

Discussion paper (revised)

Alternatives to Conditionality in Policy-Based Lending

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Abstract

This paper contends that policy reform is a slow and difficult process and consequently donors can be more effective agents of policy change if they support rather than attempt to force this process. The emphasis should be on persuasion through policy dialogue rather than the overt policy leverage often associated with conditionality. Dialogue will result in agreed policy actions, and under some circumstances these may be specified as conditions to support the reform process. Three principles to guide the specification of policy actions or conditions are suggested. First, conditions should be clearly specified, narrow in scope and relatively easy to monitor. Second, conditions should relate to policy inputs, not to outcomes. Third, conditions should be independent of each other (unless the policy actions are known to be complementary). The policy dialogue approach proposed has the further merits of promoting ownership and facilitating donor coordination.

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1. Introduction

Conditionality has acquired meaning as a term to describe the mechanism of policy-based lending that has predominated in donor-recipient relationships, especially as practiced by the International Financial Institutions (IFIs), since the early 1980s. Interpreted literally, it simply means that aid (concessional lending) is given subject to the recipient country meeting certain conditions. In this literal sense, all aid is conditional (to a greater or lesser extent). However, *conditionality* has acquired a stronger meaning than this literal interpretation. First, it is applied to conditions on policy reform (as distinct, for example, from fiduciary conditions on accounting for the use of funds). Second, it refers to the use of financing to leverage policy reform, i.e. to impose particular policies, which need not be the policies that would freely be chosen by the recipient. Third, the conditions tend to be many and wide-ranging, applying not only to most areas of economic policy but also to aspects of governance and political processes. Fourth, at least in principle, the conditions are enforced, in the sense that failure to meet the conditions to a satisfactory extent typically means that funding is not released. Taken together, these capture the meaning of conditionality as a *mechanism* to leverage policy reform.

The aim of this paper is to draw a distinction between conditionality, as defined above, and policy dialogue as alternative ways in which external agents, in the present case bilateral and multilateral donors, can influence policy transfer. Policy transfer here refers to informing and promoting policy learning in developing (aid recipient) countries. We will depict conditionality as the traditional approach to policy transfer – donors, to a greater or lesser degree, require recipients to adopt and implement specified policies. Policy dialogue is treated as a form of partnership, where donors engage with recipients to aim to convince them that particular policies should be adopted. Whereas conditionality has an element of coercion, policy dialogue is firmly rooted in persuasion. We argue that dialogue is a more promising and effective means of policy transfer, while noting that conditions can play an role in supporting dialogue and policy learning.

The brief paper follows a simple structure, with Sections 2 and 3 drawing heavily on Morrissey (2004a). The next section clarifies the limits of conditionality – why it has not evidently been an effective means to promote sustainable policy reform. Section 3 then

explores approaches to dialogue as a means of policy transfer – persuading recipient governments that it is in their interest to select particular policies. Section 4 considers how policy dialogue could be implemented as an approach to policy transfer, and outlines to guidelines for the use of conditions in policy dialogue. The final section provides a summary and conclusion, considering implications for developing countries with very weak policy environments.

2. Limits of Conditionality

Differences regarding the importance of policy reform for aid effectiveness tend to relate to the details rather than the principles. There can be broad agreement that some countries have rather bad or inappropriate policies, and that other countries have rather good or appropriate policies. Arguably, most developing countries are in between – they have some good policies, some not so good policies, and many more or less reasonable policies that are only being implemented slowly, and perhaps half-heartedly. It does matter which policy area one is considering. For example, in the case of macroeconomic stabilisation there is broad agreement, at least amongst economists, of what is required (e.g. Boughton, 2003) – control or stability in domestic credit expansion, money supply, budget deficits, etc and monitoring inflation, the exchange rate and real interest rate. There is rather less agreement on what actually is the correct target or equilibrium value, e.g. for inflation or the exchange rate, and how quickly and severely one should try to get back to that value during a period of disequilibrium. In contrast, in policy areas such as privatisation or poverty reduction there is less agreement on what should be done, and often considerable disagreement on the details.

