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# Working Paper

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## **CONCEPTUALIZING RFI'S VERSUS GFI'S**

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# Conceptualizing RFI's versus GFI's

by

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## Abstract

What is the rationale for the coexistence of Global Financial Institutions (like the World Bank) and Regional Financial Institutions (like the Regional Development Banks)? This paper conceptualizes the differences between these entities and develops a framework for assessing their comparative strengths and weaknesses in delivering different types of development assistance. It argues that in general there is scope for shifting some of the functions currently performed by global institutions to regional ones, leaving the former with increased capacity for global functions that only they can perform.

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\* T.H. Lee Professor of World Affairs and Professor of Economics, Cornell University. Paper presented to the IADB/ADB Conference on Regional Public Goods and Regional development Assistance, Washington, D.C., November 6-7, 2002. The arguments in this paper are based on and develop the propositions in my earlier work in this area. See, for example, Ravi Kanbur, Todd Sandler and Kevin Morrisson, The Future of Development Assistance: Common Pools and International Public Goods, ODC, 1999 ([http://www.arts.cornell.edu/poverty/kanbur/Future of Development Assistance.pdf](http://www.arts.cornell.edu/poverty/kanbur/Future%20of%20Development%20Assistance.pdf)); Ravi Kanbur, "Aid, Conditionality and Debt in Africa," in F. Tarp (ed.) Aid and Development: Lessons Learnt and Directions for the Future, Routledge, 2000 (<http://www.people.cornell.edu/pages/sk145/papers/africaid.pdf>); Ravi Kanbur and David Vines, "the World Bank and Poverty Reduction: Past, Present and Future," in Christopher Gilbert and David Vines (eds.) The World Bank: Structure and Policies, Cambridge University Press, 2000; Ravi Kanbur, "Cross-Border Externalities, International Public Goods and Their Implications for Aid Agencies," Mimeo, Cornell University, 2001 (<http://www.people.cornell.edu/pages/sk145/papers/IPGWB.pdf>); Ravi Kanbur, "IFI's and IPG's: Operational Implications for the World Bank," Paper prepared for the G24 Technical Group Meeting, 2002 (<http://www.arts.cornell.edu/poverty/kanbur/IFI-IPG.pdf>); Ravi Kanbur, "The New Partnership for Africa's Development: An Initial Commentary," Politikon, 29(1), 87-100, 2002 (<http://www.arts.cornell.edu/poverty/kanbur/POVNEPAD.pdf>).

## 1. Introduction

We see many levels of groupings of nations on the international institutional landscape. Groups of countries that share borders often have semi-permanent cooperation agreements on immigration and customs, and institutions that implement them. Other groupings of countries come together on the basis of and to advance an ethnic, a geographical and or a cultural identity—French speaking countries, Muslim countries, Arab states, Organization of American States, etc. Others have very specific functional purposes—NATO, ASEAN, AfDB, ADB, IADB. At the highest level of aggregation, global institutions such as the U.N., the World Bank and the IMF, count on the membership of virtually every nation in the world.

The focus of this paper is on a particular type of grouping that is relatively large in terms of country coverage without being global, and one that deploys primarily financial instruments to advance its objectives. These are the Regional Financial Institutions (RFI's)—the IADB, AfDB, ADB, EBRD, etc. A key feature of these institutions is that they have both rich and poor countries as members, the former as donors of financial resources, the latter as recipients. In other words, these institutions are intended as vehicles of development assistance. Some of the specialized UN agencies (such as UNDP) are also vehicles for transferring resources to poor countries, but they do these only through grants and do not have loan instruments. To some extent, RFI's are smaller scale versions of fully global financial institutions (GFI's, also known as IFI's), the World Bank in particular. The operations of the RFI's and GFI's overlap in many

countries, raising questions of duplication of effort and even unhealthy competition for “development business”. These tensions are immediately apparent to those with ground level experience of development assistance.

Some human activities are best performed individually. But others are enhanced when a group of individuals comes together to undertake a particular task. Underlying features of the socio-economic environment determine these characteristics. There are household economies of scale in eating from one cooking pot; exchange makes possible specialization by productivity in different activities; common defense is cheaper than individualized protection; and so on. But while grouping together can have definite scale and cost advantages, increased size of group can also make some things more difficult—for example, arriving at a decision in a potentially increasingly heterogeneous grouping. These benefits and costs of size suggest that groups will typically be of intermediate size, neither wholly individualistic nor wholly universalistic. But this still leaves an enormous range. The size will be determined by where exactly the marginal costs and benefits of size balance out, which will in turn depend on the specifics of the socioeconomic situation being discussed.

