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THE THEORY AND PRACTICE OF POLICY-BASED NONPROJECT ASSISTANCE

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In this summary review of policy-based, nonproject assistance (NPA) we examine initially the need for policy reform. Second, the theoretical and intellectual basis for policy-based program lending is examined. Third, we review the specific conditionality attached to program assistance in the Agency for International Development (AID), the International Bank for Reconstruction and Development (IBRD, or the Bank), and the International Monetary Fund (IMF, or the Fund). Fourth, several operating characteristics of policy-based program lending are reviewed. Fifth, we look at some of the pros and cons of conditionality in AID programming. Sixth, the importance and difficulty of measuring beneficiary impact are examined. We conclude with a "summing up." A selected bibliography is provided at the end.

1. The Need for Policy Reform

The recipe for development is about one part economics and two parts politics. Any freshman student of economics, for example, can explain the results for a nation when it consumes and invests more than it produces--inflation, pressure on the exchange rate, balance of payments difficulties, and growing internal and international debt, in one combination or another. Measures designed to alleviate this familiar syndrome number about one per economist, whereas the single overarching non-economic solution rests on something called "political will." Having the will to live within the limits of one's resources, for example, usually means that one will do so.

The "solution" for nations, of course, is more complicated than that for individuals, although two chief factors condition all responses. One is the scope for action that an individual or nation can take which is solely within the jurisdiction or power of that individual or nation. The other is the scope for action which is constrained by actions or events outside the individual or nation. The distinction is important, because it suggests the limits of policy responses to crises of either individuals or nations.

Large parts of the world today, especially Sub-Sahara Africa, are in economic and political disarray, with incomes and per capita agricultural production falling, and with high degrees of political instability. In Latin America high external debt is shaping policy decisions which have high short-run economic and political costs. The rate of increase in world trade is slacking off, and newly emerging economies are finding it more difficult to penetrate world markets. Greater attention among development thinkers is once again swinging back to emphasis on agriculture and internal development as the limits of the export-oriented Asian development model become clearer.

In this world context, two great ideologies compete for center stage. One is that which stresses freedom of action by individuals, market forces and competition, the role of price as an allocator of resources, and the constrained role of governments. The other is that which stresses government organization of the economy, limits to freedoms which might interfere with the state's decision-making authority, and recognition of the inefficiencies of markets. In each ideology there is a mix of intellectual and political ingredients, and each claims to represent man's best hope of achieving material plenty while enhancing his humanity.

In the 1950s many newly emerging nations adopted a political and economic development strategy based on a strong government, planning, large state sectors, and single party leadership. Whatever the full range of causes, this approach did not provide either development or the full flowering of the human spirit. Many of them were simply economic and political disasters. Even states which adopted what appeared to be a market-based approach were often so freighted down with the burden of single party (read, single man) leadership that cronyism and authority dominated and markets never were given the chance to operate. Still, as long as some growth occurred, such high cost models could be continued, even if largely to the benefit of the directors of such systems.

The current emphasis on nonproject assistance and conditionality is just the latest step in a continuous search for a strategy of development assistance dating back to the earliest days of United States' programs abroad. From Point Four in 1949, to emphasis on the missing ingredients in growth and the stress on capital accumulation in the 1950s and 1960s, and finally to the suggestion that a "direct attack on poverty" had to be launched in the 1970s, the question has always been: what causes growth, and how can a donor help in the process.

Several major events transpired beginning in the 1970s, however, which precipitated the current emphasis on policy reform. The rapid increase in oil prices caused immediate problems throughout the world economy, but they were especially severe in LDCs. The second oil shock in 1979 again worsened their position, but this time adjustment problems were compounded by rising interest rates on loans LDCs sought to maintain consumption in the face of falling real incomes. Third, population pressure in a number of areas began to threaten development and political stability, and rising productivity displaced short-run redistributive schemes as the single most important way of raising the poor out of poverty. Finally, political thinking in the developed countries began to reflect a broad suspicion that the boundaries of state authority had been extended too far into their market economies, and were causing declining productivity, potential trade wars, and worsening income distribution.

The result now is growing emphasis in developed and less-developed countries alike on "policy reform," the attempt to strike an optimal balance between the positive but constrained role of government and the necessarily more open-ended role of private initiative. Essentially, this takes the form in donor programs of conditions which are attached to loans and credits stipulating smaller budget deficits, better monetary control, more realistic exchange rates, and similar macro measures. Also, conditions often encourage institutional change such as the freeing of markets and reducing the role of parastatals. Finally, some conditions relate to strengthening the technical ability of government in such areas as budgeting and civil service management.

The argument in favor of policy reform, then, rests on the need to reverse the collapse now being experienced in many LDCs, as well as on the Western intellectual tradition stressing market-led development begun with Adam Smith. The other Western intellectual tradition of statist development is clearly on the defensive, both in the West and in various Soviet-type economies throughout the world. Adam Smith's time has come, again.

