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DISCUSSION PAPER

Can Process Conditionality Enhance Aid Effectiveness? The Role of Bureaucratic Interest and Public Pressure

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ABSTRACT

Can process conditionality really enhance poverty reduction in developing countries? This question is addressed in the framework of a politico-economic model considering political distortions both on the recipient and on the donor side. It turns out that process conditionality is a very useful tool to raise the welfare of the poor as long as the international aid organizations hold all necessary information to assess the political situation in recipient countries and to select the true representatives of the poor into a participatory process. If they do not hold this information or if other bureaucratic interests reduce their incentive to acquire this information, process conditionality loses its effectiveness in achieving the desired objective.

JEL-Classification: D 72, D 73, F 35, O 19.

Keywords: poverty reduction, process conditionality, political economy of international organizations.

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1. INTRODUCTION

There is now a wide-spread consensus that development aid is successful only under certain circumstances, and that there is no general positive relation between aid and growth (Boone 1996). This is acknowledged even in publications of the World Bank (World Bank 1998). The question therefore arises how aid can be restructured in such a way as to be more effective in promoting growth and reducing poverty. As the international community has formally engaged itself to reduce poverty by half until 2015, the challenge to enhance aid effectiveness becomes even more pressing.

In order to meet this challenge, the International Financial Institutions (IFIs) have recently shifted their focus towards increased ownership and broad based support for policy measures in developing countries. In particular, there is a now a strong emphasis on participatory processes, which have become a formal requirement for the elaboration of developing countries' "poverty-reduction strategy papers" (PRSP). Some of the IFIs' traditional conditionality was replaced by this new requirement, notably in the context of the Enhanced Highly Indebted Poor Country (HIPC) – Initiative which established a new focus on processes. This shift in conditionality requirements gave rise to a new term, the so-called "process conditionality" (Foster et al. 1999).

If taken seriously as a requirement to reach a consensus among all relevant stakeholders about a wide range of macroeconomic, social and institutional reforms, this new conditionality is probably much more restrictive than traditional conditionality ever was (Morrissey 2001). In any case, it is interesting to note that, by emphasizing political decision making processes, the IFIs today formally recognize the problems of the political economy within recipient countries. This also is a rather recent development. Until the late 1980s, during the period of the cold war, such problems may have been recognized, but were rarely pointed out directly by either the IFIs or other donor organizations in order not to lose the political support of the governments concerned at the international level (Alesina and Dollar 2000).

While emphasizing the political economy in recipient countries, it should be kept in mind that IFIs themselves and the policies they propose are subject to policy interests of the IFIs' own bureaucracy, as well as of donor governments and international NGOs (Vaubel 1991, Willett 2000, Easterly 2002). In order to fully understand the problem of aid effectiveness, this dimension of the aid giving process has to be taken into account as well.

The paper is influenced by the theoretical literature on the political economy of aid. While this literature is rather rich as far as the effects of aid in the recipient country are concerned, it is still rather limited as to the analysis of donor behavior.[1] In this field, the literature is predominantly empirical and oriented towards the general explanation of the geographic distribution of aid (see Drazen 2000 for an overview). Literature combining both aspects is even more limited. Martens et al. (2002) and Azam and Laffont (2003) are first attempts to simultaneously consider incentive problems in both recipient countries and donor agencies within a single theoretical model.

[1] A recent exception is Lahiri and Raimondos-Møller (2000).

In our paper, we explicitly focus on the interactions between the politico-economic aspects of recipient and donor policies. It can be shown that taking into account only the political economy of the recipient country may considerably bias the expected results of aid policy. While conditionality can improve the situation of the poor in developing countries if IFIs and donor governments are benevolent, this is no longer ensured if either or both pursue self-interested policies. In particular, if they are pressured by business interests or NGOs, it can also follow that the poor will actually lose from external help and conditionality.

The paper is structured as follows: In section 2, the basic model will be presented, and the effects of both traditional and process conditionality will be discussed. Section 3 introduces bureaucratic interest and public pressures. Section 4 concludes.

2. TRADITIONAL VERSUS PROCESS CONDITIONALITY

In a first step, we consider a benevolent IFI offering loans to enhance poverty reduction in a developing country. We thereby suppose that the IFI maximizes welfare in the world as a whole, i.e. in both donor and recipient countries.

The recipient government is non-benevolent and subject to influences from different local interest groups, that are brought together in the government's political-support function. For simplicity, we consider only two groups representing the "poor" and the "rich". The weight of each group's welfare within the government's utility function depends on its political influence, which may reflect its proximity to government officials, its capacity to influence public opinion, and / or its capacity to challenge the prevailing power structure through economic, financial or military means. On this basis, it appears plausible to suggest that, generally, the weight of the welfare of the poor will be rather small (Boone 1996, Drazen 2000). Thus our discussion is more applicable to cases where governments are influenced by powerful "elites" rather than being elected by the poor.

We further assume that there is a single national policy instrument that can be used by the government. This instrument can be defined as specific distortions from pro-poor growth to the benefit of the rich, and to the detriment of the poor. Examples for this are distortive taxation, tariffs and quotas, or inflation that benefit the rich and hurt the poor. Our policy instrument can be understood as an index of such distortive policies (Mayer and Mourmouras 2002). These distortions also reduce welfare in the donor country since the latter enjoys some positive long-term effects from growth in the recipient country. Taking donor interest into account and giving an equal weight to the welfare of all people in the recipient country, the IFI will try to reduce distortions by giving aid to the government. Traditionally, it does so by conditioning aid disbursements on the government's policy performance.

2.1. The basic model

In order to present the above described situation in a formal model that facilitates comparisons of different IFI and government policies, we draw on earlier work by Mayer and Mourmouras (2002) as well as Boughton and Mourmouras (2002). Their model is slightly adjusted in order to allow us to distinguish between the welfare of the rich and the welfare of the poor within the government's utility function. Apart from introducing two groups, we use a different political structure. While they use Grossman and Helpman's (2001) political contributions model, we use a political-

support function approach, because this better captures different types of political influence that are not restricted to pecuniary influences.[2]

Let W denote welfare after IFI assistance has been disbursed and before any repayment has been made. For all groups considered, W depends on the overall amount of aid (T) and on policy distortions (ω). U denotes net welfare after all loans have been reimbursed. The different political actors are denoted by superscripts (P: the poor, R: the rich, G: the recipient government, D: the donor governments, and I: the IFI). The parameter b indicates the rate of repayment of IFI loans. For grants, b is equal to zero. The money for development aid is financed by the donor government who hands it out to the IFI. The IFI decides about how much of the loan has to be paid back. It is interested in receiving back at least part of it to be able to issue further loans in the future. It is also conceivable that the amount of money that the donor is willing to hand out depends on how much is being paid back. θ indicates the weight of the poor in the utility function of the recipient government. If not otherwise indicated, we assume $\theta < 0.5$ reflecting the relatively low political influence of the poor. The parameter γ denotes the weight the IFI attaches to the overall welfare of the recipient country. Depending on the mission of the IFI the relative weight can be higher or lower. It can also be imposed on the IFI by the donor government or by public pressure such as from NGOs. All parameter values (b, q, θ and γ) are defined to lie between zero and one.

