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IFI Conditionality on Governance

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I. INTRODUCTION

This note looks at the dilemmas faced in the application of conditions on governance by the international financial institutions (IFI) in the course of their lending operations in member states. Governance relates to the activities of governments and other public sector entities in the exercise of their financial and regulatory functions and that bear directly on the proper use of funds provided by the IFI. Given the extensive range of state action, conditions relating to governance can apply to diverse areas, including the allocation of public expenditures and the collection of taxes, the rules affecting procurement of goods and services by public authorities, the effectiveness of the judicial system in enforcing contracts and the arbitration of claims and obligations between governments and all the social entities they deal with.

Given the vast range of transactions that can be affected by governance conditionality, the issue has been a contentious one and has attracted stronger reactions from member-governments and the general public than has been the case with the traditional conditionalities applied by the IFI for two reasons. First, it has been harder to prove that the conditions bear directly on the successful outcome of particular projects or programmes; second, it has been argued that developing countries are being asked to show results in the governance area in a fraction of the time taken by advanced nations and on the basis of a model that might be appropriate for the major shareholders of the Bretton Woods Institutions (BWI) but is unsuitable for many developing countries.

This is the dilemma with which both member-governments and the IFIs' have to grapple with on the governance issue. On the one hand, the IFIs are responding to an increasing recognition of the importance of good governance for the successful outcome of their lending operations; they are also aware of a growing resistance on the part of their principal shareholders/donors to providing debt relief and concessional resources for countries where governments are seen by them as not fully accountable to their citizens, where decision making processes are opaque, and where a high degree of corruption prevails. On the other hand, borrowing governments, while naturally anxious to improve their creditworthiness credentials, find their willingness to accept governance conditions circumscribed by apprehensions of a "backlash" generated by a public perception that

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they are acceding to the "dictates" of external agencies, rather than pursuing their own initiatives for good governance.

II. EVOLUTION OF GOVERNANCE CONDITIONALITIES

While the IMF has, from quite early years, applied extensive conditions on the promotion of macroeconomic stability in the context of fostering balance of payments viability, it has begun to apply governance conditions more recently than has been the case with the Multilateral Development Banks (MDB). To start with, MDB conditionality was applied in the form of loan covenants to specific projects and was justified as bearing directly on the project's success. This justification could be extended to environmental conditions when these began to be applied from the mid-1980s, on the basis that the development process could be sustainable only if the environment is protected. Even when structural adjustment lending gained a substantial share of IFI lending in the late 1980s, its broader conditionality usually applied in the same areas as were a staple of IMF conditionality. It was possible to justify their use by the MDBs, especially when their programmes became part and parcel of the "Policy Framework Paper (PFP) process" in which the BWI worked together to establish the terms and conditions of structural adjustment loans.

However, a transformation from macroeconomic into governance conditionality began when IFI reviews of investment programmes were extended into public expenditure reviews, and then into public expenditure ceilings, as part of fiscal deficit reduction programmes. With growing IMF/MDB insistence during the 1990s on the desirability of enlarging social sector expenditures, the manner in which macroeconomic conditionality was applied could be construed as a not-too-subtle means of influencing sovereign decisions on governance relating to the allocation of domestic public spending. The emphasis on governance became more explicit after the establishment of the European Bank for Reconstruction and Development (EBRD) in 1990. Its charter prescribes in its preamble that borrowing members were committed to the "fundamental principles of multiparty democracy, the rule of law, respect for human rights and market economics". While these desiderata were meant to apply to the EBRD clientele of formerly centrally planned socialist countries in eastern and Central Europe and the former Soviet Union, it was not long before similar conditions began to appear in the context of financial relations with developing countries. The Loma-IV Convention, for instance, incorporated several references to human rights in its preamble, and UNDP and other UN agencies, especially after the Copenhagen Social Summit of March 1995, began to advocate "good government" issues in their work.