The following are among the specific reasons suggested for this emphasis today: the rising government and balance of payments deficits in the U.S., coupled with the downward transformation in the labor force resulting in a slowing down of productivity and income increases; the external debt crisis of Latin America; the famine crisis and the growing evidence of "underdevelopment" in Sub-Sahara Africa; the continuing poverty along side "development" in South Asia;, and, the post-Mao achievements in the 1980s in the People's Republic of China, based in part on limited market forces.

While specific conditions differ in each country, there are common problems encountered in both Sub-Saharan countries and in those middle income countries with severe debt service problems, the two major groups of countries in which conditionality is being applied today. These are: macroeconomic imbalances, inflation, and unsustainable rates of domestic resource absorption; reductions in net capital inflows; heavy debt burdens which require raising domestic savings to very high levels; limited new private capital inflows; the need to expand exports considerably, and to diversify; high cost of required stabilization and structural changes required.

2. The Theory of Policy Reform

Current thinking is that these problems can be addressed successfully only with policies which rely on and stimulate the strength of market forces. The heart of the matter is a system in which decentralized units operate autonomously on the basis of knowledge generated within the market system. The concept traces back to Adam Smith's vision concerning The Wealth of Nations. It also derives from the important debate among academics in the 1920s and 1930s between the advocates of planning and those favoring markets, one of the most important debates ever to occur among economists on the relationship between knowledge and rational economic decision-making. It was part of the open ideological debate stimulated by the Russian Revolution over the relative merits of socialism and capitalism. Its central issue was the most efficient procedure for the generation, diffusion, and use of decentralized knowledge.

The market model is just one possible arrangement for providing rules for decision making, information generation and processing, and institutional and individual motivation, key features of any economic system. The basic case for the market is that economic decisions will most closely reflect individual wants and resource scarcities when they are decentralized among autonomous, privately-held producing units. These units are efficient because they have the best information available on consumer needs and production capabilities, and serve the individual (motivational) needs of the producer (who keeps the profit) as well as the worker (who keeps his wage). When markets are competitive, and there are no significant external effects (the case of public goods, for example, or externalities in production), price forms the main kind of information needed by both households and producers for rational decision-making which associates ends with the means of satisfying those ends. The role of government in this model is one of referee, providing "honest weights and measures," and providing legitimate public goods.

As translated into practice, this strategy emphasizes not only market-based development but export-led development as well. Recently, there appears to be a shift within the market-based paradigm toward an emphasis on agricultural development, and a growing recognition of the emerging difficulties encountered with an export-led strategy, particularly for those countries not yet already major exports.

3. The Practice of Conditionality

Current thinking among major donors is that market-oriented conditions can be attached to nonproject assistance which will lead to badly needed policy reform and structural change in LDCs. Nonproject assistance is thought to be more useful for this purpose than project assistance mainly because it is larger. (Critics suggest, in contrast, that if it is very large this probably represents a political commitment on the part of the donor which under any circumstance cannot be rescinded.)

CONDITIONALITY WITHIN AID

AID's approach to conditionality is more eclectic than that either of the Bank or the Fund. Essentially, it is based on variants of the two-gap model, with some consideration given to the monetary approach to the balance of payments.

The pattern of AID conditionality is revealed in several recent studies. In general, policy reform has four central themes: correcting overvalued exchange rates, correcting urban bias, rationalizing the public sector, and promoting workable competition.

A GAO study in 1985 examined conditionality in six countries (Costa Rica, Honduras, Egypt, Bangladesh, the Philippines, and the Sudan). Only 6 of the 19 Development Assistance (DA) projects required government action as conditions precedent or covenants. Of the 8 Economic Support Fund (ESF) programs studied, the 4 with policy conditions were in Egypt. In general, where AID did not use project conditionality there were at the same time significant ESF programs with conditionality.

The GAO report noted the difference in emphasis and scope among the three types of assistance (DA, ESF, PL-480), and concluded that each is unique in serving as a vehicle for the policy dialogue which is expected to result in policy change. One might add that if to these variations consideration is given to the political and strategic place of the country in AID programming, then generalizations on the success of policy dialogue seem to be weak indeed. Policy dialogue works under some conditions but not under others.

A different perspective is provided by a study of AID conditionality in its 1986 ESF commodity import and cash transfer programs. While the study is limited methodologically, three general observations are possible on the nature of AID conditionality. First, conditionality was employed with greatest frequency in the Latin America and Caribbean regions. It is scarcely used at all in Asia and the Near East. Sub-Saharan Africa fell in between those extremes. Second, where conditionality is employed, it tends to become more comprehensive and detailed as the amount of resources devoted to the program increases. Third, while the use of conditionality by AID is increasing, the total amount of resources conditioned upon macroeconomic performance still constitutes a comparatively small proportion of total U.S. bilateral economic assistance. In FY 1986, for example, 20 percent of ESF resources had some conditionality of this kind attached.