Given these definitions, the utility functions of the five actors can be formulated as follows:

(1) $U^P = W^P(\omega, T) - bT$, with $W^P_\omega < 0$ and $W^P_T > 0$

(2) $U^R = W^R(\omega, T) - bT$, with $W^R_\omega > 0$ and $W^R_T > 0$

(3) $U^G = \theta\, W^P(\omega, T) + (1-\theta)\, W^R(\omega, T) - bT$

(4) $U^D = W^D(\omega, T)$, with $W^D_\omega < 0$ and $W^P_T < 0$

(5) $U^I = \gamma\left[W^P(\omega, T) + W^R(\omega, T)\right] + W^D(\omega, T) + (1-\gamma)\, bT$

Moreover, in order for a loan to be attractive to the recipient government, we can formulate the condition:

(6) $\theta\, W^P_T + (1-\theta)\, W^R_T - b > 0$

Assuming that with raising ω and T, marginal welfare losses increase while marginal welfare gains decrease, we define all second derivatives to have a negative sign. This is equivalent to saying that for all political actors, welfare curves are strictly concave.

[2] For a taxonomy of different approaches to model political influence, see Drazen (2000) or Rodrik (1995).

With fully unconditional aid, the recipient government would simply maximize (3) with respect to its policy index ω, where subscripts denote partial derivatives:

$$(7) \qquad U^G_\omega = \theta\, W^P_\omega + (1-\theta)\, W^R_\omega = 0$$

This first order optimization condition allows us to compute the government's reaction (RR) and policy adjustment with respect to changes in the amount of aid:

$$(8) \qquad \frac{d\omega}{dT} = -\frac{U^G_{\omega T}}{U^G_{\omega\omega}} = -\frac{\theta\, W^P_{\omega T} + (1-\theta)\, W^R_{\omega T}}{\theta\, W^P_{\omega\omega} + (1-\theta)\, W^R_{\omega\omega}}$$

Since the denominator is unambiguously negative, the sign of this expression depends on the cross-derivatives in the numerator. Mayer and Mourmouras (2002, p. 12) suggest that the numerator is negative, so that, taking into account the negative sign in front of the expression, dω/dT also becomes negative, implying that the slope of the reaction function is negative, i.e. more aid induces the government to reduce distortions. Taking into account, however, that the welfare of the poor and the rich can be differently affected by a policy change, we come to a different result. While it is indeed plausible to assume that for the poor, the negative impact of distortions becomes even more strongly negative when aid is increased, i.e. that the negative effect increases in absolute terms $\left(W^P_{\omega T} < 0\right)$, it appears less plausible that the positive effect of distortions on the welfare of the rich should decrease with increasing aid. In fact, aid funds can be used to create additional rents from a given distortion ω (Boone 1996, Svensson 2000a). This leads us to assume $W^R_{\omega T} > 0$.[3] In this case, (8) becomes positive if the weight of the welfare of the rich in the government's utility function is sufficiently high. This actually implies that aid becomes counterproductive and is to the disadvantage of the poor.

The IFI's indifference curves are given by:

$$(9) \quad dU^I = \gamma\left(W^P_\omega + W^R_\omega\right)d\omega + \gamma\left(W^P_T + W^R_T\right)dT + W^D_\omega d\omega + W^D_T dT + (1-\gamma)\, b\, dT = 0$$

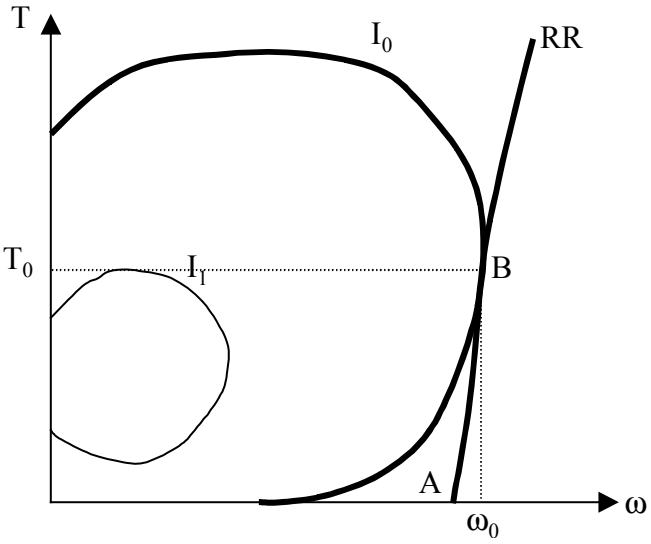
This directly allows us to calculate the slope:

[3] We can countercheck the plausibility of the assumptions on cross derivatives using the equalities $W^R_{\omega T} = W^R_{T\omega}$ and $W^P_{\omega T} = W^P_{T\omega}$. If $W^P_{\omega T} = W^P_{T\omega} < 0$, this implies that the marginal utility the poor can derive from additional aid decreases with the level of distortions. This appears to be a plausible assumption. At the same time, $W^R_{\omega T} = W^R_{T\omega} < 0$ would imply that the positive effect of aid for the rich decreases with rising distortions. The plausibility of this assumption seems to be at least questionable since distortions may be directly used for the appropriation of the additional funds in form of rents. In this case, we should rather assume $W^R_{\omega T} = W^R_{T\omega} > 0$. This is consistent with our assumptions.

$$(10) \qquad \frac{dT}{d\omega} = -\frac{\gamma\left(W_{\omega}^{P} + W_{\omega}^{R}\right) + W_{\omega}^{D}}{\gamma\left(W_{T}^{P} + W_{T}^{R}\right) + W_{T}^{D} + (1-\gamma)b}$$

Given the above assumptions of concavity of the welfare functions, the numerator turns positive for small ω, and the denominator turns negative for large T. We thus obtain the IFIs indifference curves I_0 and I_1 as depicted in Figure 1. Given the government's reaction function, the highest level of utility the IFI can reach is I_0. Assuming that the IFI has the necessary prior information about the government's best response, the amount of development assistance offered will be T_0. Accordingly, the government chooses the optimal level of distortions at ω_0. This Stackelberg equilibrium is denoted by point B.

