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Making Debt Relief Conditionality Pro-Poor

Oliver Morrissey *

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Abstract

This paper considers how the conditionality inherent in HIPC debt relief should be constituted to promote pro-poor policies. There are two dimensions to this. First, the extent to which the policies proposed are pro-poor. Second, the potential for releasing resources for pro-poor expenditures. The paper provides an analytical framework to describe the policy environment for poverty reduction, and identifies where donor effort and influence are most likely to be effective. The paper argues that the elements of debt relief conditionality should be tailored to the features of the poverty-reduction policy environment and provides guidelines for the design of conditionality.

Keywords: aid conditionality, HIPC, debt relief, East Africa

JEL classification: F35, O19, O55

* Oliver Morrissey is Reader in Development Economics and Director of CREDIT, School of Economics, University of Nottingham, and Research Fellow at ODI.

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Katajanokanlaituri 6 B, 00160 Helsinki, Finland

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1 Introduction

Debt relief is a form of aid, and one that is becoming increasingly important for poor developing countries. From the perspective of donors, funds allocated to debt relief are attributed to the aid budget. From the perspective of developing countries, debt relief reduces debt-servicing costs. As with aid, it represents an increase in funds available to government. Furthermore, as with aid, eligibility for debt relief is conditional on implementing specified economic policy reforms. The literature on aid conditionality should therefore be informative regarding the appropriate form of conditionality for debt relief. Furthermore, debt relief is intended to have a poverty-reducing effect. However, relief in itself will not affect poverty. The way in which the government funds that are freed through relief are used can reduce poverty. In other words, and this is the argument of the paper, it is the funds associated with debt relief that can reduce poverty (if allocated to pro-poor expenditures). The flaw in current debt relief conditionality is that the conditions relate to policies (that should be pro-poor) rather than to the use of these funds, which are only released after the conditions have been met. We argue that pro-poor expenditures can and should be disbursed independently of, and if necessary prior to, full compliance with policy conditions.

The economic study of the effectiveness of aid is like a very large jigsaw. Theory gives us insights into how the pieces fit together, and cross-country studies provide a vague outline of what the picture looks like. However, each country is different, both in the nature of the economic interactions that determine the effects of aid and, at least as importantly, in terms of the underlying policy process. Policy clearly influences economic performance, and thus mediates the effectiveness of aid, but there is a debate regarding the mechanism by which policy influences effectiveness (contrast Burnside and Dollar 2000, with Hansen and Tarp 2001). A separate issue, on which current understanding is limited, is whether and how aid influences policy, the aspiration behind conditionality. World Bank (1998) seems to take the view that conditionality does not work, and it is certainly true that tight conditionality is not an effective instrument to get governments to do something they do not want to do (White and Morrissey 1997). However, this may be going too far. For example, many African countries have implemented significant economic policy reforms over the past 20 years, and aid has clearly played an important role, both encouraging and supporting reform.

This paper addresses the latter issue—in what ways can aid, in the form of debt relief, influence policy reform. Being the policy that is now foremost among donor objectives, the focus is on poverty-reduction. Donors have established the adoption of poverty-reduction policies, as represented through a country's poverty reduction strategy paper (PRSP), as a criterion for aid and, more specifically, debt relief under the Highly Indebted Poor Countries (HIPCs) Initiative. The question addressed here is whether this has increased the policy leverage of aid as an instrument of poverty reduction and are there lessons for the design of conditionality associated with HIPC debt relief? We adopt a political economy approach, being concerned with the interface of politics and economics—the political factors that influence the economic policy process rather than political systems *per se*.

It is useful to distinguish pro-poor policies from pro-poor expenditures. First, we consider how liberal economic policy reforms, those associated with structural adjustment and stabilization, can be made pro-poor. Our concern is not with the detail of reform areas, such as trade or exchange rate policy, but with the broad implications. The desirability of some liberalization is accepted, the question is how to protect the relatively poor (those who either are poor, or in danger of being pushed into poverty). This leads to an emphasis on complementary policies that, in an environment of liberalization, make the reform process pro-poor. Second, we elaborate the notion of compensatory policies in respect to the policy reform conditions associated with debt relief under HIPC. Such compensatory policies comprise pro-poor expenditures that target and protect the poor and vulnerable.

In general, it is *easier* (but by no means easy) to identify and implement pro-poor expenditures than it is to implement complementary policies that make a reform process pro-poor, especially if the reform process is relatively complex and wide ranging. Macroeconomic, liberal, policy reform is a pre-condition for eligibility for debt relief under HIPC. There is considerable debate, however, regarding the effect of such reforms on the poor, and thus on the appropriate pro-poor complementary policies. The design and implementation of pro-poor policies is demanding of policy-makers, whose potential is conditioned by the policy environment—the political and administrative constraints to policy. The design and implementation of pro-poor expenditures is somewhat easier. A central argument of this paper is that given the policy environment, the objective of poverty reduction can be more effectively promoted through pro-poor expenditures than by *requiring* pro-poor policies. Less ‘up front’ conditionality should attach to the broad economic reforms and more emphasis should be given to the composition of expenditures.[1]

Section 2 considers the role of external influences, channelled through aid and debt relief, in the policy process—how policy preferences combine with the political capacity of a government to adopt policy and create a commitment to reforms that can be implemented. Section 3 considers debates on the impact of economic reform on the poor, discusses the policy context of debt relief under HIPC, and identifies the features of the policy environment for poverty reduction. The relationship between economic policy, aid and poverty-reduction is an issue of increasing research activity and policy interest, although current knowledge is limited. Section 4 concludes with some implications for HIPC conditionality and how aid can be targeted on poverty reduction via support for PRSP processes and pro-poor expenditures.

