UniS

Discussion Papers in Economics

THE VIABILITY OF ECONOMIC REFORM PROGRAMS
SUPPORTED BY THE
INTERNATIONAL FINANCIAL INSTITUTIONS

By

Graham Bird
(University of Surrey)

Wolfgang Mayer
(University of Cincinnati)

&

Alex Mourmouras
(IMF)

DP 06/05

The Viability of Economic Reform Programs Supported by the

International Financial Institutions

Graham Bird

Wolfgang Mayer

Alex Mourmouras*

Abstract

In seeking to make programs of economic reform supported by the IFIs more successful it is important to ensure that they are viable. Will governments be persuaded to participate? Will they complete the programs they negotiate? And will the IFIs be prepared to provide the resources? This paper formally analyses the factors influencing viability. It examines the constraints on participation and the need for incentive compatibility. The analysis identifies the threats to viability and the direction that reform should take. It places the effectiveness of programs firmly within a political economy framework and extends recent theories of program implementation by examining participation from the viewpoint of both the governments that demand assistance and the IFIs that supply it.

*Bird: Department of Economics, University of Surrey, Guildford, Surrey GU2 7XH, UK; Tel: +44 (0)1483 689325; Fax: +44 (0)1483 689548, Email: g.bird@surrey.ac.uk. Mayer: University of Cincinnati, Cincinnati, Ohio, USA. Tel: 513-556-2618, Fax: 513-556-2669, E-mail:mayerw@uc.edu. Mourmouras: IMF Institute, Washington, DC, 20431; Tel: 202-623-5402; Fax: 202-589-5402. Email: amourmouras@imf.org.

There is a large and long-standing literature on the design and impact of programs of economic reform supported by the international financial institutions, particularly the International Monetary Fund and the World Bank. More recently, however, attention has shifted slightly to examine the implementation of programs. The idea here is that programs will not be effective if they are not implemented. Moreover, since the record on implementation has been poor, the issue appears to be one of practical importance. The interest in implementation has spawned research into both the theory underlying it, and the empirical evidence relating to it. What factors influence the implementation of programs? The theory has focused on the role of interest groups and 'veto players' who may be in a position to effectively oppose the economic reform incorporated in programs. The empirical evidence, limited as it is, has broadly confirmed the claim that political economy factors exert a significant effect on implementation.[1]

At the same time, policy changes made by the IFIs have been designed to facilitate and encourage the improved implementation of programs. In the case of the IMF these have concentrated on streamlining conditionality - reducing the number of conditions in IMF programs, and on encouraging wider participation in the negotiations that culminate in programs, in an attempt to increase 'ownership'. The presumption is that governments are

---

[1] Drazen (2002) and Mayer and Mourmouras (2002) develop theoretical models. IMF (2001a, 2001b) summarize some of the empirical evidence. Bird and Willett (2004) and Mody and Rebucci (2005) evaluate program implementation.

more likely to implement programs that are nationally 'owned' and less likely to implement those that are perceived as having been imposed from 'outside'.

This paper aims to make a contribution to the evolving literature on IFI-supported programs by taking a somewhat different, although related, approach. It focuses on the issue of 'viability'. Following Dixit (2000, 2001), we view IFI-supported programs as incentive mechanisms. An IFI-supported program will be viable where there is sufficient incentive for a government to seek support from the IFI, sufficient incentive for the IFI to provide the support and sufficient incentive for the government to see the program through to completion. A failure with respect to any one of these requirements will make the program non-viable. Different players will be involved in determining whether a program is viable, and will be looking for different things from it. Special interest groups (SIGs) that have been advantaged by the policies that have been pursued in the period prior to the program will be looking to retain the rents that they have enjoyed. The general public will be looking for benefits from economic reform in the guise of a higher standard of living. Governments will be looking to enhance their chances of retaining power and strengthening their position vis-à-vis opposition groups. The IFI will be looking for improved economic performance in borrowing countries such that the provision of its support only needs to be temporary; it will be anxious to ensure that the borrowing country is in a position to repay the IFI credit that it has used. Otherwise the IFI's own financial status - not to mention its reputation - will be threatened.

It is in the nature of policy reform in general that not everyone will be happy about it. There will be gainers and losers. This is also the situation in the context of reform supported by the IFIs . The question is then whether the extent and nature of any 'unhappiness' is sufficient to sabotage the program. If it is, the program will not be viable; unless measures are simultaneously taken to effectively deal with the unhappiness.

