IFIs' approach to governance that should be addressed to improve the odds for GRC.

A major obstacle to any evaluation of the impact of GRC is the lack of clear analytical links between governance and economic and social performance. It cannot be doubted that GRCs have economic consequences, but a more precise understanding of those links is needed as a basis for decisions regarding the large lending (i.e. borrowing) volumes that are at stake for choices among the large variety of items on the GRC menu. At the moment it is difficult to form any reasonable expectation of economic impact proportionate either to a given “amount” of GRC or to the financial size of the programme. There is a quantum gap, for instance, between the financial precision of IMF programming models and the developmental vagueness attached to IMF strictures regarding corruption.

When it comes to the specific targeting of GRC, the IFIs have focused on *public* offices and institutions rather than on society at large. For instance, corruption has been defined as “the abuse of public power for private gain”, where, for the Bank, *public power* is being interpreted as *public office* rather than the arbitrary exercise of power by any actor, public or private, but in the *public domain*.<sup>10</sup> Thus, even though the Bank is increasingly consulting and enrolling non-state actors in borrower nations to help design and implement Bank programmes, GRC is restricted to the state. But, like the tango, it takes two to effect a bribe. More generally, the quality of governance reflects societal values, institutions and behaviour. When bureaucracies fail, it is not because they are manned by individuals more evil or corrupt than the average citizen.<sup>11</sup> To succeed, new rules and institutions for government institutions – the usual target of GRC – must survive in an alien culture.

A case in point are private audit firms. The accountancy profession, which should be part of the solution to poor governance, is in fact very often part of the problem. In practice, auditors frequently connive in concealing information from government and from minority shareholders. Foreign audit firms provide a short-term solution, but only for the largest firms, and at the cost of weakening the pressures and economic incentives for a better long-term solution based on tougher self-regulation by professional bodies. Another case is that of NGOs, whose accountability is often more upwards to donors than downwards to “the people”. Civil society can be uncivil, and NGOs can and do have interests other than the public good, just like governments and IFIs.<sup>12</sup> Ian Little has warned against the pitfall of a narrow focus: “anyone who writes that such-and-such policy would further economic development is making a

value judgement. With such words, there is liable to be a competitive struggle to get one’s definition accepted. If a definition gets accepted, it tends to de-emphasize considerations not included in the definition”.

### A. *Aggregation and trade-offs*

One design issue posed by GRC bears on the uniformity of rules across countries. Globalization is being buttressed by a thickening mesh of global rules and standards, from child labour to governance to accounting, most of which require institutional change. But the direction of regulatory convergence is towards the standards that already exist in advanced industrialized democracies. The result is an unequal distribution of the burden of regulatory adjustment: those with the least capacity have to travel the greatest distance. One reason for this inequality, of course, is that the countries that are being required to change the most so as to conform to global rules are the ones that have least influence on crafting the common rules. Also, as the number of global rules multiplies, so do tradeoffs among the rules, despite the “win-win” assumptions of the new “wholistic” development rhetoric.

The problems that arise when conditionalities and regulations pile up are, in fact, analogous to an extension of the better-known issue of cross-conditionality between the Bretton Woods institutions. But with developing countries having to conform not just to conditions arising from Bank-Fund programmes but also to a host of global conventions and rules, the implications of the aggregation problem have become more severe.

The complexities and potential conflicts of this process of rule aggregation are suggested by the sheer multiplicity of rule-making bodies. Rules related to global financial governance, for instance, are being crafted by more than a score of institutions, ranging from the purely public to the purely private, from globally representative to clubs with limited membership. In the case of forestry, there are some forty international bodies and at least 20 treaties that touch on the issue.

The limited voice of developing countries in these fora means that the new rules and conditions are not those best suited to their situations, needs and capacities. In recent years, the WTO has emerged as a major source of rules and conditions, as impor-

tant as the IFIs. Belatedly the World Bank has queried the welfare implications of the WTO for its borrowers. A recent research paper, for instance, has argued that the WTO agreements were an “inappropriate diagnosis and an inappropriate remedy, one incompatible with the resources they [developing countries] have at their disposal”. The problems of governance are severest in some of the poorest countries, but they also have the most limited institutional resources. The customs valuation agreement of the WTO, for instance, is inappropriate to their needs, or at least, not a priority that would have been chosen by them.

