GOVERNANCE CONDITIONALITY AND THE REFORM OF MULTILATERAL DEVELOPMENT FINANCE: THE ROLE OF THE GROUP OF EIGHT

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ABSTRACT

A salient aspect of the reform of the global financial system pursued by the G7/8 concerns the uses, misuses and abuses of governance conditionality by the international financial institutions (IFIs). The streamlining of structural conditionality will figure prominently in the agenda of the G8 Summit in Kananaskis, Canada, in June 2002. However, the debate has thus far mainly focused on the quantitative aspect of conditionality, oscillating between concerns over how much is too much and how much is enough. Less attention has been paid to the manner in which conditionality has been applied and the contents of the IFIs policy prescriptions. While the World Bank has significantly stretched its policy frontiers by endorsing "good governance" as a core element of its development strategy and the International Monetary Fund (IMF) has integrated concerns over poverty reduction in its lending operations and corporate policies, both institutions continue to rely on the same instruments of punitive conditionality to promote governance reform and institutional development.

This paper thus sets outs to examine the IFIs' efforts at strengthening good governance in developing countries and emerging markets. It focuses on the complex relationship between good governance and aid effectiveness and examines the World Bank's approach to governance reform. It argues that the *quality* of governance is ultimately attributable to its democratic content. Therefore, for the Bank to substantially improve good governance in borrowing countries and reinvent itself, it will need to explicitly address issues of power, politics and democracy. The Bank should abandon the belief deeply anchored in its bureaucratic ethos that governance work can be restricted to technocratic improvements, thereby circumventing political economy factors. The paper proposes a radical reform of the governance of multilateral development finance by shifting to an *ex post* form of incentive conditionality aimed at rewarding good performance and based on national ownership.

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INTRODUCTION

> "The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else." John Maynard Keynes, *The General Theory of Employment, Interest and Money* (1936)
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> "Justice without strength is helpless, strength without justice is tyrannical. Unable to make what is just strong, we have made what is strong just." Blaise Pascal, *Pensées* (1670)

The current financial crisis in Argentina has revived with a vengeance the debate on the reform of the international financial architecture. The last decade has been particularly stormy for the once-promising emerging markets, from the Mexican peso crisis in 1994 and the subsequent "tequila effect" in Latin America in 1995, the Asian currency debacle in 1997, the Russian financial troubles in 1998, the Brazilian devaluation in 1999, to the current state collapse in Argentina, the largest debt default in history.

Unable to shake a deep recession triggered by Brazil's currency devaluation in January 1999, Argentina has suffered almost four successive years of recession. A country that was once heralded as a model of the neo-liberal economic reforms advocated by the Washington intelligentsia, Argentina has seen its rate of poverty skyrocket to 40 percent of the population, dragging down an important portion of the lower middle class. The economy has stagnated since 1998 and is in a state of bankruptcy. Furthermore, and unlike Brazil in 1998-99, the Argentine crisis has developed into a profound crisis of governance, as the result of the mismanagement of the economy, an inflexible currency board established a decade ago and the ineffectiveness of political institutions. Argentina's collapse is "a decline without parallel"[1].

A particularly salient aspect of the reform of the international financial institutions (IFIs) concerns the uses, misuses and abuses of conditional lending. Conditional lending has been increasingly used not only to induce policy reform, but more fundamentally to alter the institutions of governance in borrowing countries. This new generation of conditionality has been labeled structural conditionality in the case of the IMF (Collier and Gunnning 1999; Goldstein 2001) and governance conditionality in the case of the World Bank and its sister regional development banks (Kapur and Webb 2000). The controversies concerning the effectiveness of governance conditionality emerged with great force in the aftermath of the Asian crisis in 1997. The role of the IMF in Indonesia was severely criticized, as the IMF's standard medicine only accentuated poverty (Feldstein 1998). The IMF's role in East Asia in the late 1990s went far beyond the role it played in Latin America in the 1980s.

Proposals now abound on how to reform the international financial system (Williamson 2000; Goldstein 2000). However, the reform of conditionality has mainly focused on the quantitative aspect of conditionality, oscillating between concerns over "how much is too much" (Goldstein 2001) and "how much is enough" (IMF 2001e). However, less attention has been paid to the manner in which conditionality is applied and the contents of its policy prescriptions. As such, the current controversies do not fundamentally question the legitimacy of conditionality *per se* but rather the way it is applied, including its scope, intensity and intrusiveness. For instance, upon assuming office in 2000, the IMF's Managing Director, Hans Köhler, launched an effort at streamlining structural conditionality in IMF-supported programs. The objective of the interim guidelines issued in September 2000 is to reduce the number of conditions attached to loans (IMF 2000, 2001 a through d).

The reform of the international financial system is also linked to the debate on the effectiveness of development assistance. In the 1990s, concerns over the relative ineffectiveness of aid and the pervasive effects of endemic corruption prompted IFIs to revisit their traditional approaches and question their original assumptions. The influential research generated by the World Bank now advocates a more selective approach to the allocation of aid (World Bank 1998). The new strategy bases aid allocations on policy performance and reform commitment, rather than solely on entitlements based on the "human needs" and the level of poverty of developing countries.

In a period of declining aid commitments, aid policies appear to oscillate between conditionality and selectivity, unsuccessfully trying to combine both approaches. In recent years, the strengthening of good governance in developing countries has become both an *objective* of and a *condition* for development assistance. While laudable, this dual strategy creates tensions in the governance of aid and upsets the multilateral system. Furthermore, concentrating aid on "good performing" poor countries begs the original concern that spurred the current shift in policies: how can external agencies *promote* good governance, especially in poor performing countries? After all, unsatisfactory performance is often, albeit not necessarily, associated with poor policies and weak governing institutions.

This paper sets outs to examine the IFIs' efforts at strengthening good governance in developing countries and emerging market economies. It examines the new role of the World Bank and tangentially addresses that of the IMF and regional development banks (in particular the four main ones).[2] It focuses on the complex relationship between good governance and aid effectiveness and provides a critical assessment of the World Bank's approach to governance reform. It scrutinizes the shifts in policies and strategies of the Bank during the 1990s as well as the research it generated to support them. Indeed, in the course of the 1990s, the Bank has radically changed what it does and how it does it, *de facto* altering its mandate (Santiso 2001a and 2000a through c). The Group of Seven and now Eight (G7/8) has played a critical role in this metamorphosis by pressuring the Bank to take greater account of quality of governance in borrowing countries, and in particular the pervasiveness of corruption, the strength of the rule of law and the effectiveness of public institutions. As the sixteenth century French thinker Blaise Pascal would have said, "Unable to make what is just strong, we have made what is strong just" (Pensées 1670).

The paper argues that the *quality* of governance is ultimately attributable to its democratic content. Therefore, for the World Bank to substantially improve good governance in borrowing countries and reinvent itself, it will need to explicitly address issues of power, politics and democracy. The paper further argues that aid conditionality is not the appropriate approach to strengthening good governance and reinforcing governing institutions in developing countries. It posits that the Bank should rely less on the punitive form of governance conditionality and more on an incentive-based type of governance conditionality reflecting greater selectivity. What is needed is a more radical approach in which donors cede control to the recipient country, within the framework of agreed-upon objectives embedded in a pact for good governance.

Undeniably, this new approach is an explicitly political endeavor, but the World Bank should abandon the belief deeply anchored in its bureaucratic ethos that governance work can be restricted to technocratic improvements, thereby circumventing political economy factors. The fiction of its apolitical mandate is a misrepresentation of what the organization is increasingly doing in developing countries and emerging economies.

This paper is structured in four substantial sections. The first section assesses the role of the G8 in the reform of the international financial institutions and the strengthening of governance in emerging market economies. The second section analyzes the scope and reach of the governance paradigm and reveals the limits of the IFIs' technocratic approach to governance reform. The third section proceeds to investigate the multifaceted links between good governance, economic development and aid effectiveness and the pitfalls of aid selectivity. The last substantive section advocates for an explicitly political approach to governance reform. The paper concludes by articulating a series of proposals to bridge the economic-political divide of development assistance.

I. THE ROLE OF THE GROUP OF EIGHT

As the major stakeholder in the IFIs, the Group of Eight (G8) has assumed a leadership role in steering the debates on the reform of the international financial system and improving the quality and effectiveness of aid. The Finance Ministers of the Group of Seven (G7) countries have articulated a series of proposals to overhaul the IFIs and have been closely monitoring progress since the mid-1990s. While the debate initially focused on the IMF, the complementary reform of the multilateral development banks (MDBs) has gained greater prominence. Progressively, a link is being forged between the reform of the IFI's management of financial crises and their role in promoting good governance and reducing poverty.

REFORMING GLOBAL GOVERNANCE

In June 1995, the G7 Halifax Summit identified the promotion of "good governance" as an important goal for multilateral institutions. At the Birmingham Summit in 1998, the G7 Finance Ministers submitted a report, "Strengthening the Architecture of the Global Financial System", which reflected the G8's concerns with the reform of the international financial system and the shortcomings of the IFIs in dealing with financial crises. The reform of the IFIs' international governance figured prominently in this report. The crisis that had just erupted in Asia took the G7 off-guard and revealed "a number of weaknesses and vulnerabilities in national and international financial systems, as well as in the borrowing and lending practices of banks and investors" (G7 Finance Ministers, 1998:1). As the crisis unfolded and expanded by contagion, emerging market economies saw their access to international capital markets drastically curtailed, exposing their vulnerability to volatile short-term capital flows.

The G8 Summit in Cologne June 1999 marked a turning point, as the reform of the IFIs became explicitly linked to concerns over poverty reduction and debt relief. Indeed, the handling of the Indonesia financial crisis in 1998-99 drew intense criticism on the IMF and the social consequences of the stabilization package it imposed (Goldstein 2001; Feldstein 1998). These pressures are obliging the IMF to better asses the effects of the macroeconomic policies it advocates on poverty and in particular the side-effects of stabilization and structural adjustment programs, with their excessively tight monetary and fiscal policies. As IMF lending soared to unprecedented levels in 1998,[3] the IMF asked its members for a substantial increase of its resources, which made it particularly pliable to their demands.

These factors combined made reform inescapable. As the former Deputy Managing Director of the IMF, Stanley Fisher, recognized in his remarks to a workshop on macroeconomic policies and poverty reduction in April 2001, the main argument behind the involvement of the IMF in poverty is political:

> We took tremendous heat - unfairly, because I think it was not consistent with the facts - over the impact of the Asian crisis on poverty. That was a tremendous factor in the debate over whether the Fund should get more financing - the perception that we had supported policies that hurt the poor (Fisher 2001).