The economic policy conditions attached fall into four categories: nonfinancial public sector (reducing expenditures, promoting tax reform, dismantling price and market controls, and divesting or restricting the activities of parastatal enterprises); monetary policy (reducing the public sector's capacity to borrow domestically or abroad, decontrol of interest rates, or channeling more credit to the private sector); foreign trade and exchange rate policy (reduction of tariffs or administrative controls on imports, and (less commonly) elimination of export taxes, loosening administrative requirements for exports, reducing the gap between official and market rates of foreign exchange); policies toward the private sector (elimination of price controls, enhanced access to productive resources and markets).

There were additional conditions such as the administrative condition requiring the tying of the stabilization/structural adjustment program to the purchase of an amount of goods equivalent in value from the U.S. or a restricted group of LDCs (This condition, which essentially reflects U.S. interests rather than development needs, was applied to all countries in the Latin American region except Haiti whose trade already was heavily oriented toward the U.S.).

Conditionality varied by region. The countries in Asia and the Near East, including the leading recipients of U.S. economic assistance, are subject to negligible conditionality. Conditionality in the Sub-Sahara region is relatively more concentrated in the external and private sectors. In the Latin America and Caribbean region, there is a wider variety of conditionality with greater frequency than in the other regions. The conditionality also appears to be relatively more evenly distributed among the four functional areas noted above.

From a different perspective, conditionality rarely applies to only one functional area in either Africa or Latin America. Similarly, it was also rare for a recipient to be subject to conditionality in all four areas simultaneously. The only exceptions were Costa Rica and El Salvador, both of which had comparatively large programs.

Three studies completed in 1987 of programs in Mali, Somalia, and Zambia, provide more data on AID conditionality and its effectiveness. The programs were intended to improve the agricultural sectors of these countries, and thus represent sector approaches to conditionality.

AID's experience with policy conditionality, primarily in Mali, Somalia, and Zambia, can be summed up in the following way (quoting and paraphrasing from the final report):

Impacts in the agricultural sector. (i) Farmers responded to changes in incentives. There is clear evidence that farmers responded to freer markets and price signals and made choices that maximized their welfare. (ii) Reforms led to significant increases in food production. In the presence of adequate rainfall, donor-assisted policy reform programs were the dominant causes of increased food output in Somalia, Zambia, Zaire and Zimbabwe. (iii) The major beneficiaries were small farmers. (iv) Agricultural policy reforms had a quick impact on output and income. This supports the view that the quickest way to lift African agriculture from its current stagnation is to support reforms in the producer's incentive structure. (v) Policy reforms had the greatest impact where other constraints were less binding. (vi) Policy reforms promoted private sector development in rural areas.

Economy-wide impacts. (i) Distributional equity has improved and the urban bias of their economic systems has been reduced, results consistent with the United States' fundamental goals in supporting policy reforms. (ii) Market structure and spending reforms helped African governments in their efforts to cut budget deficits. (iii) Reform programs had favorable effects on balance of payments. (iv) Macroeconomic progress has been slow.

Implementation. (i) Policy reform implementation failures can defeat the best program (Zambia was most seriously affected by these problems). (ii) Price interventions are extremely difficult to manage. (iii) Reform programs are underfunded.

Role of donors. (i) Even without reform programs, structural adjustment would take place. (ii) External assistance has been critical to the adoption of policy reforms by African governments. (iii) AID's role has been both catalytic and supportive.

Emphasis on policy reform should continue. (i) Policy reforms are not the only answer to Africa's economic problems, but they are an important part of the answer. (ii) Policy issues stretch beyond the purview of African government (e.g., African debt and future world trade are international issues).
(iii) It is important that the United States and other donors maintain their commitments to reform programs if these programs are to succeed.

In general, while problems exist, AID experience with program conditionality has been positive.

CONDITIONAL:TY WITHIN THE WORLD BANK

The World Bank began its Structural Adjustment Lending (SAL) program in 1980, and is said by Bank officials to have been a response to the sharply worsened international economic conditions of the time, and to the growing difficulties experienced by many LDCs.

From the Bank's perspective, SALs have essentially three characteristics. First, they are instruments for policy dialogue between the Bank and given LDCs. Second, they are intended to provide support over a number of years, often three to five years. Finally, they carry provision for quick disbursement of foreign exchange for imports not linked in advance to specific investment programs. In this light, it can be seen that SALs are intended to be complementary to IMF assistance since they differ in type of assistance, scope, and time frame in which the effects of policy change occur.

Initial Bank internal guidelines suggested that program lending could be up to 10 percent of total Bank lending commitments, but the volume of adjustment lending (both SAL and sector adjustment lending, or SELs) is expected to reach 15-20 percent over the next few years. SALs have been largely in middle income countries, a fact causing some criticism. Major macro components of SAL conditionality have been in the areas of trade and fiscal policy, public investment and enterprises, interest rates and debt management. By sector, conditionality has applied for the most part in agriculture, industry and energy, with less emphasis on population, the financial sector, and transport.