2 Aid and external influence on the policy process

This section presents a framework for analysing the nature of the policy process in a country with a view to identifying the appropriate ways in which external agencies, in this context aid donors, can influence the process so as to promote pro-poor policies. Some comments on terminology are in order. Government refers to the set of ruling politicians who are policy-makers (and may include senior civil servants and advisors). This paper is not concerned with the political process by which policy-makers are selected. Administration refers to the civil service and other institutions that implement policy. We wish to draw a clear distinction between policy-making—the choice, design and advocacy of policy—and implementation (acknowledging that implementation

[1] A longer version of this paper is available as Morrissey (2001) in which the arguments are illustrated with examples from Kenya, Tanzania and Uganda.

experience should feed back to policy-making).[2] Policy-making will depend on the way in which government functions, the strength of opposition, and the quality of technocrats involved in the process (the same individuals may also be involved in administration, but that is a distinct function). This is our principal concern. We recognize the importance of implementation capability, especially insofar as limitations constrain policy choice, but are not concerned with issues relating to administrative or institutional reform.

It will be helpful to locate this paper within the emerging literature on the politics of pro-poor policy, although that is peripheral to our main concern. Much of this literature starts from the premise of 'assuming that governments are willing to pursue pro-poor policy' and concentrates on three issues (Johnson and Start 2001: 9). First, how to identify activities and target beneficiaries. Second, how to ensure communication and satisfaction of needs and priorities for such activities within the public sector. Third, the politics of the interface between public sector providers and beneficiaries (such as devolving accountability, promoting local democracy and involving civil society). Johnson and Start (2001) review this literature in some detail. Although we comment on the first issue (as central to the identification of pro-poor expenditures), the concern here is with the premise. What role do external influences, in particular donors, play in encouraging governments to adopt and implement pro-poor strategies?

Morrissey (1999) proposes a framework for analysing the factors influencing governments' choices of which policies to adopt, and the presentation here builds on this. The government has to have a preference for the particular policy or reform (as elaborated below, this is distinct from the notions of 'commitment' and 'ownership' that are prevalent in the literature). Preferences in this context are policy-specific. A government may wish to retain the status quo or may perceive the need for change. If the latter, there is a preference for reform (with a particular aim), but this does not imply that the government knows what the most appropriate policies are to achieve the reform (this is where external influences come into play).[3] Aid, in itself and as a manifestation of donor views on what are appropriate policies, can play a role in shaping preferences. There is no reason why aid, or donors, should have an immediate effect. It takes time to shift preferences, although is easier when there is a policy vacuum to fill (and when governments are receptive). While the aid financing acts as a carrot, effort should be made to convince recipients that the policies proposed are indeed appropriate (made easier if, in fact, they are—a point returned to in Section 3).

To a large extent preferences are shaped by internal factors. At one extreme, ideological regimes will tend to have relatively fixed and inflexible preferences, although these can change over time. At the other extreme, liberal technocratic regimes will be inclined to search for the most appropriate policy and tailor it to internal political needs (their

2 This is not to deny that implementation is integral to the policy process, but allows the focus to be on policy-making. Grindle and Thomas (1991) provide the seminal discussion of policy-making and implementation in developing countries.

3 There are two issues here. First, donor and recipient preferences regarding reform may differ; this is the standard case of conditionality failure (White and Morrissey, 1997). Nevertheless, donors can influence preferences (Morrissey and Nelson [2001] discuss how institutions such as the WTO can influence policy-makers *beliefs* and thus shape preferences for reform). Second, having chosen a specific policy, recipients may lack full information on design and implementation. This is where donors can play a directly constructive role, assuming there are shared preferences.

technocratic nature implies an ability to do this). Most governments are somewhere in between: they have a set of preferences, but these can be altered or refined in the face of a changing internal or external environment. Our focus is on the influence of the external environment and external actors; internal politics is, in effect, treated as a constraint (this is not to claim that change may not arise internally). That is, we take internal factors as shaping initial preferences and then consider how external influences can alter these. We begin by elaborating these factors.

A core concept is that of 'political capacity'—the ability of the political system to institute policy evolution and policy change. This will depend on the nature of decision-making within the government itself, and the relative strength of constituencies that support or oppose the direction of policy. Morrissey (1999) considers four types of political regime in the context of how this shapes willingness to adopt new policies. Two are mentioned here. Established regimes tend to have vested interests they will want to protect; this combined with hysteresis renders them less willing to change preferences and adopt new policies. New regimes may find that they have power before they have formed policies and may be encouraged to become reformist.

