REVIEW OF WORLD BANK CONDITIONALITY:

THE THEORY AND PRACTICE OF CONDITIONALITY: A LITERATURE REVIEW

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THE THEORY AND PRACTICE OF CONDITIONALITY: A LITERATURE REVIEW

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THE THEORY AND PRACTICE OF CONDITIONALITY: A LITERATURE REVIEW

EXECUTIVE SUMMARY

1. This paper reviews the theoretical and empirical literature on policy-based conditionality drawing on the work carried out by the Bank itself and on academic publications. The paper presents the analytic frameworks on policy conditionality proposed in the literature and assesses their usefulness. Section I introduces the topic. Section II discusses the rationale for conditionality. Section III presents an overview of the existing literature, particularly some of the work carried out by the Bank itself. Section IV focuses on traditional conditionality and identifies the factors driving the effectiveness of conditionality. Section V reviews the theoretical frameworks that have been proposed in the academic literature to conceptualize conditionality. Section VI examines how the Bank has internalized the findings from the literature and adjusted its policies to improve its practice of conditionality. Section VII summarizes findings and considers the alternatives to conditionality.

2. With conditionality, the donor provides incentives to the borrowing government for the implementation of policies that would improve the welfare of its citizens. There are three main rationales for conditionality identified in the literature. First, the recipient government and the donor have different beliefs on the appropriateness of the policy. Second, even if the recipient government has full "ownership" of the policy, its implementation may face resistance from domestic interest groups. Third, conditionality is a signaling device by the government, which sends a message to potential private investors on its commitment to implement the required policies and maintain a sound economic environment.

3. Conditionality in policy-based lending has been the subject of extensive research for more than two decades, including analyses in the academic literature and important reviews of conditionality undertaken by the Bank since the introduction of policy-based lending in the early 1980s. The literature identified a number of cases where (a) recipient governments accept the conditions attached to aid in anticipation that they will renege, (b) donors fail to apply sanctions stipulated in the conditionality contract, and (c) recipient governments also anticipate that it will be granted funding in subsequent periods despite previous slippages. Several authors have been critical of conditionality, suggesting that it may infringe on national sovereignty, undermine democratic processes and institutions in recipient countries, and has been ineffective in bringing about the desired outcomes.

4. The main lesson learned from the literature is that conditionality can be useful in helping identify and implement necessary reforms but that it is only when there is "ownership" of the policy that conditionality can succeed. Conditionality helps when it supports governments already strongly committed to reform.

5. The evidence shows that borrower compliance with World Bank conditionality was rather poor during the 1980s but that it has gradually improved. For recent years, the

Bank's compliance record as measured by the Operations Evaluation Department is good. However, the literature suggests that conditionality has been an ineffective mechanism to induce reform from unwilling governments and often not an appropriate mechanism for genuine reformers. The main reasons why traditional conditionality has been largely considered as ineffective in the literature—i.e., why borrower compliance rates were initially low, and why donors have refrained from enforcing the agreed upon conditions by punishing noncompliance—are lending pressures, donor altruism, or "defensive lending" (lending in order to repay the previous loan).

6. Two theoretical approaches have been used to conceptualize conditionality. First, it has been viewed in a principal-agent framework. The principal offers a contract that provides the agent with the appropriate incentive to align their respective objectives but the agent enjoys private information on its ability, opportunities, and intentions that affect the action it takes and ultimately the principal's objective. Second, conditionality has been analyzed in a political economy framework. Even if the preferences of the government and the donor are congruent, domestic conflicting interests between the government and, say, special interest groups provide a rationale for conditionality. The interest groups may not favor the proposed reform policy and have the ability to take actions that are costly to the government, such as strikes, or simply have the power to veto the reform. In this case, the government action is bound to be politically impaired and conditionality is necessary to counterbalance the presence of the interest groups.

7. As a result of internal and external reviews pointing to a lack of effectiveness of traditional conditionality, the World Bank and other donors have adapted their conditionality. The Bank has embraced selectivity (i.e., channeling aid only to countries that are committed to reform) as a guiding principle of its lending, and it increasingly relies on performance-based conditionality. Selectivity rests on the assumption that donors have no influence on domestic policies. Instead of trying to induce governments to reform or create reformers, donors select genuine reformers and provide them with financing. The donors thus replace ex ante conditionality with ex post conditionality. They may condition their financing on policies or outcomes—i.e., donors select the countries to support either on the basis of the policies they implement or depending on the results they achieve.

8. New forms of conditionality are increasingly being used, such as the peer-monitoring mechanisms used by the New Partnership for African Development. The trend appears to be toward more transparent ex ante criteria or prior actions. The Bank has moved strongly in the direction of programmatic lending and streamlining conditions, which has contributed to greater ownership. An eclectic mix of traditional and new approaches is already being used—with programmatic policy-based lending offering a particularly promising way to reconcile the debate between the traditional ex ante approach and the aspirations of a results-based approach to conditionality. Rather than insist on conditionality in specific loans, donors have begun to impose their expectations on the concessional windows such as IDA. The success of the IDA replenishment itself has been increasing conditional on the World Bank agreeing to reshape its lending priorities to accommodate donor demands.

THE THEORY AND PRACTICE OF CONDITIONALITY: A LITERATURE REVIEW

I. INTRODUCTION

1. Policy-based conditionality—or simply conditionality—linking the release of funds to the implementation of a desired action or policy is a central element in the aid relationship between international financial institutions (IFIs) and recipient countries. The International Monetary Fund (IMF) has used conditionality since its inception. At the World Bank, it was used only sporadically in a project context but it gained in importance in the early 1980s in the context of policy-based lending, with structural adjustment programs. Through their conditionality, the IFIs require a recipient government to take a specific action at a prespecified date to secure the release of funds.

2. Conditionality in policy-based lending has been the subject of extensive research for more than two decades. In recent years, the use of conditionality by the World Bank and the IMF has come under renewed scrutiny. The objective of this paper is to review the theoretical and empirical literature on conditionality. The paper cannot pretend to do justice to this vast literature as it inevitably must leave out several important aspects. Its ambition is limited to presenting the analytic frameworks developed in the literature on policy conditionality. The paper offers an assessment of whether these frameworks provide a deeper understanding on how conditionality works in practice. It draws on the work carried out by the Bank itself as well as other international financial institutions, and on the academic literature.

3. This literature provides insights on the workings of conditionality. It recognizes that conditionality in the World Bank has evolved over the last 25 years as the Bank internalized the lessons from experience. While some policymakers found conditionality to be useful, others were more critical. The Bank has considerably shifted and streamlined its approach, moving from traditional conditionality to programmatic lending. This has contributed to a new perception of conditionality and perhaps greater ownership. Two important questions are answered in this paper: (a) how did the IFIs, especially the World Bank, adopt those findings and reform their policies on conditionality, and (b) do the responses of the IFIs address some of the factors determining the effectiveness of conditionality?

4. This note recognizes that there are different definitions of conditionality in the literature. The Bank's operational policy defines "conditionality" by stating "The Bank determines which of the agreed policy and institutional actions by the country are critical for the implementation and expected results of the program supported by the development policy loan.[1] The Bank makes the loan funds available to the borrower upon maintenance of an adequate macroeconomic policy framework, implementation of the overall program in a manner satisfactory to the Bank, and compliance with these critical program conditions." The IMF formally defines conditionality as "… a way for the IMF

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1 This has been noted in other contributions to this review. See World Bank, *Legal Aspects of Conditionality in World Bank Policy-Based Lending*, (SecM2005-3090/2), June 2005.

to monitor that its loan is being used effectively in resolving the borrower's economic difficulties so that the country will be able to repay promptly, and make the funds available to other members in need." From the perspective of the IMF, conditionality is meant to put in place the necessary safeguards to ensure that the funds made available to the borrower are used for their intended purposes and in a manner that does not jeopardize their contractual servicing and repayment (Khan and Sharma 2003).

