Consensus-Building, Knowledge and Conditionality

Paul Collier
The World Bank

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Abstract

Progress in poverty reduction depends primarily upon policy and institutional changes in low-income countries. The Bank's previous approach to inducing these changes has been through negotiated loan conditionalities. The empirical evidence suggests that this approach has been largely ineffective - where change occurred it was chosen by governments rather than induced by loans. I discuss various countervailing pressures which undermine the effectiveness of loan conditionalities. An alternative approach for the same objective of inducing change is to empower the domestic constituencies for change through knowledge and participation. I argue that this is likely to be more effective in promoting policy change, and that for institutional change, which is now usually the frontier of economic reform, it is likely to be essential. This change in approach is part of the rationale for the Comprehensive Development Framework.
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Introduction

Our understanding both of why some countries stay poor and of what donors can do to reduce poverty has evolved over the past thirty years. I will start with a few remarks on how our ideas on why countries stay poor have changed, but I will focus primarily on how our ideas on the role of the Bank and of donors have changed.

Why poverty persists

Thirty years ago the diagnosis of why mass poverty persisted was highly pessimistic. It was feared that even if growth could be achieved, the poor would stay poor. The evidence for the Kuznets curve appeared to suggest that growth in poor countries was intrinsically biased against the poor: and low-income countries grew richer, inequality increased. Poverty reduction would therefore require active large scale redistribution policies to offset the forces which systematically seemed to exclude the poor from the benefits of growth.

By contrast, the diagnosis of slow growth was highly optimistic. Slow growth was initially seen as being due to low savings, in turn due to low incomes. Sufficiently large aid flows would spring the society out of this savings trap. Soon it was seen that low savings could not be primary cause of low growth. In large parts of the developing world the capital stock was much lower than savings rates would have implied. For example, by 1990 around 40% of the private wealth of Africa and the Middle East had shifted offshore (Collier and others 1999). Evidently, these regions were short of capital domestically at least in part because they had hostile environments for economic activity. The diagnosis
of slow growth therefore changed from the savings trap to an explanation of what made these environments hostile for investment. However, although the diagnosis changed, it remained highly optimistic. The culprits were a short list of dysfunctional economic policies: over-valued exchange rates, high inflation, trade barriers, restricted private activity, all of which were readily fixable.

We now think that these positions were wrong.

Our analysis of mass poverty was too pessimistic. Although growth does not necessarily help the poor, it does not necessarily exclude them. With reasonable care, growth can be sufficiently broad-based to eliminate mass poverty (Li, Squire, and Zou 1998; Dollar and Kraay, 2000). Pro-growth policies have received an undeservedly hostile reaction from the development studies community and this must be contested because it undermines, and is intended to undermine, the political basis for growth. I take the example of Uganda, clearly the test-bed during the 1990s for the effects of pro-growth policies. A recent so-called `participatory assessment' of how poverty had changed in Uganda, using the standard methods of development studies, concluded that `the rich are getting richer and the poor are getting poorer' (Government of Uganda 1999, p.27). Clearly this message would normally have been used to discredit the pro-growth policies which had been so effectively pursued by the Ugandan government. Was it right? Fortunately, in this instance the `participatory assessment' results could be challenged by objective evidence. First, large, national, random sample consumption surveys had been conducted annually through the period. Their analysis (Appleton, forthcoming) showed precisely the opposite: consumption poverty had fallen in every single year, and cumulatively by a lot. Further, inequality had been reduced: the poor benefited
disproportionately from Uganda’s growth, although 80% of the reduction in poverty came from growth rather than redistribution. Now suppose we were to broaden the definition of poverty from consumption to include education and health services. Well, during the 1990s there were dramatic increases in school enrolment, and sharp reductions in infant mortality. Suppose we were to broaden the definition of poverty further to include notions of empowerment. Well, during the 1990s the population acquired meaningful electoral power, gained access to competitive sources of information through a free press and radio, and was liberated from monopoly crop marketing channels. Thus, the result `the rich are getting richer and the poor are getting poorer’ can be shown to be a travesty of Ugandan experience. We may wonder, how could the `participatory assessment’ methodology produce such a travesty? The authors of the Report breezily ignore the problem, burying the fact that consumption poverty has sharply fallen in a footnote and offering no discussion whatsoever of the contradiction between this and their own results. An subsequent attempt to defend the results (McGee, 2000) is forced to admit that the process of data collection was politicized, that some people were paid to participate, and that the improved environment in Uganda has induced rising expectations and has empowered people to complain more if social services are not satisfactory. While McGee reassures us that the participatory methodology deals with these problems in an `holistic’ way, some may conclude that a method which represents an improvement as a worsening, without even acknowledging this rather severe limitation, is suspect. The theory of fads and information cascades, of which McGee and her colleagues appear to be unaware, gives us, I think, a better insight into why the participatory methodology is liable to produce misleading results (Bikhchandani and others, 1998). False opinions can become
hegemonic as people assume that the collective opinions of others contain more information than their own limited experience: imiserizing growth becomes accepted through a cascade of gossip. In effect, the method of `participatory assessment' allows development studies practitioners to hold up a mirror to their own prejudices, while interpreting the results as if they were data.