Figure 1: Aid and distortion without conditionality



Note that as compared to a situation without aid (cf. point A), both the recipient country government and the IFI are better off. However, due to the positive slope of the government's reaction function assumed, the equilibrium with aid implies higher distortions so that the welfare effect for the poor is not necessarily positive. It is not at all clear that more aid will actually reach the poor. This result is consistent with the empirical studies on aid effectiveness by Burnside and Dollar (2000) and World Bank (1998). Aid is unambiguously positive only for the rich since they benefit from higher distortions and from aid.

2.2. Traditional conditionality

Given the above results, it is not surprising that IFIs have sought means to condition aid on good policies. Introducing conditionality, the benevolent IFI can improve its own situation and simultaneously ensure that aid is beneficial for the poor. In terms of our model, instead of proposing any fixed amount of aid, the IFI now provides aid conditioned on the level of distortions. Taking into account the government's participation constraint $U^G(\omega,T) \geq U^G(\omega,0)$, the IFI maximizes its own utility and informs the recipient government about the shape of the resulting indifference curve I_1 expressed as a reaction function $T(\omega)$. The recipient government now chooses the

optimal distortion subject to I_1. The equilibrium (T_1, ω_1) is given by the tangential point of the two indifference curves I_1 and G_1. It is denoted as C in Figure 2.

Algebrarily, the indifference curves of the recipient government are given by:

$$(11)\ dU^G = \theta\left(W_\omega^P d\omega + W_T^P dT\right) + (1-\theta)\left(W_\omega^R d\omega + W_T^R dT\right) - b\, dT = 0$$

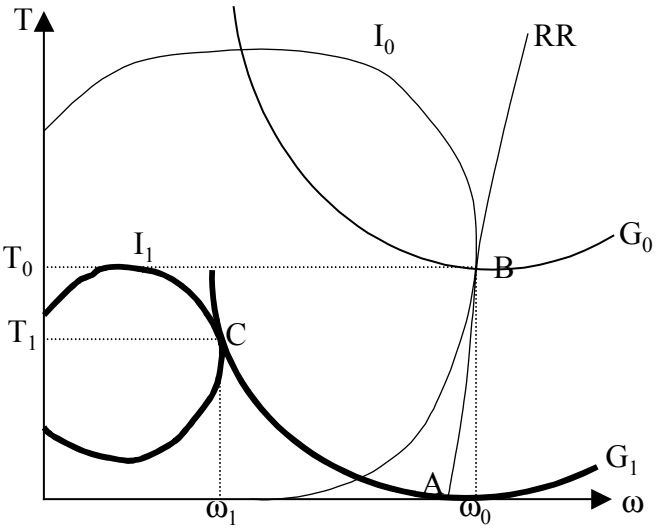
The corresponding slope is:

$$(12)\qquad \frac{dT}{d\omega} = -\frac{\theta\, W_\omega^P + (1-\theta)\, W_\omega^R}{\theta\, W_T^P + (1-\theta)\, W_T^R - b}$$

Given (6) the denominator is always positive. The sign of the numerator depends on the relative size of W_ω^P and W_ω^R. Given the concavity of both welfare functions, the negative effect of distortions on the welfare of the poor will dominate the positive effect on the rich for large ω. With the negative sign in front of the overall expression we obtain the shape of the curves as depicted in Figure 2. Note that the government's initial reaction function depicts the locus where dT/dω is just zero.

Setting (12) equal to (10) leads to the contract curve indicating all Pareto optimal decision points. However, since we have assumed that the IFI alone retains all bargaining power and predefines I_1 as its reaction function, no rents accrue to the recipient government and we obtain a single equilibrium at C.

Figure 2: Aid and distortion with traditional conditionality



Comparing the new equilibrium C to the situation without aid (A), by construction, the recipient government remains at the same level of utility. However, the welfare of the poor clearly rises since assistance is increased (from 0 to T_1) while distortions are reduced to ω_1. The IFI also reaches a higher level of utility.

As compared to the situation with unconditional aid (B), we observe that both distortions and aid are reduced. The latter, however, merely depends on the slope of

the RR-curve. If the government's reaction curve is relatively flat, conditionality increases rather than reduces the amount of assistance received. This can be explained by the fact that a relatively flat positive slope is the result of a strongly positive impact of aid on the rents of the rich from distortion. Since the IFI knows that much of its assistance will be used unproductively to increase these rents, it is not willing to offer much assistance in the first place. Once the government makes the commitment to reduce unproductive rents through accepting IFI conditionality, the IFI is ready to make higher investments.

If the amount of assistance increases, the poor clearly benefit from conditionality. Otherwise, the negative effect of aid reductions may potentially outbalance the positive effect of reduced distortions. However, as opposed to the case of unconditional aid, conditional aid always improves their situation as compared to a situation of no assistance at all. Moreover, the IFI also increases its utility level moving from B to C. Since the IFI is assumed to be benevolent, this means that overall welfare is increased.

All in all, conditioning aid on the policy parameter ω should improve the chances to reduce growth inhibiting government policies and to enhance the efficiency of aid with respect to the welfare of the poor. It will be quickly noted, however, that the model misses out on one particularly important aspect, which is the reliability of the government's commitment. Once the IFI has delivered its financial assistance, the government has no more incentive to remain at point C since, at given T_1, it can reach a higher level of utility if it chooses ω in accordance with its reaction function RR. This problem has been identified as a problem of time inconsistency (Sachs 1989, Diwan and Rodrik 1992) since the government's preferences for the level of distortions are different before and after the disbursement of aid.[4]

Others evoke the problem of lacking ownership, which essentially means the same thing: Saying that a government does not own a particular policy is equivalent to saying that it has no incentive to implement this policy. It may have had an incentive to commit itself to that policy beforehand in order to obtain assistance, but as long as the IFI has no means to enforce the commitments made, the government will continue with the policy that is in its own best interest given the amount of aid it has received. So defined, the lack of policy ownership can be expressed as the horizontal distance between point C and the government's reaction function.[5] To mitigate some of these problems, the IFIs have recently introduced "process conditionality" (Booth 2001, p. 3). In the next section we shall analyze the consequences of this change in terms of our model.

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[4] The authors quoted actually consider conditionality as a device to mitigate problems of time inconsistency. This would be true if there was an effective enforcement mechanism so that compliance could be ensured. In reality, the enforcement mechanism is lacking, and the lack of compliance, even to formally agreed conditions, and even when aid is delivered in tranches, is frequently observed (see e.g. Hermes and Lesink 2001, Morrissey 2001; White and Morrissey 1997).

[5] For an interesting general discussion of the difficulties to reconcile conditionality and ownership, see Drazen (2001). Note, however, that Drazen's definition of ownership is not fully identical with the one used here.

