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Zattler, Jürgen K.

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Jürgen Zattler*

Reviewing the Policy on Conditionality

Today there is a relatively broad consensus that the traditional approach to conditionality policy, as pursued especially by the World Bank and the IMF, is problematic. In recent years both institutions have reviewed their policies on conditionality. Although this has laid the basis for a new policy, there are a series of issues which need further refinement and thinking. This article outlines some key points for the ongoing debate.

Conditionality policy, especially that of the World Bank and of the IMF, has drawn severe criticism since the 1980s. It used to constitute a core element of what were called structural adjustment programmes. Only if a country implemented policy reforms prescribed by donors ("conditions") did donors disburse the related financial resources. The predominant economic policy recommendations of the 1980s and 1990s were largely based on a simplified interpretation of neoclassical theory. According to that view, economic development and transformation problems must be solved at two levels. For one thing, it was believed, the economic process must be liberalised and economic activity must be privatised to the greatest possible degree. For another, economic activity must not be "disrupted" by macroeconomic distortions. To that end, budget deficits must be reduced and monetary policy must be designed in the most "neutral" way possible.

Today, there is a relatively broad consensus that this traditional approach is problematic. This consensus focuses on two aspects: the substance of the conditions, and the process through which the conditions were formulated and implemented. As regards substance, it can be stated today that the policy recommendations contained in the structural adjustment programmes did not deliver the desired outcomes. Numerous countries that have deviated from classic policy recommendations in many ways – India and China being the most prominent examples – have achieved better development outcomes than those countries which have closely followed the suggestions (especially in Latin America, but also some countries in Africa). As regards processes, it is believed today that reforms cannot be forced, or imposed, on a government or country from the outside. Reforms are successful if the country in question has devised them itself and if the government itself takes responsibility for their implementation; this is referred to as "ownership." The concept of ownership has been an integral element of the donor community's policy since the late 1990s. For example, it forms the basis for the HIPC debt relief initiative and the poverty reduction programmes linked to it. The two aspects (the substance of conditions tied to structural adjustment programmes, and ownership) are closely interlinked: only on the basis of ownership will it be possible to define reform paths that are appropriate to the specific situation of the country in question.

In the past few years, the IMF has reviewed its policies on conditionality. The reform of IMF conditionality policy was aimed at reducing the number of conditions linked to the programmes and at focusing them on the core areas of the IMF mandate. The World Bank revised its guidelines for structural adjustment loans last year. The new strategy of development policy lending (DPL) takes a restrained approach to laying down specific substantive conditions, thus respecting the principle of ownership. Notwithstanding these developments, it can be assumed that some deficits continue to exist, especially with regard to the practical implementation of the new approaches. For example, the World Bank's independent Operations Evaluation Department (OED) pointed out that hardly any attention has been given to alternative economic policy options so far; that conditions have been too uniform, in other words, that inadequate attention has been given to specific national circumstances; that conditions have not focused very much on concrete outcomes so far; and that they have not been integrated sufficiently into national processes.[1]

World Bank governors called on the Bank in October 2004 to review its policy on conditionality, both in terms of strategies and practice, and to present a report by the Annual Meetings this year.[2] In the meantime, the Conditionality Review has presented first

* Federal Ministry for Economic Cooperation and Development, Berlin, Germany. The author expresses his personal opinions.

[1] World Bank: Annual Review of Development Effectiveness 2003, Washington DC 2003.

[2] The German government has been following this process very closely and held an international conference on this issue in Berlin in April together with the World Bank. The conference provided a forum, in particular, for government representatives from developing countries.

results, the main messages being: that in supporting a country-based and -led development process, the Bank will not seek to lever more or faster reform than that which a country wants. The Bank acknowledges that countries need space to formulate policy, consider the options, and build broad-based support for the path they will take. The review has put forward a number of good principles. Those principles point to the necessary reinforcement of country ownership; the importance of harmonisation and agreeing on up-front conditions as part of a coordinated framework; the necessity of customising conditions to individual country circumstances; the need to conduct transparent progress reviews conducive to predictable financial support; and the need to limit the number of conditions and to choose only those actions that are critical for achieving results.

The review has laid the basis for a new policy on conditionality. Nevertheless, apart from the question of implementation, there are a series of issues which need further refinement and thinking. The following text outlines some key points for the ongoing debate.

Respecting National Procedures

Ownership means, above all, that donors align their activities to national development programmes, such as the Poverty Reduction Strategy Papers (PRSPs) or other national strategies. Ideally, their conditions could then reflect crucial elements of the government programmes. The responsibility for monitoring and evaluating donor programmes should be integrated into national processes and instruments to the greatest possible extent. On that basis, internal and external accountability (parliament and donors) should rely largely on a uniform procedure.