The political difficulty with pro-poor reforms is that they require redistribution. On the one hand, this implies that there will be opposition to reform (from the rich, who are initially the powerful). On the other, there is the possibility that redistribution will, at least in the short run, slow the rate of growth. Alesina and Rodrik (1994) develop a dynamic endogenous growth model with production as a function of capital, labour and production services offered by governments and financed by a capital tax. The capital tax captures the re-distributive policies of government. Growth is a result of investment in capital and therefore investment and growth are lower the higher the tax rate on capital. Thus, redistribution 'is conducive to the adoption of growth-retarding policies' (Alesina and Rodrik 1994: 465). This would be of concern to governments as growth is often the most important determinant of the sustainability of policy reform. More can be attempted and support is greater during a period of growth, whereas reforms that are perceived as reducing growth increase opposition. 'Popularly elected governments realize that political survival depends upon good economic performance' (Sandbrook 1996: 6).

Much of the discussion of policy reform in developing countries has been concerned with the concepts of 'ownership' and/or 'commitment' (e.g. Killick 1995; Sandbrook 1996; Leandro *et al.* 1999; Dijkstra and Van Donge 2001), with ownership seen as necessary if policies are to be implemented successfully and sustained. The implication that ownership is a necessary, albeit not sufficient, condition for effective reform may be too strong. Typically, the concept of ownership is not clearly defined and is used in a loose sense, frequently indistinguishable from commitment. Sandbrook, for example, argues that 'ownership', which is not defined, is necessary for commitment, apparently defined as requiring that 'the executive authority must be [cohesive and] firmly convinced of the necessity of [reform]' (Sandbrook 1996: 5). Leandro *et al.* (1999: 288) acknowledge that no clear and unambiguous definition of ownership appears in the literature, and consider it some combination of commitment and capacity to 'conceive, negotiate and implement reforms'. Thus, if a government supports a particular policy, has chosen that policy itself (although it is never fully clear how it was chosen), and openly expresses its commitment to the policy, then it is claimed to own the policy. This may be an acceptable definition of ownership, but it is unlikely to be a necessary condition for effective reform. The focus here is on commitment as the necessary condition, rather than ownership. In other words, we are not concerned with where the policy originated,[4] but simply with whether the government accepts (chooses) the policy.

Commitment, defined as the explicit adoption of a specific policy, can be seen as comprising two elements—preferences and political capacity. Preferences for reform are a sufficient condition to ensure an attempt at implementation (irrespective of ownership), but do not guarantee successful implementation, nor do they guarantee that the government will make its intentions public.[5] Preferences and capacity give rise to commitment to reform, but the ability to implement successfully will then depend on administrative capability and institutional structures. In this sense, we define commitment as revealed preference. If a government favours a particular reform and believes it has the political capacity to advocate and try to implement the reform, it is willing to declare the commitment. If a government has a preference for reform but capacity is weak, it may choose not to declare its commitment (it will be implicitly, but not explicitly, adopted). If there is no preference for the reform, there is no commitment by this definition (irrespective of what the government may declare).[6]

While preferences and capacity are necessary and sufficient for commitment, this does not imply ownership—the government could simply choose to implement a set of policies 'off the shelf' (from, for example, donors). A meaningful concept of ownership, as suggested above, would require that the policy originates with the government. This requires considerable policy-making and policy analysis capacity, often beyond that available to most developing countries (at least in respect of complex issues where policy knowledge is not well known, such as poverty reduction). This is a strict definition of ownership, and neither necessary to ensure that reform is attempted nor that it is successful. Although ownership as defined *is* desirable in its own right, it is not at all evident that ownership rather than simply commitment is *necessary* to ensure that reform programmes will be advocated, implemented and sustained.

The discussion above is summarized in Table 1 which also indicates the various stages at which external influences can come into play. If policy-making within government is relatively open and based on dialogue there is scope for developing new policies and the government will be receptive to external influences. External influences are often most important in shaping preferences. Donors can encourage governments to give particular issues more priority on the policy agenda, or try to convince governments that there is 'new' policy knowledge and experience that they should recognize. Disseminating 'good' policy experiences is one of the most effective ways to influence preferences. If a government is presented with evidence of policies that have worked elsewhere, they

4 I am grateful to David Booth for suggesting this wording.

5 As should be clear from the context, preferences here do not mean that the government 'likes' the policy (although it may do). Preferences relate to policy choice, based on information given objectives.

6 It should be admitted that political commitment is difficult to define in an operational way. Ideally, one needs to know the true intentions of the government rather than relying on revealed preferences (which may be opportunistic and politically, rather than policy, motivated). A government may declare an intention to reform simply to receive aid, and then renege on this 'commitment' (the source of aid conditionality ineffectiveness). In practice, stated policy preferences are the best available indicator of commitment.

are more likely to be convinced that the policy is appropriate for them (i.e. external agencies can influence beliefs over the efficacy of policy alternatives).

Donors can also support political capacity—providing evidence to counter opposition and assistance in policy advocacy, for example. When political capacity is weak but governments accept the desirability of reform, external agencies can be 'blamed' for requiring governments to adopt unpopular policies. If responsibility for the adverse effects of the reform is not attributed to the government, but to external actors, then opposition has less to attack (Frey and Eichenberger 1994). More generally, the government may support the objectives, but may have limited capacity to advocate an appropriate policy and mobilize support for it. The type of evidence that influences government preferences is essentially the same as that which supports policy advocacy, although dissemination modes differ. The former should be designed to appeal to policy-makers (accentuate the positive) whereas the latter should appeal to the public and interest groups (e.g. deflecting or countering opposition arguments). In these ways, donors can fill the gap where preferences are pro-reform but capacity is weak. This implies working with or even for government.