Of course, pro-growth policies can be more or less effective in reducing poverty. Recent research in the World Bank has explored which among the pro-growth policies are most effective for the poor. Dollar and Kraay (2000) show that low inflation is disproportionately benefits the poor relative to other groups in society. Hence, a macroeconomic policy package which seeks to reduce poverty, rather than simply to promote growth, should give more weight to preventing inflation.

Whereas growth will eliminate mass poverty, and well-designed growth policies will eliminate it quite rapidly, there are important groups for whom growth will not be enough. That is why all developed societies have evolved sophisticated public welfare, health and pensions programs. The design of redistribution systems, and especially of quick-acting social safety nets, in low and middle-income countries will require a lot of skill. The modernization of society inevitably weakens the traditional family-based systems. There is also some evidence that as public safety nets are introduced the traditional systems are further undermined (Cox and Jimenez 1995). This is not an argument for continuing to depend upon family-based assistance. Rather, it suggests that the transition to public systems may need to be quite rapid because the two do not co-habit successfully. The rationale for combining policies which build these transfer
systems along with a pro-growth strategy is not that they mitigate the ill-effects of pro-
growth policies, it is that growth makes these systems more affordable.

While our analysis of poverty was too pessimistic, our analysis of growth was too
optimistic. The constraints on growth are not just a matter of macroeconomic policies.
Increasingly, we are recognizing that while open market economies outperform closed,
planned economies, markets need institutions and infrastructure. Institutions matter,
suevey evidence of African manufacturing shows that across the continent firms are
reluctant to do business with new clients because they lack effective means of contract
enforcement. This evidently reduces competition and dynamism: firms are just locked in
to their existing client base. Infrastructure matters. In Uganda, the single most important
constraint upon private investment turned out to be the unreliable supply of electricity
through the grid (Reinikka and Svensson, 1999), and the study of the African growth
process by Easterly and Levine (1997) found the deficiencies of the telephone system to
be more detrimental than poor macroeconomic policies. Once gross macroeconomic
misalignments have been corrected, the growth process will generally be constrained by
whichever is the weakest point in a long list of factors. However, governments cannot
tackle all potential problems at once. Making progress across a broad front spreads
limited implementation capacity too thin. Priorities must be chosen. Sometimes, as with
the ‘integrated development projects’ of the 1970s, development agencies recognized
that many factors might constrain development, but tried to move on everything at once.
These projects failed. Sometimes, there has been a willingness to prioritize, but the actual
choice of priority has simply reflected the latest fad in development thinking: the
constraint upon growth is the lack of openness, then the lack of education, then the lack of transport infrastructure.

We need a diagnostic procedure which steers us to more realistic conclusions. Each country needs first to work through an exhaustive check-list of the factors which might be the binding constraint upon growth. Does the power work? Do the phones work? Do the courts work? Does the financial system work? Does health care work? Etc. Having determined the important constraints, the next stage is a critical path analysis of efficient sequencing. If the courts don’t work, the banks cannot work because assets will not function as collateral. For example, until recently, the Ugandan courts would not in practice transfer to banks the control over assets pledged as collateral by defaulting borrowers. Defaulters could induce the courts indefinitely to delay reaching a decision. Not surprisingly, a survey of Ugandan banks found that their single most pressing requirement of government was a fast-track court procedure for collateral (Atingi-Ego and Kasekende 1997). Until the courts were improved, Ugandan firms would inevitably be short of credit. A second sequencing example is that if public sector employment reflects cronyism, it will not be possible to motivate staff to deliver services. The wages of Ghanaian public sector workers are 25% higher if they belong to the locally dominant tribe, yet wages are unrelated to workers’ skills in numeracy and literacy (Collier and Garg 1999). Until hiring and promotions are better based, the Ghanaian public sector will not be able to deliver services such as health care and education efficiently. A third sequencing example is that if markets are not competitive, then privatization will not work. In Russia, privatization has produced rapacious monopoly and in the process undermined the political constituency for private-led development.
The binding constraints on growth are not only country-specific. If policy interventions are successful they will evolve: as one problem gets fixed, another will replace it as the binding constraint. Hence it is important regularly to update the entire check-list.

