15 Donor Conditionality and Policy Reform*

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1 INTRODUCTION

My focus is on the use by aid donor agencies of conditionality to induce changes in economic policies and institutions. At the most general level, this throws light on whether it is feasible to use donor leverage to overcome weak institutions and anti-reformist governments – whether it is possible to use this as a device for prevailing over domestic political constraints on the adoption of better policies. If this appears to be asking too much, is it at least possible that donor leverage and money will tip the balance within governments between reformers and conservatives? Even failing that kind of decisive influence, conditionality may operate through a different channel: steering governments towards the acceptance of policy change in order to secure the 'seal of approval' of the International Monetary Fund (IMF), World Bank and others, and by that means to add to the credibility of their own policies. Can donors act as 'agencies of external restraint', adopting the role that Robert Bates argues in Chapter 1 of this volume is being played in some developing countries by private international investors? Can donors' policy stipulations impinge decisively on domestic policy-making by offering a 'technology of pre-commitment'? Although donors behave as if their conditionality is highly efficacious, it appears that they have not been able to achieve such results. At the same time, the general policy strategy they favour is proving quite efficacious around the world in raising economic performance, so the intention here is to explain this puzzle.

In principle, the analysis applies to all policy conditionality – macroeconomic, sectoral and project-level – by multilateral and bilateral aid agencies alike. However, most available evidence relates to the 'adjustment programmes' of the Bretton Woods institutions (BWIs). We concentrate on the experiences of developing countries, conventionally

defined, although casual observation suggests that the analysis is also applicable to the 'economies in transition' of Eastern and Central Europe and the former Soviet Union.

2 BACKGROUND

There was during the 1980s a remarkable increase in the use of donor conditionality. The IMF has always attached policy conditions to most of its credits, but various changes during the decade led to the virtual disappearance of its low-conditionality lending. Moreover, the policy reach of its conditions has extended considerably. While earlier this was largely concentrated on a limited number of fairly standard macroeconomic variables, the IMF now typically extends its policy interest to a potentially wide variety of supply-side and institutional issues. It also takes considerably more interest in the minutiae of government taxation and expenditure plans; it makes greater use of pre-conditions ('prior actions'); and it makes continued access to its credits conditional on observance of an increased number of 'performance criteria'.

The World Bank did not move into policy conditionality in a major way until the beginning of the 1980s, since when, however, there has been a massive increase in its adjustment lending, from an average of US$0.8bn in1980–2 to US$5.3bn in1994–5. If we take together its, increasingly rare, economy-wide structural adjustment programmes and its numerous sectoral adjustment programmes, the total potential coverage of its policy conditions in enormous, extending to all economic sectors and to the wide range of policy instruments that can be deployed within these.

Of course, at any one time, a borrowing government will only be confronted with conditions relating to a sub-set of what might be possible, but the range of stipulation can be extraordinary large. This is suggested by the example of Uganda, a country trying to rebuild its public administration after the ravages of a prolonged civil war. Its programme with the World Bank set out a total of eighty-six specific policy commitments for 1991–2 to 1993–4, of which seventy-nine should have been undertaken or initiated in the 1991–2 fiscal year alone. That this was not a particularly unusual case is suggested by the fact that the average number of conditions per Bank adjustment loan in 1989 was fifty-six, having risen steeply during the decade.

Even the above account does not do full justice to the broadening of conditionality since the 1980s.[1] Measures to reduce hardship resulting

from adjustment policies have featured increasingly, as have policies for the protection of the environment. Other policy causes now promoted by conditionality include reduced military spending and enhanced human development, including improvement of the position of women. In addition, since the end of the Cold War, bilateral donors have taken the lead in extending conditionality to the sphere of political systems, introducing stipulations concerning the observance of human rights and the rule of law, and progress towards multi-party democracy. The BWIs have sought to distance themselves from such overtly political stipulation, but the enthusiastic espousal of political objectives by their major shareholders has meant that they are inevitably drawn into this extension of attempted influence.