The World Bank has itself questioned “the content of obligations imposed by the WTO agreements on customs valuation, intellectual property rights and SPS [Sanitary and Physiosanitary standards which] can be characterized as advanced countries saying to the others ‘Do it my way!’” (Finger and Schuler, 1999). The imposition of the intellectual property rights (IPR) regime is another example. Despite its well documented negative welfare implications for poor countries, together with the burden of other reforms in legal and enforcement mechanisms, poor countries will be required to give prior claims to IPR-related issues over many other pressing domestic needs.

### ***B. External versus internal factors***

The IFIs’ governance agenda places an almost complete exclusive emphasis on factors internal to the country; external factors that may be part of the problem are ignored. In 1998, when member nations proposed that the World Health Organization be granted more power to monitor international trade agreements and their effects on global public health, and WHO intimated that it would support improved access to patented medicines in developing countries, the US State Department threatened to withhold funding to the organization. When the Thai Government established a Pharmaceutical Patent Review Board to assess the effects of patents on drug accessibility, the US Trade Representative’s office threatened sanctions on certain Thai exports. The board was quickly disbanded and Thailand, which sends a quarter of its exports to the United States, set limits on the right to issue compulsory licences for pharmaceuticals (*Asiaweek*, 17 February 2000).

Similarly, on issues of corruption and transparency, the operational emphasis of the Bretton Woods

Institutions has been almost exclusively on transparency in the financial accounts of emerging-market governments. In the IFIs’ agenda, respect for private-sector privacy is sacrosanct, being a defence against government intervention, especially through capital controls. The major exception has been related to money-laundering which, unsurprisingly, is vital to a rich-country priority – control of the drug traffic. But, when the line between public and private is blurred, as is commonly the case in developing countries, public accountability and transparency require a degree of transparency by private parties.

The international financial community has always argued that capital flight is a symptom and not a cause of a country’s predicament. But this argument ignores the realities of poor countries, where banking secrecy protects the ill-gotten gains of elites, whether through corruption, tax evasion or crony privilege. By contrast, banking secrecy combined with increasingly integrated financial markets has facilitated money-laundering.

Banking secrecy has made it difficult to monitor and regulate private banking activities, even in jurisdictions where there are stringent laws on *domestic* money-laundering. Even in high profile cases (such as that of Mobutu or of Marcos) countries have been unable to recover their looted wealth. The role of private banking in abetting capital flight gained prominence in 1999, when the Bank of New York helped shift at least \$7 billion in ill-gotten gains out of the Russian Federation into private bank accounts in the West. But the scandal in this case was because the lost funds were perceived to have come out of the pockets – via contributions to IMF – of US taxpayers (in itself a fallacy, but that’s a separate issue). Far more grievous scandals in developing countries go unnoticed. During the 1980s debt crisis, even as US banks were pressing floundering Latin American countries to service their debt, their private banking operations provided easy avenues for capital flight, thereby exacerbating the problem of debt-servicing (Lissakers, 1991). Some of the largest and most venerable banking institutions have been implicated in recent years.<sup>13</sup> The Mexican crisis and the travails of Indonesia and the Russian Federation have been sharply exacerbated by massive capital flight. In all these cases the benefits of borrowings are privatized and the costs socialized in that capital flight reduces the foreign exchange available to governments to pay off their debts, and they cannot capture private foreign assets to offset private and/or public liabilities.

The current approach to tackling the problem of onshore and offshore laundering havens has lacked the commitment that the magnitude of the problem deserves. IMF and the World Bank have recently become more engaged in the issues of money-laundering and capital flight, and have attempted to limit money-laundering by emphasizing good governance and banking supervision.<sup>14</sup> In September 1997 the Fund supported and pushed through the Basle Committee the Core Principles for Effective Banking Supervision, including strict “know-your-customer” rules. It has been nudged further in this direction by the embarrassment of financial scandals, involving IMF in the Russian Federation in 1996 and Ukraine in December 1997, when its funds were diverted and reinvested in speculative government debt markets.<sup>15</sup>

Both institutions have been working with the OECD-sponsored Financial Action Task Force (FATF). But the FATF has been slow to censure foot-dragging members. The developing countries have most to gain from a better control of money havens but have shown little enthusiasm, perhaps because controls would threaten their elites. Instead, leadership has come from the United States. Legislation under consideration in the US Congress would force US banks to identify the real beneficiary of an account, and make it more difficult to set up correspondent relationships with so called “brass plate” banks. However, such legislation will have to survive efforts to water it down because US banks would be hit by regulatory arbitrage, both from banks in other countries with weaker laws and from other segments of domestic financial markets. Furthermore, the fear of extraterritoriality of US law may well make other nations wary and impede cooperation.<sup>16</sup> For all these reasons a multilateral, universal approach is best suited to tackling this immensely difficult task.