One significant basis for integrating donor contributions into national processes could be provided by the annual PRSP progress reports (APRs). In the long term, these reports could become the basis for external and internal accountability and for defining goals for the coming year. In that way, APRs would simultaneously serve to assess past activities, provide guidance for the future on priority actions and their budgetary implications, and supply reports to parliaments and donors. APRs would thus also contain all indicators against which performance is measured. This would facilitate the integration of disbursements (instalments) into partner countries' budget cycles.

However, in almost all the countries concerned, this is a vision that is still far from being common practice. The problem is mainly that most countries' development programmes do not yet form a useful basis for such an approach. These programmes usually describe rather general goals without indicating specific actions to reach them. Partly as a result of this, there are many instances where budgetary implications are only described to an insufficient degree. So the main focus at this point is on encouraging partner governments to be more specific in their development programmes and to be clearer about the necessary priority actions (based on dialogue with donors). Moreover, the cost of the programmes must be specified more precisely; it should be linked as closely as possible to annual and medium-term budgeting.

In view of these problems, it would be too narrow an approach to believe that ownership must always be necessarily the beginning of the process. In most countries, there is no basis for deriving programme goals of relevance to donors (in other words, conditions) directly from existing government plans. Rather, donors' procedures and policies must be geared towards fostering government ownership. Both the programme and the conditions should be the outcome of a political process in the country in question. There should be a close policy dialogue between the government and the donors on how to design the reform programme, including a schedule.

A growing share of development cooperation resources is being provided as (conditional) budget support. One special challenge in this context is to enable partner governments to plan a sound budget by enabling them to predict, at least roughly, the volume of envisaged budget support. In the past, this has repeatedly proven to be problematic. In some cases, financial transfers fluctuated greatly over the years, partly because donors withheld budget support when they felt that insufficient progress was being made on the reform programmes. While it is certainly consistent to refuse budget support if reforms have come to a standstill, deferring disbursements can undermine predictability for partner governments and thus put pressure on the reform process itself. In particular, reliable, long-term budgeting and budget execution become more difficult. As a result, donors can come under some pressure to disburse due instalments even if previously specified conditions have not been met. Donor organisations typically lose credibility as a result.

The EU Approach: Focus on Outcomes

There are several ways of defusing this problem. One convincing option is to divide the funds into variable, performance-based instalments, a practice that has been pursued by the EU Commission for some time now.[3] This makes it possible to disburse donor contributions on a pro rata basis if targets have only

been partially met, preventing "stop and go" and improving the predictability of donor financing.

Conditions formulated by donors are typically specific policy actions, such as amending certain laws and regulations or formulating a sector strategy. The EU has devised its own special approach in this regard. It largely refrains from requiring specific policy actions and links its programmes directly to outcome indicators.[4] Outcome indicators are applied mainly to social sectors and implemented in the form of variable, performance-based instalments. In addition, there are fixed instalments which continue to be subject to process or policy conditions.

The great advantage of outcome indicators is that they foster partner governments' ownership: all that is laid down is desired outcomes, and it is up to the governments to choose policy actions by which to reach them. Moreover, the indicators encourage both governments and donors to focus all their efforts on the achievement of specific outcomes.

This approach, too, entails a number of problems when it comes to implementation.

- Just like policy action based conditionality, outcome-based conditionality hinges on the quality of the development programmes in place (such as PRSPs). Ideally, this strategy requires that partner countries' programmes already contain valid data and indicators that can be used to measure progress. However, most development programmes do not. The necessary data is often not yet available elsewhere, either. This means that targeted efforts are needed to ensure valid monitoring.
- Another problem is that policy actions often do not yield any outcomes until after a relatively long time, as is the case for increased enrolment ratios, for instance. This means that in some areas, governments have only very limited scope for bringing any significant influence to bear on the indicators in the short term. This must be taken into account when formulating the outcome indicators.

Apart from that, the outcome-based approach has been subject to criticism which appears not very well founded.

- Critics say that outcome indicators are not suitable for all areas and sectors of reform. It is true that the EU mainly uses the indicators for the social sectors. However, this criticism appears only partially justified. It would be perfectly conceivable to formulate outcome indicators for other reform areas as well. Take trade reform: there is now general agreement that open trade regimes are beneficial for economic development. However, there are differing ways of arriving there. Many countries opened their economies in the past by means of general import liberalisation – often in response to strong pressure from the international community. Critics have repeatedly pointed to the potential negative impacts of such a policy and underlined that there are alternative options, for instance selective liberalisation covering specific industries, or import liberalisation that focuses on the export sectors.[5] Outcome indicators would leave it to the government to decide how it wants to achieve an open trade regime, merely laying down the outcome in the form of target indicators (such as the share of exports and imports in the country's national product).
- Other critics say that governments can only partly be held responsible for the results of policy actions at the user level. For instance, agreed targets can be missed because of negative external factors that are beyond a government's influence (commodity prices, natural disasters etc.) However, this criticism, too, appears valid only to a certain point. The effect of such factors on outcome indicators can generally be isolated. This scenario has therefore never been a problem ever since the EU adopted this approach.