While this is true for each activity, there are likely to be similar economies (of “scope” rather than “scale”), in having the same group do more than one, related, activity. Eating together and sharing living space has economies of scope; building roads for defense and for economic transport has economies of scope; clean water and clean sanitation has economies of scope. But, eventually, diseconomies of scope will also set

in, as the activities become relatively unrelated to each other. There will thus be a similar balance to be struck in this domain.

Individuals participate in a bewildering number and variety of groups, ranging from households to nation states, from single activity groupings to associations that cover a large range of activities. This is perhaps not surprising, given the range of cost and benefits patterns present in the different activities. Nation states also participate in a large number of different types of groupings, as discussed above. Taking the perspective of costs and benefits, of scale and scope, will also help us understand these groupings and to assess them. In particular, it will help us conceptualize RFI's relative to GFI's, especially when, as seems often to be the case, both types of institutions are engaged in the same activity.

What exactly is the rationale for the co-existence of RFI's and GFI's, especially in a world in which development assistance resources are increasingly scarce? If there is such a rationale, is the current mix of RFI's and GFI's as good as it gets, or could it be better? And if it could be better, what specific reforms are needed to move in that direction? These are the questions that are addressed in this paper.

## **2. GFI's for GPG's, RFI's for RPG's**

I take as given the urge in rich countries to transfer resources and know how to poor countries, based on a desire to help them overcome their poverty, and will base the

arguments on this paper on this assumption. Whether this latter desire stems from true altruism or from a feeling that the poverty of others will eventually have negative consequences for the rich is an interesting question but one that is not relevant to my task here. Rather, I will ask—given this urge, what is the best way to execute it, and does the current configuration of RFI's and GFI's come close to this best configuration? In taking this analytical route I put to one side the obvious fact that poverty reduction is not all that drives the urge to transfer resources, and development assistance is not the only reason why rich countries support RFI's and GFI's. Narrow self-interest within rich countries is oftentimes present, as in the case of tied aid, and the foreign policy interests of rich countries are never fully divorced from the concerns they express in RFI's and GFI's.

Despite these caveats, it is nevertheless a useful organizing framework to lay out the advantages and disadvantages of alternative institutional arrangements for delivering official development assistance. The most obvious starting point is bilateral assistance. The advantage of this form of assistance is that the taxpayers of the donor countries can have, in principle, close scrutiny of this assistance. The disadvantages also flow from this very same feature—domestic political processes, and domestic distributional struggles, can begin to influence the nature and composition of development assistance. This is seen most clearly in the various pressures that come on a government to tie its aid to purchases from its own suppliers.

But an equally powerful advantage of a donor country pooling its resources with other donor countries is that it can benefit from economies of scale and scope in



development assistance activities. At the simplest level, capacity to evaluate assistance projects and programs can be centralized and the costs shared. Hence, in principle, a pooling of resources in a rich donors' club like the EU should have considerable cost advantages. However, pooling of countries in turn introduces the problem of differences in preferences of the different members on how the resources should be used. Whatever consensus is reached, it will always be unsatisfactory to some countries' preferences as donors. The cost advantages therefore have to be balanced against this disadvantage. Faced with the costs and benefits of the two alternatives—going it alone or joining a rich countries' club—therefore, a rational response for each donor country will be to diversify, to have some of its development assistance flow through bilateral channels and some through channels that group together rich country donors.

The argument above does not as yet provide a rationale for RFI's, since it discusses groupings of donors, not groupings of recipients. What are the costs and benefits of grouping recipients into groups that are defined by geographical region? The cleanest argument comes from a consideration of cross-border externalities and multi-country public goods. Cross-border externalities have received increasing attention in recent years, and do not need detailed elaboration here. Suffice it to say that when development in or actions by one country have an impact on other countries, an impact that is not mediated by classical competitive markets, the presence of such an externality can lead to sub optimal policy outcomes for the group of countries encompassed by that externality. There are gains to be had for all countries by developing a mechanism that coordinates policies and actions, with compensation as necessary. Such mechanisms

satisfy the classical economic definition of a public good between the relevant countries, and it is well established that such public goods will be undersupplied.