Understanding the evolving constraints upon the growth process is a common need for both governments and donors. Potentially, the diagnostic procedure should therefore be collaborative. Coordinated action based on a common diagnosis would constitute a major change in the aid relationship. I now turn to why it would be more likely to achieve donor objectives than previous approaches.

**How donors have tried to reduce poverty**

*Project Aid*

Thirty years ago, donors tried to reduce poverty by delivering projects with a high rate of return. This approach encountered three fundamental problems. First, a project might be good in itself but not designed so as to be widely replicable: it wouldn’t ‘scale-up’. If it wouldn’t scale up it was irrelevant in the larger context of economic growth. Secondly, projects were fungible: donor support for a project which the government would otherwise have financed itself freed up resources for the government to do something else. In reality the donor financed not the project which it appeared to pay for, but the marginal project which the government chose to undertake. Donor care in selection among intra-marginal projects thus made no difference to the overall portfolio of implemented projects (Feyzioglu and others 1997). Thirdly, whether a project failed was found to depend less upon the design of the project than upon the environment in
which the project took place. Just like other investments, donor-funded projects failed in hostile environments (Isham and Kaufmann 1999).

**Aid-for-Reform**

Good project design was therefore not enough to achieve donor objectives of poverty reduction and so during the 1980s a new approach was developed, namely conditionality. Aid was provided in return for explicit negotiated commitments to policy reform.

The obvious theory underlying this was that aid could be an incentive to policy change. However, an implication of this theory was that governments would be undertaking policy change against what they considered to be their interests, except for the receipt of aid. Policy change was the price which governments would have to pay for aid; or equivalently, policy change would be what donors bought with their aid.

The implications of using aid as an inducement for reform were uncomfortable: if donors ‘bought’ the reforms, it was clear who ‘owned’ them. Indeed, when one African head of state got sufficiently annoyed with donors for complaining about the lack of political rights in his country, he threatened to reverse the reforms unless they desisted. The notion that the reversal of a reform program could be a threat is only intelligible if it was understood by both parties that the reforms belonged to the donors and not to the government (Collier 1997).

Indeed, the implications of using aid as an incentive were so uncomfortable that a ‘fig-leaf’ alternative theoretical underpinning emerged: the notion of ‘costs of adjustment’. Under this theory policy change was initially costly and so was like an investment. Aid could finance these up-front costs.
Neither of these theories was completely wrong. Sometimes the incentive of aid was sufficient to induce a government to implement policies which it otherwise would not have undertaken. Sometimes such policy changes had up-front costs. However, as general propositions they were dysfunctional.

The lure of aid led governments to promise more than they intended to deliver, and to implement more than they could sustain. For example, the government of Kenya sold the same agricultural reform to the Bank five times in fifteen years. The same condition has appeared in seven of the past eight Policy Framework Papers for Malawi. Cumulatively, such behavior destroyed the credibility of governments not just with donors but with private investors.

Costs of adjustment are largely mythical. Most reforms, if they are sensible, lead to a rapid improvement in the economy. The emphasis upon costs of adjustment encouraged governments to exaggerate the difficulties of policy reform. The negotiating frame was such that the rational government would exaggerate the costs of policy change so as to maximize its price. Further, since donor negotiating teams saw their role as extracting the maximum reform for a given amount of aid, the government was always at the margin a reluctant reformer. At the margin, the government would always be refusing to implement reform urged on it by the donors.

Our studies find that aid has not, on average, speeded policy change. Dollar and Svensson (forthcoming) study 220 reform programs and show that, whereas their success is systematically related to domestic political economy factors such as how long the government has been in power, it is unrelated to donor behavior. There is no overall relationship from aid flows onto policy change. This is not as surprising as it might seem.
The incentives argument is indeed elementary economics: the offer of aid for reform should induce a supply response. However, it misses four offsetting effects.