As a result, in September 1999, the objectives of the IMF's concessional lending were broadened to include an explicit focus on poverty reduction. What appeared then a radically new approach to development assistance was devised. The IMF is to support, along with the World Bank, strategies elaborated by the borrowing country in a participatory manner and enshrined in a Poverty Reduction Strategy Paper (PRSP). Reflecting the new objectives and procedures, the IMF established the Poverty Reduction and Growth Facility (PRGF), replacing the Enhanced Structural Adjustment Facility (ESAF) created in 1987.

The G7 has also renewed its commitment to provide relief to highly indebted poor countries, provided that these countries implement comprehensive poverty reduction strategies and improve governance. The Köln Debt Initiative, adopted by the G7 at its Summit in Cologne in June 1999, strengthened the debt relief mechanisms established in 1996 by the Fund and the Bank. The central objective of the enhanced Highly Indebted Poor Countries (HIPC) Initiative is to provide “faster, deeper and broader debt relief for the poorest countries that demonstrate a commitment to reform and poverty alleviation” (G7 Finance Ministers, 1999:2).[4] The G7 reiterated the importance of anchoring good governance, pursuing sustainable development and fighting corruption. Debt relief is thus embedded in a broader poverty reduction framework, based on structural adjustment, governance reform and the pursuit of sound economic policies.[5]

In 2000, the G8 Okinawa Summit furthered the reform of the IFIs’ internal governance and operating procedures, setting key principles for the reform of the IMF, which include increasing transparency and accountability. By then, monitoring the reform of the IFIs had become a core item on the G7 Finance Minister’s agenda. The report on “Strengthening the International Financial Architecture” (G7 Finance Ministers 2000) addressed the pressing concern of the proper division of responsibilities between the Fund and the Bank as well as between the Bank and its sister regional development banks. Indeed, the Fund’s involvement in poverty reduction and the Bank’s involvement in governance reform have resulted in considerable encroachment on each other’s traditional institutional territory (a trend commonly referred to as ‘mission creep’).

The United States government became increasingly active and assertive in its calls for a deeper reform of the international financial architecture. Echoing the influential ‘Meltzer Report’, (IFIAC 2000) produced by the US Congress, the G7 called for a refocusing of the IFIs on their respective areas of core responsibility and competence: “The Fund and the Bank have different mandates and need to respect them. Nevertheless, the issues they deal with are increasingly interrelated and in some countries their activities are interdependent” (G7 Finance Ministers, 2000:35). The US government has also called for providing grants instead of loans through the International Development Association (IDA), the World Bank’s soft-loan arm, a proposal resisted by European governments, as it would mean a net decrease in IDA resources. The controversies surrounding the US proposal will be at the a center of the United Nations international conference on Financing for Development (FfD) to be held on 18-22 March 2002 in Monterrey, Mexico.

Refocusing the Fund and the Bank on their core competences requires a clearer definition of their respective responsibilities as well as more effective mechanisms of cooperation. While the Fund was established to respond to balance of payments problems and provide short-term lending for resolving financial crises, MDBs were created to provide long-term development financing and support structural adjustment. In terms of "clients", MDBs are pressured to focus more narrowly on low-income and highly indebted poor countries and are asked to phase down their lending to middle-income countries. This proposal, advocated by the US government, is nevertheless being resisted by its European counterparts, which underline the universal vocation of both institutions. It nevertheless reflects an increasing confusion regarding each organization's core mandate, responsibilities and competencies.

At the Fukuoka meeting in July 2000, the G7 Finance Ministers reiterated that, while the Bank is the central institution for promoting poverty reduction and growth-oriented programs, macroeconomic stability is the responsibility of the Fund. Nevertheless, in poor countries, the Fund has a crucial role in supporting macroeconomic stability, integrating its efforts with those of the Bank in the definition of poverty reduction strategies (G7 Finance Ministers, 2000:6g).[6] Thus, the central role of the Fund should be to promote macroeconomic and financial stability, focusing on surveillance, crisis prevention, mitigation and resolution, while an increased focus on poverty reduction should underpin the activities of MDBs, including in programs of policy reform, investment lending, and technical assistance. Nevertheless, given the unreliability of emerging markets' access to international capital markets, MDBs can also make an important contribution to poverty reduction in middle-income countries. The current crisis in Argentina is a dramatic example of emerging markets' vulnerabilities.

In a veiled critique of the corporate culture of the MDBs – consisting essentially of 'pushing projects' (Naím 1994a, b), the G7 Finance Ministers reiterated their call for greater selectivity and increased effectiveness of consessional lending: "MDBs should emphasize a selective, quality-oriented approach rather than a quantity-oriented or profit-oriented one on the basis of clear definition of their roles as public institutions and their development mandates" (G7 Finance Ministers, 2000:31). They requested the MDBs to strengthen collaboration and coordination in order to ensure efficient use of scarce aid resources. As a result, the World Bank concluded cooperation agreements with the African Development Bank (AfDB) in 2000, the Inter-American Development Bank (IADB) in 2001 and the Asian Development Bank (ADB) in 2002.

At the 2001 Genoa Summit, the G7 Finance Ministers and Central Bank Governors submitted their review report on the "Strengthening the International Financial System and the Multilateral Development Banks", in which the link between the reform of the IMF and that of the MDBs was explicitly made. The G7 Finance Ministers encouraged the MDBs to sharpen their focus on poverty reduction, improve the effectiveness of their assistance, and make their internal governance more accountable and transparent. They reiterated their call for greater selectivity, accountability and focus on results by the MDBs, stressing that: "A more selective approach needs to be adopted by the MDBs on the basis of their respective comparative advantages and by better developing synergies and complementarities. […] More could be achieved at the institutional level through an *ex ante* sharing of tasks in specific areas" (G7 Finance Ministers, 2001:34). They requested MDBs to progressively harmonize their country assistance strategies and submit progress towards the alignment of country strategies by spring 2002, before the G8 Summit in Kananaskis, Canada, in June 2002.

STRENGTHENING DOMESTIC GOVERNANCE

At their meeting in Fukuoka in July 2000, the G7 Finance Ministers underscored the need to improve the institutions of governance in borrowing countries. Thus, they linked the reform of global governance to improvements in national governance.

The G7 Finance Ministers have encouraged the MDBs to take an active role in governance reform and institutional development, recognizing the centrality of public sector reform, accountability and the fight against corruption: "MDBs should place high priority on good governance and the full commitment to the poverty reduction by recipient countries. They should allocate their support increasingly on the basis of borrower performance. Experience has shown that aid is only effective in reducing poverty where governments are committed to sound policies" (G7 Finance Ministers, 2000:27). They made a series of recommendations regarding how the MDBs should gradually but systematically integrate governance concerns in their lending, investment and technical assistance activities.

In addition, they called on the MDBs to provide direct support to developing countries' efforts to strengthen institutions, in particular in terms of financial management and tax administration. More fundamentally, they requested the MDBs to explicitly address the institutional and structural constraints that hamper poverty reduction, to ensure transparency, accountability, and the rule of law. Hence, the G7 provided clear guidelines on how MDBs should incorporate governance concerns in their operations by improving the quality and broaden the scope of country assistance strategies, *de facto* expanding their restrictive mandates.[7]

The July 2001 Genoa Summit made further explicit the G8's understanding of the political dimensions of the "strategic approach to poverty reduction", recognizing, in its final communiqué of 22 July, the linkages between democracy and good governance: "Open, democratic and accountable systems of governance, based on respect for human rights and the rule of law, are preconditions for sustainable development and robust growth" (G8 Final Communiqué, 2001:6) The communiqué underlined the importance of promoting accountability and transparency in the public sector, strengthening legal frameworks and corporate governance regimes to fight corruption and providing safeguards against the misappropriation of public funds, enhancing the rule of law and reforming judicial systems, and promoting the active involvement of non-state actors in the definition of development strategies. The linkage between poverty reduction and democratic governance was made explicit in the New African Initiative launched at the Genoa Summit and further underlined at the first informal meeting to discuss the New Partnership for Africa's Development (NEPAD) in early February 2002 in Paris.

During their July 2001 meeting, the G7 Finance Ministers requested the MDBs (i) to include in every country assistance strategy a review of the country's governance with particular focus on public sector management, accountability and anti-corruption measures; (ii) to produce an *Action Plan*, by spring 2002, identifying capacity-building needs in the area of public sector management in borrowing countries; (iii) to assess their in-house capacity in this field and possible actions to upgrade it, while taking into account the work of other development institutions; and (iv) to strengthen their analytical and diagnostic work (G7 Finance Ministers, 2001:39). The summit in Canada in June 2002 must closely review the progress made in these areas.

AN AMBIVALENT ENTERPRISE

The governance agenda represents an ambivalent enterprise plagued with both promises and dilemmas. The new policy underlines the importance of the institutional dimensions of development and, consequently, the political facets of development aid. Ultimately, the approach to governance reform and institutional development by each individual multilateral organization is dictated by a wide variety of factors, including its constituency, mandate, functions, and bureaucratic ethos. Nevertheless, the G8 has provided clear reform guidelines, reflecting a growing impatience with the IFIs' slow pace of reform and inability to adapt to the new challenges of the 21st century.

Reforming the systems of governance is a politically sensitive endeavor that has traditionally been considered outside the purview of the IFIs mandates. For instance, the World Bank's founding charter prohibits it from taking into account political considerations when designing aid programs. Nevertheless, the Bank has significantly stretched its policy frontiers by endorsing "good governance" as a core element of its development strategy. Assessing *The World Bank at the Millennium*, Joseph Stiglitz, the controversial former Chief Economist at the Bank, asserts that: "Views about development have changed in the World Bank, as they have in the development community. Today there is concern about broader objectives, entailing more instruments, than was the case earlier" (1999a:F587).

The concept of governance captures "the manner in which power is exercised in the management of a country's economic and social resources for development" (World Bank, 1992:1). However, as Devesh Kapur and Richard Webb underline, "For the IFIs, the new mandate is a boost to their importance, but one fraught with peril. The new mission arrived at a moment when growing doubts regarding the purpose and effectiveness of the IFIs seemed to threaten their funding, and even their continued existence" (Kapur and Webb, 2000:18).