The simple point is that economics is not a sufficiently exact science for one to be confident about what is the optimal policy on any issue – donors themselves will often have different views on areas of policy. One may be able to identify inappropriate and ineffective policies, but in most areas one is left with a ‘policy range’ rather than a specific policy. This view lies at the heart of many critiques of conditionality, where the criticism is that the conditions imposed overly restrict the policy options – in common parlance, the conditions are too tight. If the conditions are viewed as being too tight, this is likely to undermine the willingness of governments to implement the desired reforms. It has proved easy to

demonstrate that conditional lending is an ineffective mechanism to induce reform from unwilling governments, and that tight conditions are an inappropriate mechanism if governments are willing to reform (e.g. White and Morrissey, 1997).

Conditionality of this form has under-pinned policy-based lending for almost two decades. Such conditionality does not work in the sense that attaching conditions to lending is in itself insufficient to ensure that governments will undertake reforms they would not have chosen willingly. Conditionality is, in effect, dictating the policy choices that governments should make and then tying lending to the implementation of those policies. This is not a solid foundation for a development partnership between donors and recipients. Policy ownership by recipients should require that countries choose their own policies, which is not an inherent feature of conditionality.

Morrissey (2004a) assesses the literature evaluating the effectiveness of conditionality. A specific weakness of this literature is that there are few rigorous comparable studies that analyze the chain from conditions to specific policies implemented to actual outcomes observed. Many studies argue, in effect, that not all conditions were fully implemented therefore conditionality did not work. This shows scant understanding of the nature of the policy environment (Morrissey, 1999): countries with relatively strong economies and developed political systems will tend to have greater scope to implement policy reform than countries with weak economies and underdeveloped political processes. Alternatively, studies observe that the outcomes (e.g. investment, exports or growth) were not as good as anticipated and infer that conditions were not met. Even if the policies were implemented as required, there are many reasons why the anticipated benefits may not be observed. The one point on which there is agreement is that rarely if ever are all conditions fully implemented within the time period of the aid agreement. In this sense conditionality does not work.

This does not mean that conditionality has had no effect on policies. There is considerable evidence that, over time, countries receiving policy-based lending (subject to conditionality) have improved their policies, and that such improvements in policy are associated with improvements in economic performance (e.g. Koeberle, 2003; OED, 2004). As a result of policy-based lending most developing countries have implemented

policy reform, but more slowly and less effectively than promoted by conditionality. Morrissey (2004a) illustrates this with the case of trade policy. While trade reforms featured prominently among aid conditions, and strictly evaluated conditionality failed (i.e. stipulated reforms were implemented and sustained within the posited time period), many developing countries have implemented trade policy reforms over the past two decades and aid leverage has played an important role. Donors play an important role in policy not by dictating choice but by informing and supporting the policy process.

What researchers have shown is that conditional lending *per se* is not an effective instrument for ensuring relatively rapid policy reform. Perhaps this should be no surprise as reform, except in cases of severe (political and economic) shock, is an inherently slow process. There are few cases where reform was implemented quickly and dramatically (the 'big bang' approach), and these cases were almost all failures. A gradual implementation is the most common case, largely because reform is politically difficult, even if governments are convinced of the economic arguments (Morrissey, 1999). Policy dialogue recognizes that the pace of reform must accommodate political and administrative constraints, as elaborated in the next section.

3. Policy Dialogue

Morrissey and Nelson (2003, 2004) review theories of policy learning and of policy-making to explore how external agents can most effectively influence the process of policy transfer. In the most simple model, policy-makers engage in pure learning by doing; policy choices are based solely on information relating to the history of the policy they have experienced and policy-makers have no information on alternative policies (as these have not been implemented). In this context, there is no role for external agents. A second model allows a country to observe the decisions of others. Such social learning provides information on alternatives, as policy-makers can observe the policies chosen by others. If others are observed to stick to a policy that is different from a country's policy, and the others appear to be performing well, the country may come to believe that the other policy is better. This change in beliefs induces learning and policy reform. For example, Kenya's willingness to prepare a PRSP was influenced by the perceived success of Uganda's adoption of a PRSP (Morrissey, 2004b). External agents, such as donors, can

influence policy choice by contributing to the learning process. For example, donors could provide information on policies that have ‘worked’ in other countries, or could support analysis of the effects of policies being implemented. The IFIs, in particular, have a strong research capacity and are therefore better able than individual developing countries to distil and disseminate lessons from policy experiences.

