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The political economy of conditionality: An empirical analysis of World Bank loan disbursements☆

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ABSTRACT

Traditional aid conditionality has been attacked as ineffective in part because aid agencies – notably the World Bank – often fail to enforce conditions. This pattern undermines the credibility of conditionality, weakening incentives to implement policy reforms. The standard critique attributes this time inconsistency to bureaucratic factors within the aid agency such as pressure to lend, defensive lending, or short-sighted altruism. Pressure from powerful donors provides another potential explanation for lax enforcement. This paper presents an empirical analysis of the political economy of conditionality in international organizations using the case of the World Bank and the United States. The analysis examines panel data on World Bank disbursements to 97 countries receiving structural adjustment loans between 1984 and 2005. Using UN voting as an indicator of alignment with the U.S., the paper presents evidence that World Bank structural adjustment loan disbursements are less dependent on macroeconomic performance in countries aligned with the United States.

For my friends, anything; for my enemies, the law.

– Oscar R. Benavides, President of Peru, 1914–1915 and 1933–1939

1. Introduction

Traditional aid conditionality has been attacked as ineffective in part because aid agencies – notably the World Bank – often fail to enforce conditions (Mosley et al., 1995; Collier, 1997; Dreher, 2004). This pattern undermines the credibility of conditionality, weakening reform incentives for governments in developing countries. The standard critique attributes this time inconsistency to bureaucratic factors within the aid agency such as pressure to meet lending targets, defensive lending to promote repayment of past loans, or short-sighted altruism (Svensson, 2003). Yet the cost for the aid agency of lax enforcement is high since it fuels expectations that other conditions – across the agency's portfolio – also will not be enforced and hence broadly undermines compliance.

Pressure from powerful donors with geopolitical or commercial interests in the recipient country provides another potential explanation for lax enforcement of aid conditions (as suggested in Kanbur, 2000). This paper presents an empirical analysis of the political economy of conditionality in international organizations using the case of the World Bank and the United States. Because project-level disbursement data are not publicly available for World Bank lending, the analysis examines overall World Bank disbursements when structural adjustment loans (SALs) are active using a panel of 97 countries from 1984 to 2005. I use macroeconomic variables to measure the imposition of structural adjustment. Ceteris paribus, if disbursements are less sensitive to macroeconomic performance for countries friendly with the U.S., this suggests that either ex ante SAL conditions are less stringent or enforcement is lax for U.S. friends. Separately identifying these effects is difficult since data on ex ante World Bank SAL conditions are not systematically available. However, for reasons discussed below, the empirical specification used here is better suited to detecting lax enforcement.

Data are widely available only for two relevant macroeconomic indicators, inflation and the percentage change in the official exchange rate. The U.S. interest variable is a measure of UN voting alignment similar to Andersen et al. (2006b). It reflects countries making concessions to the U.S., i.e., deviating from their normal voting position toward the U.S. position on votes that the U.S. considers important. The estimation finds a significant link between macroeconomic performance

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and disbursements when countries are not aligned with the U.S. but no substantial effect when countries are aligned with the U.S. This is consistent with the donor pressure explanation of lax enforcement.

Understanding the reasons for weak conditionality is important as they may influence the success of efforts to reform international organizations. Many reform proposals focus on changing bureaucratic incentives (e.g., linking pay and promotion to outcomes) or on reducing institutional information and commitment problems (e.g., aid tournaments as suggested by Pietrobelli and Scarpa, 1992; Svensson, 2003). Such reforms may have significant merit but do not address the issue of donor pressure directly and hence could yield smaller gains and be more difficult to implement than expected. Other reforms that restrict direct donor influence in international financial institutions (IFIs) – changes in governance, donor financing, and perhaps headquarters location – also need to be considered.

2. Background

Many argue that World Bank structural adjustment conditions have not been enforced: the World Bank sets macroeconomic and institutional reforms as conditions for releasing funds from a SAL, the recipient government fails to satisfy these conditions, and the World Bank releases funds anyway (Mosley et al., 1995; Killick, 1995; Kanbur, 2000). A number of explanations have been offered for this behavior. Svensson (2000) develops the Samaritan's dilemma explanation where conditionality enforcement is not credible because the donor prefers to provide aid in all cases. Others suggest bureaucratic pressures including a “pressure to lend” to advance loan officers' careers and “defensive lending” to ensure repayment of past loans (Mosley et al., 1995; Martens et al., 2002). Finally, donor pressure is suggested by Kanbur (2000) and modeled by Mavrotas and Villanger (2006). As Kanbur (2000, p. 415) puts it:

> But in other instances it is, again only apparently paradoxically, in the donor's direct self interest not to impose the sanction of aid withdrawal when conditionality is violated. The most obvious case of this is political clientelism. How else can one explain the repeated [World Bank] tranche releases to Zaire and Senegal in the 1980s and early 1990s, for example, despite continued failure to comply with adjustment conditionality, except in terms of pressure from the US and the French?