The introduction of the concept of governance in the development agenda reflects growing concerns over the effectiveness of aid whose ultimate aim is to reduce poverty and human suffering. Confronted by declining aid budgets and increasing scrutiny by civil society, the World Bank has given greater consideration to the pervasive effects of mismanagement and endemic corruption. The corrosive effects of corruption on economic management and aid effectiveness are a major source of concern for the World Bank, as foreign finance tends to become a source of rents. "Aid allocation needs to take corruption into account because, even if aid cannot significantly reduce corruption, corruption can significantly impair aid effectiveness" (Collier and Dollar 2001:21).

Since 1996, the World Bank has begun over 600 governance-related programs and initiatives in 95 countries and is involved in supporting significant programs of governance and public sector reform in 50 countries (Development Committee 2000). Between 1987 and 1998, the Bank carried out 169 civil service reform programs in 80 countries. Since the early 1990s, it has supported legal and judicial reform and decentralization around the developing world. In 1996, the fight against corruption became a priority and the Bank began supporting programs aimed at strengthening other accountability institutions such as ombudspersons and parliamentary oversight bodies (World Bank 2000a).

However, the approaches used to strengthen good governance in developing countries remain strikingly similar to those used to promote economic reform. Aid conditionality, that is conditioning aid on a number of prerequisites and promises of reform, has been extended from the economic realm to the political arena. During the 1980s and 1990s, the scope of these conditionalities both widened and deepened as IFIs embarked on attempts at governmental and social re-engineering. Over the last two decades, the IFIs have relied on conditioned lending to influence the economic policies and governance institutions of borrowing countries.

IMF structural conditionality and World Bank governance conditionality have become customary features of the IFI's lending operations. The objective of governance conditionality is both to improve development policies in borrowing countries and enhance the effectiveness of aid. These trends have nevertheless tempted the IFIs into the political sensitive terrain of the reform of domestic political systems. However, their respective founding charters prohibit them from being influenced in their lending decision by political considerations.

As a result, the IFIs have tended to expand and, at times, over-stretch their mandates in an *ad hoc* manner and in a schizophrenic way. In Indonesia, the Fund has been heavily criticized for being too intrusive. In Argentina, it is being criticized for the opposite, as it maintained its support to the country's misguided policies between 1998 and 2001 – mobilizing almost US$50 billion - in the illusory hope that the government would be able to trim fiscal deficits during a prolonged recession.

The IFIs have been subjected to an increasing and sometimes contradictory multitude of pressures. Openly criticized by nongovernmental organizations but also by its main stakeholder, the United States, as well as by its most respected economists (Easterly 2001 a and b), the Bank is at a critical juncture in its history. The Bank plays a central role in global governance and its leverage in the aid regime is critical, as it continues to shape development thinking. It "has acquired a quasi-monopoly on institutional knowledge in the field of economic development" (Hiboux, 2000:3;), often leading to a monopoly on policy prescriptions. In a report prepared for the Swedish Ministry of Foreign Affairs, Bezanson underlines that "The World Bank continues to be the main purveyor of development ideas. In addition and although its policies change significantly over time, 'the Bank can never be wrong' mentality still prevails in much of the institution's thoughts and actions" (Bezanson, 2000:14). However, "The Bank does not just lend money and produce ideas: it packages the ideas and the money together", combining lending with conditionality (Gilbert *et al*., 1999:F610; Stern 1997). These considerations command a critical look at its intellectual ethos and its modes of operation.

Stiglitz vocally criticized the manner in which IFIs and the IMF in particular provide policy advice to adjusting countries. IMF policy prescriptions tend to reflect the prevailing neo-liberal paradigm of development economics, often leading to standardized recipes. For Stiglitz (1998), credible advice should rather lay out the risks, consequences and trade-offs of alternative policies. It is the responsibility of domestic decision makers to choose amongst the alternative reform paths. The role of the IFIs is to ensure that such decisions are informed. Nevertheless external policy advice should refrain from interfering or substituting with domestic policy-making. As Martin Feldstein argues "A nation's desperate need to short-term financial help does not give the IMF the moral right to substitute its technical judgments for the outcomes of the nation's political process" (1998:27).

An unintended consequence of the current debate on the governance of multilateral development institutions has been the increasing scrutiny of IFIs' policies and lending operations by the national parliaments of donor countries. In 1998 in France, the Finance Committee of the National Assembly requested an inquiry into the role, objectives, functions and instruments of the IFIs as a consequence of the French government's request to increase French quota share at the IMF by 45 percent. The resulting report published in 2000 is particularly critical of the model of development advocated by the Fund and the Bank and the role it assigns to the state (Tavernier 2000). It criticizes the "intellectual hegemony", "ideological foundations" and strict defense of the neo-liberal orthodoxy defended by the IFIs. It argues that "The policies of the IMF and the World Bank are not the only models for development" and that the IMF policy recommendations would not be politically acceptable in France. Criticizing the IMF's approach to the crisis in Argentina in 2000, the report asks whether "France supports in Washington a policy that the French government and the parliamentary majority vigorously reject in Paris" (Tavernier, 2000:16). The IFIs are international public institutions and, as such, subject to the same standards of behavior as domestic public institutions.

II. THE EMERGENCE OF THE GOVERNANCE PARADIGM

Although the concept of good governance is increasingly being used, its contours remain uncertain and have changed over time. As a result, the mainstreaming of good governance has been fragmented, leading to multiple understandings of the concept. A variety of definitions, greatly differing in scope, rationale or objectives, have been advanced. As Joachim Ahrens rightly stresses, "there are still no clear or settled ideas about how effective governance should be suitably defined, let alone how key governance issues can be appropriately incorporated into externally-financed programmes of policy reform" (2001:54).

The predominant neo-liberal approach to good governance, embedded in the prevailing orthodoxy of development economics, gives governance a false sense of political neutrality, as it portrays development without politics. The World Bank's understanding of good governance continues to reflect a concern over the *effectiveness* of the state rather than the *equity* of the economic system and the *legitimacy* of the power structure. However, governance work always touches on politically sensitive areas, even if donors seek to confine themselves to the economic and social dimensions of governance because of their inherent political implications. Ultimately, governance is the ability to govern and implement and enforce public policies. However, the "importance of government credibility and commitment to policy reform has been essentially neglected as a pivotal condition for effective economic reform" (Ahrens, 2001:75).

THE ORIGINS OF A CONTROVERSIAL CONCEPT

The notion of good governance surfaced in 1989 in the World Bank's report on Sub-Saharan Africa, which characterized the crisis in the region as a "crisis of governance" (World Bank 1989). It then represented an important departure from previous policy, prompted in large part by the experience in Africa.

The main thrust behind its introduction resides in the continuing lack of effectiveness of aid, the feeble commitment to reform of recipient governments and the persistence of endemic corruption in developing countries. In addressing governance issues, the Bank calls into question the ability, capacity and willingness of political authorities to govern effectively in the common interest. There is heightened awareness that the *quality* of a country's governance system is a key determinant of the ability to pursue sustainable economic and social development. In 1993, the "Wapenhans report" (Wapenhans 1993) underscored the deficiencies of structural adjustment policies and their insufficient consideration of institutional and political factors. It questioned the underlying assumption of structural adjustment policies - that, as economic growth resumes, political support for further reform would naturally follow. It thus recommended that political economy considerations be given greater prominence. However, over the last decade, the Bank, constrained by its technocratic ethos and restrictive mandate, has struggled to grapple with these issues.

A general definition of governance is the "exercise of authority, control, management, power of government,"[8] in other words the capacity to define and implement policies. According to the World Bank's standard definition, governance encompasses the form of political regime; the process by which authority is exercised in the management of a country's economic and social resources for development; and the capacity of governments to design, formulate and implement policies and discharge functions (World Bank 1991, 1992, 1994; Thomas *et al.*, 2000). However, while recognizing the importance of the political dimensions of governance, the Bank interprets the concept restrictively, arguing that the first aspect – the nature of the political system - falls outside the purview of its mandate enshrined in its Articles of Agreement. Governance has been defined in politically neutral terms focusing on its economic dimensions. It has been equated with "sound development management". Consequently, the main thrust of governance-related activities has been public sector management, financial management, the modernization of public administration, and privatization.

Similarly, the ADB, which was the first regional multilateral development bank to adopt an official governance policy in 1995, defines good governance as "sound development management" based on four interrelated "pillars:" accountability, transparency, predictability and participation. For the ADB, "good governance is good government" (ADB, 1995, 1999). AfDB, while recognizing the intimate links between democracy and good governance, also rejects a political approach to governance (AfDB, 2000).

However, the shift from the notion of "governance" to "*good* governance" introduces a normative dimension addressing the *quality* of governance. A good governance system puts further requirements on the process of decision-making and public policy formulation. It extends beyond the capacity of public sector to the rules that create a legitimate, effective and efficient framework for the conduct of public policy. It implies managing public affairs in a transparent, accountable, participatory and equitable manner. It entails effective participation in public policy-making, the prevalence of the rule of law and an independent judiciary, institutional checks and balances through horizontal and vertical separation of powers, and effective oversight agencies. Researchers at the World Bank Institute have distinguished six main dimensions of good governance:

(i) voice and accountability, which includes civil liberties and political stability;
(ii) political stability;
(iii) government effectiveness, which includes the quality of policy making and public service delivery;
(iv) the quality of the regulatory framework;
(v) the rule of law, which includes protection of property rights and independence of the judiciary; and
(vi) control of corruption (Kaufmann *et al.*, 1999).

There are understandable justifications for such a restraint. The pressure to address endemic corruption, bureaucratic ineptness and economic mismanagement was such (especially by donor governments) that the Bank had to accommodate it. Framing governance as a technical question has permitted the Bank to justify its involvement in governance issues while remaining within the boundaries of its mandate. It has enabled the Bank to address governance failures in borrowingcountries and smooth the resistance from its varied constituency - which includes countries like China and Russia. Nevertheless, this compromise has been fragile and constantly questioned in the course of the 1990s, either as inadequate or unacceptable.

THE LIMITS OF THE TECHNOCRATIC CONSENSUS

There are limits to the World Bank's technocratic consensus. "Governance is a difficult concept for the multilateral development banks that do not want to be seen as political and have since their establishment advocated a doctrine of political neutrality. They have embraced the functionalist logic that technical and economic questions can be separated from politics" (Bøås, 2001:2). The functionalist approach gives the illusion that technical solutions can solve political problems: "politics is treated as a negative input into policy decision-making" (Grindle, 2001:370), as the politics of self-interest and rent-seeking negatively distorts policy choice. This approach echoes the consensus on rational choice theory according to which the policy-making process parallels the cognitive steps of the rational model of decision-making by which policy is created in a fairly orderly sequence of stages. However, this model fails to capture "the essence of policy making in political communities: the struggle over ideas" (Stone, 1989:7) and the process framing public policy-making. It circumvents politics by negating it.