Essentially, the Bank approach to conditionality is based on variants of the two-gap growth model focusing on national accounts and real variables (or a Harrod-Domar model of an open economy) with the Bank generally following the IMF in monetary and exchange rate policy (although the Bank has been involved in institutional changes relating to exchange rate adjustment). In general, Bank efforts have been directed toward improving domestic resource mobilization, increasing efficiency and resource use by the public sector, reform of trade regimes, and rationalizing a variety of agricultural and energy pricing systems.

Both direct and indirect empirical evidence suggests that reduced price distortions enhance both growth and equity. Further, Bank studies which go beyond price reform suggest that on balance policy reform has enhanced growth, and has even helped the poorest, although short-run costs of compressed consumption are noted.

Policy-based lending of the Bank, and by implication by the Fund and by AID, has become subject to increasing criticism. On the far Left the contention is that both the Bank and the IMF simply seek to promote the interests of private capital around the world. More toward the center is the criticism of Elliot Berg and Alan Batchelder. First, they cite the "lack of clear selection criteria," and the fact that SALs have not gone to poorer or slow-growing countries, or countries suffering from especially poor policies and/or institutional weaknesses. Second, they suggest that the "theory of reform" underlying SALs is weak. For example, perfectly sensible policy suggestions are put forth without attention to the many and complex reasons explaining why reforms were not instituted in the first instance. Third, SALs today are so overloaded with conditions that limited staff find it difficult to achieve success in any one condition. Also, institutional changes are often part of SAL conditionality, and this probably weakens rather than strengthens SALs because such changes require different kinds of dialogue and different monitoring procedures.

Critical empirical studies are emerging which call into question some of the earlier findings of scholars which helped establish the intellectual case for structural adjustment lending. For example, criticism is emerging of Bela Balassa's work which suggested that countries with an export-oriented development strategy, of the kind stipulated in SALs, have fared better than those with import-substitution strategies. Ph.D. dissertations are being written which attempt independent empirical verification or negation of the Belassa and similar conclusions.

In summary, Bank structural adjustment lending is based on an export-oriented market model, and is buttressed by considerable Bank experience concerning the structure and sequence of appropriate policy change in this context. At the same time, a growing number of studies are raising questions about the theoretical assumptions underlying policy reform, about the manner in which it is administered, and about the methodologies on which favorable past evaluation of policy-based lending has been based.

CONDITIONALITY WITHIN THE INTERNATIONAL MONETARY FUND

The approach of the International Monetary Fund is different from that of the Bank. Essentially, the Bank approach to conditionality is based on variants of the two-gap growth model (see above) while that of the Fund is derived from the monetary approach to the balance of payments focusing on a flow of funds methodology and concerned solely with nominal magnitudes. The

Fund stresses the balance of payments while the Bank aims more in the direction of raising growth rates.

The types of conditionality applied by the Fund include the following: monetary policies (credit ceilings, reserve requirements, interest rate policies); public sector policies (restraint of expenditures, investments, subsidies, and transfers, and policies related to wages and salaries and other current expenditures); reform/improvements (tax structure, increase in tax rates, improvement in tax administration); nonfinancial public enterprises (curtailment/rationalization of expenditure, adjustment of tariffs and administration of prices, employment, wages); overall public sector (reduction in deficits, improvement in nonfinancial public enterprises through reduced bank borrowing (real), reduced transfer from government (real), and formulation of investment plan); external debt policies (control of commitments/disbursements both public and private, improvement of maturities); exchange and trade policies (exchange rate reform, liberalization/reform of exchange system and of trade system, import substitution measures, rationalization of import protection, export promotion or liberalization, reduction of arrears); wage and price policies (general wage restraint, wage guidelines in public sector, producer price adjustments, retail price adjustment).

This listing shows that the typical Fund-supported program includes a wide range of measures cutting across the economy. Fund studies defend the efficacy of these programs while noting that evaluation is particularly difficult since what is lacking is the counterfactual--that is, would have happened in these countries in the absence of Fund programs, or what would have happened with alternative programs?

Fund studies suggest the following conclusions on the effects of Fund programs. (i) Tighter monetary and credit policies tend to result in a fall in the growth rate in the first year after they are implemented, and if these restraints included reduction in the flow of credit to the private sector, then private capital formation and possibly the long-run rate of growth would be adversely affected. (ii) There was no clear empirical relation between growth and fiscal policy, although the separate effects of fiscal policy are especially difficult to measure. (iii) Supply-side policies, especially those to increase producer prices and interest rates, have favorable effects on production and savings. (iv) There is a close relationship between the growth rate and capital formation, which suggests that policies aimed toward increasing investment and improving its efficiency will tend to have a beneficial effect on long-run development. (v) Devaluation, on balance, exerts an expansionary rather than a contractionary effect on domestic output, even in the short run.