In this paper, I pursue this aspect of structural adjustment – the impact of donor interests on World Bank SAL disbursement. I focus on U.S. interests since the U.S. is the single most influential member of the World Bank and data on U.S. interests are more widely available. A number of researchers have explored the impact of donor interests on IFIs including the IMF (Andersen et al., 2006b; Dreher and Jensen, 2007; Harrigan et al., 2006; Stone, 2002, 2004; Thacker, 1999; Vreeland, 2005), the World Bank (Andersen et al., 2006a; Fleck and Kilby, 2006; Frey and Schneider, 1986; Harrigan et al., 2006) and regional development banks (Kilby, 2006). The current paper follows most closely Vreeland (2005) and Stone (2002, 2004) in spirit and also draws on the framework developed in Andersen et al. (2006b).

Vreeland (2005) examines two views of the IMF: “IMF as scapegoat” and “IMF as U.S. piggy bank” (my terms, not Vreeland's). In the scapegoat camp, many at the IMF and elsewhere claim that Fund programs serve as a commitment device. Reform-minded politicians in IMF program countries can deflect popular criticism of the short-term hardships of stabilization onto the IMF and hence remain in power and stay the course. To the extent that the policies promoted are in the country's long run interests, the IMF is a useful scapegoat. Vreeland points out that this function could be particularly important for a recipient government when its administration has limited power, e.g., in a system with multiple veto players. In the “IMF as U.S. piggy bank” view, international politics influence IMF lending decisions. Countries friendly with the U.S. get preferential access to IMF funds. Vreeland notes that the IMF can only serve as scapegoat when it can credibly threaten to withhold funds, e.g., in countries where it is not providing funds at the behest of the U.S.

To test these theories, Vreeland examines the probability that countries enter into an IMF agreement. Ceteris paribus, this probability is significantly higher for countries with more veto players and for countries moving toward the U.S. position in UN voting. However, the interaction of these two variables enters with a negative sign, suggesting that the scapegoat function is less important for countries friendly with the U.S. This supports the view that the effectiveness of conditionality is undermined by pressure from powerful donors.

Looking at IMF lending in Africa, Stone (2004) comes to a similar conclusion: the IMF fails to enforce its conditions fully when major donor countries interfere. The duration of program interruptions – the key indicator of IMF enforcement – is shorter for countries that are important to major donors (the U.S., France or the U.K.). Measures of importance include the volume of bilateral aid, the strength of post-colonial ties, and UN voting alignment. Stone (2002) reports similar results for Eastern European countries during the post-communist transition period. Overall, conditionality is less effective, program interruptions are more frequent (though shorter), and private capital less responsive in larger countries that were more important to major IMF donors.

Andersen et al. (2006b) develop a framework for assessing the influence of politics on IMF lending that provides an important foundation for this paper. Whereas Thacker's (1999) seminal analysis of U.S. influence over IMF lending examined the impact of “political movement” toward or away from the U.S. UN voting position over time, Andersen et al. examine movement in the voting space at a given point in time. They propose using a country's overall UN voting record as a measure of the country's true location preference in a policy space and the country's voting record on measures designated as “important” by the U.S. State Department as the country's actual location in the policy space. Thus, the distance between the country's true policy preference and its actual location reflects costly concessions made to the U.S. and should be rewarded by the U.S. via higher probabilities of receiving an IMF loan. I use this same mechanism to identify countries that are “U.S. friends.” For a detailed argument why measuring political movement over policy space may be preferable to political movement across time, see Andersen et al. (2006b).

Drawing on the IMF political economy literature, this paper presents the first econometric study of the impact of donor interests on the disbursement of World Bank structural adjustment loans. There is, however, a growing body of work on the impact of donor interests on World Bank loan allocation decisions more broadly defined. The first major contribution is Frey and Schneider (1986) who find a positive and significant link between World Bank lending and exports from several major donors including the U.S. Fleck and Kilby (2006) examine a panel of World Bank disbursement data from 1968 to 2002. After controlling for factors consistent with the World Bank's charter, they find that World Bank lending also reflects U.S. trade and foreign policy interests. Looking at Algeria, Egypt, Jordan, Morocco, and Tunisia, Harrigan et al. (2006) demonstrate that approval of World Bank (and IMF) program loans is more likely following adoption of pro-U.S. policies. Finally, Andersen et al. (2006a) estimate a selection model for IDA lending in the 1990s. Despite the IDA's more formalized allocation process, they find that alignment with the U.S. on UN votes designated as important by the State Department increases the size of IDA commitments. Thus, there is substantial empirical evidence of U.S. influence in World Bank lending decisions. What has yet to be explored empirically is whether that influence extends to the imposition of conditionality in World Bank SALs.

To assess directly the impact of donor interests on the disbursement of SALs, one would like to have the difference between planned and actual SAL tranche disbursements, the ex ante policy reform/