First, the provision of aid alleviates fiscal and payments crisis and so reduces the urgency for a government to change policy. Economists would say that there is an income effect of aid offsetting the substitution effect. Recently, in collaboration with a team of African economists, we have studied ten reform programs in detail, asking how the aid relationship affected the propensity to reform at different stages (Devarajan and others 1999). Sustained reform was never initiated by aid-for-reform packages. Reform was only sustained when initiated by the government, often triggered by crisis. Hence, in poor policy environments aid-for-reform paradoxically tends to delay reform: the income effect dominates the substitution effect. Once reform was seriously underway, conditional aid was shown to be useful, although the key conditions were those chosen by governments themselves. This was not because of the substitution effect, but rather, because by committing to two or three vital changes governments could signal priorities to their own bureaucracy. Long lists of conditions diluted such signals and so were dysfunctional. As the reform process proceeded the reforms became more complex and needed a wider constituency of support to be implemented effectively. By this stage conditionality served no purpose because the substitution effect could not be translated into effective incentives for such a large group of actors.

Secondly, aid-for-reform faces what economists call a time-consistency problem. Unless the government actually wants the reform it has little incentive to maintain it once the aid has been delivered. If, however, it does want the reform, it normally does not need
the aid in order to do it. The on-off pattern of Kenyan reforms noted above is surely an example of this time-consistency problem.

Thirdly, aid-for-reform faces a moral-hazard problem. The agencies which should enforce the conditionality also happen to have an interest in seeing their loans repaid. If the conditionality is enforced it will reduce the probability of repayment. Svensson (1999) shows that whether loans have been disbursed has depended more upon indebtedness than upon adherence to conditions: moral hazard has mattered in practice.

Finally, while the development agencies themselves might have wanted to use conditionality to induce policy reform, other OECD interest groups had their own agendas and so could be expected to try subvert conditionality to induce different behavioral change. Thaker (1999) claims to show statistically that approval of loans by the Board of the IMF during the early 1990s was significantly associated with a country’s voting record at the UN. The more a country’s voting pattern shifted towards the US position, and the closer it was to the US position, the higher the probability of loan approval. Although Thaker interprets this association as causal, other interpretations are equally possible. However, the possibility that the economic objectives of conditionality were subverted by the political, should not be dismissed out of hand.

Thus, although at first sight aid-for-reform appears to be a straightforward application of economic incentives to promote behavioral change, in practice it encountered major obstacles. The income effect offset the substitution effect; even where effective, the incentive induced policy oscillation rather than sustained reform; the agencies whose task was to enforce the bargains had an incentive not to do so; and other interests tried to hijack the bargaining.
While aid-for-reform was thus not very effective in achieving sustained policy improvement, it was effective in undermining the credibility of governments. Bad governments obviously destroyed their reputations by reneging on the spirit of agreements, but even good governments faced a problem. When a government implemented and sustained policy reform the donors claimed the credit. This claim had some credibility because even reform-minded governments were visibly resisting reform at the margin, and the donors were visibly pushing it. Hence, even when governments implemented reforms because they really believed in them, they faced great difficulty establishing their claim to ownership with the investor community. The only policies which governments could truly be seen to own were those which led to failure, because then no one else claimed them. In the language of economics, governments need to be able to signal their true intentions to investors. Aid-for-reform made this signaling process more difficult.

Aid-for-reform also diverted aid from those countries in which it could be most effective in reducing poverty. We now know what a poverty-efficient allocation of aid would look like. It would take three things into account: the level of poverty, the level of policy and diminishing returns. The level of poverty is straightforward: the more severe is poverty, the more effective is aid in reducing it. Thus, for a given level of policy and institutions, the greater the poverty the larger should be the aid program. The level of policy and institutional performance is also fairly straightforward. The better is the policy and institutional environment the more effective is aid in raising growth and reducing poverty. Thus, for a given level of poverty, the better are policies and institutions the larger should be the aid program. Fortunately, at present around 75% of the world’s poor
live in countries in which the policy environment is good enough for aid to be effective in reducing poverty. Finally, we have to take into account that there are diminishing returns to aid. Even in environments with good policies and severe poverty there is a limit to how much aid can be effectively absorbed. However, it turns out that this limit is quite high – around 20% of GDP.\(^1\) Conversely, even in environments with poor policies the first few million dollars of aid are worthwhile. Diminishing returns just set in much sooner if policies are poor than if they are good. If donors had followed these three simple allocation criteria of poverty, policy and diminishing returns, it would have been possible to considerably increase the number of people lifted out of poverty (Collier and Dollar 1999).