When lending to support the financial sector, the IFIs should insist that borrowing countries make public the list of defaulters (above a certain value). Likewise, since foreign creditors are, in practice, bailed out by IFIs’ lending, the IFIs should insist on corresponding disclosure with respect to the overseas accounts of nationals of emerging market economies. Deposits exceeding a certain amount – say \$100,000 – should be reported to a public database. Such an approach is needed to curb the corruption and capital flight that has put the burden of economic adjustment so thoroughly on the workers and taxpayers of those countries.<sup>17</sup> Such transparency would become an obstacle, not only to illicit enrichment, but to the concentrations of wealth

and power that limit the development of democracy in poor countries.

But such measures by the IFIs would be no more than a beginning, since they are incomplete on their own. To make them effective it would be necessary to hamper the workings of off-shore havens. One measure in that direction would deny access to international clearing houses, such as Cedel, the Luxembourg-based clearing house, and to banks or investment firms that refused to cooperate. Vito Tanzi, the head of IMF’s fiscal affairs division, has argued that the world’s financial community should set minimum standards covering anti-laundering rules. Countries that refuse to abide by them would face punitive taxes on capital channelled through their financial centres and have international legal recognition denied to financial transactions taking place on their soil.

### C. *Time horizons*

Inconsistent time horizons present a major dilemma for GRC: too much is expected over too short a period. After years of growing rhetoric on governance issues, the IFIs are now moving to embed governance goals into budgets, internal incentives, lending programmes and public announcements. The entire agenda is being locked into the standard, short time-horizons of IFIs that respond to the impatient demands of donors, to changing academic fashions, and to bureaucratic needs for stimulus. But all prior experience of political and social re-engineering – most notably the gradual historical processes of the now advanced countries – and previous efforts by IFIs to carry out institutional reforms, suggest that the road to better governance is likely to be long and uneven. Unlike first-generation reforms, the changes entailed in governance-related issues involve complex organizational change in bureaucratic, regulatory and legal structures.

Even with political willingness, the GRC agenda faces a severe problem of scarce capability. In the post-mortems of the Asian financial crisis, the Fund laid out a recipe to forestall future crises: “*sound* macroeconomic policies to contain aggregate financial imbalances and to ameliorate the effects of financial disturbances, combined with *sound prudential* policies designed to ensure proper private incentives for risk management, especially in the financial sector. With these safeguards, *orderly* and *properly* sequenced capital account liberalization and the

broader financial liberalization of which it is part are not only inevitable but clearly beneficial” (italics added; Eichengreen and Mussa, 1998). “Sound”, “prudential”, “properly”, “orderly” are hardly contentious terms, but there is little analysis of what such objectives may require in terms of organizational and human capital and time. Weak institutions are inherent to underdevelopment, and institutional development is a gradual long-term process. Moreover, institutions do not develop towards a fixed, unchanging goal. Financial supervision, for instance, must not only improve in general: it must continually reinvent itself to adjust to fast-changing markets. Other government institutions perhaps face less dynamic environments, but continuous change is now common to all.

The standard response has been that expertise can always be hired – indeed, hiring foreign consultants is often mandated in IFIS’ conditionality. A World Bank loan to Albania’s power sector insisted that international managers be appointed as a condition to reduce theft and mismanagement. A condition in IMF’s Indonesian programme stated that the government “appoint high level foreign advisors to BI [Indonesia’s central bank] to assist in the conduct of monetary policy”. But, as the African experience has shown, foreign experts are an expedient that helps IFIs meet unrealistic programme time-frames, not sensible approaches for sustainable development. Impatience imposes another cost on borrowers. Rather than build capabilities, borrowing countries resort to copying. “Appropriate technologies”, appropriate in particular to the informal institutions of the country, do not get a chance.