For economists who dominate the Bank's ethos, policy is essentially a sphere of rational analysis, whereas politics is the sphere of irrationality. Their approach to governance is thus aimed at extricating policy from politics, assuming that analysis and politics can be separated in the process of public policy-making. However, political reasoning is strategic. Political contexts offer both constraints and opportunities for change and the "art of politics" resides precisely on taking advantage of the latter and neutralizing the former. Indeed, the shortcomings of the market-oriented economic reforms of the 1990s reside in its insufficient consideration of the political economy of policy reform.

Despite its legal limitations, the Bank experiences difficulty in separating the economic and political aspects of good governance. This tension surfaced as early as 1991 when the Bank recognized that the reasons for underdevelopment and misgovernment are "sometimes attributable to weak institutions, lack of an adequate legal framework, damaging discretionary interventions, uncertain and variable policy frameworks and a closed decision-making process which increases risks of corruption and waste" (World Bank, 1991:i). These concerns do not refer only to the soundness of economic management but also to the overall quality of the political system and ultimately to the nature of the political regime.

A similar tension between the economic and political dimensions of good governance can be found in the IMF (IMF 1997 and 2001b; James 1998). The Fund pays increasing attention to the governance context and its implications for the successful implementation of reforms. The efficiency and performance of public policies condition the extent to which a recipient government will be able to comply with its obligations and repay its loans. In 1997, the Fund adopted guidelines specifying its role in governance issues asserting that "[it] is primarily concerned with macroeconomic stability, and orderly economic growth in member countries. Therefore, the IMF's involvement in good governance should be limited to economic aspects of governance" (IMF, 1997:3), namely, the transparency of government accounts, the effectiveness of public resource management, and the stability of the regulatory environment for private sector activity. Based on this pragmatic approach, the Fund seeks to address governance issues mainly through surveillance, policy advice, and technical assistance.

Nevertheless, the Fund's position regarding the political context borrowing countries remains ambiguous. The 1997 guidelines suggest that: "it is legitimate for management to seek information about the political situation in member countries as an essential element in judging the prospects for policy implementation" (IMF, 1997:3). Indeed, it is recognized that weaknesses of democratic institutions and the rule of law hamper the successful implementation of economic reform. An example is the controversy that surrounded the US$5 billion IMF credit to Russia in July 1998. It is believed that an important portion of the credit mysteriously disappeared in the individual bank accounts of Russian leaders. Pressured by the US Treasury Department, the IMF only reluctantly agreed to the loan, expressing concerns over the lack of a competent state guaranteeing the rule of law, as well as transparency and accountability in the management of IMF support.

Whether they like or not, the IFIs are increasingly obliged to take into account the quality of governance and the nature of political regimes when considering assisting a specific country. In particular, they have to do a better job at assessing the social consequences of their stabilization programs. As Moises Naím asserts, they "have to reconcile their political character with their technical vocation" (1994b:229). The inherent tension between the economic and political dimensions of good governance appears the most contentious conceptual issue. While democracy tends to refer to the *legitimacy* of government, good governance refers to the *effectiveness* of government. Consequently, one could in theory be strengthened and promoted independently from the other, as both have a value in their own right (Williamson 1993, 1997).[9] Nevertheless, as the legitimacy and effectiveness of government are not always congruent in reality, the relationship between democracy and good governance is imbued with controversies.

THE POLITICAL ECONOMY OF INSTITUTIONAL REFORM

The limits of the technocratic consensus permeating the World Bank's ethos is particularly salient in its public sector reform portfolio, as political economy factors become critical to ensure sustainable institutional strengthening. At their meeting in Rome in July 2001, the G7 Finance Ministers requested a comprehensive review, by the spring of 2002, of the MDB's capabilities in the area of governance reform and state modernization.

The scattered evidence available so far is mixed (World Bank 1999b, 2000a). Recent country assistance evaluations (CAE) by the Bank's Operations Evaluation Department (OED) have concluded that support for institutional development efforts - in both sector-specific and public sector management portfolios - has been largely ineffective. Most of the country assistance strategies lacked a coherent strategy on public sector reform or country-level institutional development. Reviewing a sample of 10 country assistance evaluations, Navin Girishankar argues that:

> Such efforts to improve public management systems were compromised *inter alia* by overly technocratic approaches to institutional design, a bias toward supplying capacity inputs (such as training and equipment) before reforming governance structures, as well as reliance on lending instruments that were not sufficiently flexible to accommodate the complex dynamics of institutional change (2001:1).

The challenge is to "move from axiomatic claims about the importance of institutions to more systematic analyses of institutional quality and its implications for various aspects of well-being such as access of the poor to essential services [and their] degree of empowerment" (Girishankar, 2001:23).

There exists an important gap between increasingly relevant sectoral institutional development policies and weak country-level ones, due in part to overly technocratic approaches and internal bureaucratic issues related to the incentive structure of Bank's professional advancement procedures. Critical shortcomings in the governance structure of the Bank itself hamper effective institutional development strategies. These include the quality of the corporate processes within the Bank, weak monitoring and supervision of projects, and high staff turnover, which undermines institutional knowledge (Naím 1994a,b). These weaknesses in the governance of the Bank's assistance are particularly detrimental to its institutional development efforts, as these processes of governance reform require close monitoring and constant fine-tuning.

At the country level, public sector reform initiatives often adopt an "enclavist approach" to institutional development, targeting one or several strategic policy-making institutions but failing to address the structural causes of poor governance. Relevance is also undermined by the Bank's inability to respond swiftly to emerging crises either by developing new operations of restructuring existing ones, such as in the case of Thailand, Indonesia or Albania. Girishankar concludes that country assistance evaluations:

> found that sound technocratic knowledge of institutional constraints and well-designed interventions were not sufficient in promoting public sector performance (Albania, Jamaica, Indonesia). In other words, politics mattered. Aside from noting its importance, CAEs did not offer a more sophisticated approach to the political economy of institutional reform […] Knowledge of institutions in and of themselves was not sufficient to carry out institutional reforms (2001:27-28).

In recognition of this sobering track record, the Bank has begun to rethink the analytical and operational framework that underpins its efforts to enhance countries' institutional endowments. While still a work in progress, a consensus approach is emerging, the broad contours of which include greater emphasis on a rigorous measurement of institutional performance, the use of more flexible programmatic lending instruments and sequencing strategies that ensure that institutional development efforts "lock in" improvements in the way public management systems work. A more rigorous integration of the political economy dimension of institutional reform (including notions of the bounded rationality of reformers and the path dependency of the reform processes) is required to improve the design and sequencing of assistance (Shepsle 1998; Santiso 2001a).

III. GOVERNANCE, DEVELOPMENT AND AID EFFECTIVENESS

GOVERNANCE AND DEVELOPMENT

Good governance - in the form of institutions that establish a predictable, impartial and consistently enforced set of rules for economic development – is crucial economic growth and development (Keefer and Knack 1997; Knack and Keefer 1995). Recent research on the political economy of policy reform suggests that the influence of the governance context on economic performance is determinant (Isham *et al.* 1995, 1997; Rodrik 1999a; Kaufmann *et al.* 1999; Haggard 2000).

David Dollar and Jacob Svensson (1998) found several political and institutional features associated with successful reform programs. They suggest that the success (or failure) of adjustment loans can largely be predicted by a country's underlying institutional and political features, including whether the government was democratically elected and how long it has been in power, with post-conflict and transition countries being specific cases. In general, newly elected governments have a higher rate of success with reform than authoritarian governments in power for a long time. The election of a new government opens a "window" of opportunity enabling it to launch bold reforms.

Democratic institutions tend to improve government efficiency. Well-institutionalized democracies are more likely to produce, over the long run, effective economic and social policies, because they provide stable institutional and procedural mechanisms to represent interests, arbitrate disputes, provide checks and balances, and negotiate change. Jonathan Isham *et al.* (1997) find that effective citizen voice and public accountability often leads to greater efficacy in government action and a more efficient allocation of resources. More fundamentally, open governance systems are more likely to generate responsible and responsive government and thus adopt pro-poor public policies. Daniel Kaufmann *et al.* (1999) show that the quality of governance is significantly associated with income levels in the expected manner. The quality of democratic institutions is also believed to affect the effectiveness of aid by providing accountability mechanisms in the management of external resources. In a recent study, Svensson finds that "Aid has a positive impact on growth in countries with an institutionalized and well functioning check on governmental power" (1999:275).

Effective democratic institutions, rather then their mere formal existence, are thus key. The quality of democratic institutions (defined in terms of capacity, autonomy, credibility and legitimacy) is a critical determinant of their effectiveness and influences the ability of governments to adequately respond to financial crises. Democratic institutions provide mechanisms of regulation to ease out economic crisis and respond to them more adequately. Elections provide a mechanism for rebuilding the legitimacy and authority of government, and consequently the credibility of the economic reforms needed to address the financial crisis.

The comparison between South Korea and Indonesia in 1997-1999 is particularly striking. As Stephan Haggard (2000) argues, political factors are crucial to understanding the 1997-1999 East Asian crisis and the different ways in which democracies and authoritarian regimes responded to it. Unlike Indonesia under the authoritarian rule of President Suharto, South Korea was able to use the elections of December 1997 to restore confidence in government and lend credibility to structural reforms. The events of late 1997 exposed the structural weaknesses of authoritarian rule in Indonesia, ultimately leading to the breakdown of the regime and collapse of the country. In South Korea, a new reform-oriented government came into office and Kim Dae Jung was able to initiate important policy reforms and initiate a recovery.

THE FAILURE OF CONDITIONALITY

The introduction of governance concerns in aid policies resulted from the failure of past strategies to induce policy reform in developing countries. In particular, the notion and practice of conditionality have spawned intense controversy. Defined as "a mutual arrangement by which a government takes, or promises to take, certain policy actions, in support of which an international financial institution or other agency will provide specified amounts of financial assistance" (Killick *et al*, 1998:6), aid conditionality represents an attempt by donors to use aid as an incentive for reforming the policies and institutions of developing countries.[10] Two important features of political conditionality are its *ex ante* nature and its punitive character:

predetermined conditions are set in advance to access development financing and failure to meet these precludes the disbursement of aid.