A third model, hierarchical social learning, allows an explicit role for external agents in proposing a particular policy. If external agents have an effective enforcement mechanism, this leads to governments implementing the policies advocated. In the case where external agents advocate essentially the same policies to all countries (the ‘one size fits all’ critique of conditionality), this causes policy convergence. This outcome is inferior to social learning for two reasons. First, convergence arises from effective enforcement mechanisms, not convergence of beliefs. Second, this convergence reduces ‘policy experimentation’, with an information loss for all observers. Only if the policy advocated by external agents is the best option (for all countries) will this lead to choice of the optimal policy. Even if external agents (donors) do not have an effective enforcement mechanism, they can influence policy choices in various ways.

Table 1 identifies various stages in the policy process and indicates the ways in which donors can engage to exert influence at each stage. Governments, or policy-makers, will have objectives regarding what it is they want to achieve (depending on their perceived interest) and beliefs regarding which policies best meet their objectives. The willingness of governments to implement reforms (to alter their policy choice) will depend on beliefs regarding the effect of any given policy (described as priors regarding the policy) and the range of policy options. In other words, stages A and B of the process refer to willingness to reform. Donors can influence willingness to reform in a number of ways. They can give information on the probable effects of alternative policies, affecting both priors and options, especially if they provide information on the effects of policy choices in other countries (knowledge transfer). By expressing their own views, preferably supported by analysis of evidence, donors can influence the policy agenda, and thereby influence choice. Note that such actions by donors do not require conditions.

Table 1 Donor Influences on Policy Processes

POLICY STAGES	DONOR ENGAGEMENT
A. Priors	Beliefs regarding the effects and efficacy of policies Placing specific concerns high on the agenda
B. Options	Provide and interpret information on policy options Policy advice and knowledge transfer
C. Design	Technical assistance on elements of policy design
D. Capacity	Support for policy choice and implementation strategies Taking responsibility for unpopular policies Providing evidence to build support or counter opposition
E. Commitment	Financial support for adopting policies Building policy-making capability
F. Administration	Technical support and assistance

Source: Morrissey (2004a).

Donors may also wish to influence policy-makers objectives, to encourage them to alter what they consider to be the interests of the country. This may often involve influencing political processes, such as through process conditionality. For example, the requirement for consultation and participation in the design of PRSPs affects the process of policy-making and places the interests of the poor onto the policy agenda (see Booth, 2003). Imposing process conditions is problematic as clearly donors are impinging on politics rather than specifically on policy. Within a policy dialogue approach, one could encourage policy-makers to consider different objectives by including assessments of policy impacts on different groups in society.

Much of the discussion of policy reform in developing countries has been concerned with the concepts of 'ownership' and/or 'commitment'. Ownership is often seen as necessary if policies are to be implemented successfully and sustained. What this means is not always clear. Morrissey (1999) adopts a strict definition: a government truly owns a policy reform if it has the capacity to analyze options and to choose and implement the preferred policy. True ownership requires that the policy choice originates with the government. Under this strict definition, donor leverage and influence undermines ownership, but true ownership is not necessary to ensure sustained policy reform. All that is necessary for a genuine attempt at reform is that the government chooses the policy because it believes it is the right policy. It does not really matter if this belief was arrived at because of analysis conducted by the government itself or because it was persuaded by information provided by donors (or other agencies, including independent researchers). The central issue is choice, not ownership. Donors should provide information and options, they may even indicate their preferences, but governments should then be allowed to choose. If donors agree with the free choice (which need not mean exactly the donors preferred policy), policy conditionality is not required (but donors could have fundamentally influenced the choice).

Perhaps the more interesting case is if donors do not agree with the choice. Here, theory and evidence suggest that conditions will be ineffective (White and Morrissey, 1997). An appropriate donor response would be to reduce the amount of aid released. In this context, donors should indicate which policies they consider very important or immediate, and which they consider less important. Whilst a major part of the aid commitment may relate to an overall programme of budget support, much aid will be linked to particular reform areas. Only in extreme cases would donors wish to terminate aid support completely. In principle, for any specific policy area aid disbursement can be linked to implementation of reforms in an agreed direction. If governments are not moving in that direction, disbursement is not triggered. In practice, all parties have an interest in disbursing aid once the money has been committed (this is the main reason why the threat required to enforce conditionality is not credible). If donors took a long-term view, aid commitments could be triggered by policy choices (in the right direction) with disbursements phased to support implementation.