While this listing reveals that the effects of Fund programs are mixed, Fund studies indicate that possibly a reason for continued criticism of Fund programs as contractionary is that critics focus on reductions in aggregate demand through contractionary monetary and fiscal policies. This is far too narrow an interpretation of Fund programs, from the Fund's perspective, since it ignores the other growth-inducing measures of Fund programs. The beneficiary impact of Fund programs is also said to be positive (this is explored below in section 6).

4. Operating Characteristics of Programs

Nonproject assistance can be viewed in terms of its various operating characteristics. There are, for example, various effectiveness issues attached to different kinds of aid. These are the more important: (i) the relationship between the effectiveness of NPA and its accountability (can NPA be made more accountable given its apparently greater fungibility?); (2) effectiveness of structural adjustment assistance as a vehicle for encouraging policy reforms at the sectoral or country level; (iii) effectiveness of the linkage between NPA and other flows. It is important to note the differences between these issues and those which attach to project assistance, namely: (i) the pros and cons of rate-of-return analysis in assessing project contributions; (ii) effect of government policies on project achievements; (iii) effectiveness of project lending as a vehicle for promoting policy and institutional reform, and improvements in efficiency and management in recipient countries; (iv) effectiveness of "poverty-oriented" projects in alleviating both rural and urban poverty; (v) impact of contextual factors on project effectiveness such as local-level sociocultural and political features, and such international features as movements in international prices.

The point here is that project and nonproject modes of assistance carry distinct effectiveness issues. A comparative study of such issues perhaps would be instructive for future programming.

A second operating characteristics of nonproject assistance relates to the consistency of application of assumptions and remedies in applying NPA. For example, critics suggest that the Fund applies a "cookie cutter" approach to policy reform, making the same recommendations the world around without regard to country differences. Fund spokesmen, in contrast, say that the fund focuses largely on macroeconomic policy, with little involvement in micro problems (partly at LDC insistence). This means in effect that the Fund can focus on only a rather narrow range of policy questions. Since the problems in this area are indeed similar in different countries, it follows that Fund recommendations will be similar.

Another example is the criticism noted above that the Bank SALs appear to be available only to middle-income countries. Bank staff express concern about this, but in part suggest that initiative for a SAL comes from the LDC, and the more developed LDCs are simply in a better position to put together the studies backing a SAL request.

A different kind of issue is raised by differences in country size and institutional capacity for policy reform. How much can be expected from price and market policies when so much of a poor economy lies outside of the modern price/market economy? If trading markets for capital, labor, raw materials, imports and exports, and final products, are so thin, how much impact can macro policy changes have? Moreover, in very poor countries there is at least the likelihood that political stability is a relatively important problem, and this makes anticipating the effects of macro changes all the more problematic.

Measuring the effects of policy change in carrying out conditionality provisions is extraordinarily difficult. There is no single quantitative measures, such as rate of return, for example, by which a program may be judged. This is especially important in policy-based program lending because the arguments over who gains and who loses are so intense. Also, there is a growing body of scholarship which now questions whether such conditionality is appropriate from the total macroeconomic perspective of growth. All such criticisms are of somewhat limited meaning, however, because of the absence of the counterfactual--that is, what conditions would have prevailed in the absence of the program, or what the effects would have been of alternative programs.

Essentially there are three difficulties common to evaluating the effects of program conditionality: (i) the precise links between policy change and expected change in the economy are uncertain, and require much more research; (ii) it is difficult to separate the effects of a specific policy change from those effects resulting from policy changes stipulated in other programs, from changes in external factors such as export markets, and from major internal events such as drought or especially good weather; (iii) when a policy change is merely the first of an anticipated series of such changes, the findings of the evaluation will depend heavily on when it is carried out.

Because of these limitations, non-quantitative indicators of success are being sought for evaluation of nonproject assistance. One such approach is the use of performance disbursement benchmarks, which amount to checking on the degree to which stipulated changes have been carried out, with funding divided into a series of tranches which are disbursed on the basis of satisfactory progress in implementing policy and institutional reforms. Policy and institutional changes are similarly divided into a sequence of revisions. Benchmarks are established to track progress toward achieving ultimate policy and institutional objectives in this way. The benchmark approach is a practical method of checking what has occurred under a program, but it is unsatisfying to those who seek a synthesized measure of economic effectiveness.

A second approach to evaluation is to include "trigger points" in conditionality. For example, if exports are expected to increase at 3 percent annually, but instead fall by 1 percent annually, then it could be stipulated that certain original conditions of the program would be changed. While important conceptually, this approach is risky because it places heavy weight on the validity of the original conditions and on the firmness of the expected policy and institutional responses of the LDC to those original conditions. This technique is used rarely.

A third approach intended to cast light on program effects rather than to monitor its changes is through the use of the aggregate production function concept. A production function is the relationship between inputs and outputs for a firm or for a nation. Inputs are capital and labor, and more output requires more capital or labor, or both, in the absence of technological change. Since beneficiary impact is sometimes the most important question asked of NPA, the production function concept is useful because it makes possible a close look at employment, the link between growth and equity in LDCs. (This approach is also useful in analyzing the effects of a wide range of projects by complementing or substituting for the more common evaluation approach based on the logical framework.) The method under this approach would be to compare the intended results of the program with the changes in the production function of the country after the program is well under way (five years or more) or is completed. The practical difficulties of this approach are that it is abstruse, rests on a concept (the production function) which is somewhat controversial, and has heavy data requirements.