3 THE PROBLEM

Aid agencies (including the IMF as such, for present purposes) thus have a high revealed degree of confidence in the efficacy of conditionality. As far as economic policy is concerned, this confidence stems from a conviction, amply supported by observation, that the quality of a country's policies has a powerful influence on the performance of its economy – and therefore on the developmental effectiveness of the aid it receives. Moreover, the approach to policy favoured by the BWIs has had demonstrably beneficial effects on the economic progress of many countries. In broad terms, this strategy can be reduced to three fundamentals:

- The avoidance of large macroeconomic imbalances;
- 'Market friendliness': working in cooperation with and in support of the private sector, and through market signals rather than in opposition to them; and
- Taking maximum advantage of opportunities in foreign trade and for the attraction of foreign investment.

There is substantial cross-country evidence that this type of policy strategy has produced economic results superior to what has gone before, and to available alternatives. The remarkable response of the Chinese to the partial liberalization and opening-up of their economy is a case in point. Of longer standing are the results achieved by the East Asian 'miracle' countries – countries which departed in important ways from the standard BWI model but which, nonetheless, observed the three fundamentals spelled out above. Less dramatically and with the help

of large, if undependable, capital inflows, Latin-American countries, which not long ago appeared hopelessly mired in a morass of debt, have also achieved an economic turnaround through a similar shift in policy stance. India, too, shows signs of shrugging off its economic lethargy in response to a similar package of policy changes.

And yet – and here is the nub of the problem – the evidence on the economic consequences of BWI adjustment programmes, which embody the same policy strategy, does not point to strong results. Assessment of the impact of adjustment programmes is fraught with difficulty, particularly as we can only guess at the counterfactual. However, enough consistent evidence has accumulated to provide firm indicators. The following generalizations are among the principal results of the empirical literature on the consequences of adjustment programmes:[2]

1. Programmes have limited revealed ability to achieve their own objectives. While there is consistent evidence for both BWIs that programmes are associated with improvements in export performance and other balance of payments indicators, programmes do not increase economic growth. The 1994 Bank report on Africa shows as many 'adjusting' countries slipping back as accelerating their growth. One reason for the poor growth results is that programmes are associated with reduced investment levels. Evidence on inflation is similarly indeterminate, with price-reducing and price-raising influences tending to offset each other.
2. The muted nature of the above results is related to programme implementation. Particularly in the case of World Bank programmes, there is evidence of a positive association between implementation and economic outcome: well-executed programmes are associated with better economic performance.
3. Implementation is often weak, however. One symptom of this is that programmes have high mortality or interruption rates. Over half – 53 per cent – of all IMF stand-by, extended and structural adjustment facility programmes were discontinued before the end of their intended life in the period 1980–93; and 61 per cent in 1991–3. As at April 1993, only five of a total of twenty-six enhanced structural adjustment facility programmes had been completed within their planned period and eight had apparently broken down altogether. As regards World Bank programmes, data for 1989–90 to 1993–4 show that only a quarter of programmes proceeded according to the intended schedule and that half the programmes have been either seriously delayed or, in a few cases, abandoned altogether. On average,

adjustment programmes take twice as long to complete as intended, largely because of non-implementation of policy conditions. By no means all of these departures from plan represent 'failures', but enough of them do for the two institutions to be concerned.

4. Adjustment programmes seek to achieve improve economic performance by raising the quality of domestic policies and strengthening institutions. However, a further symptom of poor implementation is that programmes have only a modest impact on key policy variables, and even less on institutions. There is little evidence that programmes exert restraint on the core IMF programme component of domestic credit, or of strong BWI influence on budget deficits, with much slippage in the implementation of fiscal conditionality. IMF conditionality does, however, exert a decisive and sustained influence on the exchange rate. There is also quite a strong association with reform of other price variables, such as interest rates, agricultural producer prices and the deregulation of consumer prices. However, they have far greater difficulty in influencing institutional change, for example in financial sector reforms and privatization programmes. The World Bank's *Adjustment in Africa* (1994) report judged that only six out of twenty-nine 'adjusting' countries had achieved decisive improvements in macroeconomic policies. In a follow-up study, fifteen out of twenty-five adjusting African countries were still judged to have 'poor' or 'very poor' macroeconomic policy stances in 1991–2, even though between them these countries had received 110 World Bank adjustment credits since 1980.[3] The quality of policy was judged to have deteriorated during 1992 in eight of the twenty-five, even though seven of the eight had had World Bank adjustment programmes during that year.
5. Even the above limited claims probably over-state the degree of programme influence, because some of the changes would have been introduced in any case. Moreover, a good many of the reforms are not sustained and some governments regress, reverting to old practices or introducing equivalent interventions 'through the back door'.