Efficient, transparent, accountable, institutions in the advanced industrialized democracies emerged slowly, indeed, over centuries (e.g. Tilly, 1990; Ertman, 1997). Path dependency and history shaped social capital, political and civic cultures and social norms, the informal institutions on whose foundations formal institutions sought their legitimacy and authority. Recent efforts to start the process of building “modern institutions” in Bosnia, Kosovo, Haiti and Cambodia, despite enormous and expensive interventions, have shown little success. Values and attitudes cannot be radically changed by decrees. If democracy in the West was preceded by an era of constitutional liberalism, LDCs are being asked to do the two simultaneously, while at the same time undergoing major changes in economic (market-based) institutions.

## V. Alternatives to conditionality

There have been suggestions from time to time that instead of traditional *ex ante* conditionality, the IFIs (and especially the Bank) move to *ex post* conditionality. In this scenario (championed by Paul Collier) the IFIs define the set of good policies and then reward countries that move towards them. In principle, *ex post* conditionality would presumably strengthen the incentive to good performance and reduce non-compliance. On the other hand, it would create a temporary lending problem, since disbursements would be interrupted until countries built up the necessary performance record.

Actually, current procedures already amount to a compromise between *ex ante* and *ex post* conditionality. The latter enters into current arrangements: (i) because loans often require “prior actions”; (ii) when disbursements are structured in tranches conditioned on performance; and (iii) through the increasing weight given to country performance in IDA allocation. Prior actions most often bear on exchange-rate adjustments, administrative price changes and tax reforms. Their importance is underestimated because they generally do not show up in loans contracts, and are often negotiated in an off-the-record fashion in consultative group meetings.

Since the 1980s IMF has been using prior actions, i.e. actions undertaken by borrowers before drawing on the Funds resources. Their importance was endorsed by IMF’s Board, though not without dissent. The Fund has also modified its lending instruments to better address governance-related issues. Over time it has set up facilities with longer horizons to match its structural conditionalities (for example, PRGF, erstwhile ESAF), while the Bank has introduced Adaptable Programme Loans/Credits and Programmatic Structural Adjustment Loans/Credits.

Other suggestions for alternatives to current conditionality have involved some form of reciprocal obligation in the form of development contracts and, less ambitiously, development compacts (Stoltenberg, 1989; UNDP, 1992). The European Commission has developed a proposal aimed at a possible reformulation of conditionality. A pilot exercise is being conducted in Burkina Faso, with the Bank and several donors participating.

## VI. Impact on the IFIs and IFI accountability

Even more than previous conditionality, GRC raises questions concerning the nature and governance of the IFIs themselves. In the first place, GRC is far more invasive of country sovereignty than earlier forms of conditionality. In a world of unequal nations, can GRC be applied equitably? The risk of unequal treatment of borrowers is increased by the vagueness that attaches to GRC, which forces the IFIs to apply a greater degree of judgment and discretion. Moreover, GRC is an uncertain art. Should a borrower, seduced by persuasion and money into scrapping an imperfect institution, bear the entire risk that the modern substitute proves unsuited to the country's cultural environment? Finally, does the combination of greater intrusiveness, risks and discretion that are inherent in GRC require greater accountability within the IFIs? These questions are not meant as an argument against GRC, since governance, however difficult to tackle, is surely a fundamental factor in development. But earlier, well-meaning crusades by the IFIs, based on less uncertain conceptual terrain, were later judged "unsuccessful" by the IFIs themselves. Many borrowers would apply even harsher criticism.

To sanction the move towards GRC, the IFIs resorted to legal wriggles. The articles of these institutions (the EBRD is an exception) contain prohibitions against the use of political considerations in lending. If it is true that one cannot wade into water without getting wet, GRC will inevitably increase the politicization of the IFIs, tarnishing the technocratic smock that provides credibility to their prescriptions. If the IFIs have always been vulnerable to the political pressures of their major shareholders, GRC opens the door more widely.

One effect on the IFIs will be a greater vulnerability to politics. In the last IDA replenishment (IDA.12), Deputies "stressed that governance is a broad-based concept intended to encompass *all* factors that impact on a country's ability to assure *sustained economic and social development and reduce poverty and noted that addressing those factors is compatible with IDA's mandate*" (italics added; IDA.12, 1998, para. 24). But Article V, section 6, of IDA's Articles of Agreement provides that "the Association and its officers shall not interfere in the political affairs of any member; nor shall they be influenced in their decisions by the political character of the member or members concerned". The sweep-

ing language used by IDA.12 will make it difficult for the management of IFIs to defend the institutions from politically motivated pressures. An explicit modification of the Articles would have been preferable. The soul of the GRC agenda is a belief in rules, yet rules have been brazenly bent to allow IFIS' involvement.