The other stages of the policy process (C-F in Table 1) relate to ability to implement reforms, and donor influence and support is even more important here. Governments may have made the ‘approved’ policy choice, but may lack the political and administrative ability to design and implement the policy effectively. Even if governments ‘made’ the policy choice because it was required by conditions, failure to implement is often due to administrative and capacity weakness rather than to an unwillingness to reform (Morrissey, 1999). Donors can assist with technical and financial support. It is worth noting that if a government has chosen the policy (is willing to reform), it will be receptive to donor assistance in implementation. Indeed, many governments argue persuasively that they need technical assistance (e.g. in implementing standards and regulatory commitments under the WTO). As illustrated in Table 1, donors can support the ability to implement at a number of stages in the policy process. Technical assistance with design and administrative are the most important and effective forms of support. Supporting political capacity (e.g. persuading the opposition or civil society) needs to be undertaken cautiously as it can appear to be political interference.

Ultimately, if the aid relationship is to be one of development partnership, donors should aim to support policy-making and analysis capacity in the country. The aim is not to tell governments what policies to implement, but rather to help them to identify the effects of implementing alternative policies so that they can exercise policy choice. This is a clear and desirable move away from attaching conditions to aid – the support is for policy-making rather than for implementing specific policies. Governments will choose the policies they believe are in their self interest, so if donors want to influence the direction of reform they should influence beliefs. If the government then chooses the policy, donors should ‘put their money where their mouth is’ and offer aid support, for implementation of the policy and perhaps programme support more generally. Arguably, donors should go further: if donors believe in the policy they should be willing to compensate governments that implement the policy if the outcome is unfavourable (Morrissey and Nelson, 2004). Viewing donor influences on the policy process in this way serves to show why conditionality has been ineffective.

There is a danger if donors are influential and give ‘standard’ policy recommendations to all governments, so that all countries are following almost identical policy prescriptions. This will encourage policy herding, reduce the information gain from policy experimentation and reduce the chance that countries will be given the ‘optimal’ policy advice (Morrissey and Nelson, 2003). Unless donors could be certain that they are providing each country with the correct policy recommendation, countries should be allowed to experiment. Policy experimentation benefits all as it provides more information on what appears to work or fail under different circumstances. Thus, rather than imposing conditions, donors should provide information and advice but encourage governments to make policy choices. If these choices are in the right direction, then support for implementation should be provided. Ultimately, donors should support policy-making capacity in countries.

4. Dialogue and Policy-Based Lending

Although policy-based lending only accounts for a small proportion of World Bank lending, mostly to middle income countries, this understates the importance of policy commitments in the donor-recipient relationship. Bilateral donors typically require that a recipient has an agreement (in effect, an agreed policy strategy) with the IFIs before they will provide programme aid. For this reason, conditionality has had a more pervasive influence on donor-recipient relations, and on recipient policy choices, than would be indicated by simply looking at policy-based lending as a share of total aid. If a policy dialogue approach is adopted, would the donor-recipient aid-policy relationship look very different? On the face of it, the answer might be no – donors would still be hoping to exert some influence on recipient policies, and implicitly or explicitly there would still be conditions attached to aid.

The real differences would be matters of emphasis, although a properly developed dialogue would be quite different to conditionality. Greater emphasis would be placed on donors to provide evidence-based policy advice if they are to alter beliefs. Thus, if donors recommend a particular policy reform, or rather for every policy they recommend, they should support this with evidence on how the policy has worked elsewhere, reinforced with analysis of how the policy would impact on the country. Good policy advice requires clarity and confidence in the policy message, implying that alternatives should be considered. If a

clear policy stance cannot be advocated with confidence, it is unlikely to be convincing and will not alter beliefs. Furthermore, it is important that local policy analysis, government and/or independent, is part of the process. For many countries, especially the poorer, local analytical capacity is weak, and donor support for building capacity is an important part of the relationship. This is also vital for local consultation processes, as effective participation requires policy analysis capacity.

