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Country Ownership of Reform Programmes and the Implications for Conditionality

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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 Division on Globalization and Development Strategies, 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 awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

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.

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COUNTRY OWNERSHIP OF REFORM PROGRAMMES AND THE IMPLICATIONS FOR CONDITIONALITY

Omotunde E.G. Johnson

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Abstract

The essence of ownership is the acceptance of full responsibility for the consequences of a programme. Ownership matters because of the expectation that programme design will be more appropriate and country authorities will be resolute in taking steps domestically to ensure full implementation of the programme. The steps include seeking proper domestic legitimation, which will prevent certain "political economy" factors from disrupting programme implementation. That programme success is correlated with degree of ownership and that ownership is correlated with implementation, which in turn is correlated with programme legitimation, are supported by available evidence. Ex ante *selectivity is easily made preferable to* ex post*, and for financial support a recipient country must satisfy the donor country or organization team as to the reality of ownership, soundness of the programme (policies and outcomes), and adequate implementation capacity. From a positive perspective, forces operating on both the demand and supply side of aid should inevitably bring about a new equilibrium regime in the aid relationship that excludes traditional conditionality.*

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COUNTRY OWNERSHIP OF REFORM PROGRAMMES AND THE IMPLICATIONS FOR CONDITIONALITY

Omotunde E.G. Johnson*

I. Introduction

As part of reform programmes (or in the event of sudden financial crises), many low- and middle-income countries seek financial assistance from multilateral organizations of which they are members as well as from governments of industrial countries. There are, no doubt, a complex set of reasons why countries do so rather than simply run to private markets. Such reasons include some or all of the following expectations: short delay before the funds are received; lower interest rates for given amounts than in private markets; some catalytic effect on private markets and hence positive effects on capital inflows; and flexibility in obtaining additional resources from the same source in case of unforeseen difficulties during the implementation of the reform.[1] Our interest is in situations where the multilaterals and the bilaterals are willing to give such assistance as a signal of their support for the reform efforts of the countries, rather than for purely political or humanitarian reasons. In this regard, Alessina and Dollar (2000), for instance, find evidence that political factors, such as colonial ties and preservation of friendship (as evidenced by the United Nations voting records), drive much of normal bilateral aid, although for some aid donors (notably the Nordic countries and the United States) the poverty of the recipient is an important determining factor as well. In other words, bilateral aid flows are not systematically related to the economic policies of the recipient countries (Burnside and Dollar, 2000).

Many reform programmes (structural, stabilization, major sectoral projects) do not seem to achieve their objectives and many observers believe that, among other consequences, world public resources have been wasted by the donors on some of the recipient countries. The reasons for the underachievement (failures) are, as a first approximation, typically distributed between those due to exogenous factors outside the control of the country authorities and those due to failures of the authorities. The latter set are of particular interest for obvious reasons. Failure due to factors under the control of the authorities have been attributed to poor programme design but mainly to inadequate implementation. Design failures could ensue from inadequacies of theory or simply misguided application of theory. Failures in implementation result from lack of political will of the authorities or simply from inadequate capacity. Many analysts have come to believe that such unavoidable failures in programme design and implementation are ultimately due to what has been

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loosely termed lack of country "ownership" of programmes. The idea is that financial constraints impel countries to seek assistance from international organizations and major bilateral donors and these aid givers and creditors impose policy "conditionalities" that drive the programmes. Given the process of negotiating the programmes in practice, the reforming (recipient) countries are left to implement programmes over which they feel little if any ownership, typically because of the submissive role they play at the design stage. Defenders of policy conditionality, nevertheless, see it as a way to deal with the risk of policy reversals, which in the case of loans helps to safeguard the resources and in the case of unrequited transfers ensures that those resources do not go to waste.

In this paper, we argue that if the policies voluntarily adopted by a country are sound and if those policies are expected to be fully implemented and sustained – barring certain unforeseen exogenous developments – then traditional (policy-based) conditionality is not necessary for timely repayment of the money borrowed from the IMF, the World Bank, or any other creditor. Country ownership of a programme could be used as the "instrument" to address policy implementation (including policy sustainability), and the IMF and the World Bank (or donor) efforts could be tailored mainly to address the soundness (and sustainability) of policies. The correctness of this proposition would be assured if there are explicit and transparent rules that are enforced relating to: (i) limitations on continuous use of the international organization's or donor's resources, and (ii) punishment for default in making timely repayment of debt to the international organization or donor (as relevant). We discuss a number of suggested approaches to reforming conditionality.

The rest of the paper is organized as follows. The next section argues that the essence of ownership is the acceptance of full responsibility for the consequences of a programme, that ownership gives a country the right to insist on making the final decisions, without coercion, on the contents of a programme, and that acceptance by a country of responsibility for a programme must be credibly demonstrated. This is followed by a section on ownership and programming, which argues that ownership matters because of the expectation that programme design will be superior and that the country authorities will be resolute in taking the appropriate steps, especially domestic legitimation, to ensure full implementation of the programme. It also argues that programme success is correlated with degree of ownership, which in turn is correlated with programme legitimation. The section following discusses the rationale for policy-based conditionality and the criticisms levied against it, in particular, that it has not succeeded in bringing good policy environments in aid-recipient countries.

Then the paper turns to a discussion of selectivity as a device for allocating aid resources, founded on four principles, namely, ownership, selectivity, support, and dialogue. We distinguish *ex post* from *ex ante* selectivity, present the case for *ex post* selectivity, which is currently fashionable among many analysts in the policy community, but then argue in favour of *ex ante* selectivity. Then the paper addresses the issue of operationalizing conditionality under *ex ante* selectivity. It pursues the argument that agreeing conditionality in this framework would entail establishing existence of ownership, soundness of the programme (policies and outcomes), and adequate implementation capacity. The penultimate section argues that, if the approach (regarding rules and organizational arrangements) outlined in the paper, is adhered to, there would be self-interest in the recipient countries in implementing and sustaining sound policies and there would be self-interest within the aid-giving organizations to insist on sound policies and satisfactory outcomes as a condition for future aid. The final section concludes, arguing from a positive perspective that the elimination of traditional conditionality in the context of country ownership of reform programmes may be inevitable in the near future.

II. Essence of ownership

Johnson and Wasty (1993: 2) note, quite rightly, that "it is seldom made clear as to what constitutes adequate ownership ...". They also remark that "the relationship between program success and ownership can be prone to a *post hoc ergo procter hoc* type circularity in argument: if the program succeeds, then there was ownership, and if it falters, then ownership was absent". In the context of World Bank supported programmes, Johnson and Wasty (1993) use a four dimensional variable to reflect "the intensity of ownership". The first dimension is the "locus of initiative": namely, who had the initiative in formulating and implementing the programme, the degree of collaboration in working out the programme, and whether or not the funding for the programme was extended despite certain reservations of the authorities (disagreements and reluctance to implement some aspects of the programme). The second dimension is the "level of intellectual conviction among key policymakers": namely, the degree to which there was consensus among policymakers on the nature and causes of the problem, the choices open for its resolution, and the approach to be taken. The third dimension is the "expression of political will by top leadership": as reflected, for example, in "up-front actions" and public statements. The fourth dimension comprises "efforts toward consensus-building among constituencies", for instance, by eliciting broad participation in the programme design and in launching a "broad-based public campaign" to elicit support for the programme outside the central government.

Killick et al. (1998: 87) have put forward the following definition of government ownership,

> Government ownership is at its strongest when the political leadership and its advisers, with broad support among agencies of state and civil society, decide of their own volition that policy changes are desirable, choose what these changes should be and when they should be introduced, and where these changes become built into parameters of policy and administration which are generally accepted as desirable.

