

Willett, Thomas D.

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## Towards a broader public choice analysis of the International Monetary Fund

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**Towards A Broader Public Choice Analysis  
of the International Monetary Fund**

Thomas D. Willett  
Director, Claremont Institute of  
Economic Policy Studies  
and  
Horton Professor of Economics  
Claremont McKenna College  
and  
Claremont Graduate University

Address: School of Politics and Economics  
Claremont Graduate University  
160 East 10<sup>th</sup> Street  
Claremont, CA 91711  
Tel: 909-621-8787  
Fax: 909-621-8460  
E-mail: [Thomas.Willett@cgu.edu](mailto:Thomas.Willett@cgu.edu)

For David Andrews, Randall Henning, and Louis Pauly, eds., *Organizing the World's Money, a Festschrift in honor of Benjamin J. Cohen*. Cornell University Press.

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## **I. Introduction**

The operations of the Bretton Woods twins – the International Monetary Fund and World Bank – have come under increasing public scrutiny in recent years. Indeed, criticisms from the far left and the far right have become so vehement that in 1999, the U.S. Congress almost failed to pass legislation to provide the U.S. share of an internationally agreed increase in IMF funding. In the spring of 2000, organizations that had protested against the World Trade Organization in Seattle turned their attention to Washington D.C. and attempted to shut down the high level meetings of the IMF's and World Bank's international oversight committees. And in fall 2001, the IMF first planned to condense the schedule of its annual meetings before finally canceling them altogether in the wake of the disasters at the World Trade Center and the Pentagon.

One common feature of most of the harshest critics from both the left and the right is a strong sense of certainty that how these international financial institutions operate is well understood. It has apparently given these critics little pause that the agreement between the left and the right that the international financial institutions are bad arises only because these two camps hold diametrically opposed views of what these institutions actually do. The left sees the international financial institutions as instruments of global capitalism, forcing excessively harsh austerity on poor nations, while the right sees them as examples of bureaucratic inefficiency that help bolster global socialism by providing funds to national governments and thus helping them to postpone necessary economic reforms.

As one turns to scholarly writing, the situation is only a little better. Many authors seem anxious to jump as quickly as possible to policy conclusions and generally take as given some particular assumption about the behavior of the international financial institutions, often bolstered by an example or two. However, while such papers typically consider only one or

two behavioral assumptions, across these analyses a substantial range of different assumptions about the positive political economy of the international financial institutions can be found. Often the international financial institutions are depicted as being dominated by virtually autonomous international bureaucrats with little or no effective oversight. Alternatively, many in Europe, Japan, and the developing world view the international financial institutions as lackeys of U.S. foreign policy with little independence of their own. A third common view sees the international financial institutions as captured by the rent seeking activities of the major private financial institutions. The Marxists, of course, see these second and third assumptions as equivalent, with big capital running both U.S. foreign policy and the international financial institutions. Moreover, there are still those who assume that the international financial institutions operate primarily according to their concepts of the global public interest. Indeed this view is implicit in many, if not most, discussions by professional economists of international monetary issues.

Clearly, this wide range of views signals the need for better positive political economy research. However, the number of studies which attempt to carefully develop and/or test hypothesis about the behavior of international financial institutions is distressing small, especially in contrast to the large literature which attempts to evaluate the effectiveness of international financial institutions programs.<sup>1</sup>

This paper has the dual purposes of calling attention to this important lacuna in international political economy research and suggesting directions for how this gap might be filled. I argue that adopting a public choice approach is likely to be fruitful. It is important

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<sup>1</sup> Exceptions include important work by Graham Bird, Tony Killick, and Roland Vaubel. Very recently there has been a substantial increase in quantitative political economy research on the IMF by political scientists. See, for example, Edwards (2001), Gould (2001), Kapur (2000), Martin (2000), Stone (2000), Thacker (1999) and Vreeland (2001).

that students and scholars interested in international political economy understand that public choice does not present a specific model of political economy but rather a whole set of models. For example some public choice theories emphasize the role of the public through median voter models while others emphasize the role of special interests and rent seeking. Recognizing that public choice offers a broad framework suggests that it offers a convenient way of trying to synthesize the various considerations emphasized in the popular single explanation approaches to international political economy.

To date, however, there has been relatively little explicit public choice analysis of the IMF and the best known of these by Roland Vaubel take a very narrow focus that emphasizes the role of bureaucratic incentives for budget maximization. In this paper I seek to illustrate how public choice analysis can be used in a much broader way to take multiple considerations into account.

I also emphasize the need for including within the tool kits of public choice and political economy analysts a softer set of assumptions about the motives of senior international bureaucrats under some types of conditions and argue that these are quite relevant for analysis of the IMF. The approach offered emphasizes the need to consider not only the multiple sources of external pressures on the IMF, but also to begin to disaggregate analysis of the IMF itself, at least to the point of distinguishing between the motivations and relative power of management and staff. In the process I highlight the relationships of the broader and softer public choice interpretation offered here with the hard core budget maximization analysis of Vaubel and with several of the other major political economy analyses of the IMF.