In sum, evaluation of the effects of nonproject assistance remains an undeveloped art. In part, this is because behavioral models linking policy changes with expected outcomes are still undeveloped. Similarly, our increasing knowledge of "rational expectations" suggests that major economic actors will, in their actions, anticipate such policy changes so that in effect such changes are aimed at a moving target. Other evaluation problems result from the long time required for the effects of policy changes to work themselves out, and the dependence of program outcomes on institutional reforms and such random events as weather. All of this suggests that evaluation of NPA will continue to rest heavily on various performance indicators measuring the extent of compliance of a government with the conditions stipulated.

5. Pros and Cons of Conditionality

There is a wide range of pros and cons concerning conditionality, which can be summarized as follows.

ARGUMENTS IN FAVOR OF CONDITIONALITY

1. The policy setting in many LDCs inhibits both growth and the achievement of equity. In many cases the policy environment has become a "crazy-quilt" of regulations, prohibitions, bloated and dysfunctional state sectors, and worsening international positions, with the result that growth has come to a standstill while population continued to increase. The support which had once existed for statism began to erode in the grim light of reality--poverty, ignorance, and corruption. Something had to be done, and since the present policies favoring state-led growth have come to be viewed as parts of the problem rather than as solutions, greater reliance on market forces is now considered necessary. No matter what the imperfections of the market might be, it is now believed that their consequences cannot possibly be worse than the failures of government control.

2. Political stability is the key to growth and growth is the key to political stability. While the evidence on the relationship between good policies and good growth can be debated in some cases, there is no case at all to be made for the idea that a nation can have good growth without good policies. Similarly, while the evidence on the relationship between growth and political stability can be debated in some cases, there is no case at all to be made for the idea that political stability can exist in the presence of economic chaos and decline. A semblance of stability might obtain, but only at the cost of great repression of commonly accepted liberties. Of course, growth in which the bulk of the gain goes to a minority is not growth at all for the majority, so it does matter that the growth be shared somewhat equitably, which, in turn, further enhances political stability.

3. While random external events will affect development, growth and welfare depend primarily on domestic policies. It is obvious that external events can have an uplifting as well as a depressive effect on a nation's economy. It is equally true that some economies are heavily export and/or import dependent, and appear therefore to be "vulnerable" to world markets or to their chosen trading partners in the case of trade with Eastern Europe. How such a country adjusts to this apparent disadvantage in the long run depends on the policy set chosen in the short run. Even the poorest country in the world can choose a policy set appropriate to its condition. To the extent that local leadership is less interested in growth than in its own perquisites, then this generalization does not hold, and policy reform seems of

rather academic interest. The result under this circumstance is economic stagnation and growing immiseration.

4. Conditionality may help LDC leadership accomplish its own goals. It is folklore in development circles that the Bank gives advice to countries which their own leadership would like to give, and there are cases where indeed this is true. Competent explanations of the dysfunctional policy and institutional settings often are available locally, of course. Nevertheless, outside advice can sometimes strengthen the political hand of those locally who propose policy reform, provided the donor engages in true dialogue that is supportive rather than imperious.

ARGUMENTS AGAINST CONDITIONALITY

1. Limited knowledge base. The gap between policy and its expected results is enormous even in developed economies. In LDCs undergoing rapid structural change, and where the data base is seriously limited, it is fantasy to suppose that any policy planner can "manage" or "fine tune" economic development by changing interest or exchange rates, stipulating budgetary limitations, and the like. In effect, the operational mechanism through which policy changes affect reality is something of a "black box." Moreover, prices in LDCs undergoing rapid structural change are unreliable indicators for rational investment decisions as between projects, sectors, and regions. At best, recommendations should be limited to such critical issues as developing technical competence among the LDC economists and others who are dealing with the problem, establishing local and international institutions for the review of problems and policies on an on-going basis, providing for coordination among donors who express interest in providing assistance, and the like. Thus, the limitations of our knowledge suggest a wider attempt at building local technical capacity and institutions capable of addressing policy issues on a continuing basis.

2. Inherent bias of policy-based lending. World Bank policy-based lending is concentrated in middle income LDCs. While the rationale is that countries at this level of development have the technical capacity to engage in policy dialogue, and perhaps the political will and institutional stability to enforce stringent conditions, this focus for conditional lending imparts a bias to how the development community thinks about development which may be increasingly dysfunctional. As attention turns to Sub-Saharan Africa and other regions in which the poorest LDCs are located, policy dialogue of the kind now dominant in the export-oriented middle-income LDCs will be irrelevant. As world trade markets become

more difficult to penetrate for newly-emerging countries, the central thrust of development will need to be inward looking, with attention directed first toward agriculture. While the needs of such a strategy are not unrelated to the needs of an export-oriented strategy, in the former much greater attention must be devoted to peasant farming, rural development, and stimulation of off-farm enterprise. This will require a new emphasis among donors, and a reorientation of conditionality toward internal development.