We shall focus on country ownership, rather than simply government ownership, as the more complete form of ownership and the one which, in our view, is desirable for ensuring smooth implementation of a programme. "Ownership" from the perspective of the typical citizen, we believe, is more about (i) the right of the country representatives to be heard in the process of diagnosis and programme design, and (ii) the freedom and ability of the country to choose the programme to be implemented, without coercion, than about (iii) who designs the programme. Of course, many among the educated elites in civil societies in "aid" recipient countries would prefer that their nationals design the programmes, if they have the requisite technical skills; they would also want, over time, their own nationals to be fully equipped to design every programme. In the short term to medium term, however, these same elites will not typically insist on a programme being designed by local persons for the programme to be deemed locally owned. Hence, there is no necessary correlation between the degree of active country participation in the programme design (relative to participation of outsiders) and the extent or degree of country ownership. In brief, the line of causation runs from country ownership (*ex ante*) to participation in design and finally to implementation.

Broadly speaking, we shall say that country ownership exists when there is general belief by citizens of the country as well as by noncitizens that the country representatives freely chose the programme to be implemented, and when there is at the same time general acceptance of the citizens of the country of full responsibility for the outcome of the programme chosen. When a country "owns" a programme it willingly accepts the costs of any failure. A country with a rational decision making process will then act consistently with this belief and acceptance of responsibility. A rational decision making process is one that is generally expected to result in a programme that is in the best interest of the citizens of the country as a whole; in other words, an expected outcome of such a process is a programme that maximizes the expected utility of the citizens, subject to unavoidable economic and other constraints.

A. Ownership right and obligation

The essential content of a reform programme is a set of targets and instruments and the implementation arrangements. If a country owns a programme, it has the right to insist on making the final decisions without coercion on the contents of a programme. In addition, the country accepts without coercion the obligation to take full responsibility for the outcome of the programme and hence for the welfare consequences to its citizens and for certain external effects on noncitizens. Furthermore, the above right and obligation would be generally acknowledged by all other parties such as creditors, international organizations, and other countries who have anything to do with the programme.

A country with the above ownership right and obligation, which are fully acknowledged by outsiders, will try to design and implement a programme that it envisages to be in its interest. Since the contents of the programme may have repercussions for other countries and "foreign" organizations, the reactions of these "others" may cause the home country to modify its programme's contents. In other words, in exercising its generally acknowledged right and obligation to design and implement its programme, a country will be constrained by the interests, and hence behaviour, of others affected by the programme.

The inevitability of constraints to freedom of choice in exercising ownership right makes it necessary to clarify what one might call the "ultimate defining quality" of country ownership. For the constraints imply that a country hardly ever acts as it would "ideally" want to do under complete liberty. They also imply that it generally would be difficult to estimate the degree of freedom with which decisions were taken by the country on the contents of the programme. In other words, the existence of constraints on the freedom to choose cannot be used to support an absence of ownership; indeed the impact of constraints on choice cannot be easily estimated.

We also cannot easily assess the extent of ownership by looking at the choices made, except perhaps for those rare occasions when one is able to observe all the steps in the decision making on a country programme right from its initial conception. Nor can we look at whether the programme was implemented or not, since there is no necessary perfect correlation between "degree of ownership" however defined and degree of implementation.

In the final analysis, then, we would posit that the defining quality of ownership is a country's acceptance without coercion of full responsibility for the outcome of a programme and therefore rationally insisting on acting in self-interest to maximize the expected utility of its citizens obtained from the programme, in the face of the constraints it faces. This acceptance of responsibility would be demonstrated by certain signals and efforts in support of the programme – before, during, and after implementation of the programme. The acceptance would lead the country to take certain initiatives and actions to further its wishes and protect its interests during the design and implementation of the programme. The initiatives and actions reflect rather than determine ownership.

B. Policy consistency

A programme that is owned would tend to be consistent with the general economic framework from which flow government policy of the country. In other words, although "expressions of political support" may be useful in assessing ownership and hence commitment to a programme, the expressions must be credible. *Ex ante*, such credibility would be enhanced by looking at a country's policies in the recent past and by looking at current policies outside the framework of the programme, when the programme is not comprehensive. When the programme implies major changes in economic framework of the government/country, then the country can use credible signals to demonstrate its belief that it owns the programme. One such signal is, of course, active participation in the programme design.

C. Country representatives

In the context of country ownership of a reform programme, we would argue that acceptance by a country of responsibility for a programme must be credibly demonstrated. Thus, the question arises as to how a country as a whole demonstrates acceptance of responsibility for a programme, since, typically, the government in power has the responsibility for the design and implementation of a programme. Ideally, then, there is a strong case for having the citizens as a group demonstrate acceptance of responsibility for the programme of the government. This could be done directly, e.g., via a referendum, or indirectly via the people's representatives in the parliament. In principle, this direct or indirect demonstration of acceptance of responsibility by the people must be without coercion: hence, there must be some minimum democratic rights of the people.

III. Ownership and programming

Not surprisingly, available evidence indicates that success of IMF-supported programmes, in achieving their objectives, depends on their being resolutely implemented. Several objectives (intermediate or final), including increased investment and economic growth, can suffer initial setbacks during implementation; hence determined pursuit of policies with no serious policy reversal is important. The general view among those who have discussed reform programmes and their implementation, or success in general in attaining their objectives, is that if a country "owns" a programme, it's commitment to implementation is stronger (Johnson and

Wasty, 1993; Killick, 1997; Killick et al., 1998; and Tsikata, 2003). In addition, many have underscored that with ownership the programme may be better in the sense of being more realistic in its objectives and in using instruments that could more assuredly attain the objectives. For both reasons, programme success is expected to be correlated with degree of ownership.

Johnson and Wasty (1993), in their statistical analysis of 81 World Bank policy-based lending operations during the period 1980 to 1988, in 38 countries, found "a significant degree of positive correlation between program success and borrower ownership". Programme success is as classified by the Bank's Operation Evaluation Department: namely, each programme's outcome is classified as highly satisfactory, satisfactory, unsatisfactory, or very unsatisfactory.

Killick and his collaborators (1998: 90) stated that in eighteen of twenty-one countries studied, "the extent of ownership, or its absence, was found to have exerted a decisive influence on the degree of program implementation". They argue (p. 98) that "ownership has strong explanatory power because it is a proxy indicator of the extent to which the policy reforms in question are perceived by those who must execute them as being in their own, and their compatriots' interests". In this context, they underscore (p. 98) that "the objectives and interests of donor agencies and of recipient governments can rarely be expected to coincide".

Putting it somewhat differently, then, ownership matters because country authorities are expected to be resolute in taking the appropriate steps domestically to ensure full implementation. From our perspective, the most important steps are seeking proper domestic legitimation for the programme and establishing appropriate institutional and organizational arrangements for effective monitoring of developments and full implementation even in the presence of serious and adverse unforeseen developments.

A. Political legitimacy

Legitimation will prevent certain "political economy" factors from disrupting programme implementation. Ivanova et al. (2003) in an econometric study of the factors explaining implementation of IMF-supported programmes found that "political economy" factors were the primary explananda. Other possible factors, *a priori*, namely, the effort of the IMF, the extent and structure of conditionality, and the initial and external conditions, did not "materially influence" implementation. Here the authors constructed three variables to gauge IMF support: (1) IMF effort, measured as the dollar costs of staff time allocated to a programme; (2) number of IMF staff missions involved; and (3) the number of mission days. As they put it (Ivanova et al.: 28): "strong vested interests in parliament, lack of political cohesion, poor quality of bureaucracy, and ethnic divisions significantly undermine program implementation". For instance, although they caution drawing definitive conclusions from their study, they do find that "[f]or a country that enjoys perfect political stability and no special interests in parliament, the probability of program implementation is very high (96 per cent)".