The next section presents a brief overview of the traditional major political economy perspectives and how they tend to view the IMF. I then sketch out key elements of the broader public choice approach as a synthesizing framework and provide illustrations of how this approach can be applied to the issue of possible biases in IMF lending. Furthermore, I argue that bureaucratic incentives for budget maximization play much less of a role at the IMF than in the typical domestic government bureau, but that there are other possible, “softer” sources of bias that are of serious concern as well.

The remaining sections discuss the growth of conditionality, the issue of ownership of IMF programs, and the need for more political economy analysis at the IMF, before concluding with some general remarks on the policy implications of the analysis. I argue that while many needed reforms will be difficult to achieve, a broader public choice approach offers a less pessimistic perspective on these possibilities than does the traditional public choice literature.

### **Major Political Economy Perspectives on the IMF**

Mainstream economists have traditionally adopted an optimal policy approach. in which the range of activities a government or organization should undertake and the specifics of the policies it should pursue are analyzed from the standpoint of economic optimization and market failure theory. This approach assumes a public interest based institution that analyzes the need to provide public goods, correct externalities, and compensate for missing or misperforming markets.

While most mainstream economists regard the number of market failures requiring government action as fairly limited, many on the left see massive market failure. Combined

with a public interest view of government, this leads to criticism of the IMF for being insufficiently activist. In contrast to these idealistic approaches, some conspiracy theorists from the left see the Fund as an agent of the global capitalist class, serving special financial interests at the expense of the poor of the world. They typically look upon the Fund as doing actual harm, and see massive market failure and the need for major income redistribution from the rich to the poor; thus they advocate radical reform of the IMF.<sup>2</sup>

From the right, applications of hard core public choice analysis also conclude that the IMF does harm, but for quite different reasons. This approach tends to assume perfect markets, rent-seeking bureaucrats, and powerful special interest groups. From this perspective the Fund is unnecessary (except as a welfare agency for economists) and should be abolished altogether.<sup>3</sup>

These different traditions have correspondingly different views on the effectiveness of institutions and organizations. The optimal policy approach assumes an autonomous government that effectively implements policy. Critiques from the left tend to see the IMF as all powerful from the standpoint of imposing its will on poor countries, but as very weak from the standpoint of resisting pressures from capitalists' special interests. Hard core public choice analysis from the right typically sees the Fund as having a great deal of autonomy from political oversight, but (at least in some versions) as subject to considerable pressure from special interest groups, typically the financial sector and/or US policy officials. Thus while the IMF is viewed by some critics as autocratic and undemocratic, others see it as a lackey of U.S. foreign policy. And while the idealist tradition in the international relations literature

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<sup>2</sup> See, for example, Danaher (1994).

<sup>3</sup> See, for example, Bandow and Vasquez (1994). Another useful collection of critiques from the right combined with defenses from the middle is presented in McQuillan and Montgomery (1999).

sees international organizations as powerful mechanisms for promoting the public good, realists see them as having little effect.<sup>4</sup>

No wonder, then, that there is widespread disagreement among commentators about the effectiveness of IMF programs. But what does the scientific literature suggest? While popular criticisms from the left fault IMF policy conditionality for its excessive harshness, most systematic studies find that the ability of the IMF to enforce its conditionality has been quite weak.<sup>5</sup> Thus it has become commonplace for critics on the right to argue that the typical effect of IMF programs is to delay rather than promote stabilization and liberalization, although the evidence for such strong formulations has typically been anecdotal rather than systematic.<sup>6</sup>

### **Toward a Broader Public Choice Approach**

It is still not sufficiently recognized that public choice analysis is not a specific theory, but rather an approach that contains a number of specific theories—many of which are mutually contradictory. For example, median voter theory sees the political process as dominated by the public through the voting process, while rent seeking theory sees government as having considerable autonomy from the general voter but not from specified interests. Thus public choice analysis should not be seen as one of the specific contending theories within the IPE literature, but rather as the name that most economists and some other social scientists have given to political economy analysis.<sup>7</sup>

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<sup>4</sup> For discussion of these perspectives, see Dillon, Ilgen and Willett (1991). For perspectives on the recent debates see Willett (2001b) and Williamson (2000).

<sup>5</sup> See the analysis and references in Bird (1996), Killick (1996), and (1998), and Krueger (1998).

<sup>6</sup> As noted by Krueger (1998).

<sup>7</sup> For a more general discussion of the public choice approach and its relation to other major approaches to the political economy of international economic relations, see Willett (1995) and the references therein. See also the contribution by Robert Gilpin to this volume.



It is true that the range of public choice analysis does not encompass the full array of political economy approaches. Public choice analysis typically focuses on rationality, the role of self interest and issues of collective action and the influence of institutions; thus it tends to be skeptical both of unified rational actor models and sociological models that privilege the group over the individual. Still, the range of consideration that it can encompass is quite impressive.