2.3. Introducing process conditionality

While traditional conditionality focuses on outcomes, process conditionality focuses on "*processes*" (Foster at al. 1999) or "*actions*" (Dixit 2000). We shall argue that the idea of process conditionality is to give more influence to those groups in the developing country who directly benefit from pro-poor grow. Since the IFI is assumed to be well informed, it does not only know what policy measures improve the situation of the poor (i.e. reducing distortions ω), but can also identify those groups who benefit from these measures. Once the relevant groups are identified, the IFI may ask the recipient government to include their representatives into the participatory process.

The empowerment of some selected groups will change the political equilibrium in the recipient country. In terms of our model where only two groups are considered, this would imply an increase of the weight of the poor (θ) in the government's utility function. Given that the poor have more political weight, the government will consider more favorably any policy that increases their welfare. This means that, at a given level of development assistance, it will now be willing to accept a lower level of distortions.

More formally, modeling process conditionality as an increase in θ, we can say that the recipient government now faces a new decision problem. It can either refuse the empowerment of the poor in which case it receives no development assistance and ends up at point A. Or it can accept the increase in θ required by the IFI and then decide upon its optimal policy choice with respect to ω given the IFI's reaction function T(ω) (or given some predefined T if the IFI fully gives up traditional conditionally).

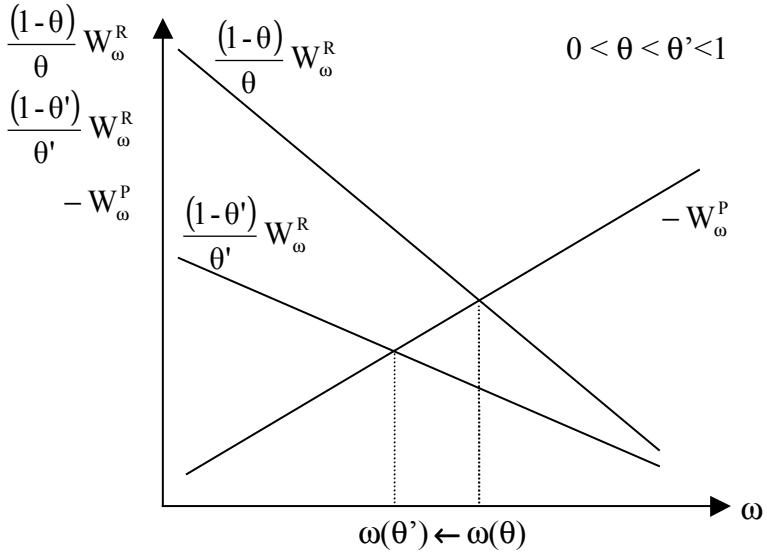
We know that with the initial weights θ and (1–θ) and without aid, the government can reach the utility level depicted by the indifference curve G_1. Since the point A on this curve will always remain among its options, it will not accept to launch a participatory process empowering the poor if its resulting level of utility is not at least as high. Since any change in θ implies a change in the shape of the government's utility function, we need to examine whether the new θ (say θ') will allow the IFI to fulfill the government's participation condition without reducing welfare for the IFI itself.

Let us first consider what the new indifference curves of the recipient government look like for higher θ. From (12) we know that

$$(13)\quad \frac{dT}{d\omega} = 0 \qquad \Leftrightarrow \qquad \frac{(1-\theta)}{\theta} W_{\omega}^{R} = -W_{\omega}^{P}$$

This equality characterizes the locus of all points where the slope of the indifference curves is just zero. Since both W_{ω}^{R} and W_{ω}^{P} are decreasing in W, an increase in θ leads to an equality of both sides of the equation at lower levels of ω (see Figure 3).

Figure 3: Determining the locus of RR'



This means that for any given utility level and for any given T, the locus where the government's indifference curves have a zero slope shifts to the left if θ is increased. This implies that the government's new reaction function (RR') lies to the left of the initial reaction function (RR) once it has accepted the empowerment of the poor.

We also have some information about the slope of RR'. Increasing θ rises the weight of $W_{\omega T}^P$ in the numerator of equation (9). This implies that for rising θ, RR becomes steeper in the T-ω-diagram and eventually turns negative.

Finally, we can calculate the effect of increasing θ on the slope of the government's indifference curves. Computing the first derivative of (12) with respect to θ yields:

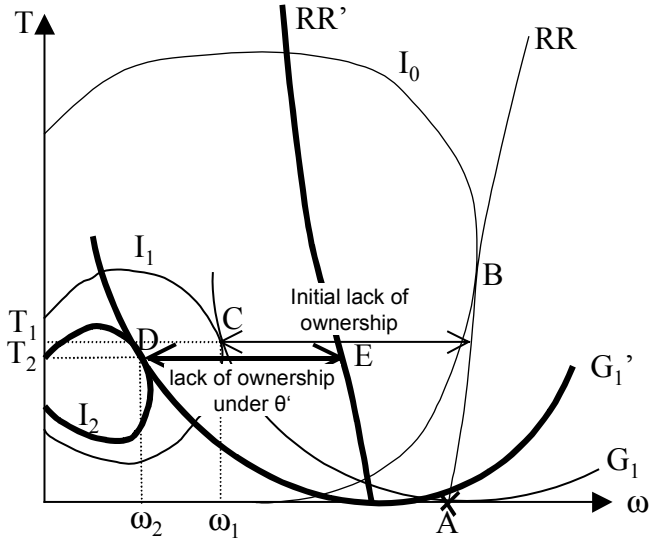
$$(14) \qquad \frac{dT/d\omega}{d\theta} = \frac{W_\omega^P\left(b - W_T^R\right) - W_\omega^R\left(b - W_T^P\right)}{\left[(1-\theta)W_T^R + \theta W_T^P - b\right]^2}.$$

Since the denominator is unambiguously positive, the sign of the expression depends on the numerator alone. The overall expression is positive as long as b is sufficiently small. If aid is delivered as a grant (b=0), it is always positive. Since condition (6) provides an upper bound for b, the possibilities for (14) to become negative are further restrained. For instance, it can be shown that for an equal marginal effect of aid on the welfare of the poor and the rich $\left(W_T^R = W_T^P\right)$ the overall expression cannot become negative as long as condition (6) is fulfilled. Therefore, we can say that in general, expression (14) is positive. This implies that the new indifference curve G_1' is steeper than the initial indifference curve G_1 where the latter is positively sloped, and flatter where it is negatively sloped.

The above described situation is illustrated in Figure 4. With G_1' the government reaches the same level of utility than without aid so that it just participates in the new regime. The IFI maximizes its utility given the new indifference curve of the government after the empowerment of the poor has taken place. As before it informs

the government about its reaction function T(ω) and the government determines ω correspondingly.