It is essential that conditions in the form of outcome indicators not be used in isolation. Rather, they should become agenda items in a close dialogue between donors and partner governments about the means – that is, policy actions – that appear suitable for achieving the agreed targets. This dialogue will also have to reveal the main causes of inadequate reform progress (where applicable); for instance insufficient commitment to reform or a lack of administrative capacity on the part of the government in question. In the latter case in particular, donors should consider possible ways of providing support.

The Substance of the Conditions

However, the lesson that country-specific solutions and national ownership are crucial to the success or failure of development efforts should not be misinterpreted. It does not mean that there are no generally

[3] The EU plans to disburse some 50% of its programmed resources in the form of variable, performance-based instalments in future. In the past few years, it has significantly increased the volume of its budget support. Between 2000 and 2004, the amount of resources allocated to that purpose almost doubled, reaching nearly €800 million.

[4] Cf. European Commission: EC Budget Support: An Innovative Approach to Conditionality, February 2005.

[5] Cf., for example, World Bank: Economic Growth in the 1990s – Learning from a Decade of Reform, Washington DC 2005; and Federal Ministry for Economic Cooperation and Development: Post-Washington Consensus – A Few Thoughts, Berlin 2004.

applicable solutions or recommendations at all that should be taken into account when formulating conditions. To name but a few of the important insights in this connection:[6]

- In formulating conditions, it should be borne in mind that all reforms involve opportunity costs. The implementation of reforms generally requires administrative capacity; it also costs money and political capital. All these factors are in extremely short supply, especially in developing countries. Conditions should therefore focus on those obstacles the removal of which will lead to the greatest real benefit ("*binding constraints*"). To that end, decision-makers must steer clear of the temptation to prematurely apply solutions that are derived directly from academic theory or "the ideal world." They should concentrate more on the practical challenges in each given country.
- Institutional reform plays an outstanding role for development processes. Development programmes should therefore take better account of *institutional aspects*. On the one hand, this goes for stabilisation measures (consolidating government budgets, fighting inflation, improving the trade balance). Normally, such measures only have long-term effects if combined with programmes to strengthen the public sector (budget management, tax administration, financial market institutions etc.) On the other hand, institutional issues also matter for the success of economic liberalisation and privatisation. The potential benefits of such actions (mainly allocative benefits) must be weighed against their risks. This includes the option of, for example, postponing steps towards liberalisation until minimum institutional prerequisites have been put in place. Where donors' programme conditions cannot be defined in the form of outcome indicators, they should concentrate more on these core institutional reforms.
- The development programmes of the low-income countries as well as the donor conditions based on them should give greater attention to the issue of *growth strategies*. In most countries, poverty reduction programmes have focused on improving basic social services by investing in health and education. However, in the long run, they must also contribute towards increased private investment and higher productivity. Otherwise it will neither be possible to reduce poverty on a lasting basis nor to maintain, or restore, debt sustainability. If budget support is provided in the form of credit, it must be geared towards increasing income and the inflow of foreign currency to facilitate loan servicing. Budget support should also help enhance the productivity of the private sector so as to compensate for potential increases in the real exchange rate. Negative macroeconomic impacts such as increases in the real exchange rate can be compensated by using budget support mainly for imported goods.
- In the macroeconomic field, too, more attention should be paid to the specificities of country circumstances, for instance with regard to *fiscal policy*. The global budget deficit is only a very limited indicator of fiscal sustainability. It makes sense to take a closer look at the structure of expenditure in the respective countries. Moreover, in defining fiscal policy targets, there should also be a more realistic assessment of the response of the private sector. There are indications that assessments of private-sector investment have been overoptimistic in many countries, resulting in overly restrictive fiscal policy targets.[7]

Donor Coordination

It is important for donor institutions to adopt a shared view of the necessary core reforms and to establish a form of division of labour that takes account of the strengths of each donor institution. In some countries, partner governments and the donors of budget support have agreed on a shared list of priority actions. It sums up the core areas of the government programme ("policy matrix"). Donors use the matrix as a basis for their conditions for the disbursement of budget support. It should be attempted to establish this type of shared basis for donor conditionality in all relevant countries.