The key players in determining the viability of IFI programs will be the government of the country which decides to seek support and the IFI which decides whether to supply it. By agreeing to implement, and then implementing agreed policies, governments are likely to lose domestic political support from some quarters. Their incentive to negotiate and implement a program of economic reform must derive from the belief that improved economic performance will garner sufficient additional political support from elsewhere to offset this loss. A difficulty for the government is that the losers from a program may incur their loss relatively immediately whereas the gainers may benefit only in the longer term. As a result there will be greater uncertainty surrounding the potential gains. Perhaps particularly with regard to the benefits, belief and reality may differ. As a consequence it is entirely possible that governments that have chosen to embark on a program will subsequently choose to abandon it when it does not deliver the intended outcomes. A program that appeared viable *ex ante* may therefore turn out to be non-viable *ex post*.

This paper examines these issues in greater detail in an attempt to provide a structured analysis of the viability of IFI programs. The paper is organized in the following way. Section 1 provides a descriptive discussion of the factors that are likely to influence viability.

Section 2 builds on this discussion to present a narrower formal model, which emphasises the need for incentive compatibility. The model illustrates how viability will be undermined if programs are inconsistent with a series of constraints, under which participants are operating. Section 3 examines the policy implications of this analysis and relates them to contemporary policy initiatives. Section 4 offers some concluding remarks and identifies the limitations of the analysis as well as examining the scope for future research.

1. THE VIABILITY OF IFI- SUPPORTED PROGRAMS: THE ISSUES.

A simple view is that governments turn to the IFIs for assistance when they encounter problems that undermine the sustainability of their balance of payments and when they value the additional resources that the IFIs provide and the policy advice offered. Equally tempting would be to perceive governments as 'unified' actors receiving universal and comprehensive national support for their policy actions. Under this scenario, governments would be fully committed to the policies negotiated with the IFIs and would attempt to complete programs and implement all the conditions laid down in them. The 'success' of programs would then essentially depend on their design. Do they identify appropriate policy actions and are they sufficiently robust to withstand exogenous shocks? If they have these features, they will work.

Early research into IMF conditionality tended to look at programs supported by the Fund in this way. It focused on their design and their impact on final macroeconomic outcomes, including the balance of payments, inflation and economic growth. It also examined the effect of programs on policy instruments such as fiscal policy, monetary policy and exchange

rate policy, and the importance of these policy instruments in terms of their implications for macroeconomic performance. The assumption seemed to be that programs designed appropriately from a technical point of view would work, while those that were designed in a technically inappropriate way would not.

In practice the reality is likely to be far different. Governments are often unlikely to be 'unified'; there may be a significant degree of disagreement and debate about appropriate policy even within the confines of government. Moreover, governments are likely to encounter a degree, and perhaps a substantial degree of national disunity. They may be confronted by a wide range of special interest groups with varying amounts of political power. Policy decisions may therefore be based on fragile coalitions which in turn mean that policy reform is vulnerable rather than robust. Governments will still turn to IFIs such as the IMF when they see a program as conferring more benefits than costs, and will continue to implement it for as long as this remains the case, but the assessment of the costs and benefits will in reality be complex, subtle and nuanced (Bird, 2004).

Governments always have policy options; sometimes more and sometimes fewer. The choice to select one option is, broadly speaking, a choice to reject others. The choice made by a government to turn to an IFI is therefore a choice to reject the alternative policy options that could be pursued outside the auspices of the IFI. What is the basis for this choice?

Different policy choices involve differing arrays of costs and benefits. There will be a both cross sectional and a temporal dimension to these. At any one moment in time there will be

gainers and losers from particular policies. However, their identity may change over time as a consequence of changes in the profile of costs and benefits. Governments anxious to retain power will not want to lose the support of powerful interest groups. To be persuaded to adopt policies that reduce the rents accruing to such groups, governments will need to believe that, by following these policies, they can muster offsetting political support from other sources. If this support is not forthcoming, governments may decide to renege on their policy commitments and cease to carry them through. In these circumstances policy slippage is not the initial intent but a response to evolving events. In another scenario, however, it may always have been a government's intention to renege on its policy commitments in order to retain the continuing support of interest groups that benefit from the *status quo ex ante*.

From this discussion a number of elements may be discerned that contribute to and together determine the viability of IFI-supported programs. First, for governments to seek assistance from IFIs they must believe that this is the best, or least bad, option available to them. Referral to an IFI will unavoidably be a political decision; after all a government is in effect sacrificing a degree of sovereignty over the design of economic policy. Does the decision to involve the IFI lead to a net loss or net gain in terms of political support? The answer will depend on the political influence of those who are affected by the policies incorporated in programs, either positively or negatively. More accurately their reactions will depend on their *perceptions* of loss or gain. There will be a difficult political calculus for governments involving a substantial amount of uncertainty which the government may seek to influence by offering to compensate losers, or by affecting expectations concerning the impact of programs.