Unfortunately, however, many of the most famous applications of public choice analysis rest on very strong assumptions and contribute to the false impression that public choice is a specific narrow theory. For example, public choice analysis of the IMF was pioneered by Roland Vaubel (1986, 1991). His work provided a healthy correction to the optimal policy view implicit in much of the economic literature and offered a number of useful insights into the behavior of the IMF and other international institutions. However, as will be further discussed in the following section Vaubel's analysis was based on the assumptions of great IMF autonomy and a strong organizational interest in budget maximization. This turns out to be misleading in a number of respects, and much of the evidence offered in support of Vaubel's analysis is equally consistent with other models.<sup>8</sup>

My general point is that it is important to distinguish between criticisms of specific applications of public choice and the general approach.<sup>9</sup> Indeed, both the public choice and IPE literature more generally have tended to be dominated by a variety of narrow approaches that overlook too many important aspects of the situations they analyze. While the proliferation of contending narrow approaches is understandable in terms of the incentive structures of academia, at best it suggests that we are only at the initial stage of a progressive

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<sup>8</sup> See Willett 2001a.

research agenda. A disinterested look at the evidence shows that most of these specific theories have some explanatory power, and that none of them have complete explanatory power. Thus we need to begin to think more systematically in terms of broader frameworks that allow various specific theories as special cases while developing higher level analysis of the major considerations that influence the relative importance of the specific theories or factors in different situations.<sup>10</sup>

The approach advocated in this paper is a middle of the road synthesis of elements of a number of different theories or approaches. It recognizes both market and government failure, but sees neither as pervasive or necessarily dominant. It views the IMF as dominated by officials who are neither saints nor sinners; they generally seek to do good, but are not entirely immune to bureaucratic incentives and external pressures. This approach sees governments as regularly facing both domestic and international pressures, but also having some scope for autonomy, the precise magnitude of which varies in systematic ways over time and across both countries and issue areas. It also recognizes the scope for bureaucratic politics and sees domestic pressures coming from both the general public and special interests.

As such, public choice analysis stems from rational choice theory but, unlike many of the formal game theory applications thereof, it focuses on the costs of acquiring information, the difficulties of understanding complex situations, and the coordination and free rider problems that occur where the number of actors involved is large. Thus it helps explain why small well-organized groups can often win politically over the interests of much larger but relatively unorganized groups. Public choice analysis also emphasizes that even where the

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<sup>9</sup> This distinction tends to be overlooked in the general attack on rational choice theory launched by Green and Shapiro (1994). See also the reactions in Friedman (1996).

median voter is dominant, she may be rationally ignorant. Whereas many hard core rational choice modes assume that all relevant actors understand the true structures of the games they are playing, a broader public choice perspective emphasizes informational complexities, uncertainty, and the role of ideas and differing mental models. Such consideration can help explain the political pressures for political business cycles and other policies that create economic instabilities and inefficiencies.<sup>11</sup>

Some have viewed public choice analysis as being inherently conservative or anti-government.<sup>12</sup> This is not so. While it is true that many of the most important contributors to the development of public choice have been from the right of the political spectrum, there have been important counter examples (such as Kenneth Arrow and Mancur Olsen). More generally, being realistic about the difficulties of policy implementation can only make for more effective policy. If a situation is heavily politicized then it is folly to advocate policies that can only be implemented effectively in a politics-free environment.

Of course the broader public choice approach has a serious shortcoming in comparison with many of the more narrow and specific political economy approaches discussed above: it does not offer easy answers. In the first place, it is a framework rather than a specific theory. It is, in effect, a broad eclectic approach to political economy that sees value in many different ways of gaining knowledge. It sees the tracing out of the implications of a narrow set of assumptions to be quite valuable, but it is hostile to the common tendency to generalize excessively from such focused analysis. It argues that genuine testing must attempt to discriminate among alternative hypothesis, not simply to settle for evidence consistent with

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<sup>10</sup> See Dillon, Odell, and Willett (1990).

<sup>11</sup> On rational ignorance and the difficulties of processing complex information, see John Odell's contribution to this volume.

<sup>12</sup> See, for example, the characterization by Gilpin in this volume.

one's favored model. It does not offer quick, easy conclusions that apply to all situations – either with respect to diagnosis or prescription. This seeming disadvantage, however, may be its greatest virtue.

### **Applications to IMF Lending**

As noted above, public choice analysis of the IMF began with an important series of papers by Roland Vaubel (1986, 1991, and 1996). In these, Vaubel makes the assumption—common to much of the public choice literature—that “bureaucracies are interested in power, prestige, and amenities. To achieve these objectives, they try to maximize their budget, their staff, and their independence” (1996, p. 195).

However, another important contributor to the development of public choice analysis of international organizations, Bruno Frey (1997), makes a contrary argument. In his view, “the public choice literature is rather mute on the question of how employees in an international organization use the leeway accorded them” (p. 120), at least as a matter of principle. And in contrast to Vaubel, Frey offers the more sociologically appealing suggestion that “international bureaucrats pursue those policies that give them most prestige and influence within the reference groups with which they are connected” (p. 121).