Political pressure became evident in recent negotiations with Indonesia. Until 1996, Indonesia had been held up as an IFIS' development success. But in 1999 the Bank's draft Country Assistance Review criticized the institution for not pushing hard enough for fundamental changes in the political system in Indonesia. It argued that "the CG [consultative group] under the chairmanship of the Bank in other countries [for example, in Africa] has been viewed by bilaterals as a valuable opportunity to collectively condition their aid to leverage changes in such areas as a government's electoral policies, human rights practices, and the treatment of the media and civil society organizations, but this was not the case in GCI [Consultative Group of Indonesia]" (World Bank, 1999c). The Government of Indonesia countered this by stating: "... if the authors of the Report genuinely believe that the Bank should have leveraged its aid to insist on electoral reform, a free press, and government transparency, they should clarify whether they believe that this approach should be applied consistently including the Bank's second biggest client in Asia".<sup>18</sup> The offending paragraph was dropped in the final report, but it was nonetheless indicative of the sanction, and indeed the obligation that IFIs are beginning to feel to comment on the domestic politics of borrowers.

In dealing with the Russian Federation during the 1990s, the Fund appeared to become a hostage to political pressure from western governments. IMF approved multi-billion dollar loan packages, even though the Russian Federation had not met its economic criteria, first in March 1996, three months before its presidential election, in an effort to bolster Boris Yeltsin's election prospects, and then in July 1998, with a \$4.8 billion programme aimed at defending the ruble, which collapsed barely a month later. By that time the Russian Federation had emerged as the largest debtor to the Fund, owing more than \$19 billion, over one fifth of IMF's outstanding loans.<sup>19</sup> In April 1999 western governments, keen to blunt the Russian Federation's opposition to NATO's bombing in Kosovo and eager to help Moscow avert a default on its foreign debt, pressured IMF to resume lending. In this case, the entire \$4.5 billion was destined to repay previous loans to the Fund. After a

first instalment of \$640 million, however, the second instalment was held up pending an investigation into alleged Russian diversions of past IMF loans.<sup>20</sup> In late 1999 Michel Camdessus hinted that the Russian Federation's campaign against Chechnya could lead to suspension of IMF money. If this did happen, the difference would be that the Fund would be suspending, not releasing, funds for political reasons. A recently published statistical analysis of IMF lending during the years 1985–1990 and 1990–1994 concludes that political considerations had played a greater role in the second period (Thacker, 1999: 38–75).

A second effect of the GRC agenda on IFIs will be to weaken bureaucratic effectiveness. This will be less a consequence of the specific content of GRC than, simply, of the widening agenda. The appearance of GRC objectives will be additive, not a substitution for previous objectives or institutional "missions". Observers of government bureaucracies have long recognized that multiplicity of missions impairs bureaucratic incentives as well as erodes institutional autonomy (Wilson, 1989).<sup>21</sup> The threat to effectiveness is perhaps most dramatic in the case of IMF: its role as a provider of liquidity in emergency situations, which – as demonstrated first by the "tequila" crisis and then the Asian crisis – seems to be a growing need of the international financial system, requires an institution with the capacity to act quickly on the basis of objective and easily verifiable criteria. The need to wade through subjective interpretations of GRC compliance is difficult to reconcile with that role.

A third effect is to erode one of the core principles that justified the founding of these institutions. The IFIs were intended to act as "institutions of restraint", that is as instruments that would help bring about a world in which countries refrained from behaviour that had short-term payoffs but long-term costs. The adherence to rules was considered the better policy for individual countries in the longer run, as well as the better policy for collective welfare. But the effectiveness of institutions of restraint is critically dependent on their adhering to a norm of self-restraint themselves.