Mecagni (1999) also found that some 20 per cent (10) of 51 interruptions experienced in the implementation of programmes with 36 countries supported by the SAF/ESAF facilities of the IMF, during 1986–1994, were due to "*political interruptions* serious enough to call into question the continuing authority of the government and, therefore, to prevent meaningful negotiations ..." (p. 220). "Political events" also played a role in the vast majority of the remaining interruptions "although not as disruptively as in the 10 episodes where they were the overriding factor" (Mecagni, 1999: 221). Programme interruptions were defined "as either an interval of more than six months between different annual or multiyear IMF arrangements or a delay of more than six months in completing a program review" (Mecagni, 1999: 217).

Dollar and Svensson (2000) found that success in structural adjustment programmes of the World Bank are mainly explained by political economy factors. In particular, success is associated with democratically elected governments and with political stability. High degrees of ethnic fractionalization and long-term incumbency of regimes are associated with failures, after controlling for other factors. Some donor (World Bank) effort variables (notably preparation and supervision staff time) are highly correlated with the probability of success. But the variables are endogenous, and once the endogeneity is taken into account, the authors find no correlation between any of them and the success or failure of reform programmes.

Johnson (1994) has, indeed, argued that: "for effective implementation of adjustment programs it is necessary for the governments to have the legitimate authority to implement the programs". Without such authority, "a government will not be able to galvanize the support, and hence cooperation, of the people ...". When it does not have legitimate authority to implement a programme, "a government may find that dependence on other forms of power (force, manipulation, persuasion) or of authority (coercion) will enable it to attain only a rather modest degree of implementation in the face of sabotage, indifference, nonparticipation, and minimum effort and compliance from the general population, despite large expenditure of resources".

Governments often start with a legitimation deficit for a programme and fail to take appropriate steps to remove the deficit. Hence, Johnson (1994: 406) states,

> To guarantee virtually full implementation of a reform program, the program designer must ensure that the government and its program managers have the authority to implement the program. When such authority seems absent or when there is sufficient doubt that the government has the authority, the program designer should advise that the government obtain the authority to implement the program; otherwise, the program designer cannot be assured that the program can be carried out.

Country ownership and legitimation of a programme will, thus, be positively correlated. Johnson and Wasty (1993: 7) state that "the following appear to be commonly associated with borrower ownership of the program: (a) political stability; (b) support of (or lack of opposition from) various constituencies; and (c) to a somewhat lesser extent, preconceived official attitudes toward or against certain kinds of reform". In this regard, political stability is not necessarily related to the political regime, and, indeed, as Johnson and Wasty (1993: 10) note, "there is no systematic evidence that a specific regime type intrinsically exhibits a greater degree of political will in support of reform". Support (or lack of opposition) from "pressure groups towards their government's pursuit of reforms" was "[p]erhaps the single most significant factor in government's ownership of the reform program" (Johnson and Wasty, 1993: 8).

The evidence of legitimation is ultimately citizens' consent without coercion, which comes via several processes – open discussion and deliberation, voting, and overwhelming demonstration of support (rather than a narrow majority) in Parliament, in the newspapers, and in civil society voluntary organizations. In this context, of major importance is institutionalizing a process of transparency and public deliberation.[2] Public debate would foster discussion of policy alternatives, including the short-term and long-term costs. Such discussion would also motivate genuine search for compromises among interest groups. Best of all, public debate would facilitate better appreciation by ordinary citizens of how the economy works and how good and bad economic developments arise. This would help in many ways, especially curbing unreasonable budgetary demands and enabling greater understanding of the value of organization, saving, and efficiency of investment.

In today's world, a search for evidence of legitimation would therefore look for signs of free and open public debate, parliamentary deliberation and voting, and referenda. If the need for ownership is to prevent policy reversal then the legitimation must probably entail more than simply majority approval and rather approach consensus. That is, where decisions are taken by voting, super-majorities may be preferred to achieve a degree of legitimation which virtually ensures that there would be no policy reversal during implementation.

B. *Participation and programme legitimation*

When open deliberation of economic policy is not institutionalized in a country, programme legitimation can still be attained by encouraging broad participation of various interest groups and individuals in the design and implementation of the programme. Indeed, this is one of the rational steps taken by a government that wants to ensure country ownership of a programme, irrespective of the actual or perceived legitimacy of the government. Typically, in such a situation, the government is anxious to assume ownership of the programme and uses broad participation of the citizens as a mobilizing tool to muster support, "educate" citizens and ensure country ownership. Although this is always a rational step to take, it is even more so when the government has doubts about its own political legitimacy and hence cannot afford to introduce a reform programme without broad-based support of citizens. In such a case, a government is perhaps not only concerned with preventing policy reversal but also with its own survival.

The description by Obeng (1996) of the case of Ghana and its Structural Adjustment Programme of the 1980s is a good example of what is entailed. As Obeng put it, one of the benefits of the "involvement of all parties in the decision making process" related to the structural adjustment programme of the 1980s was that "as a people, we achieved a sense of ownership of the economic program, a greater acceptance of the consequences of the program, and a stronger commitment to implement".[3] The governments of what became the High-Performing Asian Economies also enhanced the quality and legitimacy of their reform and growth programmes by promoting broad-based participation among citizens and organizations. As Campos and Root (1996: 76) argue in their book, "the East Asian leaders secured the support of economic elites without compromising sound policy through mechanisms designed to facilitate consultation, cooperation, and coordination".[4]

Participation is, perforce, at different levels: expert, political, and social. The government could take the initiative to draw up a programme and then actively mobilize public support and thereby obtain legitimation of the programme. In the process, it could modify the initial draft programme, to take into account the views and concerns of citizens at large. In this context, governments find useful five types of tactical moves, namely: (i) accepting, via consultation and advice, the views of outside experts; (ii) agreeing to the option of reversing or revising the programme after experience with partial implementation; (iii) introducing measures designed to accommodate distributional concerns; (iv) incorporating safety net measures as integral elements in the programme; and (v) ensuring consistency of the overall policy strategy with national cultural values.

Use of experts from prominent public and private interest organizations could prove particularly useful to a policy reform minded government that has, nevertheless, lost credibility with the populace (perhaps because it took too long to come up with a serious programme of action), or to a regime that has just taken over the reins of political office. Any type of regime can invite a group of experts to draw up a policy reform programme, to assure the citizens of the "objectivity" and utilitarian nature of such a programme, and thereby gain the necessary political support for implementation. The government could, alternatively, consult various interest groups (business, labour, agricultural, university professors, etc.) and seek their reactions to its draft programme. In the process, the preferences of these groups become evident, giving the government the opportunity to come up with a consensus programme that, at the same time, addresses the underlying problem(s) of the country.

Major policy reform programmes often get introduced in crises. In such circumstances, the citizens often find it optimal, in a world of uncertainty, to grant authority to a government they consider credible to begin implementation in a way that ensures that reversal or modification would not be costly (if the programme turns out to be unpopular). A government may, therefore, as part of its agenda-setting, give an explicit or implicit commitment that a programme it has put forward will be revised if it proves unpopular during implementation. In this way, the equilibrium programme is attained via a quasi-evolutionary process that also abates implementation costs.