Figure 1 shows why aid was not better-focused on poverty reduction. It compares how aid should be related to policy in order to be poverty-efficient, with how it was actually allocated during the 1990s. I measures policy using the World Bank’s `Country Policy and Institutional Assessment Index (CPIA), which measures across a broad range of aspects of policy: macro, structural, and public sector management. Most countries are in the range \(-2\) to \(+2\).\(^2\) The poverty-efficient allocation of aid implies a very straightforward relationship between policy and aid. For a given level of poverty, aid should be higher the better is policy. In other words, aid should be conditioned on the level of policy. By contrast, aid-for-reform conditioned aid on the change in policy. Clearly, there is more scope for promises of improvements in policy the worse is policy,

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\(^1\) Collier and Dollar (2000) estimate the rate of diminishing returns to aid for different policy environments. They measure aid at purchasing power parity exchange rates which differ from actual exchange rates in aid-receiving countries on average by a factor of around three. The text figure of 20% adjusts the figure in Collier and Dollar back to actual exchange rates, which is the way aid is normally measured.

\(^2\) The CPIA is measured on the range 1-6. We have simply transformed this into a series centered on zero.
and so aid-for-reform tended to bias aid flows towards the weaker policy environments.

Figure 1 shows that this is indeed what happened.
Aid tended to flow into policy environments which were too weak for it to be effective in poverty reduction. Conversely, aid tended to taper out in precisely those environments in which policy was good enough for it to be highly effective in poverty reduction. This second misallocation is very serious, and I will return to it when I discuss the appropriate time frame for donor-government relations. Since there was only so much aid to go round, the people who paid for the large aid flows to the environments in which it was ineffective were the people who could otherwise have been lifted out of poverty living in the better policy environments.
Conditioning aid on policy change instead of policy levels not only leads to inefficient allocations between countries, but to inefficient allocations over time. Consider a democratic government which periodically faces an election. Typically, such a government will be more reluctant to change policies in the year before an election than in the year after an election. The cycle of elections thus creates a cycle of policy change. If aid flows are conditioned on the rate of policy change they therefore become macrodestabilizing: in the run-up to an election, just when a government is increasing its expenditures, its aid finance will tend to get squeezed.

Finally, aid-for-reform may have weakened the government’s capacity to work out and communicate its own strategy. Often, governments were in reality little-involved in the preparation of the documents which they signed. The documents were sometimes prepared in Washington even before missions arrived in the country. Governments knew that donor negotiators were going to attempt to coerce them to sign up to more than they appeared to want to do. Hence, a rational government should appear to want to do even less than it really wanted. The incentive was thus to impede rather than to assist even those reforms in which the government believed.

Governments also had little incentive to sell policies to their electorates. Indeed, a whole doctrine was evolved in Washington about the efficacy of the international financial institutions (IFIs) as scapegoats: governments could blame the IFIs for unpopular but necessary policy changes. Here is the comment of the Zimbabwean Minister of Information to the media on his government’s economic reform program during 1997: ‘It’s the IMF’s program: we had to go along with it’ (IMF 1998, p.35). As with the other intellectual bases for the aid-for-reform strategy, there was some truth in
the idea that it can be helpful for a government to have a scapegoat. Maybe the Zimbabwean government would not have initially reformed quite so fast if it had had to carry the electorate with it. However, as a general proposition the scapegoat theory is surely wrong. The role of scapegoat has the corollary that the electorate is being seriously misinformed about key aspects of policy. The message ‘this policy is dreadful but we are being forced to do it by foreigners’, repeated sufficiently regularly, produces suspicion, defeatism and confusion. Perhaps, had the Zimbabwean government had to carry its electorate along, it would not have reversed the reforms quite so readily the following year.

A final possible effect of the attempt to coerce reform is that it might have given rise to the psychological phenomenon known as ‘reactance’. According to clinical psychologists, if someone tries to force you to do something then, unless their power over you is total, your natural reaction is to do the opposite. Only by doing the opposite can you re-establish your freedom of action. Governments may have found the reversal of reforms more attractive because it re-established this freedom. Electorates may have gone along with it because they had often been told that the reforms had not been a national choice.