Frey's call for greater study of the objectives pursued within international organizations is of crucial importance. These are unlikely to be the same across all organizations and situations. In deed they may well vary at different levels of an organization, as will the degree to which top-level managers can control lower level staff. Depending on the reasons for divergence from public interest behavior, different reform strategies might be

suggested. Furthermore, the prospects for effective reforms may also be affected by the reasons for the observed behavior.

To take a concrete example, there is rather widespread agreement that at least at times the IMF has suffered from tendencies for loan pushing and insufficient enforcement of loan conditionality. Such behavior is not consistent with the saintly or public interest view of IMF officials, but there are different ways to understand the observed behavior. In Vaubel's hard core analysis, loan pushing by the IMF is seen as a result of budget maximization objectives. An alternative explanation, however, is that IMF staff's career advancement may be put at risk if they lose access to high level national officials in the countries they monitor. Given this incentive, the ability of national officials to impede staff access may provide them with leverage to minimize IMF criticisms and thereby secure continued financing. The problems with such perceived incentives for IMF staff are discussed in the recent IMF external review of its surveillance policies (IMF 1999). If the path to advancement is tied to never rocking the boat, then the IMF will always operate as if it were hostage to client states. The report found concerns among IMF staff "that a report that is incisive but offends the [national] authorities is damaging to a mission chief's career while one that is bland and later turns out to be lacking in some important respect will be overlooked." (p.90). As the report indicates, it is important that those in charge at the Fund "back up staff who give frank advice" (p. 91). More generally, the problems associated with loan pushing are likely to be much more amenable to correction if we understand why this behavior takes place—that is, if it is due primarily to "soft" considerations like staff advancement incentives rather than the budget maximization objectives at the center of "hard core" analyses.

As for national monetary policy, I have argued in earlier work that the budget maximization analysis has a low degree of applicability to relatively independent central banks, and suggested that a softer public choice approach that focused more on the external pressures on the monetary discussion makers would prove more fruitful.<sup>13</sup> This analysis was in the spirit of Chant and Acheson (1972) and Acheson and Chant (1973), who provided the first explicit public choice analysis of the objective functions of monetary authorities. Assuming that central bankers' primary goals were prestige and self-preservation, these papers helped explain a number of aspects of central bank behavior, especially the emphasis on secrecy.

Applying such analysis to international financial institutions suggests that budget considerations should be more important at the IMF than at national central banks, but less than at the world bank.<sup>14</sup> For top IMF officials they are likely to be a relatively low priority. An able staff is helpful for monetary officials to accomplish objectives of prestige and influence reputation with relevant peer groups, but this staff need not be a very large one. At the IMF, the management and top bureaucrats have little incentives to hold down staff salaries and indeed Fund officials are extremely well paid, but top IMF managers would seem to have relatively low personal incentives to expand staff size either to increase their prestige or their chances for further advancement.<sup>15</sup>

This example illustrates the need to distinguish more systematically between the objectives and autonomy of the Fund's staff (international civil servants) versus its management (the Managing Director and Deputy Managing Directors, who are politically

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<sup>13</sup> See Willett (1990).

<sup>14</sup> See Willett (2000a).

<sup>15</sup> The budget maximization assumption has come under general attack in the recent literature on bureaucracy. For valuable reviews, see Borcharding and Khursheed (1998), Moe (1997) and Wintrobe (1997).

appointed for specific terms) and Executive Board. For example, neither Martin (2000) nor Vaubel (1996) distinguish between the Fund's management and staff. Incentives and objectives can differ substantially between them, however, Vaubel's loan pushing analysis is likely to be much more relevant for staff than management.

While less cynical than some hard core applications of public choice theory, the "soft core" approach I am advocating here should not be taken as the totally optimistic half brother of the public interest/optimal policy approach. Even assuming away greed and major character failures, there are numerous sources of bias to which all but saints may be susceptible. One is that humans tend to respond to lobbying pressure. Thus if most of the "advice" that senior officials receive is from a few selective groups of national policy officials and representatives of the financial community, it is these points of view that are likely to help shape the officials' own perceptions—neither personal threats nor bribery are required. A second powerful motivation is freedom to do one's job. Thus officials will typically prefer discretion over rules and prefer to minimize external monitoring of their actions. A third motivation is the fear of failure and the desire to minimize criticism.

Motives two and three—desire for freedom of action and dislike of failure or criticism—combine to yield a preference for lack of transparency in some important areas. This has been a common characteristic in national central banks as well as the Fund. Of course there are quite valid arguments why completely transparency of discussions of monetary policy making and IMF programs is not desirable either. Certainly a balance must be found. The point made by the public choice perspective is that, if left entirely to themselves, senior officials would likely have a human tendency to draw the line at less transparency than would the well informed impartial spectator. Lack of transparency has indeed been a major source of

criticism of the IMF, although strong public pressure from the Congress and others in recent years has induced a movement toward substantially greater transparency (a development which surely suggest the limits of the Fund's bureaucratic autonomy).