Figure 4: Aid and distortion with both process and traditional conditionality

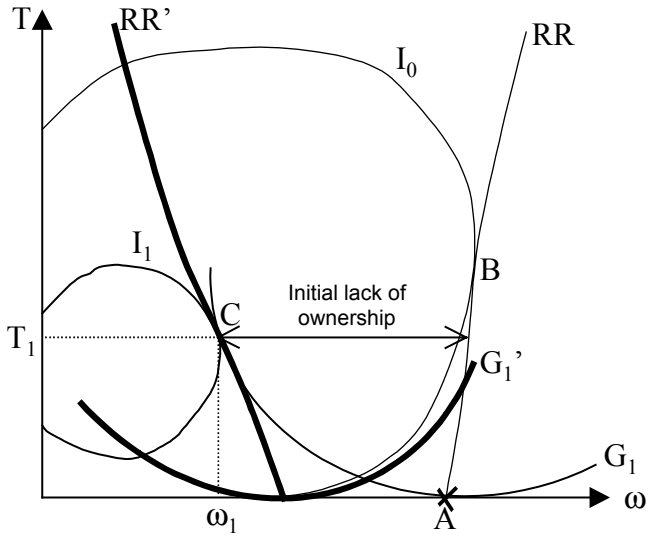


The new equilibrium is reached at D, at a higher level of utility for the IFI and, by construction, the same level of utility for the recipient government. Since the IFI's indifference curve I_2 lies to the left of its initial indifference curve I_1, we may say that even traditional conditionality has increased. As long as the IFI continues to believe in the effectiveness of traditional conditionality this is necessarily the case since otherwise, the IFI itself would have no incentive to suggest the new regime. Despite this stronger conditionality, the ownership problem may be mitigated. Due to the shift of the RR-function to the left, the horizontal distance between this curve and the new equilibrium point D may be smaller than before. This means that the policy requirement of the IFI is less inconsistent with the government's own policy priorities once all transfers have been made.

The positive effect of process conditionality comes out even more clearly if we consider that in fact, given the problem of implementation of the agreed policies by the recipient government, the IFI should actually compare the level of utility it can reach with I_0 rather than with I_1. Moreover, since the incentive problem for the recipient government persists as long as traditional conditionality is used, the policy of the IFI described above has high chances to lead to point E, even if agreement has been reached for D.

As long as the IFI has no power to enforce the implementation of agreed policies once development assistance has been disbursed, there is no reason to believe in compliance with agreed policies. Therefore, traditional conditionality will be of no use. It could be dropped and be completely replaced by process conditionality. In fact, the latter could be formulated in a way to reach exactly the level of distortions targeted through traditional conditionality in the first place (ω_1). In this case, political influence of the poor must rise so much that, given T, it is in the government's own interest to reduce distortions to ω_1. The lack of ownership is reduced to zero. This case is depicted in Figure 5.

Figure 5: Aid and distortion with process conditionality alone



It should be noted that once process conditionality assures a negative slope of the RR-curve, any increase in aid will always be beneficial for the poor. As opposed to the initial situation, more aid will then lead to reduced distortions so that the poor benefit from both, the direct increase in assistance and the policy change associated with it.

The above discussion has shown that process conditionality is an interesting tool to deal with the problems of the political economy in the recipient country. Empowering the poor increases their weight in the recipient government's utility function thereby inducing the latter to implement policy reforms by reducing distortions and promoting pro-poor growth. As long as the IFI has no means to enforce policy agreements that are not owned by the government, process conditionality actually appears to be the only viable instrument to push the desired reforms to the benefit of the poor.

3. BUREAUCRATIC INTEREST AND PUBLIC PRESSURE

We have derived the above results under the assumption that problems of political economy arise only in the recipient country. It does not seem very plausible, however, to assume that only recipient governments are subject to various interests while donors are fully benevolent. In this section, we therefore introduce some aspects of the political economy on the donor side. The IFI is no longer representing the interest of the world as a whole. Its utility function is biased by bureaucratic interest and public pressure.

In a first step, we shall consider that bureaucrats within the IFI tend to have a preference for high aid disbursements since this is regarded as a sign of their own relevance and power. This objective is frequently reported by observers of the aid business (e.g. Easterly 2002, Mosley 1996, Vaubel 1991). In a second step, we shall analyze the influence of special preferences of NGOs and bilateral donor governments for one or the other interest group within the recipient country.

3.1. The IFI as a budget maximizer

The power of any bureaucratic institution is highly dependent on the budget at its disposal. At the same time, in order to justify this budget and to be able to argue for even more funds, the available resources have to be fully disbursed. If they are not,

they may be reduced in the future with negative consequences for the institution's reputation, its influence and even the number of its staff.

For this reason, it is plausible to assume that when determining the optimal amount of aid, the IFI will not merely consider the interests of the population in the recipient country and of bilateral donor governments. Rather, the amount of aid disbursed will enter directly into the IFI's utility function. Therefore, we add ρT which reflects the IFI's interest in disbursing aid per se, with ρ as the relative weight in the IFI's utility function.[6]

We may therefore rewrite equation (5) as:

$$(15) \qquad U^I = \gamma\left[W^P(\omega,T) + W^R(\omega,T)\right] + W^D(\omega,T) + (1-\gamma)bT + \rho T$$

The slope of the IFI's indifference curve is now given by:

$$(16) \qquad \frac{dT}{d\omega} = -\frac{\gamma\left(W_\omega^P + W_\omega^R\right) + W_\omega^D}{\gamma\left(W_T^P + W_T^R\right) + W_T^D + (1-\gamma)b + \rho}$$

This corresponds to equation (10) for $\rho=0$. To see how introducing a positive value for ρ, i.e. taking into account the bureaucratic preference for the disbursement of development funds, is reflected in the results of our model, we compute the first derivative of (16) with respect to ρ:

$$(17) \qquad \frac{dT/d\omega}{d\rho} = \frac{\gamma\left(W_\omega^P + W_\omega^R\right) + W_\omega^D}{\left[\gamma\left(W_T^P + W_T^R\right) + W_T^D + (1-\gamma)b + \rho\right]^2}$$

Since the denominator is always positive, the sign of the overall expression depends on the numerator, which is positive for small and negative for large ω. For small T, this implies that the IFI's indifference curve becomes flatter, both in the area where it is negatively and in the area where it is positively sloped. Further to the right, the slope remains positive up to a higher T and ω than before. Since the government's reaction function remains unchanged, the new equilibrium is reached at a higher level of aid.

While this result is little surprising given that the IFI and the recipient government now share the objective of increasing aid, it is interesting to see the implications of this result for the different political actors. In this context, we need again to distinguish between a situation with and without process conditionality. The two cases are illustrated separately in Figures 6 and 7. In Figure 7, we assume that process conditionality is strong enough to ensure that the government's reaction function is negatively sloped.