The World Bank's policy-based lending and structural adjustment programs include a wide array of policy and structural conditions. Aid without some sort of conditionality is unthinkable and politically impossible, as donor governments must account for the use of their taxpayers' money. It could be argued that conditionality is an integral part of concessional lending. Indeed, the very first time that the Fund attached conditions to its loans was in 1954 in the stand-by agreement with Peru. Performance criteria were introduced in 1957 in the stand-by agreement with Paraguay. Nevertheless, while the principle of conditionality does not lack legitimizing arguments, it is open to criticism as to the way it is applied and its ultimate effectiveness in achieving its intended objectives.

Conditionality is unable to act as a credible commitment mechanism. Reviewing the experience in South East Asia and Latin American with structural adjustment lending, Killick dismisses the belief that aid tied to conditionality can "buy" better policies, at least in a sustainable way, and anchor sound governance institutions. The failings of conditionality reside in its inability "to create an incentive system sufficient to induce recipient governments to implement policy reforms they otherwise would not undertake, or would undertake more gradually" (Killick *et al.*, 1998:163). This finding is substantiated by a recent study on sub-Saharan African countries that shows aid cannot buy reform and that the conditionality attached to adjustment loans did not successfully induce policy change (Devarajan *et al.* 2001).

Evaluating aid conditionality in the African context, Paul Collier, Director of Research at the World Bank, asserts that: "The IFIs have radically overestimated their own power in attempting to induce reform in very poor policy environments. They have, in effect, ignored domestic politics" (1999:325-326). Similarly, a study by Paul Mosley *et al.* (1991) finds no clear association between the intensity of conditionality and success in implementation of promised reforms. In order to alleviate the "credibility problem", Collier (1999) argues, the IFIs must radically redesign their lending policies, revisit their traditional assumptions and adopt a more selective approach rewarding good behavior and performance.

Furthermore, the fungibility of aid questions the extent to which aid can contribute to its intended objectives. Aid is said to be fungible when the marginal increase in public expenditure in response to an inflow of aid is not always realised in the targeted area of public expenditure. Aid tends to free up budget resources, which can then be allocated to alternative purposes. As a result, As a result, it is critical to assess and influence the quality overall government spending, rather than focus on sectorial spending. The World Bank now regularly conducts Public Expenditure Reviews (PER) to assess the quality public finance management. Moreover, in countries engaging in inter-state conflict such as Ethiopia and Eritrea in the late 1990s, the issue of aid fungibility is particularly problematic. As the HIPC initiative is extended to conflict-ridden countries, the G8 must pay special attention to multifaceted dimensions of debt relief and aid fungibility.

THE CENTRALITY OF OWNERSHIP

Conditionality cannot substitute or circumvent domestic commitment to reform. Using conditionality to induce governance reform is confronted with a fundamental paradox. It tends to make improvements in governance *both* a condition and a goal of development aid. Since these dual objectives can hardly be met in practice, the tension becomes a contradiction in operational terms.

Furthermore, governance-related conditionality is also confronted with the traditional dilemma of external assistance: loans or grants will not yield the desired results unless the recipients are credibly committed to reform. External support to policy change has all too often failed to offset a lack of local commitment and ownership of reform. The use of financial leverage is not a substitute for weak domestic institutions or feeble political will and can instead further delay necessary reforms.

Conditionality also has perverse effects. It tends to undermine democracy by supplanting the domestic public policymaking process. Collier warns against the abuse of conditionality: "The extension of the practice of conditionality from the occasional circumstances of crisis management to the continuous process of general economic policy-making has implied a transfer of sovereignty which is not only unprecedented but is often dysfunctional" (Collier, 1999:319). David Barlett further argues that governance conditionality constitutes and "undue influence over debtor states" and that the substantive contents of conditional loans betray "the ideological biases of multilateral lending agencies" (2001:91), based on an exclusive preoccupation with macroeconomic austerity and fiscal rigor, even in times of recession.

High levels of aid dependence can undermine the quality of governance by further weakening the state bureaucracy (Brautigam 1992, 2000). Stephen Knack (2000) has measured the negative impact of aid dependence on democratic institutions, as measured by indexes of corruption, the rule of law and bureaucratic quality. By weakening democratic accountability, encouraging rent-seeking and corruption, undermining the bureaucracy, fomenting conflict over the control of aid funds, and alleviating pressures to reform inefficient policies and institutions - thus postponing further reform, aid dependence thus tends to create a particularly perverse incentive system. Aid dependence also weakens political accountability by reducing the government's dependence on its citizenry for tax revenues. It often leads to a perverse form of accountability: recipient governments become primarily accountable to foreign donors rather than to taxpayers.

Ownership of and commitment to economic and political reform have progressively been identified as major determinants of aid effectiveness. Miles Kahler shows a positive association between government commitment to reform and program implementation: in nine out of sixteen programs with high implementation levels there was also a strong prior government commitment to reform; in eight of eleven poorly executed programs, there was low government commitment (1992:115). Broadly, external agencies were less important than domestic political forces in determining the timing and scope of adjustment decisions. However, while it is now widely recognized that ownership matters for development and aid effectiveness, establishing genuine development partnerships remains an elusive quest.

INCENTIVE CONDITIONALITY AND AID SELECTIVITY

It is now widely believed within the aid community that the effect of aid on growth tends to increase with the quality of policy. Aid would be more effective if it were either more systematically targeted to poor countries with sound economic reform programs or used to promote good policies. The objective of this system is to increase the effectiveness of aid by concentrating it in those countries showing genuine commitment to improving governance.

Aid selectivity is a particular form of *ex post* conditionality establishing a positive link between aid allocations and country performance. It creates a positive incentive mechanism that defines conditionality in terms of intended outcomes, rather than rigid prior conditions and predetermined benchmarks. A recent working paper by the IMF proposes changes to the current methods of applying conditionality by introducing such an “outcomes-based” approach to conditionality. However, the paper concludes that: “while a good case can be made for incorporating outcomes-based conditionality in IMF lending, this is not an either-or matter. Programs should presumably combine both policy-based lending and outcomes-based conditionality” (Khan and Sharma 2001).

Research by Craig Burnside and David Dollar (1997, 1998) on the impact of aid, policy and growth shows that aid has been highly successful in reducing poverty and promoting growth in countries with sound economic management and robust government institutions. These authors find no evidence that the amount of aid systematically affected policy. However, when reforms have been initiated, foreign assistance helped accompany reform and assuaging the social costs of adjustment. For example, in Ghana, balance of payment support provided the government with the breathing space it required to contain domestic opposition to market-based reforms.

The Bank’s influential report *Assessing Aid: What Works, What Doesn't and Why* (1998) recommends a more systematic targeting of aid to poor countries with sound policies and effective institutions. As Anne Krueger, the former Vice President of the World Bank who has recently been appointed Deputy Managing Director of the IMF, points out: “For the World Bank, it will need to differentiate carefully between countries where reforms are serious and stand a reasonable prospect of success and those in which window dressing is used as a means of seeking additional funding” (Krueger, 1998:31). Incentive selectivity enables the aid community to target aid to performance in implementing reforms, not promises.

The Bank has progressively amended its operational guidelines to give good governance greater importance in its adjustment and investment lending operations (Santiso 2001a, 2000a, b, c). The Bank’s Country Assistance Strategies (CAS) and the PRSPs now integrate considerations over the quality of governance and, since 1999, the Bank regularly conducts Institutional and Governance Reviews (IGR). Similarly, in 1998, the 12th replenishment of the International Development Association (IDA) resources introduced a performance-based allocation system (IDA 1988). IDA, which provides highly concessional resources to low-income countries, amended its guidelines to better assess governance reform in recipient countries (Landell-Mills 2001). The IDA Country Policy and Institutional Assessment (CIPA) framework was expanded to take into consideration (i) accountable and competent public institutions; (ii) transparent economic and social policies and practices; (iii) a predictable and stable legal framework; and (iv) participation by affected groups and civil society. The 1998 CIPA exercise and the Comprehensive Development Framework (CDF) approach undoubtedly constitute major steps in the evolution of the World Bank’s policies and the integration of governance concerns. Aid allocations now take into account the efforts made to improve governance (IDA 2001).

At their July 2000 meeting in Fukuoka, the G7 Finance Ministers recommended that the performance-based lending mechanisms of IDA-12 be extended to all MDBs programs and that the CDF and the PRSPs should become the basis for programs that have strong ownership by the recipient countries (G7 Finance Ministers 2000).

Furthermore, debt relief is likely to allow greater selectivity, especially in poor countries that are highly indebted to multilateral institutions. Analyzing the "debt game" in Sub Saharan Africa over the last 25 years, Nancy Birdsall *et al.* reveal that an important portion of the IFIs loans are designed to help poor countries cover their debt servicing obligations. As a result, "the multilaterals appear to have been caught in the poor countries' debt trap" (2001:8), in a pattern of "forced" or "defensive" lending. This vicious debt game has also tended to undermine the credibility of conditionality. As a result, debt reduction will give multilateral institutions a way out of the patterns on non-selectivity in the high multilateral debt.

However, unless donors set clear parameters for preventing mounting indebtness in the future, the circular patterns of defensive lending may eventually re-emerge, as the result of misguided economic policies and bad governance. The credibility of debtor countries will be strengthened if donors use selectivity more systematically in making their allocation decisions. It is highly questionable that authoritarian countries could benefit from debt relief when mismanagement and the misappropriation of funds by governing elites was the root cause of increasing indebtness. Government-contracted debt is in many ways a tax on poverty, as corrupt governments tend to divert loans from their intended uses while the debt burden rests with the population whose taxes are used to repay outstanding debts.