5. Conditionality has greatly evolved during the last two decades. Although a historical perspective of the evolution of conditionality would be useful for a full understanding of its practice, it is outside the scope of this note. This paper emphasizes the conceptual aspects of conditionality rather than its historical evolution. In this note, conditionality will refer to the set of conditions a donor attaches to the release of the funds it provides to the beneficiary. The resources are made available upon the (promise of) implementation of a set of policies the borrower and donor agree upon. This is the "traditional" view of conditionality, on which the first part of this note will focus. Section VI of this note discussed how, following reviews and assessments of traditional conditionality, a new approach to conditionality has emerged in recent years.

6. ***Structure of This Paper.*** Section II provides a taxonomy of the situations where conditionality serves a purpose. Section III presents a brief overview of the existing literature, particularly some of the work carried out by the Bank itself. Section IV focuses on traditional conditionality as it has worked and identifies the factors driving the effectiveness of conditionality. Section V reviews the theoretical frameworks that have been proposed in the academic literature to conceptualize conditionality. Section VI examines how the Bank internalized the findings from the literature and adjusted its policies to improve its practice of conditionality. Section VII summarizes the paper's findings.

II. RATIONALES FOR CONDITIONALITY IN THE LITERATURE

7. Before reviewing the literature, it is important to understand the rationale for conditionality. The basic idea underlying conditionality is that the donor provides incentives to the borrowing government for the implementation of policies that would improve the welfare of its citizens. At first it may seem paradoxical that the government needs externally provided incentives to carry out such beneficial policies.

8. The government may simply not know of the policy in question. In that case, it is sufficient that the donor provides technical assistance and advice to make the government aware of the right policy. Once the government is convinced of the usefulness of the policy it would simply unilaterally and willingly implement it. Conditionality serves no purpose in this context; the donor certainly does not need to reward the government on top of its advice for implementing the policy. It may even be counter-productive since it provides the government incentives to reverse the policy. Coate and Morris (1996) argue that conditionality is beneficial in this context if it is used as a convenient way to convey a message of commitment. Though it may conceivably be a relevant feature for some least developing countries with weak capacity, government ignorance is generally not

considered a factor in this paper: unless otherwise explicitly noted, the recipient government is assumed to be fully able to assess the impact of the conditionality policy.

9. There are at least three cases in which conditionality in principle serves a purpose.[2] Each of these cases lends itself to a specific theoretical treatment to which this note will come back in later sections. First, *the recipient government and the donor have different beliefs on the appropriateness of the policy for improving social welfare*. They have divergent preferences on the policy to implement. There is an "ownership" failure in the sense that the recipient's preferred policy does not coincide with the one favored by the donor.[3] Conditionality is necessary in this context; the donor compensates the recipient for the expected loss concomitant to the adoption of the policy. The donor 'buys' the reform. This case reflects the early experiences of conditionality.

10. Second, the recipient government fully owns the policy, it is committed to implement it, and the donor is eager to support. *The government may however face domestic resistance for the implementation of such policy*. Implementing the policy comes at a political cost for instance or can simply be vetoed by opposing forces. The government may also know that the policy is the right one for overall welfare but has an incentive to deviate from that policy and enact a different policy preferred by, say, special interest groups who make contribution to the government. In both cases, conditionality serves a purpose and the donor will have to compensate the government for the expected costs of reform and the implementation of the policy. In the usual jargon, the donor will have to meet the participation constraint of the government.

11. Third, *conditionality may be used as a signaling device by the recipient government*. By agreeing to implement a program and comply with its conditions, the government sends a message to potential private investors on its commitment to implement the required policies and maintain a sound economic environment. Endorsing conditionality helps the country establish the credibility and predictability of the policy environment. It also allows the government to distinguish itself from nonreformers. This argument is put forward by Dhonte (1997) and by Marchesi and Thomas (1999). Whether the recipient country "owns" the policy is immaterial, it will accept conditionality whenever the expected costs associated with the policy are lower than the anticipated benefits from higher foreign investments.

12. Collier et al. (1997) identify four rationales for conditionality: (a) inducement, where the donor offers aid as an incentive to change or adopt policies, (b) paternalism, where the donors believe they know what is best for the recipient's welfare, (c) restraint, when the recipient needs a commitment device for a particular policy and conditionality as credible threat to avoid reversal, and (d) signaling, whereby a message is sent to the (international) private sector and other donors that domestic policies will improve. The ownership-failure case encompasses both inducement and paternalism rationales. However, full borrower ownership does not fit into the Collier et al. (1997) typology.

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[2] Williamson (1983) offers one of the earliest and most comprehensive set of studies on conditionality.

[3] There is ownership failure from the donor's standpoint. It is actually the donor who owns the policy since it reflects more the donor's than the recipient's objective (Killick, 1997).

III. OVERVIEW OF THE LITERATURE ON CONDITIONALITY

13. Conditionality in policy-based lending has been the subject of extensive research for more than two decades. This section presents an overview of some of the work carried out by the Bank itself, the experience of other international financial institutions, the academic literature, and analysis by civil society organizations.

A. Reviews of Conditionality Undertaken by the Bank

14. The Bank has been analyzing its own conditionality since the introduction of policy-based lending in the early 1980s. These efforts include the following:

- ***Early reviews of conditionality.*** The Bank reviewed its experience with conditionality in three very detailed reports on adjustment lending in 1986, 1990, and 1992.[4] In addition, in 1995 the Operations Evaluation Department (OED) conducted an extensive study of the Bank's experience with adjustment lending in the 1980s, including conditionality.[5]

- ***World Bank reviews of conditionality in the 1990s.*** The Bank's reviews of conditionality in the 1990s focused more on the effectiveness of its lending instruments, and less on the specific design of programs and the associated conditions.

- ***Research on aid effectiveness.*** A dominant lesson of the research on aid effectiveness[6] in the 1990s is the importance of country ownership: donors can advise on and support, but cannot buy or induce, economic reforms.[7] One conclusion could be to forgo ex ante conditionality involving promises of future actions and instead allocate policy-based loans on the basis of a country's track record. Research also suggests that programs yield long-term benefits if a country's policy environment is favorable. This suggests that policy-based lending should focus on countries with good policies. More recent contributions confirm the relevance of ownership as the driver of reforms, by showing that surges in finance do not lead policy reforms.[8]

- ***Annual Review of Development Effectiveness (ARDE) 1999.***[9] The ARDE report (discussed in greater detail in Section VI) confirmed that conditionality could foster a country's commitment to ongoing reform when there was true ownership of those policies.[10]

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4 See World Bank (1986b); World Bank (1990); and World Bank (1992a).
5 See Jayarajah, and Branson (1995).
6 See in particular World Bank (1998); Dollar, and Svensson (2000); and Devarajan, Dollar, and Holmgren (2001).
7 See Devarajan, Dollar, and Holmgren (2001).
8 See Alesina and Dollar (1998).
9 See World Bank (1999a).
10 As a framework for assessing borrower ownership, the OED report refers to Johnson and Wasty (1993).

- ***Adjustment Lending Retrospective.***[11] The Retrospective (discussed in greater detail in Section VI) concluded that the initial focus on short-term balance of payment support had largely given way to a focus on sustained support for complex and often unpredictable medium-term reforms and suggested that a programmatic approach was better suited to deal with the need to support countries in their increasing focus on medium-term structural and institutional policy programs.