As noted repeatedly in discussions of policy reform, distributional conflicts could cause delays in implementing reforms. Typically, where countries succeed in finding consensus solutions, the programmes include various devices that address distributional concerns, in order to secure the support of various groups. So-called heterodox stabilization programmes[5] employing controls with free-market policies – for instance, combining major monetary and fiscal reforms and price controls with exchange rate as a nominal anchor – could be seen as devices to balance distributional concerns of various groups, in the interest of obtaining consensus and limiting implementation costs. In the same vein, reform programmes often include ceilings on wage increases, on taxation of certain groups, on the speed of price liberalization, and on the adjustment of prices of parastatal goods and services. The challenge for policy formulation is to contain any associated allocative inefficiencies and prevent degeneration of certain policies into wasteful patronage activities or populism. For example, taxes and expenditures outside the normal budgetary processes (extrabudgetary funds) designed specifically to favour certain groups in order to obtain their support could erode a policy of fiscal restraint and make difficult assessment of effective taxation and protection of different commodities and services, while further opening doors to corrupt and other diversionary activities.

Safety-net programmes have become major ways by which governments stave off social unrest and obtain political support from what could be a large portion of the population.[6] These are poverty alleviation and income maintenance programmes targeted to the lowest income groups of the population. Temporary public works employment programmes or demand-based social funds are examples of safety nets.[7]

When governments want political support for major policy reforms, they sometimes need to demonstrate that the reforms conform to or do not violate fundamental values of the societies; for these values are among focal points for economic policy. Hence, if a government becomes unsure about the consistency of its proposed reforms with the values and ideological focal points of the society, it will probably need to launch a frontal intellectual attack on these focal points to convince the citizens of the country that the focal points are themselves inconsistent with achieving a satisfactory (high) level of economic welfare.

C. Ownership and policy soundness

We have argued that adjustment programmes need not be designed locally but that for ownership and hence full implementation they should as a minimum be always legitimated by the populace at large. We now want to underscore that the programmes must also be sustainable.

If a programme is going to be supported by outsiders – in particular by powerful creditors – then the outsiders must be convinced of the sustainability of the economic policies before they would give their support. The country authorities also need to ensure that, despite their authority and the legitimation of the programme, developments along the way would not induce the populace to withdraw its support. To obtain the support of the outsiders would normally require that: (i) the policies are well founded in accepted social scientific theory and international experience; (ii) there is credible commitment of the government to the policies; and (iii) there is adequate capacity of the state and society to implement the policies. Commitment of the government would be revealed by appropriate signalling – especially evidence of legitimation and the very content of the programme itself. Similarly, signals of the willingness and capacity of the state and society to implement the programme would include the sequencing of measures to take due account of state capacity to implement, a credible state capacity building programme, and state-society cooperative frameworks to prevent policy reversals.

IV. Policy-based conditionality and its critics

Conditionality could be seen, charitably, as a set of understandings reached by recipient countries with their donors/creditors on the conduct of economic policy. It emerges from a bargaining process between donors and recipients,[8] with the equilibrium set of conditions determined by several factors. In principle, the objective is to arrive at a set of policies voluntarily agreed by both sides that would resolve the macroeconomic and/or structural (institutional and organizational) problems of the country well enough to raise the per capita income growth rate much nearer to its potential, lower inflation, and improve the balance of payments prospects.

A. Role of conditionality

The main objectives of the understandings are to increase the probability of prompt repayment of debt and sometimes even to ensure that the funds (including grants) do not support policies inconsistent with the values of the creditors. In other words, the creditors/donors typically want the funds to be used productively, and that the recipient government is able to collect taxes and the country able to generate the foreign exchange to facilitate timely repayment of any debt assumed.[9] In some cases, creditors/donors may also want to have the country graduate out of some types of borrowing (or unrequited receipts) from them. In principle, then, conditionality is all about promoting sound policies that resolutely address the economic problems of the aid recipient country. As Ahmed et al. (2001) put it in writing about IMF conditionality: “conditionality provides safeguards to the IMF that the money it has lent is being used for the intended purpose – to facilitate the adjustment process – and that the member country will be able to repay what it has borrowed from the IMF's pool of funds (to which all of its member countries have contributed)". In addition, the understandings are really also constrained by obligations of members not to pursue certain policies except perhaps for temporary emergency purposes – such as exchange policies inimical to multilateral trade and payments (Johnson, 1977; and IMFIEO, 2002).

Collier et al. (1997) have distinguished five objectives of conditionality: inducement, selectivity, paternalism, restraint and signalling. *Inducement*, which is the dominant use of conditionality, is the offer of financial support in exchange for the country authorities introducing a certain set of policies. To Collier et al., the aid donor is buying the policies and hence really owns them, not the aid-recipient country. *Selectivity* is where the maintenance of a good policy environment is used as a condition for aid. This means, in the context of Collier et al., that the conditionality cannot at the same be an inducement since no change in policy is called for. *Paternalism* is where the aid is conditional on its being spent on particular goods or services. It is obvious that this kind of objective is not relevant for macroeconomic or broad structural reform programmes, which are the arena where the conditionality debate is most interesting.

A reform-minded government may want to use conditionality as a *restraint*, basically hoping that the reforms would be protected from reversal by domestic political pressures both during its term of office and after. This use of conditionality has some affinity with the role that IMF and World Bank conditionality supposedly have played in many country programmes. The two organizations have been said to be willing to take the blame for unpopular policies and thereby provide cover for governments. It seems clear that a government which uses conditionality in this way cannot easily claim ownership for a programme even if all the policies contained in the programme are its own, because it refuses to take full responsibility for the outcome of the programme. *Signalling* is when conditionality is used to provide information to the private sector that the donor has given its seal of approval to the future policies of the country authorities. This objective is more popularly expressed in the context of the IMF and the World Bank as the financial support having a "catalytic effect" in attracting other financial flows to the country, especially from the private sector. The catalytic or signalling effect works, of course, only if the conditionality has a reputation of indeed inducing sound policies by governments.

B. Criticisms of conditionality

According to critics, conditionality as an attempt to buy policy change with financial aid ignores certain countervailing factors. Most notably, the aid by alleviating fiscal and payments pressures could daunt the incentive for policy change. This aggravates a time inconsistency problem, namely, that once the aid was received unless the government wanted the reform it could reverse it. In addition, when a government does not sustain the reform, it has not been typically punished, for reasons that include the fact that to cut off the recipient country from further assistance would aggravate its payments problem thereby threatening its ability to repay the very aid donors, where relevant (Collier, 2001).

Some critics see conditionality as very often essentially coercive. Killick, for instance, states: "Conditionality is ... characterized by the use of financial leverage to promote donor objectives". This is not meant to insinuate that the policies are necessarily bad for the recipient country, but only to emphasize that negotiations involving conditionality are not simply pure "policy dialogues", and that the conditions are not typically consensual between recipient countries and their creditors/donors, particularly where the international financial organizations are concerned (Killick, 1997; and Killick et al., 1998).

The overarching theme is that as a matter of empirical fact, the critics argue, policy-based conditionality has not generally achieved its ultimate objective of ensuring sound policies, because the programmes with conditionality are not sufficiently implemented, and this in turn is mainly related to the fact that the recipient countries do not own the policies and also do not get punished for failure to implement policies or for policy reversals. Policies of recipients change, the argument goes, for reasons that are exogenous to aid finance. As Killick et al. (1998: 165) put it,

> In the general case, conditionality is not an effective means of improving economic policies in recipient countries. The incentive system, most notably the absence of a credible threat of punishment of non-implementation, is usually inadequate in the face of differences between donors and governments about objectives and priorities ...