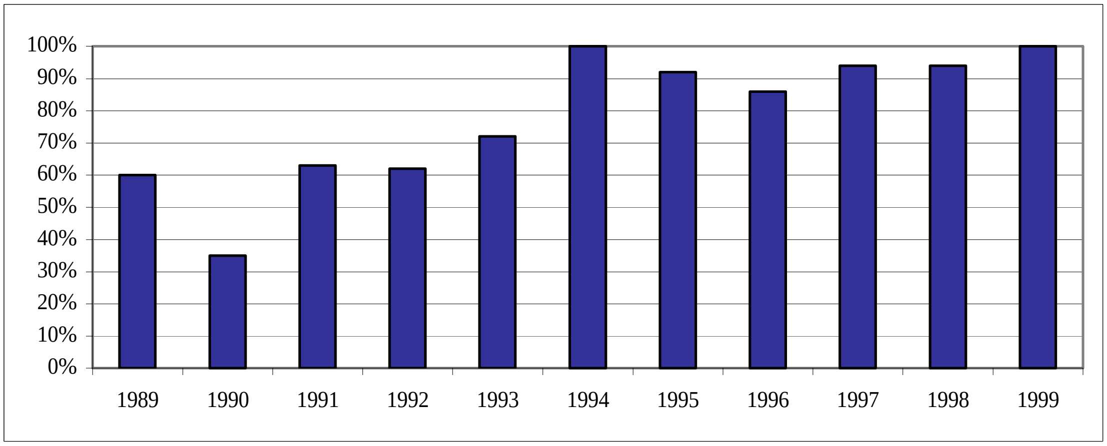
Debt relief agreements should thus include clauses that guarantee that the funds made available are used to relieve poverty and promote sustainable development. Debt relief should be more systematically linked to a commitment to strengthen governance. As Okeahalam (2001) argues, it should be possible to link the level of governance and corruption and the amount of debt relief, thus establishing a further incentive mechanism enshrined in a pact for good governance. However, thus far, conditions for debt relief are limited to economic reform and a relatively narrow range of governance issues.

THE PITFALLS OF AID SELECTIVITY

Nevertheless, even though greater selectivity is likely to increase aid effectiveness, the practice has often contradicted the evidence, suggesting that political considerations remain important in determining aid flows. Research on aid policy has found that there is no direct relationship between development aid flows and policy reform (Burnside and Dollar 1997) and that, in general, donors have not effectively tailored their assistance to the specific country and phase of the reform process (Devarajan *et al.* 2001). More, better policies and improving performance too often lead to decreasing levels of development aid (Collier and Dollar 1998), which suggests that: "Donors actually discriminate against poor countries that have reformed. They may think that these countries can attract private capital and therefore no longer need aid" (Collier and Dollar, 1999:19). Good performance should not become a pretext for a reduction of development aid.

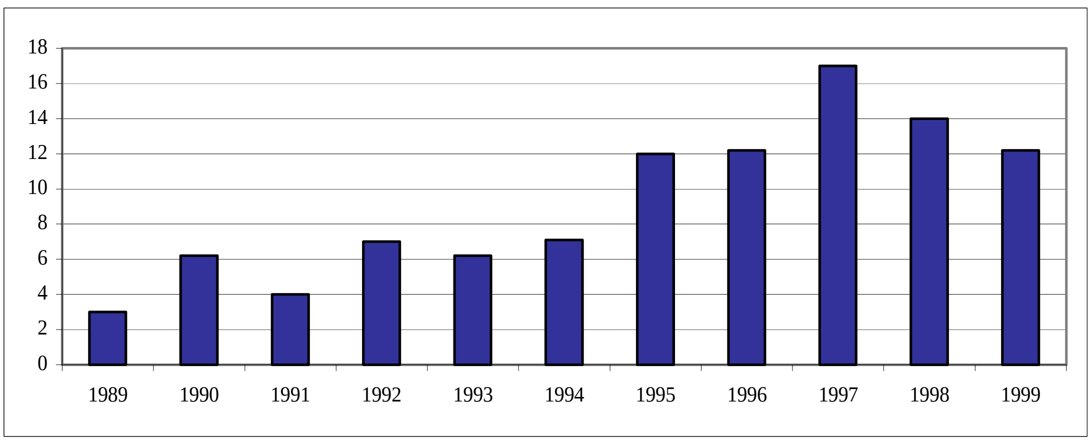
Aid selectivity has been criticized on a number of grounds. *First*, despite these research findings, the use of conditionality has expanded in scope and depth in the course of the 1990s. As the Fund itself recognizes, the share of programs with structural conditions and the average number of conditions per program have increased significantly during the past decade: from 1989 to 1999, the share of programs with structural conditions has increased from 60 percent to 100 percent (figure 1) and the average number of structural conditions per program has increased from 3 to 12 (figure 2).

FIGURE 1: SHARE OF IMF PROGRAMS WITH STRUCTURAL CONDITIONS (1989-1999)



Source: IMF 2001a, 25

FIGURE 2: AVERAGE NUMBER OF STRUCTURAL CONDITIONS IN IMF PROGRAMS (per program, per year, 1989-1999)



Source: IMF 2001b, 10

As tables 1 and 2 show, governance-related conditionalities represent the bulk of the conditions imposed by the IFIs (on average 72 percent in Africa, 58 percent in Asia, 59 percent in Central Asia and Eastern Europe, and 53 percent in Latin America and the Caribbean). Most of the conditionalities are related to transparency and accountability issues in the fiscal sector (IMF 2001c). The question then becomes whether poor countries have the capacity to manage simultaneously a wide range of reforms, some of which with dubious urgency.

Quantitative measures of conditionality are rendered difficult by the plasticity of the concept. Using a broader definition of conditionality, Kapur and Webb note that:

> even if conditionality is interpreted narrowly, its burden on borrowers has grown significantly. The average number of criteria for a sample of 25 countries having a program with the IMF in 1999, with programs initiated between 1997 and 1999, is 26. This compares to about six in the 1970s and ten in the 1980s (2000:4).

For example, according to Kapur and Webb's data, the Fund program with Indonesia of 1997 contained 81 conditions, of which 48 were governance related. It specified, in minute detailed, such things as the price of gasoline and the manner of selling plywood. Similarly, in 1999, Kyrgyzstan's program had 130 conditions, 97 of which were governance-related. "The difficult paradox," says Naím "is that any country that is capable of meeting such stringent requirements is already a developed country" (2000:9).

TABLE 1: THE BURDEN OF CONDITIONALITY

	Conditionality Strictly Defined			Conditionality Loosely Defined		
	Total conditionalities (average)	Of which governance-related conditionalities	As a percentage of total conditionalities	Total conditionalities (average)	Of which governance-related conditionalities	As a percentage of total conditionalities
Africa	23	9	39%	114	82	72%
Asia	17	4	24%	84	49	58%
Central Asia and East Europe	36	24	67%	93	55	59%
Latin America	33	13	39%	78	41	53%

Source: Kapur and Webb 2000, 7.

Data based on IMF *Letters of Intent* and *Policy Framework Papers* (PFPs) between 1997-1999 for the sample of 25 countries that had a program with the IMF in 1999: Africa: Cameroon, Djibouti, Gambia, Ghana, Guinea, Madagascar, Mali Mozambique, Rwanda, Senegal, Uganda, Tanzania, Zambia; Asia: Cambodia, Indonesia, Republic of Korea, Thailand; Central Asia and East Europe: Kazakhstan, Kyrgyzstan, Latvia, Romania; Latin America: Bolivia, Brazil, Nicaragua.

TABLE 2: EXAMPLES OF THE BURDEN OF CONDITIONALITY

		Conditionality Strictly Defined			Conditionality Narrowly Defined		
Region	Countries	Total	Governance-related conditionalities	In percentage	Total	Governance-related conditionalities	In percentage
AFRICA	Mali	26	13	50%	105	67	64%
	Mozambique	22	12	55%	74	58	78%
	Senegal	27	9	33%	165	99	60%
	Zambia	18	6	33%	87	59	68%
ASIA	Cambodia	30	9	30%	83	65	78%
	Indonesia	18	8	44%	81	48	59%
	Rep. of Korea	10	4	40%	114	44	39%
	Kazakhstan	27	17	63%	114	69	61%
EASTERN EUROPE	Albania	43	33	77%	72	47	65%
	Latvia	28	20	71%	65	28	43%
	Romania	43	25	58%	82	34	41%
LATIN AMERICA	Brazil	38	21	55%	89	45	51%
	Bolivia	32	21	66%	95	44	46%
	Nicaragua	29	18	62%	50	34	68%

Source: Kapur and Webb 2000, 5-7

Data based on IMF Letters of Intent and Policy Framework papers (PFPs) between 1997 -1999

The G8 must force the IFIs to comply with the established principle of parsimony adopted in the 1979 guidelines on conditionality. Reducing the number of conditionality represents tremendous collective action dilemmas, as it requires greater cooperation between multilateral institutions: a reduction in the conditions imposed by the IMF should not lead to an increase of those imposed by the World Bank and *vice versa*. Similarly, were IMF conditionality to concentrate on macroeconomic policy issues while World Bank conditions on structural and governance conditionality, the overall amount of conditions should nevertheless decrease.

The issue of cross-conditionality requires significantly more collaboration between the Fund, the Bank and regional MDBs. However, the rationale for conditional lending is different for the Bank and the Fund. For instance, in 2001, the Bank approved a US$400 million loan to Colombia to finance its fiscal reform. However, as Jacques Polak recently remarked in a seminar on IMF conditionality (IMF 2001e), fiscal reform does not cost money. It thus could be argued that while Fund conditionality is designed to support its loans, Bank loans are introduced to support its conditionality.

Secondly, selectivity is difficult to implement in practice, as high levels of poverty are often associated with weak governance. Reducing poverty remains the core mission of the Bank. It is extremely difficult to devise and apply consistent and even-handed criteria to measure country performance in terms of governance (Landell-Mills and Serageldin 1992). In reality, there exist few countries that can be classified as either good or bad performers. Most of them lie somewhere in between. Individual country circumstances make judgmental approaches inescapable.

Thirdly, the underlying analysis and consequent policy conclusions of the World Bank research have not gone unchallenged. The effectiveness of aid on policy reform and on economic growth and poverty reduction are two distinct things, and while aid might be ineffective in inducing and sustaining policy reform, it is effective in stimulating growth. Recent research discussed at a seminar of the OECD in January 2001 show that there may exist, after all, a positive relationship between aid and growth even in countries hampered by an unfavorable policy environment (Hansen and Tarp 2000a and b). This recent research thus argues that the performance-based aid reallocation system implied in *Assessing Aid* to be an unreliable guide to policy. It suggests that the latest fad in development thinking - aid selectivity - has entailed the emergence of a dangerous exaggeration, that aid *only* works in an environment of sound policy (Beynon 2001).

Fourthly, there remain many contested areas of debate, and many caveats and uncertainties. “Using past performance as an indicator of future performance is especially dubious in this environment, given the existing limited understanding of the interplay between aid, macroeconomic policy and political economy variables. In sum, the unresolved issue in assessing aid effectiveness is not whether aid works, but how and whether we can make the different kinds of aid instruments at hand work better in varying country circumstances” (Hansen and Tarp, 2000b:22).