15. ***Recent World Bank Reviews of Conditionality.*** In these reviews the Bank has paid significant attention to the different design aspects of conditionality, including those associated with the initiatives to enhance country ownership of programs and streamline conditionality as well as with Bank-Fund collaboration.[12]

- ***Programmatic Adjustment Lending Retrospective.***[13] The Retrospective (discussed in greater detail in Section VI) took stock of experience with the programmatic approach, and concluded that the programmatic approach had been robust and effective in a wide range of country circumstances.

- ***Reviews of Bank-Fund collaboration.*** The Bank's review of its conditionality has also been carried out in the context of reviews on Bank-Fund collaboration, which were discussed by the Boards of both institutions.[14] Building on the earlier division of labor set out in the Concordat of 1989, a strengthened framework for Bank-Fund collaboration was introduced in 2001. Under this framework, staff are expected to provide coherent support to countries through early and systematic coordination on programs and conditionality, with each institution focusing its conditionality on those areas that are deemed critical for the success of their respective programs. A special framework is provided for low-income countries, where the Poverty Reduction Strategy Paper (PRSP) process defines an overarching framework for that collaboration. The reviews carried out thus far show that both institutions have made reasonably good progress in the strengthened collaboration framework, but that there is room for improvement as well as a need to monitor and review developments in the future.[15] The next review of Bank-Fund collaboration is expected to be concluded by end-2007.

- ***Annual Review of Development Effectiveness 2003.*** The 2003 ARDE (discussed in greater detail in Section VI) focused on the effectiveness of Bank support for policy reform, acknowledging that the Bank's approach is

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11 See World Bank (2001).
12 See Stiglitz (1998); Wolfensohn (1999); and Köhler (2000).
13 See World Bank (2003a).
14 See IMF-World Bank (2001); IMF-World Bank (2002); and IMF-World Bank (2004).
15 The reviews have been based on surveys of authorities, Executive Directors, mission chiefs in the IMF, and country directors in the Bank, complemented with desk reviews of case studies and analytic work.

grounded in the country's leadership and ownership of the development agenda, with the support customized to country circumstances.[16]

- ***Conditionality revisited.*** Building on the previous literature and acknowledging that the traditional understanding of conditionality as leverage is a thing of the past, recent work by Bank staff revisits conditionality and examines the new forms that conditionality has taken.[17] According to this work, conditionality should be thought of as part of a cycle that also includes policy dialogue and capacity building, with the participation of key stakeholders. Policy advice cannot be prescriptive or based on standardized development models but should help countries develop their own solutions for applying principles that have been recognized as valid development approaches. The use of budget support for low-income countries called for aid agencies to continue their efforts at harmonizing their policies and procedures and increasing the predictability of their support. There are still outstanding issues—for instance, about greater reliance on process conditionality, or the recognition that fragile states present a completely different set of challenges—that future practice will need to answer.

B. Recent External Work on Conditionality

16. Examination of the Bank's experience with conditionality has included external consultations with civil society and other stakeholders. The two most important consultative reviews are the Structural Adjustment Participatory Review Initiative (SAPRI) concluded in 2001, and the Extractive Industries Review (EIR) concluded in 2004. These two consultations, which were directed by prominent figures from outside the Bank, concluded with reports and discussions between the representatives of participating civil society and the Bank.[18] The results of these consultations were reflected in the recent change in practice and operational policy.[19]

17. ***External Critiques of World Bank Conditionality.*** Conditionality has been the subject of extensive critiques from different political directions. The Meltzer commission on international financial institutions advocated limiting policy-based lending to countries with good policies.[20] Some civil society organizations have taken aim at what they consider to be excessive intrusiveness and lack of transparency in the Bank's policy-based lending. They also criticize the Bank's advice for being too narrow and policy-based lending for insufficiently considering policy alternatives in specific areas.[21]

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16 See World Bank (2004a).

17 See in particular Koeberle (2003) and Chapter 5 in the volume edited by Koeberle, Bedoya, Silarszky and Verheyen (2005).

18 For SAPRI, see http://www.worldbank.org/research/sapri/index.htm; for EIR, see http://www2.ifc.org/ogmc/.

19 See World Bank (2004b).

20 See Meltzer et al. (2000).

21 See Action Aid (2004); Eurodad (2003); Oxfam (2004); Save The Children (2004); and World Development Movement (2004).

18. Research has also been commissioned by groups of borrowing countries, such as the Group of 24;[22] and bilateral donors have reviewed their own positions on conditionality,[23] and think-tanks have reacted to calls from civil society and other stakeholders.[24] Other recent research looks at World Bank conditionality, selectivity, performance-based conditionality, and the implications of the aid effectiveness research.[25]

19. ***Academic Literature.*** Traditional conditionality has often been judged as overly and increasingly intrusive, infringing national sovereignty (e.g., Drazen 2002), undermining domestic democratic processes and institutions (e.g., Stiglitz 1999), and ineffective in bringing about the desired outcomes (e.g., Easterly 2005). Koeberle (2005) offers a detailed overview of this literature, which is often critical of World Bank conditionality. Using a rich database on the policy-lending operations carried out by the Bank between the fiscal years 1980 and 2003, he also assesses the validity of these critics. The main analytic ideas from this literature are summarized in the next sections.

IV. Effectiveness of Traditional Conditionality

20. Structural adjustment initially focused on achieving macroeconomic stability and promoting liberalization (for example, by getting prices right and privatizing state enterprises). But its lack of effectiveness was associated with neglect of issues involving governance, institutional structure, policy ownership, and the social costs of adjustment. The reviews of traditional conditionality undertaken by the Bank discussed in the previous section have identified many cases where (a) recipients governments accept the conditions attached to aid in anticipation that they will renege, (b) donors fail to apply sanctions stipulated in the conditionality contract, and (c) recipient governments also anticipate that it will be granted funding in subsequent periods despite previous slippages. In these cases, the government was not really willing and committed to implement the policy but the Bank continued to provide financing. For instance, the report *Assessing Aid* (World Bank 1998) acknowledges that aid was provided to Kenya to support the same agricultural policy reforms five separate times. Easterly (2005) provides empirical evidence of repeated adjustment lending and prolonged use of IMF resources with no impact on policies or growth.

21. The main lesson learned from the literature on aid effectiveness is that financing is most effective when it complements local development efforts rather than substituting for them. Successful development depends on local ownership, local involvement, and adaptation to local conditions. The term *ownership* is used to describe countries' choice of and commitment to reforms, as opposed to their reluctant acceptance. The success of reforms depends more on underlying political economy factors than on the direct

[22] The Group of 24 discussion papers include: Buira (2002); Kanbur (2002); Kapur (2002); Wade (2001); Park and Wang (2001); Ocampo (2001); Jomo (2001); Cohen (2000); R. Webb (2000); and Oyejide (2000).

[23] See DFID (2004) and Bundesministerium fuer wirtschaftliche Zusammenarbeit (2004).

[24] For example, Collier and Dollar (2004); Mosley, Hudson, and Verschoor (2004); Mosley, Noorbakhsh, and Paloni (2003); and Khan and Sharma (2003).

[25] Recent papers include Adams et al. (2004); Bulir and Hamann (2003); Morrissey (2004); Killick et al. (1998); Killick (2004); Koeberle (2003); Winters, McCulloch, and McKay (2004).

investments made by outside actors such as private investors or international financial institutions such as the World Bank. Aid from bilateral or multilateral sources can be a critical support to communities and countries where there is a genuine movement for change. But for reform programs to succeed, the country must be "in the driver's seat." [26]

A. How Effective Is Traditional Conditionality?

22. The broadest consensus in the literature is that traditional conditionality, as it was conceived and practiced until the 1990s, has not been a success. Evaluators of conditionality have rated it ineffective in terms of compliance with implementation of the agreed upon policies and with respect to its effectiveness to produce the intended results in terms of growth or reduction in poverty. This section summarizes some of the arguments made in the literature on the effectiveness of conditionality.