In the case of IMF, the original concept of rule-based, collective restraint was substantially undercut when the institution became irrelevant, as a potential source of financing, to the industrialized nations. Its role shifted, instead, to that of an instrument of economic foreign policy vis-à-vis the less developed world. In that sense IMF lost most of its differentiation with other IFIs, and now shares a similar purpose

and vulnerability to the pressures of the rich countries. Those pressures have grown *pari passu* with declining foreign aid budgets, since the IFIs provide a form of off-budget financing. With the division of IMF members into the Fund's "structural" creditors and debtors, the essence of the institution as a cooperative was lost. One consequence of that loss was to loosen the traditional restraints with respect to sovereignty. Creditor nations had fewer qualms about continually expanding the domain of IMF's role and its conditionality. European members were not troubled by agreeing to conditions that pushed Asian countries to increase labour market flexibility despite the rigidity of their own labour markets, which have produced soaring unemployment.

Greater intrusiveness has not been accompanied by any significant increase in accountability, except in the form of a closer surveillance by donor governments and NGOs, whose overriding concern is that the IFIs comply with the increasingly broad and detailed terms of reference set by the major shareholders. There is no accountability to borrowers. Accountability in general has proven exceedingly difficult to implement in practice, being naturally resisted by the institutions themselves, for they see autonomy as necessary to the fulfilment of their role as international civil servants. It is hardly surprising that internal norms and leadership have been half-hearted, at best, with respect to accountability.

Recently an external review of IMF's surveillance questioned the expansion in the scope and coverage of bilateral surveillance, especially into structural issues of a non-binding nature. The review saw little competence in the Fund on these issues, and expressed its concern that an expanding coverage would reduce the effectiveness of surveillance overall (IMF, 1999b). These recommendations were rejected by the key shareholders as well as by IMF's staff (IMF, 1999c).

## VII. Conclusion

Governance has emerged as a crucial part of the agenda of the IFIs. For better or worse, the wide array of issues subsumed under "governance" is going to occupy centre-stage in the IFIs' agenda in the coming years. For the IFIs, the new mandate is a boost to their importance, but one fraught with peril. The new mission arrived at a moment when growing doubts regarding the purpose and effectiveness of the IFIs seemed to threaten their funding, and even



their continued existence. Suddenly, the IFIs have jumped to the front lines of multiple wars being fought by humanity: against AIDS, human rights violations, gender discrimination, environmental degradation, corruption, drug trafficking, authoritarian governments, etc. To drive the point home, the World Bank has recently started to draw attention to those objectives, and to its own role, in CNN advertisements.

It remains to be seen, first, to what extent the IFIS' traditional agenda will survive – road construction, power plants, schools, etc., and, of course, international financial stability – and, second, to what extent the IFIs will be effective in their new tasks.

Because of the GRC agenda, the IFIs will be on the front pages as never before. External pressure will not be limited to the political and foreign policy interests of major shareholders, nor to a select number of rich country NGOs committed to special interests. IFI actions will now be increasingly scrutinized, second-guessed, and judged by the general public. Only extraordinary leadership will make it possible for these institutions to continue to work as before, guided for the most part by professional expertise and technical judgement. The IFIs will be criticized for acting and for not acting. And, in an era where the premium on time seems to be more than ever before, rapid results will be expected. As the United Nations Secretary-General, Kofi Annan, put it: “while the genocide in Rwanda will define for our generation the consequences of inaction in the face of mass murder, the more recent conflict in Kosovo has prompted important questions about the consequences of action in the absence of complete unity on the part of the international community”.

But there are two larger dilemmas for the IFIs. One is the GRC threat to institutional effectiveness, unless to be seen to be acting is an end in itself. The second is the threat to international fairness. Because the GRC agenda has revived interest in the IFIs by their major shareholders, the IFIs will be less able to continue to work with a substantial degree of professional autonomy. Rather, it is already apparent that IFI resources are being heavily directed to the immediate foreign policy interests of those shareholders.

For the most part, GRC goals, in themselves, are pro-poor. Poverty-acquired prominence as an IFIS' goal in the 1960s and 1970s, when it was judged a security threat during the cold war, and in the 1980s and 1990s, when it was perceived as a threat to debt

repayment and world financial stability. Despite the continuing rhetoric, poverty as a key, well-defined, and systematic criterion for IFIS' resource allocation is being replaced by a diffused and ad hoc humanitarian agenda. But as the cautionary response from President Abdelaziz Bouteflika of Algeria, speaking for the OAU, put it: developing countries “remain extremely sensitive to any undermining of sovereignty, not only because sovereignty is our best defence [in] an unequal world, but because we are not taking part in the decision-making process of the Security Council”. That dilemma also faces the IFIs. Well applied, GRC could help to empower people and nations. But if applied in an ad hoc manner, in response to the short-run foreign policy problems of the large shareholders, and with a high degree of discretion rather than commonly agreed rules, the outcome is unlikely to be fair or significantly pro-poor.