Bird (1998: 107) argues that implementation of IMF and World Bank conditionality "lies on a knife edge". As he puts it,

> There may be some governments that negotiate programs with little intention of carrying them through. There may be others where, although the intention is to implement the program, the effects of the program turn out to differ from what was expected, with the difference being either that there are higher net benefits[10] or higher net costs, and in these circumstances, governments dynamically adjust their behavior; noncompliance is the result. It is, therefore, unsurprising that poor implementation is a common feature of IFI-supported programs.

Collier (1997) also notes that because using aid as a means to buy policy reform, via the instrument of conditionality, has not worked, it has prevented countries with good policies from separating themselves within a set of countries that as a group, such as the African countries, have low risk-weighted return rating among investors because of poor policies on average. In a similar vein, Dollar and Svensson (2000) argue in general that their results "support the view that the best justification for policy-based lending is as a commitment technology for sincere reformers. However, the effectiveness of this technology is undermined if adjustment loans are given indiscriminately".

According to the critics, the poor relationship between conditionality and programme implementation has meant, among other things, that agreeing a programme supported by the multilateral financial organizations (notably the IMF and the World Bank) has not served to raise the credibility of a country's policies in the eyes of potential investors. In other words, conditionality has not in itself engendered good policies and has had no perceptible catalytic effect in attracting private capital. If anything, it has had the effect of wasting resources on poor policy environments.

Rodrik (1996: 190) finds "no evidence that multilateral lending has acted as a catalyst for private flows". At the same time he finds "some evidence that World Bank lending has focused on countries with brighter economic futures (once levels of indebtedness are accounted for)". This would seem to indicate that these loans have been assessed by the private sector, and correctly so, as having little or no information content in predicting where it is most profitable for them to lend and invest among the low- and middle-income countries of the world. Claessens (1996: 201) in his comment on Rodrik's paper pointed out, however, that causality tests show that for many countries foreign direct investment (FDI) "is not related to any other capital flow". Indeed, he asserted that, in general, "FDI investors do not need much signalling, perhaps not even by multilaterals ...". Moreover, the regression results of Rodrik in his view "make clear that the impact of multilateral lending should be measured not by subsequent private flows alone, but also by its developmental impact, including growth, poverty reduction, and increased domestic confidence (as reflected in investment, for example)" (Classens, 1996: 202).

V. Selectivity

Killick (1997) in line with others (Kahler, 1992), has argued for an approach to aid and adjustment grants and loans that virtually eliminates hard-core conditionality. Killick et al. (1998: 11) think of hard-core conditionality as "measures that would not otherwise be undertaken or not within the time frame desired by the lender, promised involuntarily by governments in urgent need of the money to which the measures are attached". The approach, summarized by Killick, would be founded on four principles: ownership, selectivity, support, and dialogue.

A. Proposals

Selectivity is the most challenging for the donor (lender or grant giver). According to most current users of the concept, perhaps, it calls for "greater concentration of aid on governments with a demonstrated commitment to the pursuit of sound policies" (Killick et al., 1998: 179). Such a demonstration of commitment could, for instance, come from prior action. As Kahler (1992) shows: "prior commitment and policy action (taken before external support is offered) is a good predictor of successful implementation". Rodrik (1996) also supports concentrating loans on countries with good policy environments. Of importance to underscore is that programmes selected for support would be owned by the country. Such an approach still would permit aid/loans for some special reasons, such as for post-war (or post-chaos) reconstruction and rehabilitation or to support certain political and economic regime changes.

On a more general plane, the real challenge is deciding the extent to which selectivity should be backward-looking (*ex post*) and the extent to which it should be forward-looking (*ex ante*), the latter permitting a credible commitment to introduce and maintain a good policy environment to qualify a candidate country for selection. Collier (1997), for example, thinks it essential that selectivity be *ex post*, that is, backward-looking. Aid should flow to "already reformed policy environments instead of attempting to buy reform in bad policy environments". In his view (Collier, 2001: 75), to condition aid "on policy *change* rather than policy *level* leads not only to inefficient allocations between countries, but also to inefficient allocations over time". A democratically elected government, for instance, that supposedly has a good policy level but is unwilling to change policies just before an election may find its aid finance squeezed at a very inappropriate time. He states (Collier, 1997: 72),

> With *ex post* selectivity, donors would come in behind reforms rather than anticipating them. For the early stages of reforms, perhaps the first three years, the government would be reforming without aid, establishing a good policy environment. Governments which reformed in this way would unequivocally establish with investors that they were reforming because they believed that the reforms were needed. They would also have to justify the policy changes to their domestic populations in terms of their underlying sense rather than in terms of donor conditions.

Once a country is selected, the "support" in terms of financial assistance should be determined by the financing requirements rather than the policy reforms stipulated. In short, there should be de-linking of conditionality and finance. Support can also come in the form of technical assistance, in a form that enhances self-reliance in recipient countries and hence fosters ownership. In particular, the technical assistance would be demand-driven. The experts should also be independent and the recipient country free to choose, at it wishes, the supplier of the technical assistance.

"Dialogue" in Killick's framework would also foster ownership while improving economic policy. It would basically comprise analytical work and advice given directly by representatives of the donor, at the early stages of decisionmaking, for use by the authorities of the country as it sees fit in its decision-making. The dialogue would allow the donor to influence policy without imposing conditionality, and hence without coercion.

B. Scepticisms

Khan and Sharma (2001: 17) criticize the *ex post* selectivity approach, *inter alia*, because "it would exclude a large number of member countries not having access to international capital markets from IMF lending, and this would be fundamentally inconsistent with the rights of all members to IMF resources under the Articles of Agreement". Unfortunately they discussed only a particular recommendation, which would have, *inter alia*, IMF financial support made at penalty rates. Most believers in selectivity do not argue with the current IMF interest rate policy. Also, as we argue below, selectivity could be governed by rules that are forward-looking. Thus access of members need not be adversely affected, while the incentive to implement sound policies would, as otherwise a member would not be selected for financial support.

Khan and Sharma (2001: 17) also argue that selectivity "provides no guarantees against undesirable changes in the domestic policy stance (perhaps through changes in government), and thus may weaken the safeguards on IMF resources". It is difficult to see how traditional (policy-based) conditionality provides such guarantees after the funds have been disbursed, and the experience is that it does not. This is one reason why certain countries continue to return to the IMF repeatedly to borrow. They also argue (Khan and Sharma, 2002: 29) that there "is also the serious problem of what the IMF should do when a country's policies deteriorate. The disqualification of a country may itself trigger a crisis". This criticism would not apply to forward-looking selectivity. In addition, once a regime of selectivity is in place and known to countries, it is bound to influence their behaviour, and one would tend to see fewer cases of policies deteriorating, since the Good Samaritan would no longer exist. Even the Independent Evaluation Office of the IMF (IMFIEO, 2002) sees greater selectivity as a tool that could be used to address the problem of prolonged use of IMF loans, "although this will always involve difficult judgments" (Goldsbrough et al., 2002: 37).

C. *A case for* ex ante *selectivity*

We also would support greater selectivity in aid giving. But we believe that well-designed *ex ante* selectivity can be superior to *ex post* selectivity. First of all, the thought process used to arrive at *ex post* selectivity is ultimately based on a simple but powerful finding: donors are unwilling to punish countries that do not keep their promise to pursue (introduce or sustain) policy reform. From that, the proponents leap onto the next step: a direct solution – encourage donors to punish those who do not keep their promises – is not possible, because presumably donors will not change their behaviour, for reasons including the incentives of their staff to push money at recipients. That may be true. But then the question becomes: why do the proponents of *ex post* selectivity believe that they have any chance of convincing donors to adopt that approach? The question is extremely hard to answer, especially when we attempt to do so against the backdrop of the finding that much aid is not being given systematically to encourage or support policy reform.