Table 1
External influences on the policy reform process

Political dimension	Donor influences
A. Preferences	*The government is in favour of the reform* • Placing specific concerns high on the agenda • Policy advice and knowledge transfer • Evidence of how policy has worked elsewhere
B. Capacity	*Ability to advocate policy and move to implement* • Taking responsibility for unpopular policies • Providing evidence to build support • Assistance for policy advocacy • Poverty monitoring and analysis*
C. Commitment	*Preference revealed because capacity is adequate* • Financial support for adopting policies • Building policy-making capability • Technical assistance on policy design and analysis
D. Administration	*Process of implementing the policy* • Technical support and assistance

Note: Basic structure taken from Morrissey (1999: Table 4.1). The aim is to identify the 'entry routes' of external influences on the politics of policy reform. A definition of the political dimension is provided in italics.

* These contribute to policy-making and therefore enhance capacity, but are also elements in implementing effective policy, therefore contribute to administrative capability.

Once commitment exists, external agencies can help to strengthen it, directly with financial support (to offset costs of implementation) or more generally with advice and help in policy design. Commitment implies the government has advocated the policy and is moving to implementation. External assistance at this stage should be directed on appropriate policy design, such as resolving problems of targeting in pro-poor expenditures. Some see such technical assistance as contributing to ownership (e.g. Leandro *et al*. 1999). This is true in a dynamic sense, if support for capacity now contributes to enhanced policy-making capacity in the future. However, technical assistance for implementing specific reforms should not be considered as promoting ownership of that reform—it is too late. Similarly, such assistance does not establish commitment, rather it assists the process of acting on commitment.

Increasing administrative capability is an essential part of effective policy reform, relevant not only to implementation but also to political capacity itself. 'However difficult and politically risky it is to decide to introduce a reformist initiative, the process of implementing and sustaining that decision is likely to be even more fraught with difficulty and risk' (Grindle and Thomas 1991: 121). The problem in many African countries is that bureaucrats were 'captured' by the elite. 'Political patrons secure positions in the civil service and parastatals for clients, who then owe loyalty to those patrons rather than their hierarchical superiors. These transorganizational factions advance the interests of their members—often to the detriment of the public they are supposed to serve' (Sandbrook 1996: 8). This captures the inherent interaction of administrative capability and political capacity. A more capable and independent bureaucracy can contribute to effective policy-making as it strengthens capacity (and promotes ownership), whereas weak capabilities undermine implementation and political capacity. Donors can contribute via technical assistance in administration and implementation.

3 Elements of a poverty-reduction strategy

This section places pro-poor policies within the framework developed above. First, we consider how liberal economic policy reforms, those associated with structural adjustment and stabilization, can be made pro-poor. Our concern is not with the detail of reform areas, such as trade policy, but with the broad implications for protecting the relatively poor. This requires complementary policies that ensure a pro-poor effect and compensatory policies that minimize or offset adverse effects on the poor (these include pro-poor expenditures). We elaborate the notion of compensatory policies in respect to the policy reform conditions associated with debt relief under HIPC. This allows us to identify some problems with HIPC conditionality as practised and to identify pro-poor expenditures. This is then related to the discussion of the previous section to identify the policy environment for poverty reduction. Given the policy environment prevailing in a country, what types of pro-poor policies and expenditures should be promoted?

3.1 The impact of economic policy reform on the poor

Kanbur (2001) provides a seminal discussion of the current state of debate on the effects of economic policy reform on poverty (or, more accurately, on the poor). He identifies three areas of disagreement over whether or not 'liberal' economic policies are pro-poor—aggregation, time horizon and market structure. The source of disagreement due to aggregation is explained clearly by an example. Economic measures of poverty mostly focus on what is happening to national headcount poverty (the percentage of households or individuals living below some poverty line). Those who work at the grassroots tend to invoke personal experience of what is happening to particular households (in, for example, a study village or region). It is therefore not unusual for the first group to argue that poverty (overall) is declining whereas the second group counters that, in their experience, poverty has increased. Both may be right, as they are talking at different levels of aggregation. It may even be the case that the percentage of the poor in poverty may decline while the absolute number increases (given population growth).

Economists (and those who could be said to adopt the 'economists view') tend to think in terms of the effect of economic policy over a medium time horizon (say 5-10 years). That is, they are concerned with what is likely to be the outcome when the economy has adjusted to the economic policy reform. This is not to say that economists ignore adjustment costs and the fact that some will suffer (on the contrary, many emphasize the need for social safety nets and the role of compensatory policies), rather that they look beyond these costs. Others, again especially those at the grassroots, are concerned precisely with those among the relatively poor who are suffering the costs of adjustment. To such people, 'short-run survival trumps medium-run benefits every time, if the family is actually on the edge of survival' (Kanbur 2001: 1089). Thus, the proponents of liberalization argue that reform is necessary for economic growth and this offers the opportunity for future poverty reduction, accepting adjustment costs as a 'no gain without pain' sacrifice. The critics of liberalization counter that they see the pain, but where's the gain? As with aggregation disagreements, there is truth in both sides of the argument. The common ground is that both sides recognize the need for policies to protect the poor from the costs of adjustment (although they may disagree on the detail).