More fundamentally, concentrating aid on “good performing” poor countries begs the original concern that spurred the current shift in policies: how can external agencies *promote* development in poor performing countries? How to deal with poor performers and unreliable governments headed by despotic rulers that repeatedly renege on their commitments? How to deal with countries such as Kenya, Zimbabwe, Nicaragua, Kyrgyzstan or Belarus? Aid selectivity remains also silent on how to improve policies, institutions and governance in poorly performing countries as well as how to support large number of poor people in middle-income countries such as Brazil (Beynon 2001). The policies of aid selectivity circumvent these questions by pushing them aside. The elegance of the approach masks an important caveat, namely that aid works in a "sound policy environment", which casts doubts on its policy implications. "Sound policies" have largely been defined in the context of the neo-liberal economic policy model of the Washington consensus. The proxy for assessing the quality of economic policies and institutional setting is derived from the World Bank's own assessment (CIPA), which marginally assesses the quality of governing institutions.

The debate on aid effectiveness is likely to remain imbued with controversy. Pragmatic observers argue that the adoption of performance-based aid allocation policies merely constitutes an *a posteriori* justification for *de facto* cuts in aid budgets, which have reached dangerously low levels by the end of the 1990s. Nevertheless, the fact that aid works *better* in good policy environments appears undisputed (Tarp 2000), although this is a tautological conclusion.

IV. BEYOND THE WASHINGTON CONSENSUS

The recognition of the central role of the institutions of governance in development compels the development community to revisit the "Washington consensus" that has dominated development economics since the 1980s (Santiso 2000c and d). The Washington consensus policy prescriptions include trade liberalization, fiscal restraint, prudent macroeconomic management, deregulation and privatization (Williamson 1990). They counsel in particular reducing drastically the size and prerogatives of the state. A major thrust of the structural adjustment programs of the 1980s and 1990s has focused on equilibrating public finances and reducing the size of the bureaucracy. Such views informed political conditionalities imposed on developing countries, through policy-based lending.

The governance agenda challenges the conceptual foundations of the Washington consensus in a number of ways. Its emergence has given rise to what some analysts describe as a "post-Washington consensus" (Burki and Perry 1998). It suggests that sustaining development requires reforming not only the policies but also the institutional framework in which policies are formulated.

REFORMING THE STATE AND STRENGTHENING GOVERNING INSTITUTIONS

A *first dimension* of the post-Washington consensus concerns the state. Fundamentally, good governance is about the government's ability to govern. Strengthening the accountability of political institutions tends to increase the responsiveness of the state apparatus to shifts in policies. Changes in the institutions and modes of governance are required to sustain market reforms and to consolidate democracy *simultaneously*.

The realization of the incompleteness of market reforms led policy makers and development economists to advocate the launching of a second phase of reforms focusing on the institutions of governance. Consequently, a distinction was made between first and second-generation reforms. While first generation market reforms aim at stabilizing and liberalizing the economy, second generation reforms seek to deepen them by reforming the state and strengthening governing institutions (Naím 1995). The main failure of first generation economic reforms is their disregard for the political economy of institutional reform and their inability to change the incentive structure facing politicians and bureaucrats. First generation market reforms have tended to circumvent these political dimensions by addressing governance failures with technical solutions and by insulating economic policymaking.

The *World Development Report* of 1997, which focused on the changing role of the state, marked a stepping-stone in the mainstreaming of good governance. It revealed that many of the difficulties facing developing countries steam not so much from excessive executive power but from institutionally weak states. The first requisite for both sustainable development and democracy is a state that works. Experience shows shrinking the state's prerogatives and capacities may have perverse effects, causing a dramatic reduction in public service delivery and eroding the authority of government.

A capable state is required to guarantee public security and the rule of law, necessary conditions for both economic development and democratization. The rehabilitation of state is underscored by the recognition of its crucial role in economic management, and in particular in the regulation and supervision of financial markets. Markets require a legal and regulatory framework that only governments can provide - appropriate legal and financial institutions and regulations ensuring competition and contract enforcement, guaranteeing property rights, ensuring sound financial and banking regulations, establishing oversight bodies and regulatory agencies.

More fundamentally, effective reform requires building the capacity to pursue it. As Gerald Caiden) points out, "countries most in need of state reform are least able to implement it" (1994:111). The rediscovery of the state has been accompanied by the need to reform it. As noted by Stephan Haggard and Robert Kaufman (1995), successful economic reform represents a paradox: "for governments to reduce their role in the economy and expand the play of the market forces, the state itself must be strengthened" (25). Thus the central question should not be the size of the government, but the activities and methods of government.

Nevertheless, the World Bank's discourse tends to reflect a reduccionist vision of the state and the development process. The Bank has adopted a minimalist vision of development focusing its approach to good governance as the search for a legal framework conducive to private sector development. The latter has become an end in itself, rather than a means to achieve sustainable and equitable development (Chavagneux 2000; Chavagneux and Tubiana 2000). According to Béatrice Hibou, "the discourse of the World Bank is unable to engage in the debate on the nature and the functioning of the state" and "politics are always treated from a technical and deterministic perspective […] setting the priorities and defining the functions of the state" (Hibou 1998:24).

A *second dimension* of the post-Washington consensus relates to the necessity to strengthen governing institutions, defined as "formal and informal rules and their enforcement mechanisms that shape the behavior of individuals and organizations in society" (Burki and Perry, 1998:11). However, the need for institutional reform, while basically acknowledged in theoretical proposals even of neoclassical inspiration, has been neglected in the practice of policy reform in the first stage of reform. The Washington consensus policies often disregarded the analysis of institutions and failed to assess how state institutions can effectively be reformed in order to make public policies more responsive to people's needs, especially the poor.

The post-Washington consensus marks the rediscovery of institutions. It focuses on the urgent need to improve the e*ffectiveness* of public sector institutions and the performance of public policies. Problems of governance involve fundamental institutional weaknesses combined with inappropriate policies and un-enforced legal frameworks. Consequently, judicial reform, legislative strengthening and state modernization must be constituent elements of the governance agenda, and not merely instrumental dimensions of good governance, as the 2002 *World Development Report* on *Building Institutions for Markets* of the World Bank seems to suggest (World Bank 2001b).

Nevertheless, while the governance agenda amends the dominant neo-liberal economic policy model, it does not repudiate it. To the contrary, it reinforces it by palliating its insufficiencies. From the IFIs' perspective, market reform remains a precondition for institutional reform (Williamson 1999; Naím 2000). The IFIs view sustaining economic reform and anchoring the market logic as the ultimate objective of governance and institutional reform. Indeed, almost all statements about the policy priorities of the post-Washington consensus include a strong preface clarifying that sound macroeconomic fundamentals are indispensable. Sound macroeconomic policy has thus progressively become not only an objective, but also a precondition for sustainable development. Certainly, as the reform agenda broadens, it is also becoming more complex.

STRENGTHENING ACCOUNTABILITY AND THE RULE OF LAW

Even in the narrow economic sense, good governance puts further requirements on the process of public policy formulation and implementation. Good governance entails essential aspects of a functioning state including the prevalence of the rule of law, an independent judiciary, effective parliamentary procedures, institutional checks and balances through horizontal and vertical separation of powers, and effective oversight agencies. The democratic facets of good governance are particularly striking. Good governance requires an efficient executive, a functioning legislature, an independent judiciary and the effective separation and balance of powers, all constituent elements of a democratic regime. Consequently, good governance is not sustainable without *effective* democratic institutions.

The recent experiences of Brazil and Argentina underline that it is not the mere existence of the formal democratic institutions that matters, but their effective functioning and constant strengthening (Santiso 2001c). Quite paradoxically, considering the fragmentation of the Brazilian political system and the complexity of executive-legislative relations, Brazil's currency crisis of 1999 did not translated into a political meltdown. In Argentina, the current financial has become a profound crisis of governance, with the resignation of President Fernando de la Rúa in December 2001 and the succession of five presidents in a period of one month.

Compared to Brazil, the Argentine political system appeared *prima facie* more coherent, with few disciplined political parties. This system is also consistent with the model considered as the most effective for implementing market reforms by the IFIs, with the insulation of key decision-makers from the intricacies of politics. However, since the second term of former President Carlos Menem, the country has witnessed a constant corrosion of governance and erosion of democracy, with the spreading of endemic corruption, the weakening of the rule of law, a pliant judiciary, increasing bureaucratic inefficiency, and an abusive form of fiscal decentralization. While these dynamics have also been at play in Brazil, they were not counter-balanced by the restraining effects of shared governance and constant bargaining over the terms of the reforms proposed.

At the core of the governance agenda is the fight against corruption and the corresponding need to enhance accountability and strengthen transparency in public policy-making. Indeed, the fight against corruption, which has been formally integrated in the Bank's mandate in 1996, constitutes the core of the governance agenda that has been forcefully advocated by the President of the World Bank Group, James Wolfensohn, since his appointment in 1995.

Agencies of restraint anchored in core state institutions such as autonomous oversight bodies and independent judiciaries are vital foundations for effective anti-corruption strategies. Although the World Bank emphasizes financial accountability, strengthening accountability entails a systemic reform of the state and modes of governance (administrative, parliamentary, legislative, and justice reform). In particular, enforcing political accountability requires the strengthening the mechanisms both of "vertical accountability" (between the governed and the governing through periodic and fair elections) and "horizontal accountability" (between the different branches of government, including executive-legislative relations and an independent judiciary). It entails the effective independence of state powers and the existence of institutionalized checks and balances, as found in pluralist democracies. It also requires the de-politicization of public administration and the existence of an effective opposition enabling the parliament to control the executive and enact legislation that is credible and impartial.

Furthermore, rule-based, predictable legal regimes are of the utmost importance in the new market order. As a consequence, the strengthening of the rule of law constitutes a central element of the World Bank's strategies to fight rampant and overt corruption. Legal and judicial reform has become a core component of the Bank's governance portfolio. The Bank stresses that its preoccupation with the effectiveness of the judiciary is primarily motivated by its concern with the regulatory environment for economic activity and private sector development. It thus focuses mainly on ensuring the stability and predictability of the legal framework, focusing on private law to secure property rights and enforce contracts. However, the reliability of the rule of law is determined by the political context. A judiciary independent from executive meddling is vital to ensure that the legislative and executive remain fully accountable under the law, and to interpret and enforce the terms of the constitution.