Fear of failure also suggests that government officials will in general tend to seek excessive insurance against crisis.<sup>16</sup> Thus we would expect the management of the Fund to prefer to err on the side of quota increases and IMF packages that were too large rather than too small. This would also tend to bias Fund officials against pulling the plug on programs quickly enough when compliance has been unsatisfactory, and to agree to initiate programs even though the odds for success are not high.<sup>17</sup> Here the early experiences of the new Bush administration are instructive. The new Secretary of the Treasury, Paul O'Neil, strongly signaled the intention of the Bush administration to be much tougher on international bailouts than the Clinton White House, yet within its first year of office the Bush team ended up supporting bailouts for both Turkey and Argentina that many international economists believed did not meet the IMF's normal standards.

Neither of these instances demonstrated that the principals—the major IMF shareholders—were unable to control an unwieldy bureaucracy.<sup>18</sup> Indeed, in the Argentine case many of the key negotiations took place in the U.S. Treasury. Geopolitical considerations certainly played an important role in the case of the loan to Turkey. But despite comments on the importance the Bush administration has placed on better relations

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<sup>16</sup> See Amacher, Tollison, and Willett (1975).

<sup>17</sup> The Fund has demonstrated considerable willingness to pull the plug on programs, at least for countries without strong geopolitical significance. This certainly falsifies the extreme view that the Fund has made itself a helpless hostage to host countries. It also casts doubts on the strongest forms of Vaubel's loan pushing hypothesis. Often, however, the IMF would reinstate programs without sufficient evidence that policy compliance was likely to be better in the future.

<sup>18</sup> For examples where the principals have failed to control the Fund in terms of the broadening of conditionality criteria, see Gould (2001).



with Latin America, it is hard to see this explaining the change in the administration's position with respect to Argentina. Nor did the linkage of additional funding to voluntary debt restructuring provide a highly convincing explanation for the policy reversal. A much more important reason, in my judgment, was the high stakes gamble of the Argentine government to make public its views that Argentina needed a new loan and was highly confident of getting it. Under these circumstances, a rejection by the IMF would have been highly likely to worsen the crisis, with much of the resulting blame laid at the feet of the IMF and the U.S. Treasury. Thus it is top officials' fear of blame, not loan pushing by career bureaucrats, that best explains the recent loans to Turkey and Argentina.<sup>19</sup>

These examples have the common feature that, from an exclusively short time perspective, the benefits of either implementing or continuing a program exceed the costs, but that by so doing moral hazard incentives and the likelihood of future crises are increased.<sup>20</sup> As any dieter knows, however, when one has operational responsibility for the short run it is very hard to focus adequately on the long term. Likewise, the same type of difficulty applies to proposals that the IMF notify the public when national officials repeated fail to heed its warnings. Since doing so would unleash speculative capital flows against recalcitrant governments, the mere threat of notification might encourage more responsible behavior.<sup>21</sup> But this policy tool is unlikely to be employed often. It is hardly realistic to expect the IMF to tilt more than modestly in this direction unless we either replace human officials with robots or make substantial changes in the incentive structures that they face.

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<sup>19</sup> The 1998 loan to Brazil also fits this hypothesis.

<sup>20</sup> On the problems of time inconsistency and short time horizons in attempting to promote external discipline, see Bird (1998).

<sup>21</sup> See, for example, Eichengreen (1999).

In short, I believe that public choice analysis of the soft motives of top IMF officials have a good deal more explanatory power than Vaubel's simple budget maximization hypothesis with respect to IMF loan policies. But these are not the only relevant versions of public choice analysis to be considered. Another hard core public choice concern adds to our understanding of the IMF's disastrous experiences with its loan to Russia in 1998.

Contrary to the loan-pushing hypothesis, numerous interviews with Fund officials suggest that the IMF was very reluctant to make this loan and did so only after considerable political pressure from the governments of the major industrial countries. This pressure, however, can easily be explained using standard public choice analysis to focus on the incentives facing the principals rather than the agent.<sup>22</sup> The governments of the major industrialized countries wanted to make loans to Russia on geopolitical grounds, but they didn't want to ask their legislatures to raise funds for such aid through normal budgetary procedures (e.g., competing for tax revenues). There was little support for such assistance, aside from the financial sector, so governments would have had to use up a good deal of their political capital to pursue this objective. Far better, from the standpoint of short-term political popularity, was to channel aid to Russia on the cheap by using the IMF. The long run cost of this strategy in terms of further damaging the credibility of the IMF was likely considerable, but this carried little weight in the classic "benefits now, costs later" political incentive structure.<sup>23</sup>

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<sup>22</sup> Applying the principal-agent framework to the IMF, it is typical to treat the major shareholder governments or Executive Board as principals and the Fund management and staff as agents. In one of the earliest application to the IMF, however, Killick (1996) treated the Fund as the principal and borrowing country governments as the agents.