Transparency is one area in which the IFIs could bring about a major reform with powerful democratizing potential. Information is empowerment, and the IFIs have a privileged degree of access to information. It would take a simple decision to publish on the Internet a multitude of reports on projects and countries, commissions of inquiry, audits, ombudsman deliberations, investigative commissions. In the case of financial-sector loans, an insistence that borrowers publicize the names of defaulters would add transparency and address an important source of corruption: wilful defaults by elites. The IFIs have refrained from this step.<sup>22</sup> Moreover, GRC have focused on drafting new rules instead of trying to enhance the convergence between formal rules and practice by pressing borrower governments to act in accordance with their *own* laws. The sovereign must have the right to legislate; but the sovereign cannot argue that it has the freedom to legislate while at the same time selectively enforcing its own laws. The IFIs' efforts are likely to carry greater legitimacy and be more helpful if they use GRC to hold governments' feet to fire if they violate their own constitutions, laws and legislation rather than pressing for new laws and legislation drafted from outside.

## Notes

- 1 In the case of external capital flows, conditionality helps the repayment of sovereign debt, but when anticipated by lenders it can get international financial institutions and sovereign debtors into a trap where the debt overhang persists, debt-rescheduling takes place periodically, and conditionality continues indefinitely.

- 2 The authors construct six aggregate indicators corresponding to six basic governance concepts: voice and accountability, political instability and violence, government effectiveness, regulatory burden, rule of law, and graft. According to the authors, based on a cross-section of more than 150 countries, there is a strong causal relationship between better governance and a better development outcome.
- 3 Botswana President Festus Mogae at a meeting in Nairobi, quoted in: "Africans agree to donor conditions on aid loans", *Development News*, 1 September 1999.
- 4 For a succinct summary of evaluations of World Bank adjustment operations see Kapur et al. (1997).
- 5 See World Bank, *World Development Report, 1999-2000*, and James Wolfensohn and Joseph Stiglitz, Personal view, *Financial Times*, 22 September 1999.
- 6 T.N. Srinivasan, Letters to the Editor, *Financial Times*, 24 September 1999.
- 7 Ninety-five per cent of all World Bank operations have a public-sector component. In recent years "institution building" has emerged as a major component of World Bank lending, averaging \$5 billion a year (about one fifth of all lending) in the period 1997-1999. It covers virtually the entire front of public institutions reform, ranging from administrative and civil service changes, public expenditure management, tax administration, legal and judicial reform, and public enterprise reform. Technical assistance amounted to almost 9 per cent of all World Bank lending between 1997 and 1999 - an average of \$2.2 billion a year.
- 8 The study sampled 124 loans to 32 countries, as well as economic and sector work from a subsample of 11 countries over the 1980-1997 period.
- 9 Gregory Clark (1996: 588), for instance, argues that "to read the Glorious Revolution as ushering in a stable regime of taxes and property rights [as North and his followers claim] is to write Whig history of the most egregious sort".
- 10 Indeed, an issues paper on combatting corruption, prepared for the September 1997 meetings of the Development Committee by the staffs of the Bank and IMF, defined corruption as "the abuse of public *office* for private gain" (italics added).
- 11 Eliot Richardson, former US Attorney General, who resigned rather than fire special Watergate prosecutor Archibald Cox on the orders of Richard Nixon, lamented ("Reflections of a Moderate") that an important ingredient (in the Watergate scandal) - "an amoral alacrity to do the President's bidding" - was traceable less to flaws in his own character (although it was reinforced by them) than to "the political and cultural evolution of twentieth century America".
- 12 See Uvin (1998); Maren (1997); Sins of the secular missionaries, *The Economist*, 29 January 2000.
- 13 A recent report by the US Senate Permanent Investigations Subcommittee charged that foreigners, with Citibank's help, used deliberately opaque networks of shell corporations, offshore trusts and other instruments to shield their identities as they secretly transferred money out of their own countries. The cases reviewed by the Congressional investigations involving Citibank, included: tens of millions of dollars transferred by Raul Salinas de Gortari out of Mexico and into overseas accounts in 1993 and 1994 during the presidency of his brother, Carlos Salinas de Gortari; more than \$40 million moved through accounts controlled by Asif Ali Zardari, husband of Benazir Bhutto, former Prime Minister of Pakistan; more than \$130 million moved through accounts controlled by El Hadj Omar Bongo, President of Gabon since 1967; more than \$110 million moved through accounts connected to Mohammed, Ibrahim and Abba Abacha, sons of the late General Sani Abacha, former military leader of Nigeria.
- 14 See, for instance, address by Michel Camdessus, "Money laundering: The importance of international countermeasures", Paris, 10 February 1998, and the communiqué at the spring 1999 meetings of the Interim Committee which stated that: "IMF regards the anti-money laundering actions advocated by the FATF as crucial for the smooth functioning of the financial markets".
- 15 "Former PM alleges \$613 million IMF loan fraud by Ukraine", *Financial Times*, 28 January 2000.
- 16 Although like all parties, the Russian Federation's official position has been against money-laundering and corruption, it refused a request by US officials to hand over banks statements, audiotapes and documents relating to the possible diversion of nearly \$15 billion from Moscow to the United States and other banks, calling it an "unnecessary intrusion" into its internal affairs.
- 17 This argument was made by Nancy Birdsall and Devesh Kapur in: Clearing muddy waters, *Financial Times*, 13 September 1999.
- 18 Comments from the Government of Indonesia to Dennis De Tray, Country Director, Indonesia, World Bank, 28 January 1999.
- 19 IMF faces dilemma over loans, *Financial Times*, 9 December 1998.
- 20 The latter fact came to light amidst investigations of \$10 billion money laundering by US and Swiss banks, and forced IMF to move the goalposts and change the criteria for the Russian Federation to receive the second tranche, with calls for more audits and safeguards against misuse of the current loan programme (an audit in early 1999 had revealed that the Russian authorities had given false figures to IMF on its level of its reserves in 1996).
- 21 These results were formalized in Dewatripont et al., (1998).
- 22 In 1993, Moeen Qureshi, who had just resigned as Senior Vice-President of the Bank and was acting Prime Minister of Pakistan, took that step at his country's level. But the IFIs did not follow suit nor press it on other countries. N. Vittal, the Central Vigilance Commissioner of India, has been pressing the case for publishing the names of defaulters by banks in India, arguing: "If you respect the social status of a willful defaulter, then why not that of pickpockets?" (*Times of India*, 7 January 2000).