The greatest disagreement is over perceptions of the underlying distribution of economic and political power. While most economists recognize the problems of imperfect competition and the need for regulating the behaviour of monopolistic firms, economists tend to base their arguments on an assumption of competitive markets. In other words, competitive efficiency is the analytic norm, and excessive market power is a distortion or exception. Critics, and the 'anti-globalization' protesters are an example of this, are more likely to see concentrated market power as the norm, and inequality in the distribution of power as increasing. Competitive markets are an academic concept at variance with what is observed in the real world. This disagreement is important and intense, and an important area for future work. For example, there is increasing recognition of the need to address the behaviour of multinationals in the context of multilateral (WTO) trade liberalization (e.g. Morrissey 2002). However, this is beyond the scope of the current analysis.

These sources of disagreement have important implications for the design of pro-poor policies, and are thus relevant to our consideration of conditionality for debt relief. At stake is getting the right balance between adjusting the reform policies to make them pro-poor and including targeted expenditures to benefit the poor during periods of reform. The issue of aggregation relates to whether one concentrates on the effects for particular groups (typically the poor) or on the economy overall (allowing that there are winners and losers, the issue is whether the net gain is positive and whether the losers are compensated).[7] Policies that promote economic growth are generally good for the poor on aggregate, and are desirable for this reason. Specific groups will suffer, and these are likely to be the relatively poor, implying a need for additional, compensatory policies targeted at those groups (Morrissey 2000). Provided this is acknowledged, there is nothing inconsistent with advocating broadly liberal economic policy reforms and having a poverty reduction objective.

3.2 Debt relief and pro-poor policies

The HIPC-II scheme, agreed in 1999, is based on conditionality linking debt relief to policies for poverty reduction. Stated briefly, countries are required to establish a good record of implementing economic and social policy reform and prepare a PRSP indicating how they will tackle poverty reduction. In the terminology above, PRSPs include pro-poor complementary policies and compensatory expenditures. However, it is the record on implementing broad economic reform, not the PRSP or pro-poor policies, that determines eligibility for HIPC relief, the timing of the decision point and the triggers for reaching completion.[8] The funds made available by debt relief would be then channelled into poverty-reduction, typically through a poverty action fund (PAF) that identifies pro-poor expenditures. Thus, there is incoherence insofar as the pro-poor element of the package does not 'kick in' until after compliance with liberal economic reforms (this is discussed again in Section 4). A number of observations are in order with respect to this process.

- As with HIPC-I, to qualify for debt relief countries must demonstrate their ability for sound economic management through satisfactory compliance with and implementation of policy reforms over three years under IMF and World Bank programmes. This is the condition on which selectivity is based. Yet 'satisfactory compliance' inevitably implies judgement, and even governments trying to comply may find themselves thrown off course by external shocks (such as the increasingly frequent and calamitous weather shocks). The inherent problem with selective conditionality is that it is the donors, specifically the international financial institutions (IFIs, the World Bank and IMF), that both stipulate conditions and judge compliance and their criteria are not transparent.

- Unlike HIPC-I, to qualify under HIPC-II countries must also draw-up a poverty reduction strategy paper (this is where pro-poor policy enters). The PRSP process should include consultation with civil society and other interested parties. While commendable *prima facie*, involving affected parties in the design of poverty-

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7 Non-economists often criticize economists for considering only the aggregate effect, whether the net effect is likely to be positive. In fact, welfare economics places strong emphasis on distribution—a change is only welfare-improving if the net effect is positive and nobody is made worse off (i.e. the gainers compensate the losers). This of course does not require that the poor become non-poor, rather that the non-poor do not become poor (or that nobody becomes poorer). However, welfare criteria can easily be made pro-poor simply be attaching a greater weight to the welfare of the poor (and this is what the critics are in effect doing).

8 An established record of implementing policy reform over three years is the requirement to reach the decision point, at which point a commitment for debt relief is made. The completion point is deemed to be reached after a further period of sustained reform, often interpreted as three years, and then relief is actually granted. In effect, credit is given for previous reform so that a country can qualify for relief within three years.

reduction strategies, this is a highly demanding condition. On the one hand, as elaborated above, there is no consensus on what actually constitutes a 'pro-poor growth strategy' while the impact of economic policies on poverty is not well understood. On the other hand, 'consultation with civil society' is a politically sensitive topic.

– The Fund and Bank must endorse and assess the PRSP. They will then agree with the government a policy reform and macroeconomic management programme to be followed during the HIPC period. Consequently, there will be some degree of cross-conditionality (Killick 2000). The poorest countries, almost by definition countries with weak policy-making and implementation capacity, are being required to design and implement a sophisticated programme of linked policies. This is likely to stretch political capacity and may undermine commitment.

– Performance criteria, monitoring and review will be applied regularly and relief will be disbursed in tranches. The timetable will depend on how well the government complies with the PRSP and policy programmes agreed. Upon completion, which requires implementation of the PRSP for at least a year, debt relief is provided without conditions. The inherent defect with this approach is that the resources to fund pro-poor expenditures are not released fully until the end of the process. The problems experienced with conditional lending in the past remain. The effectiveness of HIPC-II will depend on the time-frame and severity with which implementation is evaluated.