<sup>23</sup> See, for example, Willett (2000b).

## **The Growth of Conditionality**

One of the most notable features of the evolution of IMF programs has been the huge increase in the average number of conditions included and the great expansion of the range of policies to which policy conditionality have been attached. This proliferation of policy conditions has attracted a great deal of criticism.<sup>24</sup> From public choice and constitutional political autonomy perspectives, the question is not just what policy should be, but who should make this determination. With respect to the IMF, this suggests the need for institutional self-restraint and careful delineation between policy advice and the terms of policy conditionality. The Fund's management, staff, and Executive Board should consider not only whether a particular policy would be good for the country in question, but also whether making the adoption of that policy a formal condition for funding—instead of just being an object of recommendations—is appropriate for an international body. Thus, for example, one might believe that capital controls are bad and hence recommend against them, but also believe that the negative externalities they generate are typically not sufficiently large to make their adoption subject to international sanctions.

It is doubtful that we could ever develop a set of objective criteria that could automatically answer all questions of the appropriate scope for IMF activities, but explicit discussion of the criteria for reaching judgments in the area needs much more emphasis. To its credit, the IMF has recently begun to take seriously the criticism of expanding conditionality. Shortly after the selection of a new Managing Director, Horst Köhler, the need for streaming conditionality became the IMF's official mantra and a substantial review of the Fund's conditionality was initiated with public comment invited.<sup>25</sup>

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<sup>24</sup> See Feldstein (1998), IMF (2001), James (1995), Kapur (2000), and Polak (1991).

<sup>25</sup> See IMF (2001).

A great deal of analysis has been presented about the potential pathologies of conditionality. The recent external review of the IMF's external surveillance policies concluded that straying from its core competencies hurt the quality and credibility of Fund analysis, and that the emphasis on too many objectives diluted the effectiveness of Fund recommendations. Furthermore, there is a danger that, "the proliferation of conditionality has tended to undermine government ownership, which may well be the most important determined of program success."<sup>26</sup>

If expansion of conditionality is so suspect, what accounts for it? There is such a rich menu of plausible explanations that it is likely to prove quite difficult to determine their relative explanatory power.<sup>27</sup> But while there is now widespread agreement that for a variety of reasons IMF conditionality needs to be "streamlined," there is little agreement yet on how far this scaling back should go or what criteria should be employed. A recent paper by Martin Feldstein (1998) makes an important start, however.

Feldstein argues that "the legitimate political institutions of the country should determine the nation's economic structure and the nature of its institutions...The IMF should provide the technical advice and the limited financial assistance necessary to deal with a funding crisis and to place a country in a situation that makes a relapse unlikely. It should not use the opportunity to impose other economic changes, however helpful...." (p. 27). These objectives, he suggests, lead to three criteria for evaluating potential IMF programs of policy conditionality, namely:

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<sup>26</sup> Killick (1996, p. 218).

<sup>27</sup> For recent discussions of explanations for the expansion in IMF conditionality see Gould (2001), IMF (2001), Kapur (2000), and Martin (2000).

- “(1) Is this reform really needed to restore the country’s access to international financial markets?
- (2) Is this a technical matter that does not interfere unnecessarily with the proper jurisdiction of a sovereign government?
- (3) If the policies to be changed are also practical in the major industrial economies of Europe, would the IMF think it appropriate to force similar changes in those countries if they were subject to a fund program?” (p. 2).

Feldstein argues that the actions should be taken only if all three criteria are met.

While this analysis is a fruitful starting point, the issues raised require considerable further study. In many cases, reasonable people may differ about the answers to Feldstein’s questions with respect to specific policy areas. Whether financial sector reforms meet Feldstein’s three criteria is a case in point. Another example is the degree of specificity of fiscal policy changes. The original conception of IMF policy was that the Fund should determine the maximum allowable size of the budget deficit and leave it up to the country to determine the mix of revenue increases and spending cuts necessary to achieve this objective. Over time, however, IMF conditionality has expanded to include in many cases details of how deficit reductions will be brought about. This would appear to violate the Feldstein criteria and may in some cases have been due to factors that violate the spirit of Feldstein’s approach. But some degree of specificity may be necessary for effective implementation. Given the history of over optimistic projections of stabilization programs by national governments and the substantial degree of slippage in the IMF’s ability to enforce policy conditionality, IMF officials should be confident that a government has a reasonable strategy for implementing its plans before a program is approved. Proposals for unspecified budget savings seldom carry

much credibility. Thus the IMF does have a legitimate interest in more than just the projected bottom line of the budget.