In addition, *ex post* selectivity projects the future using only information from the past. This is unfortunate, especially since the economic policy environment depends crucially on the political environment. If a proponent of *ex post* selectivity finds out via perfect foresight that soon after a certain aid is disbursed, a change in the policy environment would occur, because of political developments, such a proponent, we believe, would prefer to hold the aid and wait, unless of course the aid is regarded as payment for past efforts rather for "keeping up the good work".

In our view, *ex ante* selectivity could be designed so as to be both forward-looking and backward-looking. A good predictor of the future cannot ignore information from the past, so it would incorporate the information used by *ex post* selectivity. Given recipient country ownership, selectivity (*ex ante*) would then be guided by a simple rule: the aid (financial support) would be given when the donor has reasonable belief that the funds would be effective in helping to solve the country's economic problems (including especially poverty alleviation). The effectiveness of the aid would come from the fact that the programme of the country contains sound policies *as a package* (not item by item) and outcomes, as assessed by the donor, and the expectation by the donor that the policies would be implemented, *inter alia*, because they have been legitimated by the populace and the country has appropriate institutional and organizational capacity to implement them. Technical assistance would be given if the recipient country determines that it needs such assistance in specific areas to enhance its capacity to formulate and implement sound policies and if the country chooses the donor as the supplier of the technical assistance.

VI. Reforming conditionality: with and without selectivity

The general consensus is that the number of conditions attached to loans and grants has become too large. The IMF has perhaps been under greatest fire in this regard, particularly with respect to conditionality related to structural factors. The organization accepts this criticism and has been making effort to streamline conditionality (see, e.g., Khan and Sharma, 2001; 2002). But simply streamlining is not enough.

To argue in favour of traditional conditionality is to argue that conditionality improves the prospects for having sound policies and for ensuring implementation. There is general agreement that ownership not conditionality is the important element for effective programme implementation. The issue then becomes whether without conditionality the soundness of programmes would decline. It is possible to conclude from the evidence available that macroeconomic and structural adjustment reform programmes supported by the IMF and the World Bank, with the usual conditionality, have on the whole been sound; namely, controlling for certain unforeseen exogenous shocks, when the programmes have been implemented the policies in the programmes have generally achieved their objectives, even if with a lag, and these objectives have been reasonable in light of the economic situation of the countries (Haque and Khan, 1998). But in the absence of ownership, programmes have not typically been implemented.

Policy-based conditionality, also, cannot guarantee timely repayment of loans and hence safeguards to IMF and World Bank resources; for it cannot guarantee the *sustainability* of sound policies (that is, an absence of policy reversal) after the funds have been disbursed. Only country ownership, because of its appropriate legitimation process, can prevent adverse domestic political developments and guarantee sustainability of policies. Thus, again, for timely repayment of the debt, country ownership is the essential requirement not conditionality.

Perhaps IMF and World Bank conditionality could influence the soundness of programmes if it influences IMF and World Bank effort in country programme design and implementation. Hence, the question becomes whether desirable IMF and World Bank effort (say because of weak capacity of a government and the inability to obtain technical assistance and advice from other sources) will necessarily be adversely affected – that is, precluded from being supplied – by the absence of traditional conditionality. It is easy to see that this need not be so. The quantum of IMF and World Bank effort is not perforce determined by conditionality; only the *nature* of the effort should be so determined. We note that donor country effort (in preparation and supervision activities) does not seem to influence significantly the success or failure of programmes. For example, in the case of World Bank loans, Dollar and Svenson (2000: 4) find no evidence "that any of the variables under the World Bank's control affect the probability of success of an adjustment loan". In our framework, under country ownership, donor's effort is not intended to affect success of a loan, but rather to improve the quality of the policy framework used by the recipient. The result may be to make certain the success of the programme as compared to the counterfactual case of zero donor effort. Donor effort could be directed, generally, at improving the quality of the recipient country policy environment. More narrowly it could focus specifically on assessing, and where relevant helping to improve: (i) the soundness of the programme chosen; (ii) the capacity of the country to implement the programme; and (iii) the adequacy of country ownership of the programme.

A. *Floating tranches*

It has been suggested that conditionality could be made flexible, by employing a device often dubbed "floating tranches" (Khan and Sharma, 2001; 2002). The idea is that the lender – say the IMF – would agree with the authorities of the country on the policy measures but would allow the country some freedom to decide on the timing of the implementation of some of the measures; stipulated tranches of the funds would be accessible only after the particular policy or policies have been implemented. It is never suggested that the implementation of all policies would qualify for floating tranche conditionality, since timely introduction of some policies could be critical for the rest of the programme and since sequencing usually matters in policy implementation.

B. *Outcome-based conditionality*

Another suggestion for reforming conditionality is to move away from "policy-based" conditionality to "outcome-based" conditionality (Khan and Sharma, 2001; 2002). By this is meant that conditionality could focus on certain intermediate and final targets and agreement on a time pattern for the achievement of specific quantitative levels of these variables. For instance, variables such as inflation, gross international reserves, or economic growth could be selected for outcome-based conditionality. Many outcome variables (related to foreign reserves, the budget, and credit, for instance) likely to be used in this approach tend already to feature in conditionality, even when not as performance criteria or even as structural benchmarks. Outcome variables such as growth (of gross domestic product) and overall balance of payments will not, for many countries, be available more frequently than on an annual basis and hence not really usable for conditionality tied to quarterly or semiannual access to funds borrowed. Still the spirit of the suggestion could be captured by avoiding certain policy variables such as exchange rates, tariffs, interest rates, specific commodity prices, reserve requirements, and public sector wages as elements of conditionality.

C. *Explicit precommitment*

Somewhat along the lines of outcome-based conditionality, but much more encompassing, is the suggestion by Bird (1998) to have the international financial organization "require a precommitment to carry the program through to completion". Failure to honour this commitment would adversely affect future access to the organization's resources. In other words, the IMF and the World Bank must become more willing to punish noncompliance with conditionality than they have demonstrated in the past. An argument of Kanbur (2000) is relevant here. Kanbur does not see much of a practical distinction between *ex post* and *ex ante* selectivity, *inter alia*, it seems, because one can simply augment the "frontloading" of conditions, so that countries do not get any money before virtually all the conditions have been met, coupled with being steadfast about punishing for any policy reversal. This frontloading is effectively forcing precommitment.

D. *Outcome-based conditionality with selectivity*

Collier et al. (1997) favour a redesign of conditionality which select countries to support on the basis of their policy environment and then conducting periodic assessment with the achievement of certain outcomes becoming the condition for continued financial support. For instance, future financial support could be made conditional on the achievement of certain levels of growth, after controlling for influences outside the control of the authorities. Outcome-based conditionality related to other objectives such as poverty alleviation could also be designed. In this context, review periods for assessment may need to be one-year or longer.

Gunning (2001: 136) states, among other points, that "outcomes-based allocation promotes accountability by signalling that donors have no involvement in policy choices, being interested only in results". Gunning, like other proponents, argues that outcome-based conditionality cum selectivity would also enable aid to play effectively the signalling and restraint roles denied it under the current regime of policy-based traditional conditionality without selectivity. Namely, aid would provide credible evidence of sound policy environments and could be used by recipient governments to resist policy reversals, "by pointing out that such reversals would lead to a loss of aid".