3. Dysfunctional distributive effects. While increasing attention among donors is directed toward the short-run costs of adjustment programs, the compression of consumption following application of conditionality still does not receive sufficient attention. The best evidence of this perhaps is the continuing apprehension and suspicion in which policy conditionality is held by leadership in LDCs. In effect, the ascendancy of policy reform lending is a return to a trickle-down strategy of development which ignores the lessons of history which led to the movement away from such theories in the first instance and toward a "basic human needs" approach. Decades of trickle-down development with growing poverty have spawned or strengthened in many countries repressive, authoritarian political structures (a case can be made that causality is in the reverse direction). The present return to trickle-down strategies in this context may create not only transitional consumption problems (the standard view) but may set the stage for long-run structural rigidities which will adversely affect equity for decades to come. Conversely, such a strategy may so worsen conditions in the short run that evolutionary change will give way to revolutionary change.

4. Asymmetrical policy conditionality. While stringent policy conditionality is applied to many LDCs, major lending countries engage in the most economically appalling policies imaginable. The difficulty of coordinating policy among Western Europe, Japan, and the United States dwarfs the policy problems of most LDCs. The disarray in the agricultural policies of most developed countries surely matches the agricultural policy miscalculations in LDCs, although with different results. Growing trade restrictions in developed countries against exports of LDCs gives the game away as one of continuing attempts at exploitation of LDCs. (The limitations imposed by the United States in its "Caribbean Initiative" are viewed among LDCs as symbolic of the real difficulty faced when a developed country proposes "helping" an LDC.) The basic difficulty with this asymmetry is that it reinforces within LDCs a climate of suspicion that assistance to them is a game among developed countries played out largely for internal political reasons, with the interests of the LDCs taking a distant second place to developed countries' concerns with their own economies. In the long run this has two effects. It makes cooperation more

difficult around mutual interests which surely do exist between developed and less-developed countries. Second, it fuels acceptance of radical thought from Eastern Europe, the Soviet Union, and China which suggests that the only safe course for LDCs is alignment with world (Soviet-type or Chinese-type) socialism.

BALANCING THE TWO VIEWS

In summary, there is no easy way to balance the pros and cons of policy-based program lending. Each argument is valid in its own right and under certain limited conditions. Ultimately, a balance will rest on two factors. First, much more analytical and empirical work is required on all aspects of the effects of conditionality. Second, the way one approaches the questions which need to be asked of conditionality, and indeed the questions themselves, will be affected by the researcher's world view, i.e., by whether the researcher "believes" that LDCs can prosper in the world economy in a positive sum game, or whether LCDs inevitably will lose in their struggle with more developed country in a zero sum game.

6. Beneficiary Impact

Nowhere is this divergence (resulting from different empirical studies and world views) better illustrated than in estimating the beneficiary impact of conditionality. While critics may concede that on balance better policies mean faster economic growth, at the same time they often insist that the poor do not benefit, or may actually suffer, from such growth. Who are the gainers and losers?

The programs which have been subjected to the most intense criticism in this regard are those of the Fund. These programs are also the same programs that have been most actively and visibly defended. The Fund's basic argument is that while there may indeed be some reduction of consumption, this may affect all groups rather than just the poor. In any case, it is stressed that this compression would have been greater in the absence of the adjustment programs and the financial support they provide. Specifically, the Fund view is that the distributional impact of exchange rate devaluation is mixed in the short run, but that in the long run improved growth and employment will occur so that all groups will share in higher national income.

In the monetary area, appropriate policies on money creation and credit tend to curb inflationary pressures, and this should help the poor who usually do not own assets which would rise in value with inflation. This beneficial effect is somewhat counterbalanced by the fact that established and urban firms are in a better position to compete for credit than are smaller firms in the rural sector, so the distributional benefit from appropriate credit policies is not as great as might first appear.

The distributional impact of fiscal policy is also mixed. On the revenue side, through improved direct taxation the distribution of wealth and income can be made less unequal, and this is possible as well for selected indirect taxes. On the expenditure side, getting civil service size and salaries under control will have an immediate positive effect on distribution. Reduced subsidies which result in increases in prices of food, transportation, and petroleum ultimately will increase employment. Current food subsidies for the poor largely ignore the very poor who live in rural areas. Under any circumstance, food subsidies must be targeted much more closely to the lowest-income households.

In summary, the IMF position provides a strong conceptual defense for the kinds of conditionality now common among major donors in the areas of exchange rates, and fiscal and monetary policies. World Bank studies, as well as recent AID evaluations of its conditionality provisions in some countries, support this view also.