Feldstein's analysis implicitly assumes that the IMF is dealing with a country that is a unitary actor. Public choice analysis stresses that while this is useful for some purposes, in many cases the unitary actor assumption leads to seriously faulty analysis. Furthermore, even if this simplifying assumption is retained we are left with a somewhat paradoxical situation: if the "good" government is strong relative to various "bad" short run political pressures, there is likely to be little need for IMF programs, while if the government is extremely weak, IMF programs are likely to do little good.<sup>28</sup> In between these two extremes, however, are cases where the IMF and a the national government with "good" intentions, they can form a benign coalition that seeks to counter the operation of domestic political biases. In some cases IMF programs may provide the leverage to tip the balance of domestic political forces in the direction of stabilization and reform. When the assumptions of benign intentions are relaxed, however, then the analysis can become quite complex. The Fund may become subject to "inappropriate" pressures, thereby involving management and staff in numerous multiple level games involving both the Fund's owners and its clients. On top of this, in the absence of "ideal" internal institutional structures, particular actors within the Fund and national governments may face private incentives that differ from "the public interest" (consider Mr. Suharto in this regard), leading to further complexities.

For example, there is a widespread perception in South Korea that Japan and the United States took advantage of Korean weakness during the recent crises to use the IMF as a lever to force liberalization in areas that were unrelated to the causes or solutions to the crisis.

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<sup>28</sup> The same conclusion holds with respect to the use of exchange rates as nominal anchors. See Willett (1998).

Such behavior from major powers is just what would be expected from realist analysis, and fits as well with public choice analysis of governments as the agents of powerful rent-seeking economic groups. On either interpretation, such perceptions undermine the political legitimacy of Fund programs and can substantially weaken the effectiveness of these programs. Our challenge is to see if we can develop some workable, albeit imperfect, criteria for evaluating these questions. Even if no general consensus can be achieved, a focused debate about such questions should prove fruitful.

### **Ownership and the Need for More Political Economy Analysis**

It is now widely accepted that national “ownership” of the international financial institutions’ programs is essential for their effective implementation.<sup>29</sup> The meaning of ownership in this contest is far from clear, however, and there has been little serious grappling with this issue, perhaps because in the context of a unified actor model the answer is straightforward. In a world of multiple actors, however, the issue of how broadly ownership needs to extend becomes quite crucial. As noted in the recent staff study on conditionality, the IMF has traditionally assumed “that the program is fundamentally the [national] authorities’ own” (IMF 2001, p. 18). The same study recognizes, however, that if “one views conditionality as a mechanism by which the Fund uses financial leverage to induce the authorities to implement reform they do not endorse, any expansion in conditionality implies a reduction in national ownership” (p. 18). The document goes on to note that the relationship

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<sup>29</sup> On the importance of government “ownership” of programs see Killick (1996). He stresses the important role which intellectual persuasion by the IMF and World Bank has played in the process toward liberalization and macroeconomic stabilization in developing countries and argues that this function can be undercut by too much emphasis on conditionality. He also suggests that governments should take on a much larger role in drafting letters of intent.

between conditionality and ownership is complex; it raises the important question of “whose ownership is relevant?” (p. 19), but makes little progress in suggesting either an answer or even how to go about analyzing how to try to get an answer.<sup>30</sup>

While from some normative perspectives ownership might be designed so broadly as to include almost all residents, a pragmatic approach to ownership would argue that its breadth be defined in terms of what is necessary to secure implementation of the programs. In the terminology of modern political science, then, ownership should include all potential veto players. The IMF has traditionally dealt primarily with central banks and finance ministries but even for narrow fiscal policy issues the relevant authorities may include the national legislature and, as in the recent cases of Argentina and Brazil, regional governments as well. It was the failure of the Russian legislature to pass the budget measures agreed with the IMF by the Executive Branch that was the spark that ignited the Russian crisis in 1998.

The Fund appears to be beginning to pay more attention to such issues but progress is slow. The IMF has relatively little expertise in political economy analysis and taking such considerations explicitly into account runs against the traditional culture of the Fund. Understandably, the IMF staff is dominated by economists who specialize in giving advice on optimal economic policies. It does little good, however, to get a government to agree to such policy strategies if it does not have the intention or the capability to implement them. A purely “economic” (that is to say, optimal policy) approach to designing the initial agreement, followed by a “political” approach to forgive implementation failures, is not a happy strategy

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<sup>30</sup> Their brief discussion does note that there are many stakeholders in society and suggests that the range of relevant parties is greater for many of the structural policy areas than for the traditional IMF core of monetary, fiscal, and exchange rate policies. Calomiris (1998) gives an excellent discussion of how the extent of special interests in the “intermediate” area of financial sector reform that implementation there much slower and more difficult than in the core areas.



for dealing with the complex interactions among politics and economics that inevitably surround IMF programs.

The External Surveillance Review reports a widespread, albeit not universal, perception among senior IMF staff that they “did not see it as their function to come up with policies that, while less than first best, moved the country in the right direction and were politically and institutionally acceptable” (p.43). The report likewise notes that IMF staff “...appear in general to be reluctant to give advice...that takes into account the political and institutional constraints within which policymakers need to operate” (p. 95). Given the training of most economists, such reluctance is quite understandable. Economists have no particular expertise in making such judgments. What is needed is additional capability at the Fund so that it can engage in the necessary political economy analysis.