23. In the literature, the record of conditionality has, in most cases, been measured in terms of compliance rates. The quality or adequacy of the conditional policies is generally not assessed—and the only relevant indicator is whether the government implemented, without reversal, the policies in the conditionality contract—because it is difficult to evaluate whether the policies associated with adjustment lending have led to better outcomes in terms of growth and welfare. Such an evaluation involves devising counterfactuals and separating the effects of the adjustment loan/credit from other influences, and raises a number of complex methodological issues. Such evaluations are difficult but not impossible.[27]

24. Other functions are typically highlighted in practice, such as the importance of the process, signaling, coalition building, and strengthening domestic institutions.

25. Heckelman and Knack (2005) use the period 1980-2000 to study the impact of aid on market-liberalizing policies. Contrary to Morrissey (2002), the authors find that higher aid volumes have slowed the reform over that 20-year period. Easterly (2005) also finds no positive impact on policy of repeated adjustment loans to the top 20 recipients of adjustment lending over the period 1980-1999. The evidence thus suggests that that the threat of donor sanctions carries little weight in the implementation of the requested reforms. Recipients comply only with reforms of their choosing and set their own reform timing. Conditionality ineffectiveness stems from two major proximate reasons: poor borrower compliance and lack of donor enforcement.

26. Although it is generally accepted that traditional conditionality has failed, the extensive research on the subject has revealed conditions under which conditionality can be useful in helping identify and implement necessary reforms. The overarching conclusion is that conditionality can succeed only when there is ownership of the policy. Conditionality helps when it supports governments already strongly committed to reform; see Devarajan et al. (2001). The ARDE report (World Bank 1999a) confirmed that conditionality could foster a country's commitment to ongoing reform when there was

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[26] See Stern, Dethier, and Rogers (2005).

[27] A good overview of the various methodologies that are available is provided in Bourguignon and Pereira da Silva (2003).

true ownership of those policies.[28] Moreover, when there was ownership, conditionality allowed the borrowing country and the Bank to develop and nurture mutual trust and commitment. The report suggests a new and flexible approach, with conditionality as a mutual commitment device between the Bank and the borrower, suitably combined with capacity building.

27. Contrary to the mainstream literature, Morrissey (2002) suggests that conditionality has had some effect on policies. Expanding the time horizon, he asserts that under donor stimulus recipient countries have implemented many reforms. Morrissey (2002) argues that donors have influenced the direction but not the pace of reforms—that is, recipient countries have implemented proposed reforms albeit often times years after the agreed timetable. Therefore, a study on conditionality compliance would fail to exhibit any move toward implementation if it restricts itself to the loan's original timetable. This view asserts the preeminence of the recipient in the decisionmaking as to when to implement the conditional policy.

B. Aid Recipients' Compliance Record

28. Do borrowers comply with conditionality? This is the central issue in assessing the effectiveness of conditionality. It is misleading to use program success, as several studies have done, to assess conditionality effectiveness because, as stated in Morrissey (2004), even if the borrower fully complies with the conditions, there is no guarantee that the outcomes will be as anticipated. The conditions maybe inappropriate or external factors may have undermined their impact. What is important for our purpose is that the conditions be implemented as agreed, this is the relevant indicator and it is easy to monitor if conditions are precisely stated and quantifiable actions defined.

29. The literature provides some evidence that borrower compliance with World Bank and IMF conditionality was poor during the 1980s but has gradually improved. The Bank's compliance record as measured by OED is quite good. The external literature, which often refers to data from the 1980s, is more critical. Considering 100 World Bank adjustment programs, Killick et al. (1998) infer from delays in second and third tranche disbursement that slippages occur in more than 75 percent of the programs. Delays in disbursement might signal that the conditions are, in fact, being enforced, on the basis that the Bank may refuse to release the funds for noncompliance. However, although compliance does not follow the delays, disbursement rates are near 100 percent, which means that the funds are in the end released irrespective of performance. World Bank (1999b) analyzes compliance with adjustment lending in 34 Sub-Saharan African countries, and finds that less than 30 percent of the countries have a good compliance record.

30. ***Conditionality as an Instrument for Policy Reform.*** White and Morrissey (1997) and Morrissey (2004) show that conditionality has been an ineffective mechanism to induce reform from unwilling governments and an inappropriate mechanism for genuine

[28] As a framework for assessing borrower ownership, the OED report refers to Johnson and Wasty (1993).

reformers. Many case studies, such as Devarajan et al. (2001), Mosley et al. (1995), and Killick et al. (1998), show that traditional conditionality as an instrument for the promotion of policy reform is rather ineffective. This is especially true when the government is not fully committed to implement the reform. Using a sample of 21 countries, Killick et al. (1998) shows that governments comply only with conditions they believe serve their best interest. Dijkstra (2002) arrives at the same conclusion using cases studies for 8 countries. In the same vein, Dreher (2002) and Mosley et al. (2004) use econometric methods to reveal the determinants of compliance rates. Mosley et al. (2004) find that certain country characteristics—such as income level, economic performance, and political stability—explain a sizeable degree of compliance rate variation. Dreher (2002), on the contrary, shows that only regional autonomy and elections significantly and positively influence compliance rates. Recipient countries comply with the conditions of their choosing and at the time they want. Compliance rates are significantly lower during sensitive political periods such as election or pre-election years. Dollar and Svensson (2000) also show that implementation of conditions is almost entirely explained by domestic political variables.

31. On balance, it can be said that compliance with traditional conditionality was rather weak at the beginning but improved over time as the World Bank incorporated in its practice the lessons of experience. Koeberle and Malesa (2005) provide evidence on how conditionality has evolved from 1980 to 2003 and conclude that (a) the average number of conditions decreased; (b) single-tranche adjustment operations are usually of higher quality than multitranche operations; (c) loans with fewer conditions are generally of higher quality than loans with many conditions; (d) World Bank policy-based lending is selective and favors better-performing countries; (e) the average number of conditions is lower in better-performing countries; and (f) the focus of conditionality has changed from short-term reforms to longer-term and more complex issues. To reform conditionality, one needs to understand the reasons for this poor compliance record. This issue is discussed in the next section.

C. World Bank Enforcement Record

32. The evidence on World Bank enforcement of terms and conditions of the aid contract when slippages occur differs depending on the source. Among the external literature, Killick et al. (1998) find that out of 16 cases of noncompliance, the World Bank condoned 12 by not enforcing the contract and denying future credits to the noncompliers. Killick et al. (1998) argue that loans are always disbursed regardless of compliance record. And Dreher 2002 claims the cancellation rate of World Bank programs is close to zero. This is corroborated by Svensson (2003), who shows that the profile of loan cancellation is the same for successful and unsuccessful operations. Mosley et al. (1995) show that the World Bank is even less likely to punish noncompliers with high debt service, which lays the bedrock for moral hazard. Dijkstra (2002) shows that the World Bank stopped many structural adjustment loans for not respecting the conditions. However, the World Bank almost immediately thereafter engaged in renegotiations with the countries to fund a new loan. In any event, the donor sends the "wrong" message to borrowers, undermines the credibility of sanctions, and harms the donor's reputation.

