

Paul Collier's Presentation (edited by Peter Silarszky)

Policy-Based Lending in LICUS countries

The African Low Income Countries under Stress (LICUS) are the countries that have the weakest governance policies and institutions. This group of countries is an unsolved problem and a large group of poor people is living in these countries. The performance of these countries is not improving – on the list presented by the previous speaker, there were no African countries among the countries with significant improvement of policy environment but there were three African countries among the countries with deteriorating policies. So these countries start from the worst policies and institutions, dreadful outcomes in terms of poverty, and, even from this low base, conditions are tending to deteriorate. Thus, we shouldn't lull ourselves into a pretence that things are going well.

Conditionality versus Partnership in LICUS Countries

The language used on the issue of conditionality versus partnership is saturated with political correctness. Underpinning the issue of conditionality was the idea that there should be a bargain between donors and recipients of aid. However, you have bargains or deals in situations where objectives differ. After recognizing that objectives differ, bargains or deals are created where each side gets some of what they want in return for giving the other side some of what they want. Partnership by contrast pre-supposes shared objectives – the only problem you are overcoming with partnerships is a collective action problem.

With selectivity, i.e., for countries with acceptable policy and governance, it is very sensible to think in terms of a partnership framework. In these countries there is indeed a reasonable basis for presuming that the objectives are common, and so what is required is to overcome the collective action problem. However, it's not helpful to pretend that we are in the world of partnership in the LICUS countries – there are insufficient shared objectives. The reason why conditionality fails in these countries is not that its premise of different objectives is wrong, its premise of different objectives is actually right. The reason conditionality fails is that deals are not enforceable. We have to face this fact, and not hide this in politically correct language where we pretend that we're all agreed on the objectives. In LICUS we are not.

Problems of Old-Style Conditionality

The old-style policy conditionality ran up against two massive problems. First, there is a psychological problem called 'reactiveness', which is nothing distinctive to economics. It is a well-known concept in psychology, and if only we had had one psychologist at the time we were planning conditionality, we would never have gone down that route. The point of reactiveness is that if I tell a person what he's got to do, first of all he does not like being told what to do, and the only way he can re-establish his liberty and independence, and convince himself that he is free, is to try and do the opposite. So if the condition was pretty sensible, the person's incentives now become to do something that is

actually rather foolish. Thus the fundamental problem with policy conditionality is that when a list of things is ordered on to countries, the governments can establish their independence only by trying to do the opposite.

The second problem is the credibility of ex-ante conditionality. John Williamson in his introductory statement perfectly described the foundations of the credibility problem when he said that the first motivation for policy conditionality was to be able to disburse big money fast. If the basic motivation of donors for going into policy conditionality is to disburse big money fast, then the credibility of an enforcement agency is destroyed, and the experience with conditionality over the years has just reinforced this fundamental problem.

From Policy to Institutions and Forward

Recently, the focus of donors shifted from policy to institutions and policy rules, and there is growing evidence that policy results are basically embedded in institutions. So, attempts to change policy without changing policy rules face a fundamental credibility problem. This is the message coming from recent research such as that of Acemoglu, Johnson and Robinson (2001, 2002).

However, even the institutions themselves may not be fundamental, since they themselves are embedded in the beliefs and attitudes of a society. For example, why did post-world war II Germany have low inflation? Well ostensibly it was because it had an independent central bank. However, the learning experience that the German population had had with hyperinflation in 1920s underpinned the authority of the central bank.

The Importance of Learning Experiences

More attention needs to be paid to the learning experiences that cumulatively build beliefs and attitudes in the societies. Aid should reinforce the effects of reform, so that it accelerates favorable learning experiences. The most powerful learning experiences in a society tend to come from crises.

Let's examine the biggest single reform experience in Africa. Unfortunately, it went drastically wrong and it was a collective International Financial Institutions (IFIs) mistake that made it go wrong. In 1986 Nigeria, for the first time in its recent history, adopted a decent set of economic policy reforms. In economic terms the outcomes were remarkably encouraging – right through the second half of the 1980s. This was the fastest-growing period of Nigerian recent economic history. It is even more remarkable because it coincided with a severe depression following the crash in oil prices. So, in economic terms the reform program worked out well in the short-term. However, as a learning experience it was a total disaster.

In 1986, the world oil price dropped by about 50% causing a shock to Nigeria as a big oil exporter. In addition, Nigeria moved from a strategy of irresponsible borrowing to a strategy of debt repayment. These coincident shocks, i.e., fall in oil price and move from borrowing to repayment, halved real expenditure within a year. As a result, the population experienced a huge fall in living standards. At the same time, the IFIs

introduced a reform program, and so everybody in Nigeria now believes that reform causes poverty. This is the single biggest impediment for any reform program in current Nigeria, and therefore it is a disastrous example of the failure to separate stabilization from reform.

The lesson to be learned by the IFIs is that the stabilization should have been done quite separately from reform, and the consequences of that crash in living standards should clearly have been attributed to the failures of past policy – the disastrous policies of the early 1980s. Instead, the Nigerian population looks back on the early 1980s and the policies associated with them as the golden age – that's what they want to re-establish.

Errors versus Shocks

It is critical to determine what is the cause of each crisis – distinguish between errors and shocks. The Nigerians had a crisis partly because of cumulative errors but also because of external shocks.

The two star reformers in Africa, Uganda and Ghana, faced external shocks caused by crashes in their export prices a few years ago. Living standards came down due to big deteriorations in the terms of trade and this coincided with an election year. As a result, we very nearly lost both of the continent's star performers. We need better strategies to cushion those external shocks so they don't mislead electorates.

Selectivity and Credibility

If ex-ante conditionality works as an incentive then selectivity is bound to work as an incentive, because it has all the incentive effects of ex-ante plus no credibility problems. Ex-ante conditionality is now so contaminated by the credibility problem that the only way we get an incentive effect is with ex-post conditionality, i.e., with selectivity. This is not the main reason why I believe in selectivity, but I think if you are keen to get incentive effects from aid, then ex-post conditionality is the only hope.

Process Conditionality

I was one of the critics of policy conditionality, but I'm not a critic of process conditionality. However, the important question is which processes?

The big gap in the LICUS countries is in accountability. Not accountability to IFIs and the international community but accountability to the domestic population. Conditionality can become more legitimate by insisting on accountability to the domestic population. At the moment, even where there are the formal mechanics of democracy, it is generally without genuine accountability.

There are two epicenters of domestic accountability. One is a set of checks and balances associated with media, courts and elections. It is, I think, entirely legitimate to condition aid on those checks and balances. The second is accountability around budgets, and it is absolutely fundamental that we have transparency in budgets. Transparency is a critical input into domestic scrutiny, not an end in itself. Until budgets are transparent they can't

be scrutinized domestically. And even if they are transparent, a collective action problem has to be overcome to generate domestic scrutiny.

How can we get this domestic accountability? What should we be insisting on? I believe we should try and get more international standards and codes describing minimum acceptable practice (not necessarily best practice) – standards that are pertinent for the particular circumstances of the LICUS countries. The Extractive Industries Transparency Initiative is a very good example of creating a new standard and code in an area that is hugely important for low income Africa, i.e., the use of natural resource rents. Similar standards should gradually be made a condition for the other significant rents of sovereignty.

References

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