The link between cross-border externalities, multi-country public goods, and development assistance becomes clear if all or some of the countries encompassed by the externality are poor countries, and the proposed mechanism will benefit them. If these conditions are met, then since the objective of development assistance is to improve the lot of poor countries, it follows that mechanisms that address such cross-border externalities have a natural claim on aid resources. These mechanisms are not costless—far from it. A use of donor resources to finance them is a legitimate use of aid resources.

However, by definition, the use of resources in this way requires groups of countries encompassed by externalities to come together. Let us consider a progression of groupings, starting with near neighbors at one extreme, and gradually expanding to include all countries in the world for externalities that are truly global in nature. If setting up of these country groupings were entirely costless, then a separate one could be set up for each externality and dealt with separately. But it is very likely that there will be economies of scale and of scope. If the fixed cost of setting up institutions is large, there is an argument for grouping together the groups themselves. One criterion for such grouping is the likelihood of the occurrence of cross-country externalities across the different groups. Given the high likelihood that geographical proximity is a key determinant of the likelihood of certain types of physical externalities (water table, forest

cover, migration, civil war, transportation, smuggling, etc.), it does seem that a regional grouping is a good initial cut.

Of course, the regional cut is not appropriate in some cases. For truly global phenomena like global warming, global financial contagion, global spread of infectious diseases, or global conflict, a global grouping is needed. To the extent that these phenomena affect the well being of poor countries, and global coordination could improve their lot, global mechanisms for addressing these problems, and global institutions that do so, also have a claim on aid resources. There may be yet other types of externalities where neither regional nor global groupings are appropriate—the producers of a single commodity like coffee come to mind—but, while recognizing their importance, I will not pursue these further here.

The above argument suggests a division of labor—regional externalities to be dealt with by regional institutions, global externalities by global ones. Put another way, RFI's to supply Regional Public Goods (RPG's), and GFI's to supply Global Public Goods (GPG's). Of course the division is not clear-cut, since sometimes there are some spillovers from a regional phenomenon to the global setting. But even a cursory examination of the operations of the World Bank and the Regional Development Banks (RDB's) does not suggest a division of labor in addressing cross-border externalities. Granted that such operations are a small part of the operations of these institutions, but the World Bank is more often than not involved in the supply of what are regional specific multi-country public goods, with either no involvement or overlapping

involvement of the relevant RDB. But our argument suggests strongly that the World Bank should reduce its role in and the RDB's should increase their role in such activities. To the extent that there is lack of capacity in the RDB's to undertake these activities, this is an argument for the donor community to build up RDB capacities, perhaps even using some of the resources currently devoted to World Bank activities. Such specialization would also be helpful because it would allow the World Bank to focus on its comparative advantage—global externalities.

### **3. Country Specific Operations**

While addressing cross-country externalities involving poor countries is indeed a legitimate claim on aid resources, and while the perspective developed here suggests a sharp framework for examining the division of labor between the World Bank and the RDB's, in fact as is well known the vast proportion of the operations and the budget of the Bank and the RDB's are conventional country specific operations with little regard to multi country dimensions. It is here that the overlap between the Bank and the RDB's is most apparent. A typical operation (project or program) in Africa will have involved in it both the Bank and the African Development Bank (plus the EU and a host of bilaterals, of course). The same is true of operations in Asia, Latin America and in Eastern Europe. What can possibly be the rationale for such overlap between the Bank and the RDB's?

Recall that we are focusing on country specific operations, to which each donor agency brings financial resources and, hopefully, technical expertise. The case of

technical expertise illustrates some of the tensions present. Technical knowledge on development has a local and a general dimension. Lessons learnt across a range of projects in different circumstances can be synthesized to develop general principles and guidelines. But then the translation of these general principles into specific action requires local knowledge. The combination of the two is what produces the best outcome. Clearly, if it were costless then the synthesis should be across as wide range of experiences as possible. But the introduction of a cost factor might suggest a narrowing of the scope to a small range of experiences. A natural route to narrowing is to focus on experiences within the region. But whether one accepts this argument or not, it should be clear that it is wasteful for the World Bank to do regional syntheses and each of the RDB's to do a regional synthesis on a particular topic. But this is exactly what happens.

While there is at least an argument for a fully global perspective on knowledge and experience, it is not clear how exactly it translates to financing, which is fungible. Unless of course the argument is made that without financing projects each agency would not have a seat at the table and would not therefore build up its experience. But this seems a stretch. What we have at the moment is overlapping involvement of each RDB and the World Bank in a large number of country specific operations in a region, with the RDB and the World Bank then drawing on this experience to produce regional syntheses.