The only economically and politically adequate defense of policy-based, nonproject assistance which will hold up in the long run is that in fact the poor do benefit. To ensure this, it is necessary to view policy reform and poverty reduction as complementary goals, not opposites. This means, in turn, that poverty must become a policy focus in any program for change intended to enhance overall economic growth. In effect, a version of a "growth with equity" model is the appropriate analytical framework with which to design policy reform. The important point to remember is that economic crises will force adjustment in some form. Policy-based program lending provides the opportunity for an orderly transition away from the problems. However, without adequate attention to the poor the transition itself is threatened, as is the likelihood of permanent improvement.

In brief, if the claims of poverty alleviation are seen as opposed to the needs for structural adjustment, in a crisis situation the claims of poverty might be ignored. For this reason, actions taken to alleviate poverty must become a supportive part of the policy reform package, contributing to increased productivity and growth and not seen merely as income transfers which will reduce growth.

Recent work done at the Overseas Development Institute in London notes the following kinds of actions which have been taken in recent Bank lending (cited with permission of the Bank), actions intended to: (i) enhance the access of the poor to productive assets through land reform which is associated with adjustment, as was done in Thailand; (ii) increase the rates of return on assets held by the poor, as done in Ivory Coast where positive income distributional effects resulted from higher agricultural prices; (iii) improve access to gainful employment through assistance to retrenched public-sector employees, and in emergency employment schemes, as in Gambia and Guinea-Bissau, and Chile, respectively; (iv) maintain or increase the rate of human capital accumulation of the poor through protection of social expenditures, particularly health and education, as done in Brazil and Indonesia; (v) target income and consumption transfers to the poor whose incomes are not increased by structural adjustment, as discussed in the case of food subsidies in Morocco and Jamaica. The central point is that positive programs enhancing the contribution that the poor can make to structural adjustment can be built directly into policy-based programs, and will be acceptable as parts of the growth process. The few remaining instances where transfers are required for the poor will be seen as a relatively small part of such programs.

Even assuming that programs are designed to help the poor, the evaluation difficulties noted above remain important in judging beneficiary impact. The time frame for a program "payoff" may be a decade, and over that period different groups may benefit in different ways. To the extent that price distortions are reduced, for example, the beneficial impact in the short to medium term is almost certain to be in the rural sector. And since women play such an important role in that sector, women stand to benefit. Beyond this, it is difficult to generalize on specific beneficiary impact. Each program is somewhat different from all others, and each country setting is unique. This suggests that evaluation of beneficiary impact perhaps can be pursued most successfully within a given country, rather than in studies of cross-country effects.

6. Summing Up

Today, after two "successful" U.N. development decades in which growth of GNP in less-developed countries rose briskly at five percent and six percent respectively in the 1960s and 1970s, while simultaneously poverty became more widespread, the strategy being sought is that found in the theory of markets, and market-based development.

At the same time, there are already signs that policy reform may be promising too much. There are standard technical arguments for a go-slow approach on reform. Our knowledge base is certainly limited, and in the very areas in which problems are worst, so too is our knowledge base. Also, ambitious donors often pile condition on condition so that the complexity of meeting any condition is tied in with meeting the others. Moreover, we lack a behavioral model which clearly relates policy change to expected outcomes. The connection between the two often is impenetrable to rational to rational, empirically-based analysis.

As currently applied there is reason for the cynicism among some observers who note that LDCs are expected to run a "tight ship" while at the same time the more developed countries are permitted the most profligate of domestic practices as well as international restrictive practices. Finally, as with other "strategies" which have gained ascendancy at one time or another in development thinking, policy reform raises expectations. In this case, however, the expectations go beyond the limited hope that good results from the program will be forthcoming. Policy reform requires extensive restructuring of economies, sometimes to the short-run disadvantage of large numbers of the poor. In turn, this requires that donors accept the responsibility not only for sufficient assistance for the "reform," but for the costs which must be borne for those "losing" from the changes, and hence for political stability, over the medium term. In other words, donors, as well as LDC leadership, must be willing to "stay the course."

There is no reason to doubt that the current effort at policy reform is both overdue and appropriate. Evaluating the effects of such reform remains difficult, of course, because there is no simple quantitative expression by which one can judge success or failure. However, wildly out of balance budgets, overvalued exchange rates, inefficient government restrictions on the sale of agricultural products, and a host of similar aberrations, have produced a policy chamber of horrors in many LDCs. Under these conditions real development is unlikely to occur, and the poor unlikely to benefit except from the random largess of a leader buying political support.

All of this mans that policy reform is both an economic and political act; because it changes the balance of political power among groups in the economy. From this perspective, perhaps the main problem encountered in encouraging policy reform is to convince the leadership that they will be able to survive, and even prosper, while at the same time giving up power and authority. This is why policy reform cannot be imposed from the outside if it is expected to be of lasting value. Policy dialogue requires patient, long-term (decade or more) collaborative efforts among donors and recipients alike if it is not to become just another promising, but failed, development fad.

D R A F T D R A F T

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