So the problem addressed is why programme implementation should be so imperfect, since if they were to honour their policy promises governments might reasonably expect better economic results – and hence greater popularity? The next steps are to clarify the concept of conditionality and to present an analytical framework within which this question can be addressed appropriate.

4 THE CONCEPT

Policy conditionality can be viewed as comprising 'hard core' and 'pro forma' elements. Hard core conditionality can be defined as *policy changes stipulated as a prerequisite to the approval of, or continued access to, a grant or loan, or to subsequent assistance*. The expectation must be that the borrowing government would not voluntarily undertake the changes required, or else the stipulations serve no useful purpose and are probably counter-productive. Conditionality is thus characterized by the use of financial strength to promote donor objectives.[4]

Such 'hard core' conditionality is, however, only a sub-set of the content of letters of intent spelling out the detailed content of adjustment programmes. The remainder can be described as 'pro forma' conditionality: mutually agreed, or non-significant, or formalistic provisions which both parties find it convenient to write into a programme. We concentrate on the hard core element, but should acknowledge that the *pro forma* elements may be important: in supporting the position of reformers within government; in defining and timetabling actions with a precision they would not otherwise have; and in making agreement acceptable to each negotiating team's superior authorities.

5 PRINCIPAL–AGENT FRAMEWORK

Principal–agent theory provides our main analytical peg for analysis of the evidence, informing formulation of hypotheses, although not all the relevant considerations can be accommodated within this mould. Principal–agent issues arise when the maximization of more than one party's utility requires some form of cooperative action, and when the objectives of the parties differ. The essential problem is how principals (in the present case, donors) can design contracts which embody rewards that make it in the interests of agents (recipient governments) to further the principals' objectives. In the present case, donor ability to do so will be determined by governments' assessments of their own interests, in which the cost of executing an outside policy agenda must be set against the benefits. The key variables are, on the one hand, the extent of government aversion to the policy measures in question and, on the other, the rewards attached to implementing them.

The extent of government aversion to the measures stipulated by the donor agency constitutes a *participation constraint*, indicating the minimum level of inducements necessary to bring the government to the

negotiating table. Governments' participation constraints will be strongly influenced by the degree of tension between donor and government objectives. It may safely be assumed that these will not exactly coincide, because the parties are answerable to different constituents are each constrained by the internal politics of their own organizations, and will probably have differing time horizons (with donors usually wanting more rapid action than governments). Some level of government aversion will, therefore, be normal. Much of the discussion of programme 'ownership', fashionable in aid debates, is about differences in objectives (a programme can be considered as being 'owned' by the party whose objectives and/or policy choices dominate). Implementation is expected to be a function of ownership, because when donor objectives dominate government aversions (their calculation of the costs or risks) are liable to be strong.

The aversion is reduced, however, where a recipient government can use donor-driven measures to promote its own objectives, even though these differ from the door's. This can happen when an agreement raises the credibility of a government's policies, allowing it to surrender some discretionary power in order to pre-commit itself to a defined set of policies for some period into the future. So long as programmes are taken seriously by outsiders, the government can enlist the BWIs as tacit guarantors of the time consistency of its policies, as a reassurance to investors and others. Hence the idea that conditionality can offer a 'technology of pre-commitment'.

The other major element in the equation is the *adequacy and structure of the incentives offered*, relative to participation constraints. Besides the amount of finance the donor can offer directly, this includes the expected catalytic effects of a programme, inducing additional inflows of aid and private capital. An important dimension of the reward system is the credibility of threats of punishment (withdrawal of access to donor support) for non-compliance with donor stipulations. This dimension introduces donor motivations. The plausibility of threats of withdrawal of aid will be eroded if a donor has internal reasons for continuing to lend (to defend past loans, to promote some objective other than policy reform, or as a result of pressures acting upon it) and where the recipient knows this to be the case. Further, the incentive structure may be undermined by competition between donors and other possible sources of finance, permitting recipients to play one off against another.