However, agreeing on such a shared framework defined by the policy matrix does not necessarily mean that all donors will rely on the same conditions or use the same indicators to assess the progress of programme implementation. As mentioned earlier, the World Bank typically uses policy indicators, whereas the EU Commission relies, to the greatest possible degree, on outcome indicators to monitor compliance with programme targets. Individual donors may also arrive at differing conclusions because they attribute differing weight to progress in the various reform areas.

This practice is not necessarily detrimental to partner countries and their reform processes. It can help, for instance, to prevent donors from turning the flow of funds on or off all at the same time, thus jeopardis-

[6] Cf. Federal Ministry for Economic Cooperation and Development, op. cit., for the implications of recent experience and insights for the substance of economic policy recommendations.

[7] Independent Evaluation Office: Evaluation of Fiscal Adjustment in IMF-Supported Programmes, International Monetary Fund, Washington DC 2003.

ing partners' reform processes. However, care should be taken to ensure that this approach will not result in excessive increases in the number of conditions and indicators. It is alarming that the number of indicators continues to be very high in some countries and has actually risen in a number of cases. All donors should therefore exercise restraint in this regard.

One main reason why this problem is difficult to overcome is that there is a kind of natural proliferation of conditions. For example, the various departments of the World Bank have an interest in incorporating their specific concerns (health, infrastructure, education etc.) into the PRSC (Poverty Reduction Support Credit) conditions,[8] which helps them foster their own reform agenda and establish a basis for relevant policy dialogue. In addition, there are the other donors, each of whom wants to incorporate their own concerns and priorities, which undoubtedly have their merits.

In the past, the German government has provided budget support only to a very limited extent. German macroeconomic budget support has mostly taken place in the form of cofinancing World Bank loans to low-income countries (PRSCs). In these cases, German development cooperation has largely refrained from formulating its own priorities, basing its decisions on those of the World Bank instead. In practice, a World Bank decision to disburse a loan means that the German contribution will be disbursed as well.

However, the Federal Ministry for Economic Cooperation and Development (BMZ) has decided to align German development cooperation more closely to partner countries' policies and to participate more often in programme-oriented joint financing. The focus is to be on the joint financing of sector programmes. But greater use is also to be made of direct general budget support. This is a welcome decision, as budget support in particular can make a major contribution towards enhancing the efficiency and effectiveness of development cooperation and strengthening partner governments' ownership. Moreover, it helps foster the transparency and quality of budgetary procedures. Finally, budget support will reduce the administrative workloads involved in development cooperation, especially for the recipient countries and particularly in the long term.

The decision to orient German development cooperation more towards programme-based approaches and rely on budget support more often also means that relevant procedures and methods must be defined for designing the German contributions; this also includes a policy on conditionality. German development cooperation should increase its efforts to raise systematically concerns of its own for inclusion in the policy matrix (for instance in the form of separate indicators). Such an approach assumes having a great deal of knowledge about the policy areas in question. German development cooperation must therefore give greater attention to related reform debates in partner countries and to the development of appropriate capacity (especially in the recipient countries). This can only be done in the medium term and also requires energy and capacity to be freed by partially withdrawing from project operations. Existing capacity and knowledge deficits could be mitigated in the short term by working more closely with the EU Commission on a case by case basis.[9]

Moreover, German development cooperation should define priority areas for its future involvement in programme-oriented joint financing or budget support. Two criteria should be used in defining relevant areas. For one thing, guidance should be sought from existing priority areas of German development cooperation with the country in question ("Länder-Schwerpunktsektoren"). This would enable the experience gained, in particular at the project level, to be used for the policy dialogue at the meso and macro level. Secondly, German development cooperation should identify two or three areas which it can pursue throughout all countries, regardless of the priority areas of cooperation with a given country. Greater involvement in the field of public expenditure management is definitely a must both for fiduciary and for strategic reasons: the core areas of the development programmes are reflected directly in budgeting and budget execution. Another important issue which has been given little attention so far is government revenue policy and tax policy. There are a number of reasons why this issue should be chosen as a priority area of German involvement: government revenue rates in low-income countries are very low and must be increased in the longer term so that revenues will at least cover recurrent expenditure. Moreover, involvement in this area would stave off the risk of partner countries neglecting their own efforts for resource mobilisation as a result of growing budget support. Finally, there are indications that many partner countries' tax and revenue policies currently do very little to enhance social justice, especially as a result of loopholes and inefficient systems.

[8] Sector decision-makers also hope that this will enable them to obtain part of the World Bank budget linked to the PRSC. This shows that the World Bank needs to clarify its internal procedures and responsibilities with regard to PRSCs.

[9] A recent study on EU budget support arrived at a relatively positive result; cf. Petra Schmidt: Budgethilfe in der Entwicklungszusammenarbeit der EU, DIE Studies No. 10, Bonn 2005, Deutsches Institut für Entwicklungspolitik (DIE).