[6] This simple extension of the basic model challenges the argument that disbursing aid should be delegated to IFIs to achieve credibility for the donor governments (Svensson 2000b). With an IFI that has an interest in maximizing budgets delegation has just the opposite effect.

Figure 6: The IFI as a budget maximizer, without process conditionality

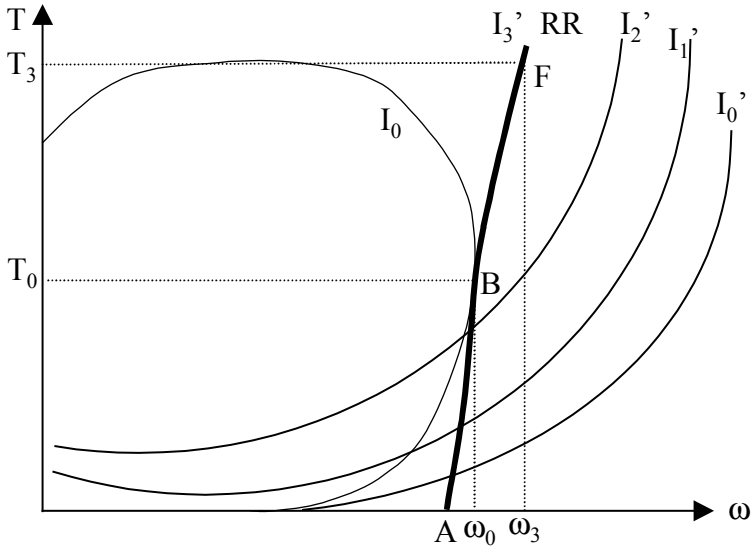
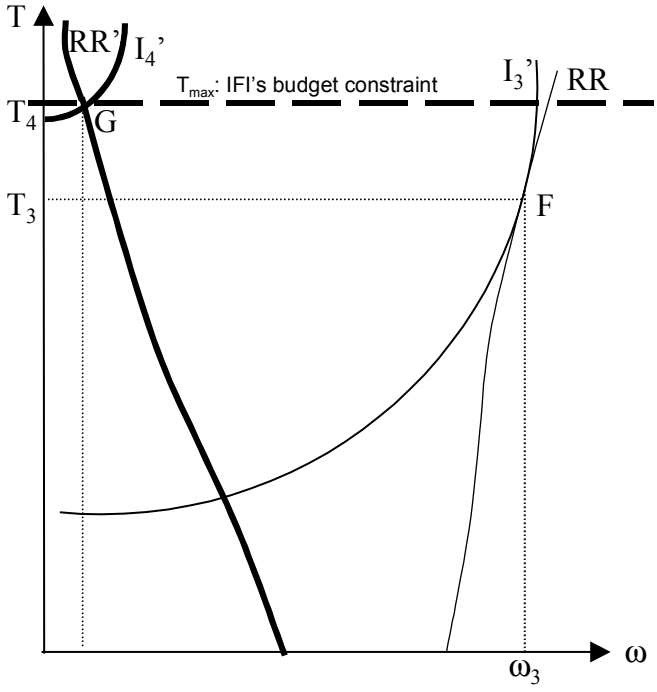


Figure 7: The IFI as a budget maximizer, with process conditionality



Clearly, in both cases, the recipient government reaches a higher level of utility than before since its own objectives with respect to the amount of aid coincide to a large extent with those of the IFI. As long as the poor are only weakly represented in the government's utility function, it cannot be excluded, however, that all benefits arise for the rich while the poor are worse off than before. This is because increasing aid goes hand in hand with increasing distortions, as we have shown above.

Process conditionality can ensure that the benefits of the recipient government do not arise to the detriment of the poor. As the weight of the poor increases in the government's utility function, its reaction function turns to the left and becomes negatively sloped. Increasing aid then goes hand in hand with decreasing distortions. Any increase in aid therefore becomes unambiguously beneficial for the poor.

The effect on the rich is clearly positive in the case without process conditionality, and may remain positive in the case with process conditionality – despite reduced distortions. The only clear losers of the budget maximizing behavior of the IFI will be the donor governments. At any given volume of development assistance, their losses in utility will be highest without process conditionality, since their disutility of increasing aid will then be exacerbated by higher levels of distortion.

However, as illustrated in Figure 7, in the case of process conditionality, it may well happen that the IFI's and the recipient government's indifference curves become so similar that no tangential point can be reached for any finite amount of aid. Donors therefore need to closely monitor the IFI's spending behavior and to define a budget constraint determining the maximum amount of aid the IFI can disburse.

We conclude that given the political economy of the recipient country and the typically high weight of the rich in the recipient government's initial utility function, the IFI's bureaucratic budget maximization behavior runs the risk to be detrimental not only for donor governments but also for the poor. The only unambiguous beneficiaries in the developing country will be the rich. The empowerment of the poor can change this situation, mitigate the donors' disutility for any given volume of aid, and ensure the benefits of the poor. Taking into account bureaucratic budget maximization therefore strengthens the case for process conditionality.

3.2. The IFI under external pressure

So far, we have assumed that the IFI knows who best represents the interests of the poor and uses process conditionality in order to increase their weight in the recipient government's utility function. In reality, however, the situation in developing countries is complex, and the best representatives of the poor might not always be easy to identify. There are often numerous groups claiming this role.

Even within the donor community, there is generally no unanimity with respect to which groups should or should not be empowered. International NGOs have often complained that local Civil Society Organizations (CSOs) – often their own local partners – have not sufficiently been integrated into the discussions (see e.g. Marshall and Woodroffe 2001, pp. 10f.). Complaints by local groups whose intention to participate was declined, are taken up by various interest groups in the donor countries as well as by external researchers. Even in the case of Uganda which is frequently cited as one of the most successful countries with respect to the implementation of the PRS-process, numerous groups are dissatisfied with their integration into the related discussions (Lister and Nyamugasira 2003, pp. 102f.).

Even if the IFI knows who "really" represents the poor, it will tend to take into account the position of other relevant actors too. Permanent pressure from bilateral donor institutions or international NGOs could deteriorate the IFI bureaucrats' working climate. Moreover, in the long run, dissatisfaction of bilateral donors may also lead to reductions in the IFI's budget. The IFI therefore has a strong incentive to integrate the positions of NGOs and bilateral donor governments, at least partly, into its own policy stance in order to avoid too much criticism and external pressure.