A second factor influencing the viability of programs relates to the evolution of costs and benefits throughout their intended lifetime. Adverse exogenous shocks will tend to increase the costs of meeting quantified policy targets and will impinge negatively on viability. Furthermore, SIGs that bear the costs may turn out to be more powerful politically than imagined by the government *ex ante*, or may feel that any compensation they have received is inadequate. Their opposition to reform may transpire to be greater than expected making the program less viable. Alternatively the gains may turn out to have been over-estimated so that the additional support for policy reform coming from the general public emerges as being insufficient to ensure the viability of programs, given the resistance of disadvantaged SIGs. As a result the reform process may peter out and IFI-supported programs will remain incomplete.

There is a third factor affecting viability. For a program to be agreed, the IFI must have a reasonable presumption that it will be implemented and will succeed. There are two related elements to this. One is that the credit (loan) will be repaid. Non-repayment will adversely affect the IFI's financial status and reputation and will mean that the revolving nature of its resources will be at risk. A second is that the structure of incentives, as perceived by the IFI, will encourage governments to complete programs. In as much as completion contributes to their success in terms of macroeconomic outcomes, this will in turn enhance governments' ability to repay.

In short, the above discussion suggests that governments will be willing to participate in IFI-supported programs if they believe that the financial resources thereby acquired will allow them to offer some compensation to groups disadvantaged by the program or that improved economic performance will sufficiently quickly generate wider public support for the policy reform incorporated in the program so as to offset the loss of support from SIGs. The IFI will be willing to participate if it believes that improved economic performance will generate the extra resources that will allow the credit to be repaid and still offer a net increase in national welfare. Where repayment instead hinges on reducing national welfare, the IFI's concern will be that this will erode national support for the program, making it non-viable. Can we model these basic ideas more rigorously?

2. A MODEL OF PROGRAM VIABILITY.

a. The Players

The requirements of program viability can be modeled by considering an asymmetric information version of a model of IFI lending in the tradition of special interest politics (see Mayer and Mourmouras, 2002, 2005). There are three main players, the government of the assistance-receiving country which chooses economic policies, a domestic interest group that provides political support to the government in exchange for policy distortions, and an international financial institution (IFI) that decides whether to provide loans to the government in support of policy reforms intended to reduce these distortions. The government maximizes its overall political support which, following Grossman and Helpman (1994, 2001), depends on support from the general public and financial resources to be used

for political campaigns. The public's support is directly related to the performance of the economy as measured by national income net of repayments for past assistance, Y. Financial resources are obtained from interest group contributions, C. The government's political support function, G, is written as:

(1) $\qquad G = C + aY$

where $a > 0$ is a parameter expressing the importance of the public's well-being for support of the government. Income that can be spent by the public is:

(2) $\qquad Y = g(T)y - z,$

where y denotes national income in the absence of assistance, T is the amount of aid received, z is the amount that has to be paid back to the IFI, and $g(T)$ is a function that indicates the magnifying influence of assistance on national income. It is natural to assume that foreign assistance raises national income and that it is subject to diminishing returns: $g(0)=1, g(T>1,$ $g'(T)>0$ and $g''(T)\leq 0$ for all $T>0$.

We consider a time period that is sufficiently short so that we can take the economy's resource base as fixed and focus on the stochastic nature of national income. In the absence of assistance, national income depends not only on these resources but also on the outcome of the state of nature. We assume here that there are only two possible states of nature, a good one and a bad one: the high-output state of nature is denoted by $\bar{y}$, while the low-output state is $\underline{y}$. The value of $\Delta y =(\bar{y} - \underline{y}) > 0$ is a measure of the variability of economic performance.

While actual output is publicly observable to all domestic and international agents, neither the government nor the IFI know with certainty what caused this output level. It is common knowledge, however, that the probability of the high-output state occurring is greater when the economy is reformed than when it is distorted. Specifically, let $0<\pi<1$ be the probability of attaining high output when the economy is reformed and $0<\pi_o<\pi_1<1$ be the probability of attaining high output when the economy is not reformed. The IFI not only cannot observe whether the government really implements the promised reforms, but it also cannot observe whether the government continues to receive support from interest groups. While the IFI cannot observe whether an actual contribution has been made, it can calculate how much the interest group would give if no reforms were instituted and that it would not give anything at all if reforms were implemented.