E. *Credible evidence of ownership and implementation capacity*

Consistent with our approach in this paper, we would suggest replacing traditional conditionality with a different form of conditionality: namely, to qualify for aid (gift or loan) support, a country's representatives must provide adequate proof (credible evidence) to the donor that it (the recipient country) accepts full responsibility (ownership) for a programme considered sound by both sides and that it has in place appropriate institutional and organizational capacity to fully implement the programme. An implication is that in the interest of safeguarding its resources the lender (for example the IMF or the World Bank) must approve the country's programme and establish proof of ownership as well as the existence of adequate implementation capacity. Funds would be disbursed on the basis of their total contribution to the reform effort of the country, rather than on the basis of some specific set of policy implementation schedule.

VII. Operationalizing conditionality under *ex ante* selectivity

We have argued for *ex ante* selectivity. Agreeing conditionality in this framework would entail establishing the reality of ownership, soundness of the programme (policies and outcomes), and adequate implementation capacity of the authorities. This, no doubt could be a formidable undertaking. Lancaster (1999), among others, reminds us that implementing the now popular calls for selectivity and recipient country ownership to enhance aid effectiveness may not be as easy as some would think. We believe that it is a challenge we must accept. Boughton (2003), also, in discussing IMF conditionality in the context of ownership, says: "If ownership is a necessary condition for successful policy implementation, then it follows that the Fund should refuse to lend when ownership is lacking". He goes on to note that applying such a rule "is far from straightforward", *inter alia* because ownership is "not directly observable". Although we agree that applying the rule would not be easy, we believe that it is possible to rationally assess the extent to which ownership exists and to make a reasonably good judgment as to its adequacy, in any particular context, for implementation of a given policy package.

A. *Proof of ownership*

The procedure for assessing ownership must be forward-looking. To conclude that ownership is real, one must have convincing evidence that effective ownership prevailed at the initiation of the programme and that the probability of policy reversal due to political changes is very low, either because such changes are unlikely in the foreseeable future or because any new political leadership likely to emerge would continue to implement the programme. Hence, the assessors must be armed with a theory of that state (predatory, interest group model, democratic and competitive model, etc.) and how the political institutions of the country work. This would, *inter alia*, facilitate a model of the structure and efficiency of the government as an organization (civil service bureaucracy, etc.), and permit an overall assessment of both the commitment and the capacity of government officials and employees to implement the programme. Intra-government rivalries and communication would be important elements in the above analyses and assessments.

The overarching concern is to make sure that, without coercion, virtually everyone in the country is committed to the policies in the programme; namely, that there is national consensus on the policies. Without such commitment and consensus the risk of policy reversal cannot be estimated with confidence. The onus must be on the authorities (the government) to come up with the evidence of commitment and consensus. Knowledge of the system would enable the assessor to form a rational judgment on the credibility of that evidence.

Some guidelines are possible on the methodology of assessing the evidence. Indicators of the existence of ownership would comprise, as a minimum, a "political legitimation indicator" (or test) and an "economic model indicator" (or test). The former would consist of convincing evidence that the programme has evolved out of decisionmaking processes that, in the past history of the country, have resulted in effective cooperation, among all major parties and interest groups, engendering collective agreement, without coercion, on major policy issues. Hence the elements in the evidence would depend on the specific circumstances of a country, including the political regime, ethnolinguistic composition, and consensus building mechanisms. The "economic model indicator" would comprise convincing evidence that the programme is consistent with past (especially recent) economic policies of the country. Apart from this backward-looking element, this latter indicator must also have a forward-looking aspect, which could include public pronouncements of the current government about its future economic policies and the institutional and organizational arrangements to implement those policies.

B. Soundness of policies

Ownership is not sufficient for "selection" for support. The soundness of the policies would be also important. We shall say that the policies of the programme are sound if as a package they are assessed as adequate to achieve the objectives and if the objectives are considered reasonable in light of the economic circumstances of the country. Basically, for a macroeconomic programme, the exercise would involve assessing the reasonableness of objectives – over some period of time (say three to five years) – such as per capita economic growth, balance of payments, external debt and debt service relative to GDP, and inflation; the past and prospective policies that affect these objectives would also be assessed. This may involve evaluating both macroeconomic and microeconomic policies, such as interest rate policy and/or policies to control some monetary variable, real exchange rate policy, external tariff policy as well as policies affecting infrastructure, labour market and human capital, government efficiency, and microeconomic policies in important sectors, e.g., agriculture. Neglect of the microeconomic policies would risk not being able to make an informed judgment about the likelihood of the package of policies being adequate to attain the economic growth objective, especially since microeconomic, including so-called sectoral, policies could neutralize the favourable impact of macroeconomic policies on particular sectors.

Alternatively, of course, it is possible to take an approach somewhat similar to the outcome-based approach to conditionality. This would involve agreeing the objectives and then leaving the country the freedom to decide the means to achieve the objectives, the means being perhaps subject to constraints due to certain international obligations such as requirements of membership in the IMF or the World Trade Organization (WTO). In this case, country teams would not have any obligation to pass judgment on the adequacy of policies, and financial support would begin only after the country had achieved certain objectives. Since, in principle, financial support has positive effects on the targets, the initial level of the objectives would be set taking into account the absence of any financial support. Some countries may find this approach more to their liking and in our view they should have the opportunity to use it, without compromising the requirement of ownership.

C. Country implementation capacity

Given ownership and soundness of policy framework, the next logical step is to test for implementation capacity. Although implementation capacity has been taken into account in establishing conditionality associated with IMF financial support, still, in a few cases, low implementation capacity has played a role in programme interruptions (Mecagni, 1999). This often means that expected technical assistance to remedy capacity weaknesses did not materialize in time or was not as effective as projected. Capacity problems can arise in any area, but budgetary reforms and privatization have proved particularly troublesome for a number of countries.

VIII. Incentive compatibility

We believe that, with the approach outlined in this paper, adequate incentive compatibility will exist to foster effectiveness of aid: there will be self-interest in the recipient countries to implement and sustain sound policies and there will be self-interest within the aid-giving organizations to insist on sound policies and satisfactory outcomes as a condition for future aid.

A. Donor

The proposals contained in this paper will positively alter the incentives of country officers in donor countries and international financial organization to push funds to countries with weak policy environments. A country team must, in recommending financial support of a programme, attest that the programme is sound and that it expects the country to implement the programme. Hence, if the programme is not implemented, the team cannot simply say that there was lack of political will on the part of the government or the political elites of the country. The country team must explain why, *ex ante*, it projected that there would be political will and what factors it could not have foreseen that came into play during the actual implementation phase of the programme. Thus the country team will have self-interest in recommending financial support only to countries that have an excellent chance of sustaining a sound policy environment, given the political environment of the country. There is no doubt that in predicting future behaviour of countries, past behaviour will be heavily weighted, perhaps with weights declining the further away the past date is from the present. The preceding incentive structure could be strengthened by instituting explicit guidelines for the performance evaluation of staff members recommending Board, department or organization approval for a programme that was not implemented, taking due account of the staff members' explanation of why, contrary to their expectation, the country did not implement the programme.

B. Recipient

With ownership, the country should have a self-interest in implementing its programme. Expectation of future interactions with the creditor/donor is another self-interest factor in implementation of its programme, as long as this implementation record affects future behaviour of the creditor/donor towards it. Selectivity, then, becomes an inducement to introducing and sustaining a sound policy environment.

For appropriate incentive-compatibility of the recipient, institutional arrangements must therefore be put in place for the donor/creditor to have a self-interest in punishing non-implementation of the recipient. The insistence on approval of the country team and their onus to explain any failure in predicting implementation is an element of this institutional framework. Even one-off interaction with a particular creditor/donor will not save the recipient country from punishment because of reputation: namely, as long as the behaviour of all potential creditors/donors is influenced by the reputation of the recipient in implementing its programmes in the past. In the case of private creditors, the self-interest comes from the effect on their profits. For multilateral organizations and bilateral creditors/donors, the self-interest comes from the effect on their credibility (in the case of the IMF and the World Bank, for instance, the effect on the value of their good housekeeping seal and hence catalytic effect vis-à-vis private markets).