Next came the Report of the Task Force on Multilateral Development Banks,[1] which emphasised the importance of "more effective government and the emergence of strong civil society". It asserted a strong relationship between "good public sector policy and economic activities and interests, government's accountability to its citizens, effective measures to curb corruption, a participatory approach to development, easy access to important services, and sound decision making reflecting the actual needs of people". The Report concluded that the "the MDBs should help create and maintain such

[1] *Serving A Changing World* (Final Report, Development Committee Task Force on Multilateral Development Banks (DC/96-01).

an environment while being at once sensitive and determined". In commenting on the Report, the World Bank stated that "the Bank is now actively promoting good governance, not only in traditional public administration areas but in strengthening legal systems, helping governments improve their public communication capability on difficult economic development issues, increasing participation, and responding to many government requests for help on decentralisation".[2]

The World Bank's work on good governance has since expanded to the regional development banks. In a significant recent development, presumably connected to the institutions' work on anti-money laundering and the combating the financing of terrorism, the IMF joined the MDBs' on an agreement for combating fraud and corruption that was announced during the 2006 IMF/World Bank Annual Meetings in Singapore. This agreement, while concerned with policies and procedures for the sharing of information and discussion among the IFIs', carries the potential of becoming the prism through which conditionality will be viewed by their member-governments in future.[3]

III. BACKLASH EFFECTS

As noted earlier, governance conditionality attracts strong reaction from the general public and, in particular, from vested interest that are beneficiaries of governance deficiencies, especially when these have persisted for any length of time. Anti-government campaigns launched by interest groups are more apt to attract general support when there is an element of truth to the charge that but for a governance condition laid down by an external lending agency, a project would have moved faster and/or could have been completed at lower cost if the government was simply following its own agenda of good governance. Similar difficulties arise when IFIs' seek to bring nongovernmental organisations (NGOs) into their project preparation process. In many instances, NGOs can serve a valuable countervailing social interest by empowering weaker elements in the society against the overbearing influence of local élites. However, in many developing country contexts, NGOs can, just as easily, become instruments, advertent or otherwise, in the hands of the same elite interests when opposing a government initiative. It is easier to attack an IFI for giving ear to foreign NGOs. Oftentimes, NGOs in industrial countries tend to be single-issue advocates, and their ability to bring influence to bear on their own governments to apply conditions on bilateral assistance programmes is extended to IFIs when these agencies seek funding for concessional resource from legislative bodies in donor countries.

The governance conditionality advocated by foreign NGOs can raise sensitive foreign and domestic policy and security issues and create obstacles to implementation inside the borrowing country, e.g., if those officials that negotiate with the IFIs are seen to be trespassing beyond their traditional jurisdictions. Often these NGOs seek to

[2]Comment on the Task Force Report (DC/96-6).

[3]The Singapore Framework covers agreement among the IFIs'on (i) standardised definitions of fraudulent and corrupt practices for investigating such practices in activities financed by them; (ii) common principles and guidelines for investigations; (iii) strengthening the exchange of information...with due attention to confidentiality, in connection with investigations; (iv) adopting general integrity and due diligence principles relating to private sector lending and investment decisions and (v) exploring how compliance and enforcement actions taken by one institution can be supported by the others.

superimpose their own cultural values on societies subscribing to different ethical and spiritual values. Consequently, such governance conditions are seen as imposing the ideological or cultural preferences of advocacy groups in the industrial countries on borrowers, thereby inviting the charge that the IFIs' are being made to serve as instruments of rich-country paternalism, especially in their dealings with poorer member countries, who must depend on the concessional windows of the IFIs for funding. Great care has to be exercised by the IFIs to ensure that the participation of NGOs, whether foreign or local, does not encroach upon areas of responsibility assigned to state institutions under the respective constitutional arrangements of borrowing countries or intrude into the development of direct relations between governments and their own civil society organisations, including local NGOs.