Two major qualifications on the relevance of agency theory should be admitted. First, not all obviously relevant facts fit easily into this

framework – for example, the disruptive influence of exogenous shocks. Second, being concerned with individuals, the agency literature treats principals and agents as single decision units, but such treatment is dangerous when applied to the conditionality case, because each donor and recipient government is a collectivity, within which there are varying interest and objectives. This fragmentation may sometimes render it misleading to analyse them as single optimizing decision units.

6 THE EVIDENCE

Agency theory (suitably augmented by other relevant factors) suggests a possible line of explanation for the frequently weak execution of adjustment programmes: that donor agencies have often been unable to put together a system of rewards and punishments that is sufficient to overcome governments' participation constraints. When governments do not honour their promise, this is because they do not regard it as being in their interests to do so.

Testing this line of explanation is a difficult research problem, however, not amenable to the economist's usual tools of empirical analysis. Table 15.1 summarizes evidence drawn from a secondary-source survey of the experiences with World Bank adjustment programmes of a sample of twenty-one developing countries, drawn from all major developing regions and with a wide range of income levels.[5] The hypotheses listed in the table are mainly derived from the analytical framework just discussed. These were tested against the country case-study findings of other researchers, to the extent that these bore upon the hypotheses. Hypotheses 13 and 14 in the table relate to influences on implementation that fall outside the agency framework.

The main results are summarized in column (6) of Table 15.1, and detailed below.

The approach worked

The results were generally quite satisfactory and well behaved, with generally high levels of support for most hypotheses.

Participation constraints and 'ownership' influence implementation

The probability of implementation is strongly influenced by recipients' participation constraints: their perceptions of the balance of costs and benefits to themselves (Hypothesis 1), and of the extent of conflict of

Table 15.1 Summary of country survey results

Hypotheses	*na* (1)	*nev* (2)	*Unclear* (3)	*No* (4)	*Yes* (5)	*(5) as % of (4) + (5)* (6)	*(5) as % of (3) + (4) + (5)* (7)
	Number of observations consistent with hypothesis						
Relating to participation constraints							
1. The probability of implementation is a function of the extent to which governments/ministers/officials perceive the benefits of compliance, in terms of their own objectives, to outweigh the costs.	1	2	1	0	17	100	94
2. Recipients' calculations of costs and benefits will be particularly sensitive to the extent to which programme measures are expected to affect the distribution of income, and to the relative degrees of organisation of gainers and losers.	0	3	0	4	14	78	78
3. Programme implementation is prejudiced when the objectives of donors and governments differ, resulting in conflicts of interest.	2	1	1	0	17	100	94
4. Programme 'ownership', an indicator of extent of interest conflict, will have a decisive influence on programme implementation.	0	0	1	2	18	90	86
5. Agreeing a BWI adjustment programme, through its pre-commitment effect, raises the credibility of the government's own policies, and private-sector responses to these.	2	8	4	7	0	0	0

Relating to rewards and punishments							
6. Implementation will be a function of the reward system through its influence on governments' or ministers' perceptions of likely net costs and benefits.	5	2	0	2	12	86	86
7. When objectives differ it is not possible to devise an incentive system sufficient to ensure that governments fully promote donors' objectives.	4	3	1	0	13	100	93
8. Non-compliance with the terms of a loan is not effectively punished by reduced access to new credits.	4	1	4	0	12	100	75
9. Programme effectiveness is undermined by political, bureaucratic and financial pressures upon donor agencies to lend.	1	9	1	3	7	70	64
10. The availability of a credit, by easing financial constraints, weakens the incentive to implement reforms.	0	9	1	2	9	82	75
11. Implementation and programme effectiveness will be reduced by the extent to which the donor has multiple, conflicting or unclear objectives, and by the number of other donors applying separate conditionality.	7	1	1	0	12	100	92
12. There is an 'adverse selection' problem, with donors continuing to support poorly-performing recipient governments to safeguard past loans and/or to maintain an appearance of success.	7	4	1	2	7	78	70
Other influences on implementation							
13. Programme implementation will be powerfully influenced by exogenous shocks.	0	7	0	2	11	79	79
14. A long relationship between a donor and a government will improve programme implementation and results.	4	1	1	9	6	38	38

na = not applicable, nev = no evidence available.