A clearer rationale for having both the World Bank and the RDB involved financially in the same country operation is that each agency reflects, in some way, different donor preferences. These are institutions comprising different groupings of

countries, and therefore reflect some aggregation of these countries' preferences on different dimensions of the development agenda. For any given donor country, therefore, its own preferences are perhaps best approximated by diversifying its resources between a number of different agencies. This is, of course the benign view of the matter. There is a less benign view that sees rich countries as using the multilateral financial institutions as instruments of their foreign policy. Each RFI is then seen to be the vehicle for the interests of particular rich countries that have historically dominated the landscape in those regions, perhaps by virtue of a colonial legacy. But, as noted above, this line of argument will not be pursued in this paper.

The “different preferences” view of multiple agency involvement in the same project in the same country is in principle an attractive rationale, but it depends very much on these preferences being articulated and understood. For example, if one agency particularly favored one theory of development or, within a broad universal consensus, emphasized this or that aspect somewhat more or somewhat less, then it would be in the interests of donors, and recipients, to have both agencies present and “competing.” However, the problem is that such differentiation does not seem to be very sharp at all. Broad objectives and even more specific instrumentalities are similar across the agencies, with the result that projects often become turf battles, and such coordination as there is, is often in the form of simply “carving out market share”. A clear statement of the comparative advantage of each RDB vis a vis the World Bank, subjected to the line of questioning developed above, would be a good start in strengthening the rationale for multiple involvement which at times looks simply like duplication.

#### **4. Conditionality and Ownership**

There is, however, one generic issue in which a clear case could be made for potentially different comparative advantages of regional versus global institutions. Conditionality, as practiced by the Bretton Woods Institutions in particular, has come in for a lot of criticism, for being imposed from the outside on an unwilling and resentful population. And this is just on economic conditionality. As the development dialogue broadens from the purely economic to include aspects of governance and democracy, tensions between donor and recipient are bound to increase as different interpretations are given of these concepts and their implementation.

I start with the premise that it is not conditionality per se, but its nature and its implementation that is at issue. For example, most NGO's (Northern and Southern) would like to see stronger conditionality on governments to spend more on the social sectors. It is not conditionality per se that they object to, but its content. For many in the middle class elite in recipient countries, it is not necessarily economic conditionality that jars so much as the perceived "imperial" mechanisms for their implementation. The wait for the IMF/World Bank mission to pronounce on the country's performance brings to mind recent eras of political domination by foreign powers, direct and indirect. In this atmosphere, no benefit of doubt is given, and even policies that would otherwise be accepted become the subject of vehement discourse, not because of the policies themselves but because of the mechanisms for their implementation and monitoring. Even for governments convinced of the broad policies, and willing to take the domestic

political heat, there is irritation at the detail in the conditionalities, and at the lack of appreciation of the time needed for implementation.

There will always be conditionality, implicit or explicit, in a donor-recipient relationship. No donor will write a blank check, and there will always be differing views on what constitutes an appropriate development strategy and an appropriate use of donor resources, between donor and recipient, and among donors themselves. Our task, rather, should be to fashion mechanisms that reduce these tensions and that do not, by themselves, become obstacles to reaching agreement on use of resources. And it is well to recognize upfront that in these matters, perception is as important as reality.

Perhaps the problem can be best posed in terms of a government and a polity that needs to be delivered a “tough” message about its policies. I do not specify what these are, but they could range from economic through social to governance issues. Of course, the best source of such a message is the population itself, through the ballot box. But sometimes the population itself is behind these policies. In any event, one possible messenger for this tough message is from outside the country. This can come in a variety of ways, one of which is through establishing and implementing conditionality in the transfer of resources from donors. We can then ask the question—who should this messenger be?

An examination of the recent New Partnership for African Development (NEPAD) initiative in Africa highlights some of the issues involved. A central feature of



the NEPAD initiative, which sets it apart from all of the many previous Africa-wide initiatives coming from the continent, is the proclamation of the importance of governance and democracy as key building blocks of development and poverty reduction. But equally important is the philosophy of “mutual monitoring” in ensuring that common standards are met and followed in these (and other) areas. It is understandable why donors have welcomed this initiative. It is long recognized that conditionality applied in the past through the Bretton Woods Institutions has not worked, and the doubts and suspicions sown in the past negatively impact any reforms of conditionality through processes that emphasize “ownership”. The standard criticism of the PRSP (Poverty Reduction Strategy Paper) process, for example, is that the content of the papers is very little influenced by the dialogue surrounding it. Whatever the truth of this criticism, the point is that any process emanating from the IFI’s will now be seen as tainted and for that reason less effective than it might otherwise have been. In this context, alternative mechanisms for developing and monitoring conditionality need to be explored.