**How Policies and Institutions Really Improve**

Aid-for-reform was well-intentioned, but it was based on a misunderstanding of how policies and institutions are changed on a sustainable basis. At the risk of oversimplification, I suggest that within reason we now know what constitutes a good macroeconomic policy environment, but that we have rather less idea as to what constitutes good institutions. Good macroeconomic policies are fairly generic: an
overvalued exchange rate has qualitatively the same damaging effects in Peru or in India, which is why such policy variables are significant in growth regressions (Burnside and Dollar, forthcoming). There are, of course, some high profile issues still in dispute. For example, most scholars now probably accept that in many developing countries unrestricted capital accounts may on balance be unwise, but even this needs to be nuanced: in Africa, despite controls, there has been so much capital flight that open capital accounts may need to be part of the strategy to attract capital back. Good institutions are much more historically specific: we know, for example, that the design of legal institutions is much less important than how they are in practice operated (Berkowitz and others 1999). This suggests that reform of macroeconomic policy may need a different process from reform of institutions.

Policies depend largely upon the balance between domestic political constituencies. In countries with very poor policies there are large latent constituencies for policy change because poor policies inflict poor outcomes. The process of policy reform depends upon strengthening these constituencies. Constituencies for reform are those which suffer from poor policies. During the 1990s there was greater empowerment of these constituencies. The visible failure of the soviet model stimulated a wave of democratization, and provided a massive injection of information into the debate on development policy. Albeit fitfully, governments were pressured into improving the economic environment. Even benevolent leaders learnt from having to listen more closely to their populations. For example, when President Museveni of Uganda had to go out into rural areas to campaign for votes in the first fair Ugandan presidential election he discovered that what people wanted was free primary education for their children. This
demand became so pressing that in mid-campaign he announced a massive change in policy. The abolition of primary school fees led to a doubling in school enrolments the next year. Governments learn from their citizens and respond to pressure. More generally, we now know that pressure from civil society is effective in raising government performance. For example, civil liberty such as freedom of the press raises the return on public investment (Isham and others 1999).

In respect of primary education it was easy for electors to understand what policy change they needed. However, in many areas of policy the bottlenecks in the process of electoral pressure have become a lack of information. Electorates are insufficiently well-informed for development policies to be able to discipline leaders very effectively. Ironically, in the poorest countries of the world ‘it’s the economy, stupid!’ has been less accurate as a description of political debate than in the richest. There are four major knowledge bottlenecks.

First, there is a lack of transparency. There has recently been much emphasis upon the need for transparency in the banking system so that depositors can assess solvency. However, the much larger problem is that often electorates lack the basic information on which to assess the performance of governments. Democracy needs the disclosure of information in order to be effective.

Secondly, electorates often lack a basis for comparison. Especially if neighboring governments are also performing badly, there is little basis for judging whether performance could be better. This is why regional role models have been so valuable. The gang of four in East Asia, and Chile in Latin America fostered a transformation. Such
models have been lacking in Africa and the Middle East. Electorates need a window onto the world in order to turn information into knowledge.

Thirdly, the effects of many policies can only be understood with the benefit of analysis. For example, the true effects of trade restrictions are usually fairly straightforward for an economist to work out, but are highly non-obvious. To know these effects, the electorate either has to have a remarkably sophisticated understanding of the economy, or it has to be told what the effects are by an authority which it can trust. In practice, when analysis is required electorates are dependent upon trusted authorities. In many developing countries these are missing. The consequences of this are that poor policies persist supported by economic myths. I will give a trivial but revealing example. In Nigeria the largest denomination of currency is barely worth a dollar. The reason for this is that people imagine that the introduction of higher denomination notes would be inflationary. This perception is false. Further, the lack of high-denomination notes increases the costs of transactions because firms need to buy note-counting machines, and increases the government’s costs of printing money. I estimate that the costs of note printing imply that the Nigerian government is paying the equivalent of a real interest rate of over 20% p.a. on its supply of currency, so that seignorage, far from being its cheapest form of debt is its most expensive. What is needed is for a Nigerian think tank to puncture the myth that high denomination notes are inflationary, and for the Nigerian press to spread the message. More generally, the society needs to develop a capacity for analysis.