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International institutions are facing a double challenge of effectiveness and legitimacy. Many dissatisfied or disenfranchised governments and groups are deeply affected by global governance yet feel governance is poorly executed and that they themselves are inadequately represented. As global governance expands, few can hold those who exercise power to account. Washington, DC: IMF. Kapur, Devesh and Webb, Richard (2000) Governance Related Conditionalities of the International Financial Institutions. G-24 Discussion Paper Series 6:3.4. New York and Geneva: UNCTAD and Center for International Development, Harvard University, August.

Nicolaidis, Kalypso (2004) "We, the Peoples of Europe", *Foreign Affairs*, November/December, 97-110. One of them is related to the sustainability of international monetary and financial relations. As the economies are increasingly interdependent, it does not seem to be possible to envisage a possible recovery only at a national level. Financial systems play the role of a core reactor of the economic engine in market-related capitalist economies. In a globalized environment, the evolution of financial markets affects every domestic economy even when some of them are not totally integrated within international financial circuits. These funds tend to come with conditionalities, sometimes turning the transaction into a double-edged sword. However, until recently, the tides seem to be shifting and alliances seem to be repositioning. Governance conditionality and the reform of multilateral development finance: The role of the group of eight. Carlos santiso. The first section assesses the role of the G8 in the reform of the international financial institutions and the strengthening of governance in emerging market economies. The second section analyzes the scope and reach of the governance paradigm and reveals the limits of the IFIs' technocratic approach to governance reform. Traditionally, international financial organizations have advised member countries to pursue sound economic policies "policies that promote growth through low inflation, sound and prudent monetary and fiscal policies and a sustainable balance of payments position. Presently, in the context of changed economic environment, it is necessary to broaden the scope of the economic policies to include other elements, popularly known as "second generation reforms" which are considered vital for economic growth and financial stability, namely Economic governance consists of the entire institutional framework of the government engaged in the evolution and implementation of the general economic policy in all its manifestations affecting its internal and international economic relations.