The theory behind the NEPAD mechanism is presumably that Africans and African governments are more likely to accept criticism from other Africans than from people outside the region. There is certainly some truth to this, and it applies more generally to other regions as well. But this is obviously too simple a characterization. A counter argument is that neighbors might be less likely to criticize each other, for a host of reasons also related to proximity. The reluctance of African leaders to criticize Mugabe in Zimbabwe is often produced as evidence for this position. Indeed, some donor countries have made the Zimbabwe case the first “litmus test” for the workability

of the NEPAD mechanisms. This in turn has led many in Africa to criticize NEPAD as simply a tool for donor interests. At the other extreme, however, there is a worry that localized monitoring mechanisms may fall prey to the intense ethnic and other rivalries that exist between neighbors, and may actually destabilize the region rather than bring it under an overarching cooperative frame. By this argument, then, there is something to be said for having a complete outsider deliver those tough messages.

The central problem with the World Bank and the IMF delivering these tough messages to individual countries, and making their funding conditional on them, is that these agencies are widely perceived to follow the interests of the G7 countries. As long as this perception persists, there will be resistance and resentment at the involvement of these agencies. To the extent that the RFI's are not plagued by this perception, because of their governance structures or because of a perceived greater understanding of ground level problems, the RFI's can play an important role, perhaps even a lead role, in developing conditionality and monitoring its implementation. Following the thread of the argument developed above, in an ideal setting the IFI's would only come in for situations where a true outsider was needed, perhaps in the framework of an "appeal" process whereby a country could go to the IFI's as a higher, more independent, authority. But for this to happen the IFI's would have to be restructured to earn this standing—certainly, reform of governance structures would be a key. Till this restructuring takes place, however, there is an argument for allowing the RFI's to take the lead in the process of interacting with the recipient country in developing and monitoring donor conditionality.

## **5. Conclusion**

The broad arguments developed above clearly need to be fleshed out further. However, they already point to five specific policy conclusions on the division of labor between RFI's and GFI's, and on what both types of institutions should be doing to improve their effectiveness.

First, the responsibility and resources for region specific public goods should be increasingly shifted to the RFI's. To the extent that the RFI's do not have the capacity to deliver on these just yet, a purposive program of building up these capacities should be developed, using the resources currently at the World Bank. The specific case of the AfDB comes to mind. In the long run, financing of multicountry projects within Africa should devolve to the AfDB from the World Bank. Clearly, the AfDB does not at the moment have the capacity to do this. Donors should divert resources to the AfDB to help it build up this capacity, while continuing to use the World Bank's current capacity for the next decade, say. The World Bank could provide global syntheses of experiences across regions, but this would be a limited role.

Second, truly global issues such as greenhouse gases, financial contagion, global spread of diseases, etc. should stay the purview of global institutions. Indeed, the GFI's capacity to address and to finance responses to these issues should be strengthened, in partnership with other relevant global agencies such as the World Health Organization for health or the United Nations Environment Programme for greenhouse gases.

Third, on country specific operations there should be a presumption in favor of donor resources flowing through RFI's rather than the World Bank. This does not necessarily mean the end of the country operations of the World Bank. Certainly in the short to medium term (extending for a decade or more) the RFI's will need to build up capacity to take on this greater role. However, even in the long run there would be a significant financing role for the World Bank if it represented a view on development strategies that was clearly defined and differentiated from the RFI's, presumably because of the global nature of the World Bank as an institution.

Fourth, there should be a presumption that the lead role in interacting with a government in developing and monitoring conditionality should fall to the RFI's rather than the IFI's. The logic of the argument applies both to the World Bank and to the IMF, although in this paper it is intended primarily to a division of labor between the World Bank and the RDB's. Again, this does not mean that there is no role for the World Bank. In the long run, there could be an important role as a trusted and independent entity from outside the region, capable of transcending interregional rivalries and tensions. But in order for this role to be possible, the governance structure of the Bank will have to be changed to make it more independent of G7 interests.

Fifth, the RFI's should apply the same tests to themselves vis-a vis sub-regional financial institutions (SRFI's), to ask which roles and responsibilities are best devolved to them, and whether the instruments they have are the best for the tasks at hand.

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