If conditionality is interpreted as 'select this policy if you want the money', it is evident from the foregoing that policy dialogue would be quite different. Current knowledge on the impact of many policies is quite limited. For example, while there is evidence that spending on social sectors tends to improve aggregate welfare (e.g. spending on health is associated with lower infant mortality) and can improve the welfare of the poor, there is less confidence regarding which growth policies are likely to be pro-poor (Morrissey, 2004b). If policy dialogue implies that agreed reforms are restricted to those for which there is solid evidence, the pace of reform will tend to be slow. Furthermore, as agreement is required and local conditions and alternatives will be considered, flexibility and 'policy space' will be important.

In practice, there is little new in this – donors and (most) recipients already have, to some degree, a dialogue on the policy options that are subsequently included in the aid-policy agreement. However, if more and clearer policy analysis is required so that government makes an informed choice, and the onus is on the government to choose rather than the donor to stipulate, aid agreements may be linked to quite specific policy areas. For example, it may prove easier to reach mutual agreement on macroeconomic and trade policies than, for example, on privatisation or policies towards capital inflows. Policy dialogue will be associated with slower and less extensive reform objectives than typically embodied in conditionality. Furthermore, as dialogue implies and should require a greater local input, the policy details are more likely to be tailored to the local environment. One implication is that a policy dialogue approach promotes ownership. Once the government makes its policy choice, it is up to the donor to decide if it is willing to support this with aid resources. If so, an agreement can be reached (in respect perhaps of the specific policy area). If not, dialogue continues and may, in some cases, breakdown (at least for particular donor-recipient pairs on specific policy issues). The implications for donor coordination are considered at the end of this section.

Policy Actions or Conditions?

The policy dialogue approach does not imply that there is no role for conditions in policy-based lending. Conditions associated with monitoring the use of aid, while justified, are not of concern here (e.g. donors providing budget support may want to impose conditions restricting the areas in which the money can be spent). However, there may be certain policy actions that the donor requires, even if only to demonstrate commitment to moving in the required direction of policy reform. If the government is convinced these policy actions are appropriate and is in fact committed, then there is no need to specify them as conditions (it may actually be counter-productive to do so). They could be listed as required policy actions, with the implication that when the agreement (or the release of tranches of funding) is reviewed their implementation will be given high priority. There are circumstances when it can be mutually beneficial to specify conditions, if the government wants to signal its commitment or lock-in reforms. While the primary objective is to provide evidence to alter beliefs and convince governments that the policy reform is beneficial and desirable, attaching policy conditions may reinforce the government's policy choice, especially in cases where strong opposition is anticipated.

Aid agreements in general, and policy-based lending in particular, involves an implicit or explicit contract. As part of this contract, it is reasonable that certain actions or objectives are specified. The issue is whether they are specified as conditions (required actions) or agreed/desired actions. While we would generally favour the use of 'policy actions' rather than conditions, it should be acknowledged that conditions can feature in policy-based lending agreements resulting from dialogue. Such conditions should be of the general form of ensuring that a particular policy direction is followed, and should not be overly restrictive (given that the intention is to reinforce agreed policy, rather than impose policy). The aim is to get policy moving in the direction that is shown to be best for the country. Three guidelines for conditions are recommended – that they be narrow in scope, relate to policy inputs, and are independent across policy areas – and also apply to specification of policy actions. The first guideline follows from the tendency of policy dialogue to result in agreements (aid contracts) relating to specific policy areas:

G1. Conditions should be specific, clearly stated and relatively easy to monitor.

The most important criterion is that any conditions relate to policy inputs – actions taken that are in the control of the policy-makers and where the actions themselves can be observed. This is important for a number of reasons. First, the policy input is the action undertaken by the government – it describes what they do. Second, it is relatively easy to monitor actions and assess if the policy input was implemented. Third, concentrating on policy inputs rather than on target outcomes avoids assessment of implementation being contaminated by factors other than government action that determine outcomes. The fundamental objection to conditions based on outcomes is that it is never possible *ex post* to attribute with certainty the causes of an outcome. Consider an example.

In the context of restoring macroeconomic stability, reducing the budget deficit may be an objective. Under the conditionality approach, a target deficit (as a ratio to GDP) could be specified. If this is a condition, the problem is that it relates to an outcome, and even if a ‘correct’ policy input was made, the target may not be met. For example, a government may reduce spending but if, due to external factors, tax revenue fell below target then the deficit reduction would not be achieved. A better type of condition could relate to the policy input, such as measures to reduce spending and/or to increase tax revenue. Implementing the required policy input implies meeting the condition. If the output (deficit) target is achieved, there is no problem. If the target is not achieved, then it is necessary to determine why – was it due to external shocks or events, or was the policy input inappropriate or not actually implemented? If an output target is not achieved, one cannot be certain that failure on behalf of the government was the reason. This problem does not arise in the case of policy inputs, giving rise to the second guideline:

G2. Conditions should relate to observable and verifiable policy inputs.