One might also argue that the IFI itself is not always sure of who are the real representatives of the poor. Alternatively, the IFI might be well able to find out the right group to support, but this process might take more time than the IFI is willing to invest. There is ample evidence on "hurry-up lending" (Vaubel 1991) and rushed aid disbursements or debt forgiveness, most recently again in the context of PRS-processes (Michaelowa 2003, p. 472; Marshall and Woodroffe 2001, p. 10; Booth 2001, p. 18). In all these cases, orienting the IFI's policy at the bilateral donors' position will at least provide it with some immunity against later criticism.[7]

Therefore, if the utility function of bilateral donors is characterized by a specific valuation of the different interest groups within the recipient country, the IFI will not only consider direct welfare in the donor country, but integrate the donors' utility function into its own.

More formally, returning to our model with only two interest groups in the recipient country, we may rewrite the donors' utility function (4) as:

$$(18)\quad U^D = W^D(\omega, T) + \varphi\left[\lambda W^P(\omega, T) + (1-\lambda)W^R(\omega, T)\right], \qquad 0 \le \varphi \le 1,\ 0 \le \lambda \le 1$$

The change from (4) to (18) implies that the donors' utility now depends on welfare in the recipient country in a different way than assumed earlier. While initially, cross-national interdependence was modeled only through the international spill-over effects of the recipient country's policy ω (e.g. trade effects or effects on the financial markets), the donors now derive a direct utility from the welfare of the two groups in the developing country (altruistic preferences). The parameter φ is defined in a way to reflect the assumption that altruistic preferences do not dominate the preferences for the donors' own direct welfare. The weights λ and $(1-\lambda)$ reveal the strength of donors' preferences for the poor and the rich respectively. Since NGOs are not included separately in the model, they are assumed to exert their influence via the donor governments. NGO pressure on donor governments to put more emphasis on the well being of the poor would thus be reflected in a higher λ. If, however, business interests are more interested in the well being of the rich, and can influence the donor governments accordingly, $(1-\lambda)$ should increase. As a short cut, we assume that the donors' utility function reflects the result of the entire aid related politico-economic process within donor countries.

If the IFI takes the donors' interests into account, its objective function becomes:

$$(19)\quad U^I = (\gamma + \varphi\lambda)W^P(\omega, T) + (\gamma + \varphi(1-\lambda))W^R(\omega, T) + W^D(\omega, T) + (1-\gamma)bT + \rho T$$

and the slope of the IFI's indifference curve becomes:

$$(20)\quad \frac{dT}{d\omega} = -\frac{(\gamma + \varphi\lambda)W^P_\omega + (\gamma + \varphi(1-\lambda))W^R_\omega + W^D_\omega}{(\gamma + \varphi\lambda)W^P_T + (\gamma + \varphi(1-\lambda))W^R_T + W^D_T + (1-\gamma)b + \rho}$$

[7] Note that this pressure has probably increased in recent years, where several commissions have been active to investigate the role and function of IFIs. Since most tend to be quite critical about the IFIs, they have any incentive to try to please donor governments by taking their positions more strongly into consideration.

For $\lambda = 0.5$, i.e. equal weights for the poor and the rich in the donors' utility function, this expression comes very close to equation (16). However, the introduction of altruistic preferences into the donor governments' objectives leads to a generally higher weight of welfare in the recipient country. This implies, in particular, that the denominator turns negative only for T larger than before, so that the backward bending of the IFI's indifference curve will occur only for relatively large T.

What is really interesting here, however, is the case where donors do not attribute equal weights to both groups. We can consider the effect of rising λ, i.e. of increasing the weight of the poor in the considerations of the donor country, by computing the first derivative of (20) with respect to λ:

(21)
$$\frac{dT/d\omega}{d\lambda} = \frac{\varphi\left[(2\gamma+\varphi)\left(W_\varphi^R W_T^P - W_T^R W_\omega^P\right) + \left(W_T^D + (1-\gamma)b + \rho\right)\left(W_\omega^R - W_\omega^P\right) + W_T^D\left(W_T^P - W_T^R\right)\right]}{\left[(\gamma+\varphi\lambda)W_T^P + (\gamma+\varphi(1-\lambda))W_T^R + W_T^D + (1-\gamma)b + \rho\right]^2}$$

Since the denominator as well as the first term of the numerator are always positive, the sign of the overall expression only depends on the second and third term of the numerator. The second term becomes negative for $\left|W_T^D\right| > (1-\gamma)b + \rho$. Given the concavity assumption for W^D, this tends to happen predominantly for large T. The third term becomes negative for $W_T^P > W_T^R$, i.e. if at a given level of distortions, an increase in development assistance is more beneficial for the poor than for the rich.

For the shape of the IFI's indifference curves this result has the following implications: As long as the overall expression remains positive, the IFI's indifference curves become steeper (in the predominant area where they are positively sloped). This is not surprising since the higher weight of the welfare of the poor leads to the necessity to compensate them with higher amounts of aid for any increase in distortions. Only when the donors' direct welfare becomes too seriously reduced by higher aid this situation will change. This tends to happen only for relatively high T where the initial indifference curves are negatively sloped so that, here again, the slope of the new curves tends to be steeper. Finally, a large positive effect of aid on the welfare of the poor will dampen the impact of rising their weight in the IFI's utility function since in this case, small increases in aid are sufficient to make up for higher distortions.

All in all, and especially if the latter effect is not too strong, the equilibrium with higher weights of the poor will be reached at even higher levels of aid, at least as long as the IFI's budget constraint is not binding. Increasing λ is always beneficial for the poor. Their welfare can be increased even further if the IFI makes use of process conditionality to "move" the relative weights of the two groups in the recipient government's utility function closer towards its own preferences or those of the donor governments.

Unfortunately, the above discussion suggests that the politico-economic process on the donor side may not always result in an increased but also in a reduced weight of the poor. For any decrease in λ, we face a situation where the IFI's indifference curve

tends to be strongly negatively sloped for small ω, and flatter thereafter where the slope is positive. If business interests are in favor of putting a larger weight on the welfare of the higher income classes, than "altruism" can actually have negative effects on the welfare of the poor.