IV. DIFFICULTIES IFIs FACE IN APPLYING THE GOVERNANCE CONDITIONALITY

Managing their interaction with the NGO community is not the only, or even the most pressing, issue confronting the IFIs in applying governance conditionality. A fundamental question is how to reconcile the nonpolitical mandate of the IFIs with the application of conditions that are likely to push them into the domestic political arena.[4] An example of IFI conditionality in post-conflict situations (e.g., Angola, Guatemala, Nicaragua) requires the government to adhere to the terms of a peace accord. Since the protection of human rights is typically written into such accords, the IFIs become embroiled in domestic disputes when political opponents charge that their rights are being violated by the government, in contravention of the terms of the peace accords.

Another difficulty arises because monitoring compliance with governance conditions inevitably calls for subjective judgments on the part of the IFIs, much beyond what they have had to deal with in the past. Deciding where and how to draw the line between the technical and political dimensions of governance conditions requires the staff to reach unambiguous conclusions about situations or outcomes that are often ambiguous. Working on governance issues entails a broadening of IFI contacts beyond normal governmental (executive) channels.[5] This means not only extending attention to elements of the administrative machinery beyond the usual circle of the officials in planning and finance ministries as well as central banks, but also to other organs of the state, i.e. with the judiciary or with the parliamentarians (e.g., where deadlines for legislative enactments are involved). Such contacts carry risks that politicians would associate the IFIs with the government in power, leaving them exposed to attack when governments change.

[4]Section 10, Article IV of the IBRD Articles of Agreement stipulate that "the Bank and its officers shall not interfere in the political affairs of any member, nor shall they be influenced in their decisions by the political character of the member or members concerned. Only economic considerations shall be relevant to their decisions". Section 1(g), Article V of the IDA Charter uses identical language and adds that IDA pay "due attention to considerations of economy, efficiency and competititive international trade *and without regard to political or other non-economic influence or considerations*" (italics supplied).

[5]Section 1 of Article V of the IMF Articles of Agreement stipulates that "Each member shall deal with the Fund only through its Treasury, central bank, stabilisation fund or other similar fiscal agency, and the Fund shall deal only with or through the same agencies".

There is another, deeper risk: that of non-discriminatory treatment among borrowing members. The governance agenda substantially raises the political cost of borrowing but, in practice, it does so quite unequally. Larger borrowers are better able to "finesse" the implementation of some of the new conditions; their application affects mostly the smaller and poorer countries that have little or no access to private sources of funding and depend on highly concessional terms for their foreign borrowing. The resulting discriminatory treatment has two serious implications: firstly, the loan portfolio of the IFIs' tends to be skewed away from stronger towards weaker borrowers, thereby impairing, or threatening to impair, their creditworthiness; secondly, the governance conditions are applied mostly to governments that are already struggling to govern, and the conditions erode their credibility with their own people, if they are suspected, or accused, of accepting conditions out of financial exigency rather than from any conviction as to their suitability in their prevailing circumstances. This loss of credibility feeds back into the "backlash" problem.

Finally, there arises an issue of evenhandedness, as between creditor and debtor Governments, especially when applying conditions relating to corruption, While many of the causes of corruption inhere in domestic conditions, corruption in the award of contracts for the supply of goods and services always involves two parties; the corrupter is apt to be a supplier, typically located in an advanced country, sometimes sheltering under a "tied aid" arrangement or relying on the domestic procurement requirements of an official export credit agency. In such cases, the application of anti-corruption conditions only to the procurement process in the borrowing country raises issues of legitimacy and fair dealing. The IFIs' are seen to have little power over suppliers in donor/creditor countries that offer financial inducements to buyers in the borrowing countries, especially where such "marketing commissions" can be written off as ordinary business expenses under the tax regimes of the supplier country. Although members of the OECD ratified in 1999 the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions that makes it a criminal offense for companies to bribe foreign government officials, there has been little success with enforcing that agreement[6] and in many instances advanced country governments have failed to put in place in their own countries the kind of transparent public procurement approach that their aid agencies press for in developing countries. This failure, on the part of the major supplying countries, places the IFIs in a difficult moral position when applying governance conditions that constitute a "double standard" in their dealing with their members.