Source: Author's research.

interest between themselves and donors (Hypothesis 3). Similarly, ownership is an important determinant of implementation, with weak ownership implying substantial participation constraints (Hypothesis 4). A World Bank study of eighty-one adjustment credits provides substantial, statistically highly significant, confirmation of the importance of ownership for programme outcomes, with the extent of government ownership predicting outcomes in three-quarters of case (Johnson and Wasty, 1993). In the absence of local ownership, governments evade commitments and regress when opportunities arise. The large apparent advantages of 'home-grown' programmes helps to explain the favourable Asian and Latin-American experiences cited earlier, whose policy actions owed little or nothing to donor conditionality (as distinct from the donors' intellectual influence).

Government attitudes are highly sensitive to expected distributional outcomes

Recipient assessments of costs and benefits are strongly influenced by the expected influence of the policy measures in question on the distribution of income, and by the relative organizational strength of gainers and losers (Hypothesis 2).

Programmes have little pre-commitment value

There is no evidence of positive credibility effects (Hypothesis 5), although the total number of observations in this case is small. This result is not surprising, given the evidence of the high programme mortality rates and weak implementation summarized earlier. 'Outsiders' do not have enough expectation the BWI programmes will be rigorously enforced for them to regard programmes as having much pre-commitment value. Indeed, it has been suggested that conditionality may actually weaken policy credibility by making it harder for economic agents to assess whether a measure is being introduced because the government believes in it, or only at the donors behest.

Rewards are insufficient

When there are goal conflicts, rewards tend to be inadequate (Hypothesis 7). The limited scale of the BWIs' own resources is well known, and there are complaints within them about under-funded programmes. Given their own limited resources, much depends on the ability of their programmes to exert a catalytic influence on other financial flows. The evidence on this is mixed. Killick's (1995a, pp. 57–8, 71) research

on the IMF does not indicate any large induced inflows overall. However, the position differs between private and public sources of capital. There is evidence that public capital, chiefly aid, does respond positively to the existence of a BWI programme, as bilateral donors move to support BWI programmes. But there is little indication of an equivalent positive response on the part of private capital, and some evidence to the contrary. Indeed, it would be surprising if private capital was very responsive, for reasons set out in the previous paragraph.

Unsurprisingly, compliance with conditionality is sensitive to the extent of government reliance on the financial support of the BWI in question. Our research shows that recipient access to alternative and uncoordinated sources of finance is a common negative influence on implementation (Hypothesis 10).

Delinquency often goes unpunished

Rewards imply sanctions. If implementation is to be rewarded, there must be a credible threat of withdrawal of support in the event of non-implementation. However, there is near-unanimity among observers that delinquent governments rarely have much to fear, for reasons suggested earlier, and this is supported by our evidence. See Hypothesis 8.

One explanation is that the BWIs have a 'pro-lending' culture, where maintaining a flow of new credits has become partly an end in itself, with staff perceiving their careers to be enhanced by success in negotiating new programmes.[6] The punishment for non-compliance fits poorly with a desire to 'keep the money moving'. This is reinforced by an 'adverse selection' problem, whereby donors are anxious to keep lending in order to protect past credits, or to defend the institutional credibility invested in backing a particular government's policies. There is substantial supporting evidence for this, particularly when the test is confined to poorly-implementing countries (Hypothesis 12). One source of difficulty here is the strategy adopted by the BWIs in the face of growing recipient–government difficulties in servicing their multilateral debts. The past BWI response has been to roll over past credits, but this tends to lock them into debtor countries irrespective of the quality of their policies, further undermining the credibility of conditionality (Killick, 1995b). That the BWIs are cooperatives, lending to their own members, and that donor–shareholder governments have an interest in smooth foreign and commercial relations, adds to the difficulties of imposing effective sanctions. External pressures on the BWIs to lend to favoured governments can be important, further eroding the threat of punishment for non-compliance, although such

pressures are not invariably present (Hypothesis 9) and may have diminished since the end of the Cold War.

Other influences

Turning to influences on implementation that lie outside the principal–agent framework, Hypothesis 13 confirms the results of a good deal of other research, that implementation is often knocked off-course by exogenous shocks: terms-of-trade fluctuations, natural disasters, and so on. More surprisingly, only in six of our cases did a long-term relationship between the government in question and the World Bank improve implementation, with a larger number (ten) of contrary cases.