A major criticism of HIPC-I was its excessive reliance on conditionality (Killick 2000). Campaigners for debt relief have argued that conditionality can be used by donors to avoid granting the promised relief. If the conditions for macroeconomic stability and policy reform are demanding, it will be difficult for debtor countries to qualify for relief. Furthermore, the debt burden itself may be one reason why the debtor has difficulty meeting the conditions. HIPC-II, in requiring a PRSP to be drawn-up by the country that meets Fund/Bank requirements may make eligibility more difficult to achieve for the poorest countries. The severity of conditionality is a major concern in any debt relief programme. HIPC-II, by appearing to increase the conditions required, and by making these a criterion for pre-selection, is very demanding of poor countries.

Another difficulty arises in trying to make the process pro-poor. One approach is to make the conditions pro-poor, by adapting the types of economic policies that constitute 'a good record of implementation' as defined by the IFIs. An alternative approach (that is not exclusive of the former) is to place the pro-poor policies in the PRSP. As this is in keeping with the argument for complementary and compensatory policies above, it is the approach discussed.

On the face of it, PRSPs are about listing the policy areas of specific concern to the poor and providing a list of proposed actions in these areas. As such, there appears something of a template that includes education, health, agriculture, water and security. Other areas may be included, but these are the core. Similarly, the policy detail may differ from country to country (although PRSPs rarely include much detail on policy actions), but all will address these five areas. Of course, for most countries, especially HIPC ones, these areas encompass the issues of greatest importance to the welfare of the poor, especially if interpreted broadly. As our interest is in general principles rather than fine detail, discussion under these areas is appropriate.

The essential pro-poor policies in PRSPs can be considered under two headings—those relating to the provision of and access to public services and those relating to the rural sector, as the majority of the poorest in HIPC countries are in rural areas. The former are mostly pro-poor expenditures while the latter are mostly pro-poor policies. Consumption of public services is an important element of the well-being (or real income) of the poor, usually omitted from income-based measures of poverty (Kanbur 2001). The most important services are education, especially at the primary level, health (including nutrition) and water (sanitation and access to safe water). To maximize the consumption of the poor, it is necessary not only that public services are delivered but also that they are available for free (at least for the relatively poor). Charges for access to health or education (including implicit charges, such as for school uniforms, textbooks or drugs) bear disproportionately on the poor. Even if they do make efforts to meet these charges, and thus secure access, this implies a severe reduction in income available for food and other basic needs. Consequently, increased public spending on the provision of social services is a central element of PRSPs. The abolition of charges or the inclusion of specific targeting schemes provides the means of ensuring that such expenditures are pro-poor.

Policies to address poverty in low-income countries must address the rural dimension, especially the relevance of the agriculture sector that provides the livelihoods for most rural people. 'Seventy-five percent of the dollar-poor work and live in rural areas; projections suggest that over 60% will continue to do so in 2005' (IFAD 2001: 15). Policies to address rural poverty must tackle four types of inequalities (IFAD 2001). First, the rural poor have unequal access to physical and financial assets—distribution of land is highly concentrated and the poor are disadvantaged in access to irrigation, safe water, credit and productive assets. Second, the poor require access to technology and extension services to increase productivity. Third, markets tend to discriminate against the poor (this relates to the issue of market structure mentioned above). Fourth, institutions, political and financial, often fail to serve the poor. PRSPs typically contain a range of policies directed towards subsistence and small-holder farmers, intended to support a pro-poor agriculture policy.

The role of debt relief itself is to provide increased government resources to finance these pro-poor policies; the poverty action fund (PAF) details how savings on debt servicing will be spent, and monitors expenditure. The conditionality associated with debt relief under HIPC is intended to assist in two further ways. First, the record of sound economic policies should ensure that the country has in place pro-growth policies, including policies to reverse any bias against agriculture. Second, the PRSP process should ensure that the needs of the poor are recognized and pro-poor policies adopted by the government.

3.3 The policy environment for pro-poor policies

We have now identified some priorities in pro-poor policies. To see how these can be turned into policy actions, and to identify an effective role for donors, it is useful to place the 'pro-poor agenda' within the policy process discussed in Section 2. One way of summarizing the policy environment for poverty reduction is on two dimensions.

Political commitment can be either low, where the desire and capacity to adopt pro-poor policies are weak, or high, where preferences and capacity are strong. Similarly, administrative capability can be weak, such that only a few fairly simple reforms are feasible, or strong, such that the reform programme can be more ambitious. An advantage of this approach is that specific types of pro-poor policies can be classified according to whether they are more demanding of political commitment or of administrative capability, or both. This can be represented in the four quadrants of Table 2 (following Morrissey 1999, but here applied to poverty reduction policies). An appropriate objective in the design and sequencing of reforms is to keep the range of reforms narrow and increase complexity as commitment and capability are expanded. Successful implementation of even simple reforms can promote commitment and enhance the capability for attempting more complex reforms.

If a country has neither the desire nor means to commence reform (cell I) then only minimal reforms are likely. Countries with such an environment (e.g. where there is a strong bias against agriculture) are unlikely to embark on a PRSP process, as that requires commitment, so most poverty-reduction will be embodied in donor projects (aid is used directly). Donor dialogue plays a role here to shift preferences towards poverty reduction, and initiating the PRSP process can be a central element of such dialogue. For a country initially in this position, shifting preferences and then supporting political capacity are the appropriate functions for external agencies.