Donors often like to specify conditions in terms of outcomes or results, as this demonstrates that the objective is being achieved. Although this forms part of the dialogue, as in effect the donors are claiming that by adopting specific policies the desired results will be achieved, outcomes should not be made conditions for the attribution problem outlined above. Whether a particular policy yields the desired outcome will depend on a variety of factors in addition to the policy actions taken, especially shocks and unexpected events. The importance of shocks differs across countries. Typically, the poorest countries are also the most vulnerable to adverse shocks (e.g. terms of trade declines or bad weather), thus the

countries with the weakest policy environment are also those with the weakest link from policy inputs to outcomes. The importance of shocks also differs across policy areas. For example, macroeconomic outcomes are affected by terms of trade shocks, whereas health outcomes are affected by outbreaks of disease. It is for this reason that it is not sensible to have assessments in one policy area conditional on performance in another area. Different policy areas should be treated separately, i.e. conditions should be independent across policy areas. This gives the third guideline:

G3. Conditions in individual policy areas should be defined and assessed independently.

In practice, policy-based lending will relate to a variety of policy areas and in some cases the effects are related. Continuing our example, whilst one target may be to reduce the budget deficit, another may be to liberalise the trade regime. Trade liberalisation typically involves tariff reductions, which may be revenue-reducing. In this case, implementing conditions in one policy area may undermine achieving targets in another policy area. If conditions are inter-dependant, governments could end up being penalised (for not meeting outcome targets) even if they implement appropriate policy inputs. Of course, if the analysis underlying the policy recommendations were carefully conducted, such complementarities would be identified during the dialogue. Care should be taken to identify cases where cross-policy conditions are complementary versus those where they may conflict.

Adopting these guidelines for specifying conditions, and policy actions more generally, in an agreement resulting from dialogue can facilitate improved donor coordination. The separation of policy areas and placing the onus on donors to ‘make the case’ for the policies they will support offers the possibility for different donors to focus on different policy areas. This could be particularly relevant if donors wish to concentrate on particular sectors, such as health or education or private sector development. If donors are in agreement, among themselves and with the country, on the broad policy direction, or on policies in particular sectors, a case can be made for them to pool their resources (e.g. Kanbur *et al*, 1999).

5. Conclusions : Engagement in Different Policy Environments

The core argument of this paper is that the most effective way to influence the process of policy reform is to promote and support policy learning. Policy dialogue to encourage transfer of ‘proven’ policies is the best way to alter government’s beliefs about

which policies they should implement. Altering beliefs is the most effective way to promote sustained policy reform. Conditionality is not inherently a means of altering beliefs, therefore is not an optimal instrument of policy transfer. Nevertheless, appropriate conditions on policy inputs specified for each area of policy can reinforce policy transfer.

These general principles apply to all recipients. Among developing countries, some are more willing and able to implement reform than others, but this does not mean one needs a different approach to policy dialogue in each case. Where governments are committed to policy reform, and have the capacity (political and institutional) to implement a reform programme, the aims can be quite ambitious. Where governments have a weak policy environment (Morrissey, 1999), because they have weak political or institutional capacity to implement reforms, the reform agenda should be less ambitious. One could start with relatively simple reforms in a few areas, as it is typically easier to demonstrate the potential benefits of relatively simple reforms. Successful implementation of simple reforms will help to alter beliefs and build momentum for further reform.

There are likely to be some cases where the policy environment is so weak that even policy dialogue is difficult to establish, such as failed states or evidently authoritarian regimes. The problem posed by these cases should not be depicted as an inherent weakness in policy dialogue, as conditionality is unlikely to be effective in these cases either. Difficult environments, where donors cannot even engage in dialogue, should be considered on a case by case basis, and any aid intervention would be quite limited. Initially, it may be more sensible to focus on projects or sectors rather than engaging on policy. These cases are the exception, however, and dialogue, albeit over a limited policy range, is feasible even in many of the poorest countries.

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