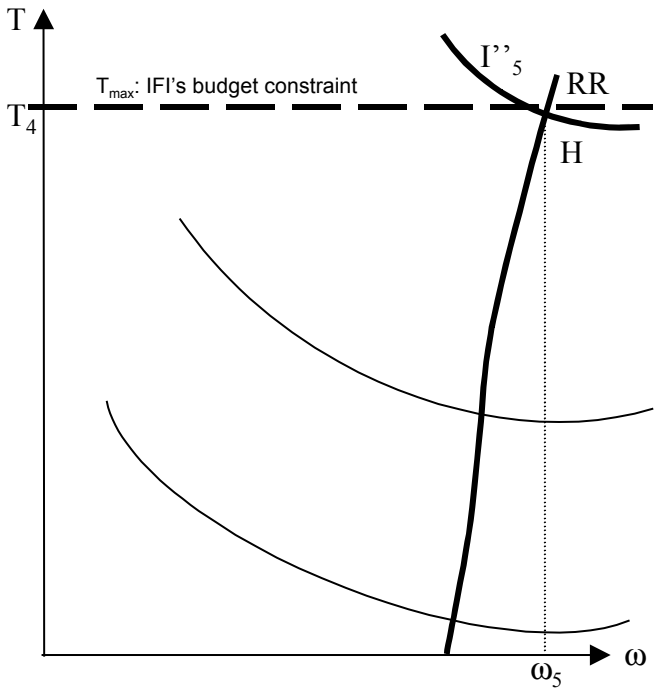
The most extreme case would be $\lambda = 0$. In this case, equation (20) can be rewritten as:

$$(22) \qquad \frac{dT}{d\omega} = -\frac{\gamma W_{\omega}^{P} + (\gamma + \varphi) W_{\omega}^{R} + W_{\omega}^{D}}{\gamma W_{T}^{P} + (\gamma + \varphi) W_{T}^{R} + W_{T}^{D} + (1 - \gamma) b + \rho}$$

Note that the poor are not fully left out of consideration since we assumed that the donors' positions influence the IFI's utility, but do not fully substitute for the IFI's own initial valuations. Nevertheless, the strong weight of the rich in the IFI's revised utility function implies that the numerator turns negative only for relatively higher values of ω. In fact, it may even happen that the IFI now reaches a higher level of utility for both higher T and higher ω.

Of course, in this situation, the IFI has no incentive to use process conditionality to increase θ, the weight of the poor in the recipient government's utility function. This situation is illustrated in Figure 8. Ignoring who really represents the poor or opportunistically listening to donor governments and the vested interests they represent, the IFI may even support the rich conditioning aid on lower θ. In this case, the situation would become even worse.

Figure 8: Aid and distortion when donor interest groups lobby for the rich



As can be observed, the political equilibrium will be obtained at point H, implying the highest level of development assistance consistent with the IFI's budget constraint. Moreover, the level of distortions reached (ω_5) is the highest of all cases analyzed so far.

A last case to consider is that the donors are themselves influenced by the position of the recipient government. Given the difficulties to assess the political situation in any far away developing country, political actors in donor countries, including both aid agencies and NGOs, often argue that the weights can be determined correctly only within the recipient country itself. Unfortunately, it is most likely that developing country governments have any incentive to present their preferences for the poor and the rich, θ and $(1-\theta)$, as the "true" values and that precisely these weights are reported to the donor agents as reflecting the situation in the recipient country adequately and unbiased. There is a high probability that in this case the equilibrium levels of aid and distortion will be similar to those depicted in Figure 8. In any case, the IFI's and the recipient government's indifference curves will then look relatively similar, and there will not be much scope for any process conditionality to the benefit of the poor.

Overall, this section has shown that taking into account the political economy on the donor side can reverse the optimistic picture drawn in the previous sections. Process conditionality appears to be a very interesting and useful tool to enhance pro-poor growth and to rise the welfare of the poor as long as the IFI holds all necessary information to assess the political situation in the recipient country and to select the true representatives of the poor. If it does not hold this information or if other bureaucratic interests reduce its incentive to obtain and / or make use of this information, process conditionality loses its effectiveness in achieving its desired goal. While the instrument as such appears to be really innovative, it will become useful only once the more fundamental problems of the aid business have been solved.

4. CONCLUSIONS

It is well known that within recipient countries of official aid, governments' preferences are often biased towards the interests of the "rich" who tend to have a higher political influence through economic, financial or military means, through their proximity to government officials, or through their capacity to influence public opinion. Therefore, it is not at all clear that more aid will actually reach the poor.

In such a situation, conditioning aid on the participation of the poor in the political decision making process can indeed be very effective. Participation leads to empowerment, and even more so, if it is supplemented by other measures of capacity building. The poor thereby obtain a political voice which in turn leads to a change in the weight attributed to their welfare in the utility function of their respective governments. As a consequence, developing country governments will adopt policies more in line with pro-poor growth. Since this policy shift will be based on their own changed preferences, the ownership problem arising in the context of traditional conditionality can be avoided. Process conditionality therefore appears to be clearly beneficial for the poor.

This result, however, holds only as long as IFIs and bilateral donors are assumed to be well informed and benevolent. The situation may be different if they are not. In a first step, the IFI can be considered as a bureaucracy interested in the amount of development assistance disbursed, rather than in the efficiency and effectiveness of aid. This will generally lead to high aid and strong policy distortions to the detriment of the poor. However, this situation further increases the relevance and effectiveness

of process conditionality. With process conditionality, IFI aid expenditure will remain high, but at least, it can be ensured that this will encourage policies enhancing pro-poor growth.

If, however, in a second step, public pressure on bilateral donor governments and the IFIs is also taken into account, the picture suddenly changes. Public pressure by NGOs and other interested parties, which seems to have been growing over recent years, is beneficial for the poor only if the poor are really at target. However, not only "good" intentions are behind public pressure. Business interests, for instance, might lead to different priorities when it comes to the empowerment of a particular group in a developing country. Within donor countries, NGOs and other interest groups have the incentive to try to promote their own partner organizations pretending that these are the real representatives of the poor.

In fact, intentions do not even need to be "bad". It suffices that there is uncertainty about the true socio-economic and political situation in the recipient country, and that there are different local interest groups claiming to represent the poor. In reality, it is often difficult to determine who really represents the poor. It may well happen that those already having much voice within their country will also be listened to most in donor countries. Aware of their own informational deficit, donor aid agencies and NGOs may also directly recur to the advise of recipient country officials in order to find out which local groups should be promoted. In both cases, the resulting priorities will reflect rather closely the already prevailing balance of power in the developing country. The IFIs now adopt – at least partly – the donor countries' position. After all, this is an easy way to avoid both, later criticism and the cost of more detailed information through their own staff. Therefore, the IFIs' own policy preferences move closer to those of the recipient, and there will not be much scope for any process conditionality to the benefit of the poor. In extreme cases, process conditionality can even become counterproductive.

Overall, it can be concluded that the effectiveness of process conditionality crucially depends on the selection of the true representatives of the poor. For the IFIs, this requires substantial information about the socio-economic and political conditions in the recipient country, and the willingness to defend their position against external pressure. It appears that currently, IFIs do not fulfil either of these conditions. In particular, rushed lending or rushed debt forgiveness destroy all chances of a meaningful participatory process. Moreover, increasing international criticism seems to have made the IFIs even more responsive to the pressure of bilateral donors. Democratic accountability of the IFIs, while in itself a relevant objective, can backfire in a situation where uncertainty is as high as in the relationship between aid and pro-poor growth.

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