The IMF, for its part, could further strengthen its incentive regime by a transparent and effective policy toward continuous use of its resources by members. It could, for instance, subject a member to special conditions, including strict prior actions, if it applies for further assistance (beyond a certain objectively determined level) before a certain time period has elapsed since the country's last use of IMF resources (after controlling for the amounts outstanding in relation to quota, perhaps). If a country defaults in its repayment obligations, its membership could be suspended and the country subjected to special conditions before being restored to good standing. Both the limits to continuous access and suspension of membership should be guided by strict rules that are not easily breached. Any waiver of those rules for a country should be very rare, after discussion and approval by a supermajority of the Board members with the bulk of the quota holdings.

IX. Conclusion

In this paper, we have been concerned with the conditions for the elimination of traditional conditionality and the case for doing so in the context of ensuring country ownership of reform programmes. We have argued for a different form of conditionality from the current policy-based conditionality: to qualify for an aid or loan support, a country's representatives must provide adequate proof to the donor that it (the recipient country) accepts full ownership for a programme considered sound by both sides and that it has in place appropriate institutional and organizational capacity to fully implement the programme. An implication is that in the interest of safeguarding its resources the lender (for example, the IMF or the World Bank) must approve the country's programme and establish proof of ownership and adequate implementation capacity. A country team of the international financial organization must, in recommending financial support of a programme, attest that the programme is sound and that it expects the country to implement the programme. But a recipient country could opt for an alternative approach in which it agrees targets/objectives with the lender/aid giver and then have instrument autonomy to take whatever means it finds appropriate to achieve those objectives, except for actions proscribed by its international obligations vis-à-vis (the IMF or the WTO). With this alternative, the country will start receiving funds only after an initial agreed set of objectives (final or intermediate targets) have been realized.

Making major changes in conditionality accompanying programmes supported by the IMF and the World Bank would constitute significant institutional changes in the modus operanda of the world financial system. Hence, there will and should be substantial and sophisticated debate on the merits of taking such a step. The Bretton Woods exchange system did evolve into something quite different from its original form devised soon after World War II, despite fears of many who saw great merits in preserving it in its original form or after making significant but not fundamental modifications to it. We would predict the same for traditional conditionality of the Bretton Woods Institutions, for reasons operating both on the demand and supply side of "aid".

On the demand side, the "absence of policy-based conditionality" attached to financial support will become an intangible asset in world financial markets. The ability to obtain IMF and World Bank support without traditional policy-based conditionality will prove a powerful signal in world financial markets. In other words, traditional conditionality will not survive in an increasingly globalized financial system. Countries that are willing to own their programmes and to implement sound policies will increasingly see an absence of traditional conditionality on IMF and World Bank support as an asset in world financial markets – an indication of trust in their governance ability by the two organizations – and they will demand it as an instrument to separate themselves from certain types of high-risk countries to which financial firms have a prior belief they belong. In contrast, countries with traditional conditionality attached to their support from the IMF or the World Bank will see their creditworthiness negatively affected, relatively, in financial markets. This all comes from the fact that traditional conditionality is seen by the market as a means to get countries who would not otherwise do so to pursue sound policies. The poor record of this approach has damaged the credibility of that sort of conditionality as a signal of good policy environments. Thus, recipient country governments will increasingly demand an absence of traditional conditionality by demonstrating an ability to design and implement programmes that they own and that are appropriately legitimated in their countries.

On the supply side, we believe that selectivity will be increasingly preferred by bilateral donors and by the major shareholders of the multilateral financial organizations for both fiscal and political reasons. The fiscal burden of aid and contributions to multilateral organizations is coming under increasing scrutiny domestically in the industrial countries, and the end of the Cold War has removed an important driving force behind aid without selectivity focusing on the policy environment. Country ownership is essential in making selectivity effective. With selectivity and country ownership, traditional (policy-based) conditionality has no real value in making aid effective. An approach based on periodic assessment of the policy environment, review of recent outcomes (of intermediate and final objectives), and understandings on future objectives would then be preferred to policy-based conditionality, in determining financial support to low- and middle-income countries (by bilaterals and multilaterals).

Nelson (1996) has also pointed out that the objective environment is changing, making conventional conditionality even more difficult to rationalize and monitor; namely, the weight of market-oriented institutional reforms is increasing in reform programmes relative to stabilization and liberalization reforms. Institutional reforms tend to achieve results at a slower pace and typically require greater domestic consultation and participation to design and implement successfully. An obvious conclusion is that the demand for ownership will be necessarily stronger in such cases and the periodic assessment of the policy environment and a focus on outcomes may be a better approach to monitoring progress than the specification of precise policy (especially quantitative) measures. Thus this factor could affect the nature of conditionality desired by both demanders and suppliers of aid. We would note, though, that while it may be true that the effectiveness of institutional reforms may take longer to assess, it is still possible to design policy-based conditionality even for institutional reforms. The one difference is that the nature and sequencing of the policies need to be country-specific and the recipient country will typically have the freedom to select from among best practices the particular institutional reforms it wants to implement. This is the approach, for instance, that the Bretton Woods institutions have been taking in supporting financial sector reforms in low and middle-income countries and in the former socialist countries.

The transformation to a world without (traditional) policy-based conditionality may go through a period with dual structure, where some programmes have no traditional conditionality attached to them while others have such conditionality. But we do not believe selectivity would lead to undesirable distribution of aid resources, except in the initial stage before the recipient countries have had the opportunity to adjust to the new reality. Rather, during the period of dual-structure policy-based conditionality could be used as a threat, and absence of such conditionality as a carrot, to encourage countries not to reverse implementation of sound policies promised in programmes they own and that are financially supported by either of the Bretton Woods institutions. In that world, as far as the IMF is concerned, it would still be beneficial to have explicit and transparent rules that are resolutely enforced to: (i) limit continuous use of IMF resources and (ii) to punish defaulters in making timely repayment of debt to the institution.

Notes

1 For general analysis of why countries come to the IMF see, e.g., Conway (1994) and Bird (1996).
2 See the discussion by Faruquee (1994) of a national debate in Nigeria of a suggested IMF-related adjustment programme. Unfortunately, that process was not sustained over time.
3 Also of interest here is Tsikata (2003), who compares ownership issues and experience as they arose in Ghana and the United Republic of Tanzania.
4 Famous among the "mechanisms" were deliberation councils comprising representatives from the private sector and the public sector. Each council assisted the government in formulating policies "that would enhance the performance of a particular segment of the private sector (if not the private sector as a whole)" (Campos and Root, 1996: 79).
5 See Bruno (1993) for a discussion and case studies of such an approach to stabilization.
6 For analysis and case studies, see, e.g., Graham (1994) and Stewart (1995).
7 See, for example, the discussion of Bolivia's Emergency Social fund by Graham (1994: 54–82), which she credits for increasing the political sustainability of reform as well as contributing to poverty reduction.
8 An interesting model of the bargaining process involved, with specific application to the structural adjustment loans of the World Bank, is found in Mosley (1987).
9 See the critique by Sachs (1989) of conditionality in the case of countries experiencing serious debt crisis and Buira (2003) for a critique of conditionality in the context of programmes by the IMF.
10 The point here, according to Bird (1998: 106) is that if, for example, the balance of payments situation of the country improves – say because of improved income terms of trade – "the government has the opportunity to regain independent control over economic policy, and disengaging from the IFIs may now enhance the government's political prospects".

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