Fourthly, in many countries governments themselves lack the capacity to work out and communicate a coherent program of reform. As discussed above, during the aid-for-
reform strategy governments may even have learnt techniques of passive resistance to
reform. They need a capacity for design.

Now consider the process of institutional reform. Even quite simple and specific
issues of appropriate institutional design are unresolved. For example, although it is
common to lump together Anglo-Saxon economic institutions and contrast them with the
continental European or Japanese models, even within the Anglo-Saxon model there is
radical disagreement over which of two very different bankruptcy procedures is better.
The American model uses the courts, the British model by-passes the courts and uses the
private sector. The American system seems to be gaining some popularity, but arguably,
where the courts are weak, the British system is preferable. Policy for the regulation of
the utilities is even less clear: OECD countries keep changing practice between price caps
and profit rate caps. Neither is clearly preferable in all situations. Institutions seem to
matter, but unlike macroeconomic policy we cannot usually identify a good blue-print.

In such circumstances knowledge becomes a basic constraint upon reform. Thus,
creating an effective reform process is essentially synonymous with creating an effective
knowledge discovery process. The core of such a process is experiment and competition.
There needs to be sufficient institutional variation and institutional choice that some
institutions are revealed to be better than others. It is quite possible for companies to be
given a choice of legal system when specifying a contract. Local governments can be
encouraged to innovate institutionally. We know, for example, that those American states
which have elected boards overseeing their electricity utilities have persistently lower
electricity prices than those where boards are appointed. We do not know whether, say, an
elected judiciary would improve the functioning of courts in Africa, and we will never know until some African courts experiment.

**What this implies for the donor role**

There is much that the donor community can do to assist both policy reform and institutional reform. With respect to the former, donors can help the pro-reform constituencies within the constraints of appropriate conduct. The international community can legitimately encourage standards of good practice for information disclosure. It is an obvious conduit for information on how performance differs elsewhere. It can supply the analysis which shows the true effects of policy. With respect to institutional reform donors can show governments that there are a wide range of potentially viable options, and stress that diversity and experiment are legitimate responses to uncertainty. They can finance pilot institutional reforms which, if successful, can scale-up through imitation.

However, the international community cannot supplant the role of government. The government cannot abdicate responsibility for working out a development strategy. There are good reasons why this process should be a partnership between the government and the international community rather than an activity done entirely by the government. The government will usually start from limited information, limited knowledge, and limited analytic and design capacity. This was, after all, an ostensible reason for the heavy IFI involvement in drawing up reform strategies to date. What then is different about collaboration if it is based on partnership rather than coercion?

The key difference is that *how* we relate determines *what* can be achieved. I will give five examples.
First, as I have discussed, negotiation and collaboration do not co-exist very well. In a negotiation the government has an incentive to conceal information and convey misleading signals. While ever the donor team is evaluated on the basis of successfully extracting government concessions in tough negotiations, the government has an incentive to impede reform. By contrast, once the prime purpose of interaction is the construction of a common strategy for development, it becomes possible to reap the gains from information pooling. Because governments, IFIs and donors have such different informational advantages such gains can be large. *Co-operation should produce better-informed programs.*

Second, except in the short term, the pace at which reform can be implemented is likely to be constrained by the willingness of the electorate to accept change. For example, in Africa there is evidence that policy reversals are a response to urban rioting following changes which disadvantage sections of the urban population (Morrisson and others 1994). Such policy instability is to no one’s advantage. Of course, it is not possible to govern entirely by consensus. However, in developed countries much policy change is achieved through persuasion, accommodation and co-option. There is a need for a mechanism through which agreement can be reached *ex ante.* By placing each particular reform in the larger context of a medium term strategy, each social group can more readily accept that they will lose from some policy changes but gain overall. It then becomes rational to sustain the integrity of the strategy, rather than simply to block each change from which the group loses. Of course, governments will not always be able to build such consensus: it requires skill and a belief in the possibility of mutual gains.
However, while governments disown their economic reform programs as externally imposed, they are actively building a consensus against reform. *Consensus-building should produce a faster pace of sustainable policy change.* With respect to institutional reform, where there *ought* to be domestic diversity of views because there is no international consensus, it may still be possible to build consensus around the need to experiment and to try competing approaches.

Third, the participation of donors in strategy design will increase the information flow to donors and so reassure them of government intentions and of the viability of government plans. Donor reassurance is important not just in determining the scale of public resource flows, but of their stability.