33. By contrast, several studies within the World Bank strongly suggest that the record of compliance with conditionality has been markedly improving over the last decade. For instance, an early study by OED (World Bank 1992c) found that tranche release rates were close to 100 percent although compliance rates with agreed upon conditions were below 50 percent.[29] Another OED study (World Bank 1997) shows that of the total amount the Bank allocated to adjustment lending between 1980 and 1996, 72 percent went to countries with poor track records on compliance with conditionality. The most recent OED evaluations indicate that policy-based operations seem to increasingly meet their development objectives. Operations are considered to have satisfactory outcomes if they achieve or exceed their main goals; this includes the relevance of and compliance with conditionality.[30] OED satisfactory outcome scores for policy-based lending increased from 60 percent in the 1980s to 68 percent in FY90-94, then rose to 82 percent in FY00–04. Most ex ante conditions in recent World Bank policy-based loans have been met. In addition, the Annual Review of Development Effectiveness 2003 also found that the Bank was successful in linking its support with good and/or improving policy environments.[31]

D. Factors Explaining the Limited Effectiveness of Traditional Conditionality

34. The previous discussion raises two closely intertwined questions: (a) what explains low compliance rates by borrowers, and (b) what explains low donor enforcement of agreed upon conditions?

35. Among the reasons for lack of enforcement are lending pressures, donor altruism, and defensive lending. Pressures to lend or "push the money" have been repeatedly invoked in studies about the World Bank. Kanbur (2000) cites numerous sources of pressure to release funds in the absence of compliance. Pressures may be exercised by private contractors (international or domestic), bilateral donors, and even other multilateral donors when there is cross-conditionality, for instance. Villanger (2002) shows in a multidonor model that conditionality may fail if companies that contract with the recipient have an influence on the donors. World Bank (1992b) also suggests that staff feel pressured to spend their budget and that this undermines implementation effectiveness and hence aid effectiveness. Dreher (2002) also argues that there are built-in pressures to lend in the World Bank because it finances its lending with money from the private capital markets.

36. Altruism may also prevent enforcement. In the short term, punishing the borrower for noncompliance by withholding resources only worsens its situation. Indeed, the borrower is probably expecting the funds left in the higher tranches of the loan to implement its own plan. Blocking the funds could disrupt the borrower plan and increase poverty, to which the donor is averse. This is certainly the case in Ghana, as reported by Kanbur (2000), where following a violation of a condition in its structural adjustment credit, suspension of the tranche resulted in the World Bank holding up as much as one-

[29] See Kanbur (2000).
[30] See World Bank (1999a).
[31] See World Bank (2004a).

eighth of the annual import bill of the country. Not releasing such an important amount of funding could have seriously affected the economy. The donor is faced with the Samaritan's dilemma,[32] especially when it cannot assess the reasons for noncompliance, such as adverse external shocks beyond the recipient's control.

37. The donor may also engage in defensive lending (i.e., issuing new loans or continuing to disburse despite noncompliance to enable the recipient country to service previous loans). Institutional incentives not to stop the lending pipeline may also exist. As stated by Thomas (2004), studies show that such perverse institutional incentives play out within the World Bank. However, the same studies have failed to demonstrate that these incentives are the "predominant cause of the Bank's failure to enforce."

38. There are several possible explanations for low compliance rates by borrowers. Compliance has been low for policies for which there was no sense of ownership, for politically difficult reforms, or reforms required to be implemented in sensitive political periods. The borrower may refuse to comply after agreeing to the conditions only because it feels that donor's sanction for noncompliance is not a credible threat. Considering the World Bank record, Thomas (2004) calls this the "enforcement critique," and concludes that the "Bank's failures to enforce have not been shown to be the predominant cause of poor borrower implementation," and that "no study has attempted to evaluate the extent to which failure to enforce was responsible for borrower noncompliance." The government may not be able to implement the policies it agreed upon because of domestic political reasons. Special interest groups whose rents may be jeopardized by the reform may lobby to block implementation.

39. Among other possible reasons for the mixed record on compliance are lack of capacity to implement agreed policies, especially in low-income countries, and the rigidity of traditional conditionality, which requires a specific action to be taken at a specific time. The institutional setting in the borrowing country may be such that straightjacket deadlines cannot be met, which implies lack of compliance. A large number of conditions can also constitute an impediment to compliance by undermining the willingness of the government to reform if it feels overburdened by the requirements.

V. THEORY OF CONDITIONALITY

40. Two approaches have been used in the academic literature to conceptualize conditionality. The first coherent framework to analyze conditionality is game theory, which uses as a prism the principal-agent framework. The risk with this approach is that it may tend toward an ahistorical analysis, which is why several authors prefer to view conditionality in terms of conflicts of interest in a political economy context. Several

[32] The expectation of charity can undermine the incentives to work and lead people to behave in ways that keep them in poverty. Buchanan identified this as the "Samaritan's dilemma." It is basically a time-inconsistency problem. Possible solutions to this dilemma involve punishment within an iterated game, reshaping the game in the direction of a dynamic one-shot game, and the delegation of the power of decision to an agent. See Buchanan (1972). For an easy-to-read presentation, see Dixit and Nalebuff (1994).

features of conditionality viewed as a complex game (such as the enforcement critique) will ultimately have to be solved empirically. This section presents the main features of these theoretical approaches.

A. Principal-Agent Framework

41. The most appropriate tool available to economists to understand conditionality is the principal-agent model. This model contrasts two players with conflicting objectives. The principal offers a contract to the agent that provides it with the appropriate incentive to align their objectives. A fundamental feature of the principal-agent model is the asymmetry of information between the two actors. The agent enjoys private information on her ability, opportunities and intentions that affect the action it takes and ultimately the principal's objective.

42. The principal-agent framework is well-suited in the case of an ownership failure. Indeed, the donor (the principal) offers aid as an incentive to the recipient government (the agent) to align their preferences. The lack of ownership reflects the conflict of interests. The basic framework in the literature is one in which the donor has altruistic preferences and cares about, say, public spending aimed at poverty reduction, whereas the recipient government weighs poverty reduction with some other component that benefits only segments of the population (e.g., the elite). As the donor is seen as more concerned with the poor than the recipient government, it typically relies on conditionality to enforce compliance with poverty reduction policies. The principal then will make transfers to the recipient "conditional" on increases of poverty reduction spending. The agent enjoys private information on its cost of choosing the donor's preferred policy. The donor may not be able to observe the action but only the final amount of poverty reduction spending, in which case we are in a moral hazard setting, as in Svensson (2000, 2003) or Azam and Laffont (2003). Adverse selection, on the other hand, arises when the donor is uncertain about the weight the recipient government attaches to poverty reduction spending. Mosley et al. (1995) and Killick (1997) are among the pioneers in applying the principal-agent framework to foreign aid.

43. In the principal-agent framework, the effectiveness of conditionality hinges on the ability of the principal to commit to enforcing the contract. The strength of the donor's commitment ability is inversely related to its degree of altruism. Indeed, a highly altruistic donor will always release the funds even though the recipient government does not implement the required action. As long as the donor does not have access to a commitment technology that will help carry out the sanction ex post, the recipient government will have the upper hand because it knows and takes advantage of the donor's altruism. In the worse case scenario, the recipient may even want to impoverish the country to receive higher aid transfers.

44. It is now widely accepted that the principal-agent is the best theoretical vehicle to operationalize the traditional conditionality relationship. There is also a consensus in the literature that the ultimate factor that makes aid ineffective to induce policy reform is the inability of the donor to strongly commit to enforcing conditions. What can the donor do

to signal commitment? Did donors learn from the findings of the literature and adjust their conditionality policies?