Enhancing good governance entails ensuring the effective separation of powers (executive, legislative and judicial), so that they are able to restrain and control each other. It thus requires addressing the factors underpinning the political independence of the judiciary, guaranteeing the impartial administration of justice and reducing "the opportunities for corruption by cutting back on discretionary authority" (World Bank, 1997:8). Furthermore, a particular thrust in the current efforts at reforming and modernizing the state focuses on the devolution of power to lower levels of government. Decentralization, which carried the promise of local self-government, has indeed become a major component of the Bank's reform strategies (World Bank 1999).

ADVANCING DEMOCRATIC GOVERNANCE

Democracy and good governance need to converge, both conceptually and practically, in the study and practice of public policy-making. The concept of *democratic governance* gives that of good governance a normative content. In theory, governance may be about exercise of power irrespective of the political system, but in practice good governance involves enforcing accountability and transparency, strengthening the rule of law and promoting meaningful participation. It also entails increasing the responsiveness of public policies. These are precisely the working conditions of democracy. Democracy and good governance are mutually reinforcing. It could be argued that there is a symbiotic relationship between the concepts of democracy and good governance, not in the sense of either being necessary for the other but in the sense that neither is ultimately sustainable without the other. Improving governance systems is thus inextricably linked to the consolidation of democracy.

Some multilateral development banks have adopted a more assertive approach to the promotion of democratic governance in their lending operations. The IADB has interpreted its mandate more broadly and adopted a clear political stance, promoting the strengthening and consolidation of "democratic governability" (Santiso, 2000a). In 1994, the Eighth Replenishment of its resources mandated the IDB to emphasize state reform and the strengthening of democratic governance more prominently. The IADB articulated a broad policy outlining the contours of its involvement in the promotion of democratic governance in member countries. The 1996 guidelines focus in particular on the modernization of the state and the strengthening of civil society as critical components of the IADB governance strategy (IADB, 1996), but only in 2001 did the IADB defined a strategy to combat corruption in its lending operations and borrowing countries. This evolution was largely made possible by the renewed commitment to democracy of the inter-American system.

The European Bank for Reconstruction and Development (EBRD), established in 1990, is the only multilateral development bank to include a commitment to multiparty democracy in its founding charter (EBRD, 1992). However, it has progressively adopted a more conservative approach to the political dimensions of its mandate. To varying degrees, sub-regional multilateral development banks such as the European Investment Bank or the Council of Europe Development Bank, have included explicit or implicit governance clauses. Ultimately, the approach adopted by a specific multilateral organization depends heavily on its constituency.

CONCLUSION

> "Looking back on the past year of reform, I can draw one important conclusion. It is that introducing new laws and institutions alone is not enough. Reform can succeed only when these institutional changes are accompanied by changes in people's attitude. This is the real test." Kim Dae-jung, President of South Korea, February 1999

Reoriented post-Cold War foreign policies and broadened concepts of development have led multilateral development institutions to reconsider their approaches for promoting policy reform in developing countries. The introduction of the concept of good governance in aid policies has resulted in a broadening of the understanding of the development process and has significantly altered the agenda of the IFIs. More fundamentally, it has affected *what* they do and *how* they do it.

The World Bank has radically changed in the course of the 1990s. The introduction of governance concerns in development assistance reflects a shift in economic development thinking and signals an increased willingness to take the political dimension of development into account. The modernization of the state, the fight against corruption, the reform of judiciary, the strengthening of legislatures and the decentralization of government are now integral parts of the Bank's public sector work. However, the Bank's approach to governance reform remains inhibited by its technocratic ethos and restrictive mandate. The Bank must broaden its understanding of governance and its approach to governance reform to confront the political economy of institutional development.

The G8 must fully assume its responsibilities in global governance by steering the course of the reform of the international financial system and multilateral development finance. It must establish a much sharper division of responsibilities between the Fund and the Bank by, for instance, moving the PRGF from the Fund to the Bank, which the G8 itself has identified as the central institution for combating poverty in developing countries. At the same time, the Bank should forcefully address its shortcomings in its areas of responsibility. The G8 should incite it to cross the Rubicon of politics by explicitly recognizing the political dimensions and institutional foundations of governance, which would entail considering amending the Bank's Articles of Agreement. More fundamentally, the G8 must aim at bridging the divide between political and economic assistance by revisiting the governance of the global aid regime, in particular the division of responsibilities within the United Nations system and between the UN and the Bretton Woods institutions.

Traditionally, multilateral development finance has operated ignoring the realities of power and the intricacies of politics in recipient countries. It tends to rely on technical solutions to address political problems, often adopting a "therapeutic approach" consisting in the mechanistic application of a standardized package of reform. This approach faces significant hurdles when applied to the reform of the institutions of governance, in particular policy-making processes, judicial systems and parliamentary structures. Without addressing the underlying distribution of power, parliaments will likely remain passive and judiciaries dominated by the will of omnipotent executives. Although IFIs should not meddle in politics, they should not be politically naïve and cannot be oblivious of the political economy context. Governance reform and institutional development require focusing more explicitly and more rigorously on issues of power, politics and democracy.

Furthermore, the emerging governance paradigm questions the prevalent neo-liberal consensus of development economics. The renewed emphasis on democracy and good governance raises questions about the extent to which recipient states have the sufficient space to articulate their own development strategies and political development models. As Rodrik rightfully stresses:

> Policy making at the international level has to create spaces for national development efforts that are divergent in their philosophy and content. Forcing all countries into a single, neo-liberal development model would be unwise – in light of the potential political backlash from national groups – even if there are serious grounds to believe that the model is economically advantageous. It is absurd when the evidence on the model's economic superiority is itself in doubt (Rodrik 1999b:150).

In a critical statement of the IMF stabilization package for Russia in 1998, Stiglitz (1999b) argues that the failures of reform in Russia were not just due to sound policies being poorly implemented, but were rooted in the misunderstandings of the foundations of a market economy as well as a misunderstanding of the basics of an institutional reform process.

More fundamentally, while structural adjustment programs provide a response to balance of payments problems, stabilization in and of itself will not spur economic growth and development. Fiscal righteousness, macroeconomic discipline and spending profligacy do not automatically translate into equity-enhancing economic growth and sustained poverty reduction. Indeed, the Fund and Bank policy prescriptions have often been criticized for their excessive insistence on severe monetary policies and tight fiscal policies, even in times of recession. The Fund does indeed display an excessive zeal for fiscal contraction.

The Bank does not appear to possess the "magic formula" for encouraging economic growth and development either (Easterly 2001a and b). Structural adjustment, instead of being a means for promoting economic development, has tended to become and end it itself, providing the ultimate benchmark to assess performance. For instance, Burkina Faso is considered amongst the IMF stellar performers in terms of macroeconomic rectitude. However, the level of poverty remains dismal and the country ranks 159th in terms of human development out of 161 countries included in the United Nations' 2001 Human Development Report.

The orthodox stance of IMF stabilization packages and their rigid insistence in balancing budgets by sharply reducing government spending even in times of crisis should be revisited. There is a large consensus that balanced budgets are the foundation of long-term economic stability and growth. However, in times of enduring crisis, moderate government deficits can be a desirable, yet temporary, counter-cyclical policy. Rigid demands to balance budgets at all times only exacerbate downturns. The crisis in Argentina is not only the dramatic collapse of a bankrupt economy. It questions the neo-liberal foundations of the prevailing development paradigm that has dominated international development economics since the mid-1980s.

The traditional punitive form of conditionality is not the appropriate approach to strengthening good governance in developing countries. What is needed is a more radical approach in which donors would cede developing countries greater control over the use of aid, within the framework of agreed-upon objectives. Greater emphasis should be put in positive forms of incentive conditionality, based on well designed selectivity approaches and "outcomes-oriented" conditionality. These development partnerships should be embedded in pacts for governance reform enshrining the shared political objectives of the cooperation as well as the mutual obligations and reciprocal commitments between donors and recipients. The Bank has indeed started to alter its operational strategies accordingly. The CDF approach represents a promising avenue for reforming the governance of aid. However, its implementation has encountered significant resistance, especially within the IFIs themselves. The G8 must radically re-assess the governance of aid and actively support innovative and comprehensive approaches to development such as the CDF, which could contribute to the closing of the gap between economic and political development assistance.

Ultimately, the concept of good governance questions the legitimacy of the IFIs as institutions of global governance. The governance agenda introduces a tension in the policies of institutions mandated not to meddle in politics and upsets the traditional division of labor within the global aid regime. Nevertheless, as Kapur and Webb rightfully stress:

> Well applied, [governance-related conditionality] could help to empower people and nations. But if applied in an ad hoc manner, in response to the short-run foreign policy problems of large shareholders, and with a high degree of discretion rather than commonly agreed rules, the outcome is unlikely to be fair or significantly pro-poor (2000:18).

ENDNOTES

1 *The Economist*, 2 March 2002:26-28.

2 The four main regional multilateral development banks are the Asian Development Bank (ADB), the Inter-American Development Bank (IADB), the Africa Development Bank (AfDB) and the

European Bank for Reconstruction and Development (EBRD). There exists a myriad of multilateral development institutions.

3 IMF-led official rescue packages for Thailand, Indonesia, Malaysia, and South Korea amounted to almost US$120 billion.

4 The HIPC Initiative provides debt relief to poor countries whose debt burden has reached an unsustainable level and that pursue IMF- and World Bank-supported adjustment and reform programs, but for whom traditional debt relief mechanisms are insufficient.

5 As of late-2001, 24 countries had qualified to debt relief under the HIPC initiative for an overall amount of over US$36 billion. The total cost of providing assistance to 34 countries under the enhanced HIPC initiative is estimated to be about US$33 billion. While the current wave of HIPC countries are characterized by fragile governance and unstable politics, the next wave of countries is likely to prove more challenging, are they are mostly war-torn and conflict-ridden countries.

6 It is indeed indicative that the IMF is the lead agency in the management of the HIPC Initiative, an arrangement that has often been criticized (Williamson 2000).

7 The following statement is unequivocal: "Since Country Assistance Strategies (CASs) are comprehensive tools for effective and efficient MDB support for developing countries, MDBs should work to improve their quality and broaden their scope. These strategies should take full account of a borrower's policy environment including governance as well as the legal, institutional and regulatory frameworks. Public Expenditure Reviews (PERs) should be an essential building block of the strategies. Every CAS should provide an assessment of the country's financial sector and governance" (G7 Finance Ministers 2000:28).

8 *Webster's Unabridged Dictionary.*

9. Interview with John Williamson, Institute for International Economics (Washington DC, 8 November 2000).

10 There exists various forms of conditionality, including preconditions or prior actions as well as trigger actions that determine continued access to development financing and the next outstanding instalments of the credit.

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