V. REDUCING BACKLASH EFFECTS

There is clearly a tension inhering in the application of governance conditionality that needs to be handled carefully. How to manage this tension becomes one of the most

[6]An OECD evaluation of the UK's record on combating bribery stated that: it is surprising that no company or individual has been indicted or tried for the offence of bribing a foreign official in the six years since the Convention was ratified. The example is quoted by Susanna Mitchell of the New Economics Foundation in commenting on a decision taken by the UK Prime Minister ordering the country's Serious Fraud Office to drop their inquiry into the Al-Yamama arms deal between BAE Systems and Saudi Arabia (20/12/2006). For other examples of assymmetric application, see Frank Vogl Letter to *Financial Times* (12/12/06).

difficult issues confronting the IFIs when dealing with corruption. At one extreme is a position, initially espoused by World Bank President Wolfowitz, to cut off dealing with any member-country that countenances widespread corruption. Such an action is patently unworkable in most cases, simply because the IFI is typically in "mid-stream" with its members, being in the midst of a chain of transactions, on some of which it is disbursing funds (which could presumably be suspended) and others in respect of which it is receiving repayments, on which the borrowing government could suspend its debt servicing. Moreover, this extreme posture forecloses the possibility of influencing the course of reform in many situations. Governments are rarely monolithic entities, and there are contending forces within each of them. The influence of any external agency is exercised primarily through alliances (mostly implicit, hardly ever overt) with domestic groups that are seeking to improve governance and whose hands are strengthened by the promise of external funding. To withdraw altogether from dealing with certain governments thus becomes a counsel of despair, rather than a pragmatic way of pursuing good governance objectives, except in the most extreme of situations.

In seeking governance objectives, the IFIs' have to be highly selective in targeting efforts to areas that offer the promise of yielding tangible results in a reasonable period of time. This calls for a fairly deep understanding of the governance situation in each country and a willingness to adapt the conditionality to the individual country situation, rather than seeking uniformity of prescription across member countries. Once these targeted areas are selected in agreement with the authorities of the borrowing government, the IFIs must be willing to commit substantial resources, by way of technical and financial assistance, for capacity building and other improvements in the selected sectors, and to allow sufficient time for results to emerge.

While IFIs' normally work with national government entities , an approach that might yield better results in the governance area involves working with lower levels of government in a typical area of corruption, namely, the transfer of property rights in urban land plots and zoning for commercial land uses; the gains to those able to acquire land rights or zoning variances through state action tend to be enormous, given the fact that in most of the larger cities in the developing world, land values tend to match, if not exceed, those in many developed countries. Funding for machinery at the municipal level to register mutations and transfers of property rights, and to ensure speedy access to land records and zoning approvals, might be a constructive method of tackling a major area of misgovernance.

It is notable that many governments have regulations on the books for exercising budgetary discipline over spending, for competitive bidding on procurement contracts, for proper auditing of fiscal transactions, etc. It is lack of full compliance with such regulations, more often than their absence, that creates some of the governance problems in the public sector, especially in the management of state enterprises. Governance conditions that support better compliance would have greater public acceptability (and less danger of public misapprehension) if tied to existing regulations and laws already "on the books", instead of requiring new legislation to fulfill IFI conditions.

Past efforts have been made by IFIs' through technical assistance extended in such areas as public administration, privatising of state-owned enterprises, and the reform of fiscal and financial systems, with varying degrees of success. It is important to derive

lessons from these experiences to find out what succeeds and why. Equally important is that the IFIs' exercise utmost caution in claiming credit for success associated with the application of governance conditionality. They must remain ever mindful of their non-political mandates and not allow any "public relations" concerns of their own, or of their industrial country shareholders, into appearing to be acting in discriminatory ways, especially in relation to their smaller and poorer member-countries that depend on consessional funds for their development.