45. The objective of the recipient government is to keep the donor within this environment. The donor, a victim of the Samaritan's dilemma, will be unable to achieve any sustainable and tangible change in the recipient country. The recipient country will each year renege on its promises to make reforming efforts. The heart of the problem is the donor's access to a commitment technology to carry out sanctions. This would render the donor's threat to stop the aid flows credible. The recipient will in turn realize that the donor is serious about withholding funds if the policies agreed upon are not implemented. There are at least three ways to access that technology.

46. First, the donor may use yardstick competition by considering several recipient countries at the same time. Since the donor is equally altruistic toward the poor population in the recipient countries it will only reward the government that implements poverty reducing reforms. This is a time-consistent strategy since the return of aid is highest for the reforming country. However, with diminishing returns to aid there may be a point beyond which the donor will give transfer to the nonreformer. Not reforming on the other hand becomes a dominated strategy. This idea has been considered by Svensson (2003) and Federico (2001). Yardstick competition can be interpreted as selectivity whereby the donor rewards only the committed reformers.

47. A second tool at the disposal of the donor to enhance its commitment ability is the inherently dynamic nature of the donor-recipient relationship. Aid relationships are clearly repeated interactions over the long term. The Bretton Woods institutions have now been active for over 60 years, and the Bank has been providing policy-based loans for 25 years, sufficient time to build an "enforcer reputation. Clearly in a one-shot game there is no reason for the donor not to give the aid if it helps even marginally reduce poverty. However, in a longer-term perspective, the donor may be willing to incur the cost of having high poverty rates for the few periods necessary to establish its reputation. This would enable the donor to "force" the recipient government to take the right action for the remaining (infinite) periods.

48. Third, the donor may delegate the task of aid giving to a third party that is less averse to poverty. The donor will still have to write a contract with that third party. Delegation can be costly and is not immune to collusion. Svensson (2000) proposes the delegation of aid to multilateral institutions, which are supposedly less averse to poverty and less prone to commitment problems.

49. Yardstick competition, also an appealing idea, suffers from a serious drawback. It does not take into account the possibility of collusion among the recipient countries. Because the recipient countries do not want to exert any reform effort, they may collude and agree to carry out the same effort level, say zero. In this scenario, the donor is still faced with identical countries that have backtracked on their reform promises. The donor still cares about poverty reduction and will equally divide the aid budget among the recipient governments. It should be noted that this collusion issue may be mitigated by increasing the number of countries that compete for a given budget. Indeed, because of

coordination problem and costs of communication, the likelihood of collusion is inversely related to the number of competing recipients. It must, however, be noted that collusion is highly unlikely unless the donor explicitly shapes the game as a tournament.

B. Political Economy Perspective

50. The principal-agent framework is a good vehicle for the conditionality game when the recipient does not own the donor's favorite policies. Indeed, when there is recipient ownership, the conflict of interest seemingly disappears and so does the need for conditionality. Drazen (2002), however, argues that conditionality and ownership are both central to aid programs. Khan and Sharma (2003) support the same claim. As recognized by Drazen (2002), in order for conditionality not to be redundant (or counterproductive) there must exist a conflict of interest *somewhere*. If government and donor preferences are congruent, domestic conflicting interests between the government and, say, special interest groups provide a rationale for conditionality. The interest groups may not favor the proposed reform policy and have the ability to take actions that are costly to the government, such as strikes and so forth. They can also simply have the power to veto the reform. In this case, conditionality is necessary to counterbalance the presence of the interest groups. The fact that domestic political factors are important for compliance with conditionality is demonstrated by Dreher (2002), who empirically shows that compliance is low during election and pre-election years, meaning governments refrain from implementing prescribed policies that may jeopardizes their political future, even though they reflect government preferences.

51. The political dimension of the aid/conditionality relationship has been recognized by the literature since at least the seminal paper of Boone (1996), which shows that aid is ineffective when the regime in place is not "liberal." Svensson (1999) also shows that politics is an important ingredient to determine the effectiveness of aid. Dollar and Svensson (2000) show that the length of tenure of the incumbent government and whether it has been democratically elected are significant determinants of reform and adjustment program success.

52. There are many political obstacles to economic reforms that induce the government to postpone reforms for better times, for instance after elections. There is a growing literature on the political economy of reform that tries to explain poor compliance with conditionality and weak implementation of reforms. This literature mainly argues that reforms are delayed or not implemented because of the presence of conflict of interests between the government and entrenched interests groups. The latter have an interest in the maintenance of distorting policies and an incentive to oppose reforms aimed at removing them, including reducing or removing tariffs, privatization of state-owned enterprises, or land redistribution. The political economy of reform, which dates back at least to Alesina and Drazen (1991), has been usefully applied to the aid and conditionality game and helps sharpen our understanding of an important determinant of the success of conditionality. Many papers using this framework have recently emerged that discuss conditionality when domestic politics are the driving force for reform implementation; see, for example, Mayer and Mourmouras (2002), Joyce (2004), Drazen (2002) for IMF conditionality, and Johnston and Wasty (1993) for the World Bank.

53. The purpose of conditionality in this setting is to support the recipient government in its battle against special interest groups, to implement policies that benefit the majority. Conditional assistance can strengthen the bargaining position of the government in its move to push reform.[33]

54. To conclude, the literature has revealed one proximate and two ultimate factors that may drive the lack of effectiveness of conditionality. The proximate factor is ownership, on which most of the literature and IFI efforts have concentrated. When there is no ownership of the reform, it is the inability of the donor to back up the threat of sanctions with a credible commitment technology that undermines the donor effort to "buy" the reform. When the government is committed to the policy, the power of special interest groups to influence the policymaker's choice is the main determinant of the success or failure of conditionality.

VI. New Approaches to Conditionality

55. The international financial institutions have gradually adjusted their practice, learning from operational experience and integrating the main findings of the extensive research on conditionality. This section briefly discusses (a) the operational changes that have taken place, (b) the move to ex post programmatic lending, and (c) the range of proposals—some of them radical, such as pooled funding—that have been put forward to reform conditionality.

56. ***Changes in Operational Approach.*** The Comprehensive Development Framework—which outlines the way in which the World Bank should do business with recipient countries and other development partners—was introduced in 1999. It promotes four principles, addressing past shortcomings in development assistance. First, development efforts should be rooted in a long-term, holistic vision of a country's needs, not just macroeconomic but also social and structural. Second, it should focus on results rather than inputs. Third, it should be based on country-owned strategies. And fourth, development actors should foster partnerships to support the country-owned strategy. These principles provided the backdrop for a major innovation in aid delivery—the poverty reduction strategy (PRS) process adopted in 2001 by the boards of the World Bank and IMF. This process became the basic springboard for all low-income country access to expanded debt relief, and then to the concessional funding windows of the two institutions—the IDA and the Poverty Reduction and Growth Facility (PRGF), respectively. It marks an advance on previous aid-delivery mechanisms in several key respects.[34]

57. First, the PRS process is more explicitly based on country ownership than past approaches. Each PRS is developed by the recipient country and presented in a Poverty Reduction Strategy Paper, through what is envisioned as a participatory process with representatives from all major groups in society.

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[33] See Hsieh (2000) for a political economy of reform model based on a bargaining game between two parties, say, government and pressure group.

[34] See Wolfensohn and Bourguignon (2004).

58. Second, the PRS process offers a new vehicle for effective coordination and harmonization among donors, reducing the costs of donor fragmentation. It is not only the explicit coordination between the World Bank and the IMF that marks an advance. Several bilateral donors, among them the European Commission and the U.K. Department for International Development, have thrown their full support behind the PRS approach and placed their own grants to low-income countries under the same discipline. For many countries, the PRS process has now become the main forum for donor coordination.