The IFI's goal is to channel assistance to the developing country in order to raise world welfare. This objective is to be achieved through two channels: the flow of resources, *T,* and the correction of policy-created distortions of the economy through market reform. The IFI makes the repayment conditions to its loans dependent on economic performance. The payback when output is high is denoted by $\bar{z}$, whereas $\underline{z}$ indicates the payback when output is low. Success of this conditional assistance program requires that certain conditions are satisfied.

b. Viability Constraints

Participation Constraint

First, acceptance of assistance and implementation of market reforms must yield at least as much overall political support for the government as it has with no assistance and no reforms. This leads to the following *participation constraint*:

$$(3) \qquad a\{g(T)[\pi_1 \bar{y} + (1-\pi_1)\underline{y}] - \pi_1 \bar{z} - (1- \pi_1)\underline{z}\} \geq ag(0) [\pi_o \bar{y} + (1-\pi_o)\underline{y}] + C.$$

The left-hand side (LHS) of (3) states the government's expected political support when the government receives assistance T, which raises productivity, $g(T) > 1$, and implements market reforms which raise the probability of the economy doing well, $\pi_1 > \pi_o$, but also results in the loss of political support from the special interest group. When market reforms are implemented, the interest group no longer enjoys a privileged position and, therefore, it will no longer contribute. As the LHS of (3) states, the IFI program calls for repayment of $\bar{z}$ when the economy does well and of $\underline{z}$ when the economy does poorly. The RHS of (3) expresses political support when there are no IFI resources, $T=0$, a lack of market reforms keeps the probability of the good outcome at a lower level, and the interest group contributes C. As discussed later in this section, the equilibrium value of C is endogenously determined, based on the relative bargaining powers of the government and the SIG.

Incentive Compatibility Constraint

Assuming that (3) is satisfied, so that the government has an incentive to accept assistance T from the IFI rather than going it alone, a second requirement for program viability relates to the government's incentive to actually implement the reforms envisaged in the agreement with the IFI. In light of the private nature of the information the government has about the implementation of reforms, it is entirely conceivable that it will agree to the program, accept the resources from the IFI but fail to implement the agreed reforms, blaming exogenous factors for this lack of compliance. More specifically, incentive compatibility requires that the government's political support be at least as strong when it accepts assistance, implements reforms, and loses support from the interest group as it would be if it took assistance but failed to reform and, thereby, kept the interest group as a financial contributor. This *incentive-compatibility constraint* is stated as:

(4) $\quad a\{g(T)[\pi_1 \bar{y} + (1-\pi_1)\underline{y}] - \pi_1 \bar{z} - (1-\pi_1)\underline{z}\} \geq a\{g(T) [\pi_o \bar{y} + (1-\pi_o)\underline{y}] - \pi_o \bar{z} - (1-\pi_o)\underline{z}\} + C.$

Political Survival Constraints

When the IFI and the government design the assistance program, they must also be concerned that the repayment conditions do not destabilize the government. The general public in assistance-receiving countries are quite sensitive to foreign influences and loss of national sovereignty over policy priorities. If foreign 'interference', in the form of assistance

with conditions attached, is considered to have hurt the economy, the public will try to remove the incumbent government. Clearly, such political instability is not in the government's or the IFI's interests. To avoid it, the program must ensure that the country's income net of repayment is at least as large under the assistance program as in the absence of assistance irrespective of the state of the economy. The following *political survival constraints* are present, one for each state of the economy:

(5) $$g(T)\,\bar{y} - \bar{z} \geq g(0)\,\bar{y}$$

(6) $$g(T)\underline{y} - \underline{z} \geq g(0)\underline{y}.$$

The LHS of (5) and (6) state the actual spendable income of the assistance-receiving country in the good and bad state of the economy respectively when assistance is received and repaid, whereas the RHS states the corresponding income when no assistance is received.

Finally, the SIG maximizes its net income, equal to economic rents earned from the presence of distortions minus financial contributions to the government. The interest group's income is a share s of national income net of repayments. This share critically depends on the implementation of market reforms. It is s_o when there are no market reforms; that is prior to the IFI offering conditional aid to the government of the receiving country. The share declines to s_1 when economic reforms are implemented and the interest group loses its privileged position. Accordingly, welfare of the interest group is:

(7) $$V_o = s_o g(0)y - C$$

in the *status quo* in which there is no assistance, no policy reforms and the interest group makes financial contributions C to the government. And it is:

(8) $\qquad V_1 = s_1[g(T)y - z]$

when the economy is reformed, assistance is received and repaid, and the interest group no longer contributes to the government.