High commitment, or at least preferences for poverty-reduction, but low capability (cell II) is perhaps the most common case in Africa. Governments may have adopted and embarked on the PRSP process but administrative capability is the constraint that must be relaxed. Aid in the form of technical assistance can be very important here. Given the weak capability, it is inadvisable to attempt wide-ranging reform, so a sector focus is helpful. Donor initiatives in sector-wide approaches (SWAPs) are appropriate, and our earlier discussion suggests a focus on agriculture and social sectors (health and education). As policy-making capacity is weak, ownership need not be emphasized (it is commitment that really matters) and appropriate policy strategies can be offered or even imposed.

Table 2
Policy environment for pro-poor policies

		POLITICAL COMMITMENT	
		Low (weak preference and capacity)	High (strong preference and capacity)
ADMINISTRATIVE CAPABILITY	Weak	**I (minimal)** donor dialogue donor projects initiate PRSP	**II (incremental)** sector focus (e.g. SWAPs) technical assistance/PAF 'imposed' strategy
	Strong	**III (erratic)** interim PRSP targeted schemes dialogue	**IV (extensive)** consultative PRSP integrated budget 'owned' strategy

Note: Basic structure taken from Morrissey (1999: Table 4.3), although that relates to trade liberalization policies.

As so few African countries have a strong administrative system, the case of strong capabilities but low commitment (cell III) is rare. Unfortunately, and for the same reason, the case of strong capability and high commitment (cell IV), where extensive reforms can be implemented successfully, is also rare. Nevertheless, cell IV is the objective and the notion of the policy environment cautions for gradual sequenced policies that build administrative capability and political commitment. Donors can do much to assist in capacity building. In practice, it may be more meaningful to interpret cell III as representing an intermediate point between a 'minimal' and 'incremental' policy environment. As preferences are shifted and administrative capability is strengthened, political capacity becomes stronger. However, the underlying weakness in capacity suggests that such a phase is unstable and associated with 'erratic' policies, as policy reversals arise to placate strong opposition. It is because this phase is unstable that extensive reforms are not feasible; these require the establishment of adequate commitment and capability. Only then can one have a truly consultative PRSP process, an integrated budget (as donors trust the ability of the recipient to monitor spending) and, ultimately, pro-poor policies that are owned by the country.

4 Conclusions: Implications for conditionality

The basic argument of this paper is that the potential for implementing poverty reduction policies is conditioned by the policy environment in developing countries. Of central importance are government preferences for pro-poor policies and the political capacity to promote a pro-poor agenda. Taken together these create commitment. Persuasive economic arguments supported by relevant research can shape preferences while technical and financial support can enhance political capacity. Through such interventions donors can help to establish commitment to poverty-reduction strategies. A poverty-reduction strategy requires increased spending in certain sectors. Developing countries have limited capacity to reallocate spending from domestic resources to any significant degree, and limited ability to increase revenues. Aid can here play its traditional role of bridging a financing gap. More importantly, debt relief is important to release resources for allocation to pro-poor expenditures.

The binding constraint to increasing pro-poor expenditures is resources, and donors can relax this (especially as new resources obviate the early need for domestic redistribution that can undermine reform and growth). Pro-poor policies, on the other hand, are more difficult to design and imply redistribution. They therefore require stronger political capacity and administrative capability. This problem is compounded by the disagreements and limited knowledge on the effects of economic reform on the poor. If the primary objective is poverty reduction, therefore, the prior policy is pro-poor expenditures, and this is a feasible implementation objective (conditional on the policy environment that prevails). Pro-poor policies, however desirable, are of secondary priority. They are more difficult to design and achieve, and external intervention can as easily be counter-productive as it is constructive. Pro-poor expenditures offer a first stage in building commitment and a foundation for pro-poor policies.

What are the implications for conditionality? The obvious implication is that the current approach to HIPC conditionality reverses these priorities. The resources for pro-poor expenditures are only released after a record of policy reform has been demonstrated and after the basis of a pro-poor policy is outlined. This is not necessary, and results from a misguided approach to conditionality. It is not that pre-selection is a misguided principle. Rather, the implication is that eligibility for the release of resources (aid and debt relief) should be based on pro-poor expenditure criteria. This is more simple, and more transparent, than eligibility criteria based on a package of economic reforms that interact in complex ways, are often contested regarding appropriateness, and can be undermined by poor economic performance (not infrequently due to events beyond the control of governments). Support for broader economic reform may require eligibility criteria, but these could relate to pro-poor policies and should not be a precondition for release of funds for pro-poor expenditures.

There are at least two reasons why conditions may be attached to debt relief. First, the donors want to encourage policy reform in a particular direction. A distinction can be made between pro-growth reforms intended to enhance the opportunities for economic performance, about which there is some dispute, and specific pro-poor policies and expenditures, about which there is less dispute. The inherent problem with current HIPC arrangements is that the first set of conditions determines eligibility whereas the second only come into effect once the PRSP is accepted and resources are released. This blurs the distinction, and can delay the implementation of pro-poor policies that do not require comprehensive economic policy reform. In particular, this approach delays the disbursement of pro-poor expenditures. Second, conditions are criteria for monitoring the compliance required, if aid flows are to be maintained or debt relief granted. In this sense, conditions (by stipulating what must be done) serve an enforcement role by triggering eligibility. This further blurs the distinction between types of reform.