59. Third, the PRS process has supported a move away from project-centered assistance, setting development assistance in an explicit policy-consistent framework. Where countries have demonstrated some track record of seriousness in their reforms, aid is now often delivered as direct budget support through poverty reduction support credits, complementing or subsuming individual projects. To provide accountability, the PRS identifies clear targets for results and monitors progress toward them.

60. Finally and most importantly, in its emphasis on country ownership and budget support, the PRS process has supported a move away from excessive conditionality. The adjustment lending programs of the 1980s and early 1990s were marked by a proliferation of conditions—as many as 40 legally binding conditions per operation in the early 1990s.

61. While conditionality can support policy changes, it cannot persuade reluctant reformers. Since aid was becoming more focused on "willing reformers" articulating a development vision through the PRS process (i.e., on those poor countries that had relatively good institutions and policies), donors have attempted to lighten conditionality and mainly support measures the country included in its PRSP. For example, in the IMF's Poverty Reduction and Growth Facility, conditionality has become more limited, and is focused on the Fund's core areas of expertise and restricted to measures that have a direct and critical impact on the program's macroeconomic objectives.[35]

62. The change to a more country-driven process is not trivial. There is an inherent tension between a voluntary, country-owned statement of priorities (the PRSP) and a mandatory, externally driven judgment about its quality and feasibility. The two may be notionally separate—the government "owns" its strategy and the donors "own" their independent assessments of the strategy and resulting aid allocations. But in practice, different power relationships and local chemistry determine how much one actually influences the other. It is too soon to evaluate this evolution in the way of delivering aid. The implementation of this reform is taking time, both by donors (harmonization) and recipient countries (elaboration of PRSPs). But the first results are encouraging.[36]

63. The evolution over time of the practice of conditionality in both the World Bank and IMF is evidence that the IFIs internalize the findings of the literature and adapt their conditionality policy to the new findings. The changes in their practice of conditionality

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[35] See IMF-World Bank (2004).
[36] For evidence, see World Bank and IMF (2004).

are a response to the studies showing that fixed-tranche rigidity and high number of conditions hamper the effectiveness of conditionality. The institutions have introduced flexibility in phasing and tranching of their loans and also reduced the number of conditions. The introduction of programmatic policy-based lending gave more flexibility to the government to implement complex and unpredictable medium-term policy changes, and contributed to stronger ownership. The Bank's 2003 Programmatic Adjustment Lending Retrospective concluded that the programmatic approach had been robust and effective in a wide range of country circumstances.[37] Early experience with the approach was positive largely because of the design features that provided sufficient flexibility to facilitate a stronger focus on results, participation, and harmonization. Reliance on prior actions and on subsequent flexible triggers was seen as key to allowing greater ownership and to enhancing the predictability of Bank support.

64. The increased efforts to streamline the numbers of conditions in World Bank policy-based lending is strikingly clear in Koeberle and Malesa (2005, p.49). An initial phase of an increasing number of conditions from the beginning of the structural adjustment era was followed by a sharp decline starting in the early 1990s. The number of conditions started to decline following claims that governments were overloaded with conditions, which undermined the effectiveness of conditionality. Similarly, Khan and Sharma (2003) are strong and convincing advocates of the streamlining process adopted by the IMF.

65. Several internal reviews of the Bank document how the Bank has adapted its practice of conditionality. They show that the Bank has paid attention to the different design aspects of conditionality, including those associated with the initiatives to enhance country ownership of programs and streamline conditionality as well as with Bank-Fund collaboration.[38] The 2001 Adjustment Lending Retrospective concluded that the initial focus on short-term balance of payment support had largely given way to a focus on sustained support for complex and often unpredictable medium-term reforms. It suggested that a programmatic approach allows the Bank to base its support on performance rather than on promises, which is better suited to dealing with the need to support countries in their increasing focus on medium-term structural and institutional policy programs. The Retrospective indicated that conditionality cannot be a substitute for country ownership and reform readiness.[39]

66. The 2003 ARDE (World Bank 2004) focused on the effectiveness of Bank support for policy reform, acknowledging that the Bank's approach is grounded in the country's leadership and ownership of the development agenda, with the support customized to country circumstances. Bank lending was concentrated in countries that had relatively good policy environments, where the support backed further improvements in policies within a stable reform environment. The review noted, however, that the Bank's conditionality had not resulted in good outcomes in situations of high uncertainty. Strong analytic underpinnings were identified as a major factor contributing to the

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[37] See World Bank (2003a).

[38] See Stiglitz (1998), Wolfensohn (1999, Köhler (2000).

[39] See World Bank (2001).

success of policy programs. Nevertheless, the review noted that the Bank had not always paid sufficient attention to alternative perspectives or to individual country circumstances; it said that generic "best practices" should give way to intensified efforts to customize and adapt knowledge to specific localized problems, taking country experience into account. The review called for the Bank to "experiment with approaches that would complement intermediate indicators and conditions with indicators of direct poverty reduction results or other outcome-related indicators." It also encouraged the Bank to find ways to reduce the tension between its instruments of support and the efforts to promote country-led partnership approaches to development.

67. ***Importance of the Political Economy.*** The Bank has also increasingly been aware of the importance of domestic politics for the success of policy-based conditionality. It has acknowledged the influence that various stakeholders or interest groups have on the policy reform process and has increasingly called for the building of partnerships at the local level between the government and its constituencies or opponents to help build a broad-based consensus around the policy platform through public discussions. These efforts to achieve consensus have been shown by Drazen and Isard (2004) to enhance program ownership. The Bank also advocates partnership among donors, to harmonize their views and coordinate their efforts to more effectively support the government-owned strategy.

68. ***Selectivity.*** Recent external research that looks at World Bank conditionality shows that the World Bank has embraced selectivity as a guiding principle of its lending, and that it increasingly relies on performance-based conditionality.[40] This clearly shows that the World Bank did internalize the findings of the literature and change the way it practices conditionality to reflect that knowledge. For instance, Dollar and Levin (2004) show that the Bank is exercising higher selectivity based on the Country Policy and Institutional Assessment (CPIA) ratings when compared to other multilateral or bilateral donors. The greater selectivity applied by the World Bank in the allocation of policy-based lending is also confirmed by Koeberle (2005), who shows that during FY95-03 around 76 percent of the policy lending volume went to countries with above average CPIA scores.[41]

69. The selectivity approach implies channeling aid to countries that are committed to reform. The donors select the countries to support either on the basis of the policies they implement or depending on the results they achieve. As noted by Gunning (2000), policy-based selectivity may run into the same problems as traditional conditionality and undermine ownership. Indeed, if donors signal that they will select countries that follow good policies and simultaneously supply a predetermined list of such policies, the immediate effect is that recipients will face powerful incentives to adopt the prescribed policies. They will end up trying to implement policies they do not own. If the policies do not have a tendency to "persist" (Coate and Morris 1996), they will be reversed.

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[40] Recent papers include Adams et al. (2004), Bulir and Hamann (2003), Morrissey (2004), Killick et al. (1998), Killick (2004), Koeberle (2003), and Winters et al. (2004).

[41] See World Bank (2003b).

70. Given this caveat, outcome-based conditionality may be preferable over policy-based selectivity, as argued by Collier et al. (1997). Outcome-based conditionality has been tested in a number of African countries by the European Union. While it seems to be a promising avenue, there are serious practical drawbacks (Adams et al. 2004). Using outcomes as a basis for the selection of deserving countries has its own problems, such as the difficulty of measuring outcomes and the risk of not rewarding effort but sheer luck, because outcomes may result from policies and factors outside the control of the recipient. The heterogeneity of country circumstances may also be a difficult variable to control for. A solution proposed in the literature by Llavador and Roemer (1999) is the equal opportunity approach, where the *circumstances*—exogenous factors that counter the country's efforts (e.g., being landlocked)—of the country are taken into account and each government is rewarded for its efforts at making the economic environment enabling.