Bargaining and the size of interest group contributions

We now examine the determinants of the size of interest group contributions to the government. The SIG makes a positive financial contribution to the government, $C > 0$, when there are no economic reforms, and it makes no contributions, $C = 0$, when the government reforms the economy. The magnitude of this contribution plays a role in both the participation and incentive compatibility constraints of the government. The loss of the financial contribution represents the cost of implementing economic reforms to the government. The assumption that, prior to the IFI offering conditional assistance, the government does not undertake economic reforms implies that political support is stronger with no reforms and positive contributions from the interest group than with reforms and no support from the interest group; that is,

(9) $\qquad ag(0) \, [\pi_o \bar{y} + (1-\pi_o)\underline{y}] + C \geq ag(0)[\pi_1 \bar{y} + (1-\pi_1)\underline{y}]$.

This suggests that the minimum contribution the government must receive in order to keep it from unilaterally enacting reforms is:

(10) $\qquad \tilde{C} = ag(0)[\pi_1 \bar{y} + (1-\pi_1)\underline{y}] - ag(0) \, [\pi_o \bar{y} + (1-\pi_o)\underline{y}] = ag(0)\Delta\pi\Delta y,$

where $g(0)$ $\Delta\pi\Delta y$ is the expected gain in national income due to the implementation of economic reforms. The actual benefit to the government from no reforming is $(C - \tilde{C})$.

The interest group must also have an incentive to support the government or economic reforms could not be prevented. The expected income of the SIG in the presence of economic reform, when its income share is $s_1 < s_o$ and the probability of high output is $\pi_1 > \pi_o$, is:

$$(11) \qquad s_1 g(0) \; [\pi_1 \bar{y} + (1-\pi_1)\underline{y}].$$

Expected income of the SIG with no reform, when its income share is s_o, the probability of high output is π_o, and it supports the government with financial contribution C, is:

$$(12) \qquad s_o g(0) \; [\pi_o \bar{y} + (1-\pi_o)\underline{y}] - C.$$

Our assumption that, prior to the IFI offering conditional assistance, the economy is not reformed implies that:

$$(13) \qquad s_o g(0) \; [\pi_o \bar{y} + (1-\pi_o)\underline{y}] - C \;\geq\; s_1 g(0) \; [\pi_1 \bar{y} + (1-\pi_1)\underline{y}].$$

It follows that the maximum amount the interest group is willing to contribute is:

$$(14) \qquad \hat{C} = g(0)\{ \; s_o[\pi_o \bar{y} + (1-\pi_o)\underline{y}] - s_1 g(0) \; [\pi_1 \bar{y} + (1-\pi_1)\underline{y}]\},$$

which equals the difference between the SIG's income with no reforms and with reforms.
The net benefit of the interest group is $(\hat{C} - C)$.

The actual value of C is determined through a bargaining process between the government and the SIG. The combined total benefit for government and interest group is $(\hat{C} - \tilde{C})$. How much of this total benefit goes to the government and how much goes to the SIG depends on their relative bargaining strengths. The actual interest group contribution is a linear combination of the maximum amount the interest group is willing to contribute and the minimum the government has to receive in order to stall on implementing economic reforms:

(15) $$C = \gamma \hat{C} + (1-\gamma) \tilde{C}$$

where $0 \leq \gamma \leq 1$ rises in value the stronger the bargaining position of the government.

IFI Solvency Constraint

As already discussed, the viability of a conditional assistance program imposes certain constraints relating to the borrowing government and the public. A conditional assistance program is viable if it satisfies the government's *participation constraint and incentive compatibility constraints,* and the public's *political survival constraints*. In this section, we turn to the conditions on program viability that are imposed by the requirement of IFI solvency.