Donor financial support should be a source of stability: it should be regarded by the government, the international agencies, and investors as being reliable over the medium term. Aid-for-reform has cumulatively undermined this perception of reliability. Governments would commonly be in breach of some promised conditions, and so the continued flow of aid depended upon the discretionary decisions of donors as to whether to grant waivers. This created volatile and unpredictable aid flows. One reason why aid tends to taper out in good policy environments is that in important quarters there is a view that aid is so unreliable that it is safer to learn to live with less of it. Associated with this is loose talk of the problem of ‘aid dependence’. Recall that the effect of this tapering out of aid is to deny aid in precisely the environments in which it is highly effective in reducing poverty. In fact, over the last quarter-century as a whole, donors have not been unreliable. For example, in Africa aid has been less volatile than government revenue and so a large aid inflow has been a source of stability not of instability (Collier 1999).
However, by placing donor involvement within a medium term framework and by making the design of that framework cooperative, there would be a firmer basis for donor commitment. In poor countries with reasonable policies and institutions increasing aid flows will be desirable for poverty reduction over the horizon of at least a decade. *Government-donor co-operation can produce larger and less volatile aid flows into those environments in which aid is most effective.*

Fourth, a medium term strategy can improve donor coordination. At present, some governments are quite suspicious of donor coordination because they see it as donors ‘ganging up’ to force through their own priorities. Agreement on objectives is therefore a necessary condition for coordination. The current lack of coordination reduces aid effectiveness. At the project level it results in the duplication of some interventions, the omission of others, and occasionally incompatible interventions. At the macro-level it results in mis-allocation between countries. Our research shows that currently IDA has the most poverty-efficient allocation rule: if all donors followed the IDA rule we could substantially increase the number of people lifted out of poverty. At present, many donors do not follow this rule, as demonstrated by Figure 1. The Bank thus faces a dilemma. At one extreme we can stick to the rule for our IDA resources and encourage others to adopt it. At the other extreme we can use the rule as a guide to total aid resources, and use IDA resources to smooth out the omissions of the rest of the donor community. Each of these extremes faces major difficulties. Medium term development strategies can help to reduce the dilemma. The provision of aid becomes more dependent upon the total needs implied by a viable development path and less by the provision of short-term incentives for policy change. *Hence, an agreed development strategy can improve donor coordination.*
Fifth, private investors need reassurance. Africa is rated as the riskiest investment region in the world, and even those countries which have been strong reformers are severely rated (Collier and Pattillo, 2000). Aid-for-reform commitments have evidently failed to provide sufficient reassurance to private investors: the commitments lack credibility. What is needed is a visible process of building a medium term social consensus around policy reform. To the extent that such a public consensus-building process succeeds, it builds investor confidence. For example, as I have discussed, the Ugandan presidential election constituted the first substantial opportunity that the society had had to discuss a vision of the future, and resulted in a large vote in favor of an explicit program around the banner of `modernization’. The successful election was followed by the largest improvement in the investor risk ratings which any African economy has experienced. We have seen the same phenomenon in reverse in East Asia. The collapse in the investor ratings for Indonesia were surely in part a reflection of the lack of political consensus. Visible political consensus is more effective than conditionality in reassuring investors.

Conclusion

Poverty-reduction is now possible on a grand scale. It depends upon navigating the policy and institutional changes needed for broad-based growth. In many social contexts this is likely to be easier if there is an informed constituency of opinion and if the government attempts to build consensus around it. Information-provision and consensus-building sound like motherhood and apple pie. Consequently, it is easy to dismiss them as decorative rather than functional parts of the development business. I have tried to show why this would be a mistake. In the past we may have paid lip-service
to them, but our practice has been different. Aid-for-reform attempted to by-pass the process of getting agreement within society. In the limit this resulted in governments publicly disowning their own programs. In such situations it is not surprising that private investors regarded the reform process as incredible.

Developed societies do not just happen to have good policies and institutions. They have them because governments are pinioned to them by informed and engaged social groups. Somehow, the international community needs to encourage the formation of this equilibrium in developing countries.

I have described how the international community could do this through working with governments to identify a critical path of policy reform, and to initiate institutional experiment and competition to discover which institutions work best. I have described why ex ante social consensus would both speed these processes and enhance their credibility. What I have described is, in fact, my understanding of the Comprehensive Development Framework.
References