7 CONCLUSION

We have addressed the question of why the high-conditionality adjustment programmes of the IMF and World Bank have only a rather weak revealed ability to achieve their own objectives, even though their general approach to policy has elsewhere been associated with strengthened, sometimes remarkable, economic performance. We have suggested that this paradox results from governments' reluctance to act as promised. We have sought to explain weak implementation with an analytical framework informed by agency theory, adopting the over-arching hypothesis that conditionality-applying donors (specifically the BWIs) are often unable to put in place a system of rewards and punishments sufficient to overcome perceived conflicts of interest between themselves and recipient governments. This view and specific sub-hypotheses have been tested against the experiences of twenty-one developing countries with World Bank adjustment programmes.

This evidence provides strong support for the overall hypothesis. It points to an inadequate system of rewards and, especially, punishments relative to governments' participation constraints, which are often substantial. In the event of serious donor–recipient disagreements, domestic politics usually dominates. The use of donor financial leverage is emphatically not a substitute for weak domestic institutions or 'political will'; there is little that conditionality can achieve without a willingness to act – but if there is already a willingness to act, conditionality is largely superfluous, and probably counter-productive because it undermines local ownership. We have also found that the conditions necessary for donors to be able to act as 'agencies of external restraint' are often not satisfied, and that conditionality therefore does not offer an effective pre-commitment technology.

Although we have not here examined the use of political conditionality, the above conclusions also prompt scepticism about the potential of using donor leverage to achieve major political-system reforms. To echo the conclusion of the contribution by Gavin and Hausmann in Chapter 5 of this volume, donor leverage cannot substitute for the gradual building and strengthening of local institutions, either for political self-expression or for economic management. There is an analogy here with experiences with international sanctions. Sanctions provide a more draconian, if exclusively negative, incentive system, but the most authoritative study of this subject arrives at conclusions close to our own: that they have limited ability to achieve their goals, that external policy-makers have inflated expectations of what sanctions can achieve, and that there is a weak correlation between economic deprivation and political willingness to change (Hufbauer, Schott and Elliott (1990), pp. 92, 94).

The conclusion, then, is that the BWIs and other donors should recognize that their main contribution to policy reform in developing countries has been through their influence on the contemporary intellectual climate, and persuasion of governments through regular contacts. The issue for the donors is how they may maximize their influence, by better utilizing already-existing opportunities for 'dialogue', for example, when working out their country assistance strategies, and to practise better the principle of the local ownership of reforms which they espouse in theory. Taking this principle more seriously would have the desirable effect of making donors more selective in the governments they choose to aid. Decentralization of aid administration could also help (as most donors are rather centralized) devolving genuine policy and financial authority to country missions, because country offices are more likely to exert influence through local knowledge, greater understanding and continuous contact. Donors also need to address their own pro-spending incentive biases, including budget allocation procedures and personnel assessment systems.

Notes

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1. See Nelson and Eglinton (1993, pt. I), and Hewitt and Killick (1996) for fuller discussions.

2. There is an extensive empirical literature on the effects of Bank and Fund programmes. Khan (1990) offers a valuable discussion of the methodological problems and surveys the literature on the effects of IMF programmes. Killick (1995a, ch. 3) offers a more recent survey and additional evidence. The best independent source on the effects of World Bank adjustment programmes is Mosley, Harrigan and Toye (1991); see also Corbo and Rojas (1992). Substantial in-house Bank evaluations are provided in World Bank (1992a and b). Results in Africa are presented in World Bank (1994) and Elbadawi (1992). I am also drawing on evidence from my present research on conditionality, to be presented in Killick.
3. Calculated from Bouton *et al.* (1994) and World Bank data on adjustment credits.
4. The frequently imposed nature of conditionality is confirmed by Johnson and Wasty (1993), who show that government ownership was regarded *by Bank staff* as 'low' or 'very low' in half (40 out of 81) of programmes, and 'very high' in only a fifth (16 out of 81).
5. The countries were: Argentina, Chile, Colombia, Gambia, Ghana, Guyana, India, Indonesia, Jamaica, Kenya, Korea (South), Madagascar, Malawi, Mexico, Philippines, Senegal, Tanzania, Thailand, Turkey, Uganda and Zambia.
6. The existence of such a bias, and the malign effects of this, were among the findings of the well-known but unpublished Wapenhans Report on the quality of Bank project lending.

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