VII. Conclusions

71. This paper has reviewed the literature on conditionality, explored the benefits and drawbacks of various approaches, and attempted to provide a balanced assessment of its findings. In some cases, policymakers have found conditionality to be useful: conditionality should play a central role in policy-based lending, but it cannot substitute for country ownership and good policies. Traditional conditionality in policy-based lending has often been criticized as being ineffective and intrusive. The literature identifies a failure of traditional conditionality, which it attributes largely to the difficulty that donors have in sanctioning noncompliance. According to the literature, this weakness of the donors induces recipients to agree on ex ante conditionality, since they anticipate that they can renege and still obtain donor aid. Over time, this has led to the gradual replacement of ex ante conditionality with ex post conditionality and to a focus on ownership, selectivity, and partnerships.

72. ***Selectivity and Programmatic Policy-Based Lending.*** An exclusive focus on conditionality based on ex ante commitments or ex post results may not be practical or useful for the Bank's policy-based lending. Thus a key recommendation is to use conditionality selectively, tailored to country circumstances. Indeed, an eclectic mix of traditional and new approaches is already being used—with programmatic policy-based lending offering a particularly promising way to reconcile the debate between the traditional ex ante approach and the aspirations of a results-based approach to conditionality.[42] The Bank has moved strongly in the direction of programmatic lending and streamlining conditions, which has contributed to greater ownership.

73. The only factor that undermines the effectiveness of traditional conditionality that has not been tackled is donor capacity to enforce the conditionality contract. Gunning (2000) has discovered only one case where a government initially hostile to a reform finally implemented it and did not backtrack under donor pressure (the liberalization of the cashew sector in Mozambique). Selectivity is a revealed preference. By choosing to be selective, the donor deals with governments that own the policies and therefore

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[42] Koeberle (2003).

nonimplementation comes from external factors, in which case the government should be supported, not punished.

74. ***Alternatives to Conditionality.*** What are the alternatives to conditionality? The most popular option to date is selectivity, which rests on the cornerstone assumption that donors have no influence on domestic policies. Instead of trying to induce governments to reform (or to create "champions" or reformers), donors select genuine reformers to whom they distribute the aid budget. The donors thus abandon ex ante conditionality to adopt ex post conditionality. They may aid condition on the basis of policies or outcomes. As a result, donors do not have to face a punishment decision because of noncompliance and they do not need to have a commitment technology to carry out sanctions.

75. There is however a caveat in this reasoning. Selectivity is in fact a commitment to sanction governments that do not want to follow good policies.[43] Drazen (1999) models selectivity as an incentive mechanism that donors design to induce countries to reform. For a country that refuses reform, the donor may find it necessary to wait until the recipient country's economic situation (significantly) deteriorates. The denial of foreign aid and the continuous deterioration of the recipient's situation may in the end bring about regime change. If donors can be selective, cherry-picking countries they financially support and excluding others, what prevents them from being able to enforce their conditions in the old-style conditionality game?

76. Other alternatives to conditionality include greater emphasis on country ownership of programs (as envisaged in the Bank's development policy lending) and peer-monitoring mechanisms, such as used by the New Partnership for African Development (NEPAD), which is discussed below. It is also important that there be a separation of powers between the agencies that lend the money and impose conditions and those that monitor compliance. As long as the actions of lenders separate risks from rewards (both political and financial), they will induce a "conditionality moral hazard." However, as argued by Kapur (2004), conditionality is akin to an incomplete contract and there are inherent limitations to what the instrument can achieve. According to Kapur, a more viable, albeit radical, change would be to institute broad-ranging risk-sharing contracts between individual developing countries and the wealthier countries, mediated through the IFIs.[44]

77. While the conditionality regime has stepped back from its micro-detailed orientation, the trend appears to be toward more transparent *ex ante* criteria or prior actions. Thus, rather than insist on conditionality in specific loans/credits, donors have begun imposing provisions on the concessional windows of the IFIs, beginning with IDA in the 1980s. The success of the IDA replenishment itself became increasing *conditional* to the World Bank agreeing to reshape its lending priorities to accommodate donor demands. Thus, even as donors insisted on "increasing selectivity" in World Bank lending, recent IDA replenishments have added new issues. For example, in IDA13, although donors insisted that stakeholders be involved in Bank projects, they were more hesitant when it came to stakeholder involvement in Bank policies, especially lending priorities. And while a survey of preferences of opinion leaders from IDA borrowing countries found that the agenda of "Northern" donors was near the bottom of the list of

[43] The other side of the selectivity coin is that it may also be interpreted as a reward for reformers.
[44] This summary of alternatives to conditionality draws on Kapur (2004).

recipient countries,[45] to ensure that donor funds were spent wisely, 29 progress indicators were added to the IDA13 results measurement system. (In the end. IDA13 had a total of 23 objectives and its recommendations/actions added up to 62).[46] The Heavily Indebted Poor Countries (HIPC) initiative to reduce the debt of 41 "debt distressed" countries to a sustainable level is another example of shifting conditionality from specific loans to concessional windows. While the argument for debt reduction for these countries was straightforward, countries had to meet a set of criteria to qualify (i.e., undertake prior actions).

78. IFI conditionality has an intrinsic weakness: the design, lending, and monitoring functions are imbedded in the same institution, thereby creating an inherent conflict of interest (Woods 2000). A recent innovation is to separate the monitoring function through a peer-review mechanism. An example is NEPAD, launched in 2001. It commits African governments to democracy and good governance in return for greater aid and investment from the developed economies. Countries in the 53-member African Union can join NEPAD by signing its Democratic and Political Governance Initiative—a set of 12 commitments and eight actions—and by agreeing to an external review every three years by a panel of eminent Africans. This peer review system marks an unprecedented development in the most stressed region in the world. Thus far, 17 countries have agreed to be reviewed. The first round of reviews examining compliance with NEPAD's standards will focus on Ghana, Kenya, Mauritius, and Rwanda, and is scheduled for completion by 2006. As a way to hold African leaders accountable, the African peer review mechanism has drawn wide interest. It represents an ambitious attempt to subject African leaders to an ongoing examination by other Africans in priority areas and to shift from donor-imposed conditionality to peer monitoring.

79. A radical option is to develop risk-sharing contracts for development on the lines proposed by Shiller (2003). Commercial examples of such contracts, while rare, are not unknown. The most obvious form is to tie the rate of interest on sovereign loans to gross domestic product (GDP) growth. For instance, in 1994 Citibank arranged a loan of US$1.865 billion to Bulgaria, whereby the higher Bulgaria's growth rate, the greater the interest rate. Goldman and United States and the Deutsche Bank in Europe created an Economic Derivatives Market in 2002. Shiller's proposals are much more ambitious. As described by Kapur (2004), an example of Shiller-type contract would run as follows: Country A pays other countries if its GDP did better than expected relative to other countries' performance during the contract period, while other countries pay country A if A's economy did less well. These arrangements would work best among countries that are both geographically and economically "distant," since this would result in a lower risk correlation in their economic fortunes. The contract could be made not between country A and B, but between each of them and an international agency. For this to work, the contracts would have to be long term (50 or more years) and would require prior agreement on expected per capita growth rates for each country. The effect would be tantamount to an exchange of unexpected GDPs. Shiller's plan would also include a fixed annual fee paid among countries, regardless of GDP. There is no doubt that such a proposal, which would require concerted political will, could only emerge in the long run.

[45] See IDA (2001), Tables 3 and 4.
[46] See IDA (2002), Annex 3.

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