Toward this end, the report recommends that a higher proportion of the senior staff at the Fund be selected from among economists who have had significant national policy experience. This is a worthwhile recommendation, but it does not go far enough. Unlike the situation twenty years ago, there is now a substantial group of political scientists and a smaller number of economists trained in the study of the intersection of politics and economics. For some time, political economy has been a highly active research field. While (like traditional economics) it does not have a monopoly on the solutions to these matters, it nevertheless now contains a substantial body of useful knowledge that could easily be drawn upon by the IMF in the development of its programs. Among the benefits likely to result from developing an explicit political economy capacity at the Fund would be wider consultations within the host country, including the different components of the national government. Likewise, one of the most crucial aspects of designing an IMF program is how to package it to sell best to the

legislature and the public. While such packaging must be primarily the responsibility of the national government, this is an area where a political economy group at the IMF could be quite helpful in offering advice based on previous Fund experience and the growing body of professional literature on political economy.

### **Concluding Remarks**

One of the banes of traditional public choice scholarship is that the very same analyses that identify possibilities for improvements of public policy also usually suggest that it would be extremely difficult to get these reforms through the political process.<sup>31</sup> However, to the extent that the softer elements stressed in this paper are relevant, the chances for meaningful reform at least in some areas, may not be quite so bad after all.

Identifying potential biases is much easier than correcting them. Still, the identification effort can be worthwhile. Increased awareness of such potential biases may in themselves have some effect. There has been a substantial increase in the transparency associated with IMF programs over the last several years; there may also be methods of revising institutional structures and/or management practices to reduce some of the major problems of loan pushing and insufficient enforcement. For example, if Fund country officers are susceptible to partial capture by client governments and have become too cautious in recommending the termination of programs where policy conditions are being insufficiently met, then an internal review board could vet the recommendations of missions before they were sent to the Executive Board. The same would hold with respect to crisis bailouts designed to limit contagion.

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<sup>31</sup> See, for example, Tollison (1997).

The Fund did create just such a mechanism some time ago, in the form of its Department of Policy Development and Review.<sup>32</sup> However, discussions with IMF staff and the research studies on the enforcement of IMF programs suggest that the effectiveness of this review mechanism has been limited.<sup>33</sup> While serving as a strong potential counter to possible biases of area department staff, the review department has little independence from senior management who, after all, still control the career paths of officials staffing the department. This suggests the possibility that the senior management of the Fund, even though they are appointed directly by the IMF member governments for limited terms, may be a greater source of policy bias than the career staff. If correct, this would make it particularly useful to devise ways of strengthening the Executive Board relative to management and especially of limiting management's ability to informally commit the IMF before discussions by the Executive Board.

Prescriptions for reform of the Fund of course rest heavily on perceptions of the problems that need to be corrected. Our available evidence does not yet allow us to say with much confidence the relative importance of the various types of potential biases discussed in the literature on the political economy of the IMF. It is clear, however, that multiple factors are important and thus simple remedies may not be easy to find. Because of the problems of political manipulation by national governments, there is a strong case for giving the IMF more protection from short run political pressures along the same line as the case for independence of national central banks. However, because of the types of bureaucratic problems identified

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<sup>32</sup> The Research Department also plays such a role to some extent. Policy Development and Review was not started from scratch, but rather was based on the long standing Department of Exchange and Trade Relations, which had been the defacto coordinating group for the area departments.

<sup>33</sup> In response to recent criticisms, the IMF has announced that it will establish a new independent evaluation unit. The precise institutional structure of this new unit, will be of considerable importance, but this is certainly a desirable step.

by Vaubel and others giving the Fund management complete discretionary autonomy would likely not be a good idea.<sup>34</sup>

The mechanics of governance at the IMF are now under debate, with the French pushing for greater political oversight through a strengthening the role of the ministerial level Oversight Committee relative to the Executive Board, which is staffed by lower level political appointees. (An uncharitable interpretation of the French motivation, however, is to develop a stronger political counterweight to the influence of the United States.) So far, there appears to have been little discussion of what kinds of principles should guide discussion of the Fund's governance structure. This is clearly an important topic on which the literature on public choice and constitutional political economy should be highly relevant.

Public choice analysis suggests that the hardest problem to solve is the use of the Fund by the major powers for political purposes. Even here, however, there may be some basis for a little optimism. It is in the longer-term self-interest of the major powers not to undercut the effectiveness of the IMF. Of course, it is a pipe dream to think that the IMF, any more than national central banks, can be fully depoliticized. But as has now occurred in the central banking legislation of many industrialized countries, there is some hope that governments might be willing to lengthen their time horizons and embrace approaches that stress medium-term stability over short-term expediency. Governments' willingness to rise to such occasions is, of course, in scarce supply, but sometimes it does happen.

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<sup>34</sup> For a specific proposal to give the Fund much greater independence see De Gregorio et al (1999).

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