It is important to note that these two 'roles' of conditionality may conflict. Typically, the extent of reform the donor wants to encourage will be broader and deeper than the minimum reform required to maintain aid flows. In other words, the level of reform required to continue receiving aid is less than the level of reform required to be eligible for debt relief. This conflict lies at the heart of the problems and ineffectiveness of conditionality, as it gives rise to a signalling problem. Recipients want to signal a commitment to reform in order to be eligible for debt relief. Whatever the level of genuine reform they wish to implement, recipients will only see a need to meet the minimum requirements. If the compliance conditions are set too high, even recipients that are genuinely trying to reform may be denied relief (there are many reasons other than intentional behaviour to explain failures in implementing reforms). Alternatively, if the conditions are set too low, insufficient reform is encouraged. Donors do not know how much reform a recipient really wants to implement, therefore may set the conditions at the wrong level (White and Morrissey [1997] provide an exposition of this argument). A general resolution to this problem is to allow the recipients to set the target level of reform, and donors can decide whether this is acceptable. This is implicit in the spirit of HIPC selection criteria, but is not so evident in the application.

A related problem is how compliance is assessed. In the case of aid, it is the donor who decides the conditions and if compliance is satisfactory. A donor wishing to continue disbursing funds faces an incentive to tolerate more non-compliance than really desired. Consequently, levels of compliance (evaluated against the time-frame of the aid agreement) were often low without punishment being triggered. Allowing the recipient to in effect establish the conditions (the target level of reform) reduces the uncertainty and makes it more credible for the donor to assess acceptable compliance. The recipient wants to propose sufficient reforms to be acceptable to the donor, but not so much as to run the risk of non-compliance and punishment. This incentive structure encourages recipients to commit to a feasible level of reform. Donors, if they accept this as the minimum target, could still offer additional incentives for exceeding the target.

A similar line of argument can be extended to debt relief. To facilitate future fiscal and debt sustainability, donors (who are the creditors) are justified in desiring pro-growth reforms, hence such reforms have been the basis for eligibility. Donor emphasis on poverty reduction lead to the addition of pro-poor policies under the PRSP in HIPC-II. These were not part of the eligibility criteria, and thus have implicitly been subject to softer conditionality based on performance indicators rather than the implementation record. Pro-poor expenditures are in a sense an add-on, being activities that support implementation of pro-poor policies. However, although the PRSP allows the debtors to set the performance indicators for the PRSP (pro-poor policies and expenditures), the IFIs in effect set the tighter pro-growth conditions for eligibility. Thus, tighter conditions (with greater likelihood of unsatisfactory compliance) are applied to pro-growth policies than apply to pro-poor policies. By implication, countries that could implement pro-poor policies, especially expenditures, are being at least constrained, if not prevented, from doing so by being denied eligibility. Reversing these implicit priorities could enhance the provision and effectiveness of debt relief.

Four measures to reform HIPC conditionality to promote and support pro-poor policies are recommended.

- Aid resources should be deployed to support pro-poor expenditures, the only condition being the existence of an *expenditure strategy, monitoring arrangements and performance indicators*.

- Debt relief should be initiated subject only to a PRSP plan being in place. This facilitates the initiation of pro-poor policies. The minimum conditions for eligibility should not be very tight, otherwise countries trying to reform may be unfairly punished. Softer conditions favour genuine reformers by allowing them to signal good intentions by exceeding the performance targets.

- Debt relief can be accelerated when an appropriate package of pro-growth policies is in place. The developing country should be allowed to establish the level of reform intended. The aim is to get countries moving in the right direction. In this way conditions can support or underpin government policy.

- Conditions should be part of a negotiating incentive strategy rather than as a coercive punishment strategy, and used to encourage rather than force policy reform. Conditions should be consistent and policy coherent.

Has the PRSP process enhanced the capacity of aid to contribute to poverty reduction? The answer is an unequivocal yes, but there remains considerable room for improvement. In particular, the need to meet eligibility criteria has delayed the granting of debt relief, hence delayed the release of funds for pro-poor expenditures. The requirements for broader economic policy reform, under our proposals, would be lessened and de-linked from initial debt relief. There is no necessary reason why this would undermine the reform process in any country. In fact, front-loading support for pro-poor policies is likely to enhance commitment to and potential for economic and social reform.

Policy advisors and donors, who tend to be the major proponents of poverty-reduction strategies in developing countries, should show greater awareness of the prevailing policy environment, and work with it rather than against it. Donors can assist the policy-making process through providing technical assistance and aid, to support the budgetary costs at the initial stage of moving to poverty-reduction strategies and to support projects and sector programmes directed at helping the poor. Donors can also help to increase administrative capability; support for technical assistance and training is the most obvious mechanism. Technical assistance is equally important in contributing to policy-making capabilities, also enhancing administration but perhaps at a higher level. In both contexts, but especially the latter, it is best if the assistance is in and through, rather than simply to, the government. Most importantly, implementing pro-poor policies should not be held hostage to judgements regarding the broader policy reform agenda.

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