We assume that the IFI makes loans to a large number of identical countries. The realization of the state of nature is independently distributed across IFI borrowers. Each IFI loan is of size T and is made under the same conditions of asymmetric information already described. The IFI sets its repayment terms so that it breaks even. This policy allows it to maintain the

real value of its capital so that it can continue making loans in the future.[2] IFI solvency

requires that expected repayment to the IFI is at least as large as the value of the assistance

provided; that is:

(16) $\pi_1 \bar{z} + (1 - \pi_1)\underline{z} \geq T.$

In order to determine the factors that make it more likely that the IFI's *break-even condition*

is satisfied we examine what the values $\bar{z}$ and z are. IFI repayment in the good and bad states

of nature must satisfy the participation constraint, equation (3), the incentive compatibility

constraint, equation (4), and the political survival constraints (5) and (6). We now show that

as long as the government receives a larger financial contribution from the SIG than is

absolutely necessary to stop it reforming the economy, the incentive compatibility constraint

and the political survival constraint in the bad state of nature for the economy are binding. In

other words, $\gamma>0$ implies that equations (4) and (6) are binding whereas (3) and (5) are not

binding. That is, the equilibrium values of $\bar{z}$ a nd $\underline{z}$ can be gleaned from equations (4) and

(6). To demonstrate this, we first rewrite (4), stated as an equality, as:

(4') $ag(T)\Delta y \Delta\pi - a\Delta z \Delta\pi = C.$

From (10) and (15), in turn, we know that, as long as $\gamma > 0$, it must be that $C > \tilde{C} = ag(0)$

$\Delta y \Delta\pi$. Substitution of this inequality in (4') requires that $\{[g(T) - g(0)]\ \bar{y}\ - [g(T) - g(0)]\underline{y}\} >$

$\{\bar{z} - \underline{z}\}$. Finally, we substitute (6), stated as a binding constraint, and obtain:

---

[2] This specification could be easily extended to accommodate a growing world economy in which the IFI would
need to earn sufficient income to maintain its size relative to that of the world economy.

(4") $[g(T) – g(0)] \ \bar{y} \ > \ \bar{z}$.

This implies that, when the incentive compatibility and bad-state political survival constraints are binding, the good-state political survival constraint is not binding.

Next we return to (4), stated as an equality, and substitute its RHS into the LHS of (3). This reduces the participation constraint of (3) to:

(3') $[g(T) – g(0)][\pi_o \ \bar{y} + (1-\pi_o)\underline{y}] \geq [\ \pi_o \bar{z} -(1- \pi_o)\underline{z}]$

which, after substitution of (6) when binding, becomes:

(3") $[g(T) – g(0)] \ \bar{y} \ \geq \ \bar{z}$.

It follows from (4") that the participation constraint is not binding either.

We now return to the IFI's *break-even constraint* of (16). Whatever the value of *T* is, this constraint must be satisfied. We already know that $\underline{z} \ = [g(T) - g(0)]\underline{y}$. Hence, the payback in a bad state of the economy is equal to the increase in the bad-state national income that is made possible by the inflow of assistance. The remaining question concerns the value of $\bar{z}$, the payback when the economy finds itself in the good state. To determine this value, we return to the binding *incentive compatibility constraint* of (4') and restate it as:

(17) $g(T)\{ \ [\ \bar{y} - \underline{y}] – [\ \bar{z} - \underline{z}] = C/[a\Delta\pi]$,

which, after substitution of $\underline{z} \ = [g(T) - g(0)]\underline{y}$ reduces to:

(18) $\bar{z} = [(g(T) \ \bar{y} - g(0)\underline{y}] - \ C/[a\Delta\pi]$.

The payback in good times depends on the difference between output under the good state when enlarged through assistance and output under the bad state when no assistance is received minus a term that depends on the level of lobbying expenditure prior to economic reforms, as well as on the government's responsiveness to the public's wellbeing, and the effectiveness of economic reforms in raising the probability of the good state of the economy occurring. Importantly, the larger the contribution of the interest group prior to the implementation of conditional assistance, the smaller is the payback in the good state of the economy. Accordingly, the IFI's break-even constraint is more difficult to meet when the government receives large financial backing from the interest group prior to the reform. Significant dependence of the government's political support on the general public, as expressed by the value of a, and greater effectiveness of reform, in terms of making the good economic situation more likely, enhance the chance of the IFI's break-even constraint being satisfied.

3. POLICY IMPLICATIONS

The analysis in this paper carries with it implications for policy. Policy objectives may be viewed at two levels. At the first level the objective is to identify programs that are unlikely to be viable. If this is possible, it would enable the IFIs to be more selective in the programs that they support thereby improving their track record. IFIs would lend only in support of programs deemed viable. At present a significant proportion of IFI-supported programs fail in the sense of remaining uncompleted. This has led to the perception amongst some observers that the allocation of IFI resources is inefficient, and, in the extreme, to the suggestion that lending should be curtailed.

At the second level, the objective is to enhance the viability of programs and to transform non-viable programs into viable ones. By identifying the potential constraints on viability, actions may be taken to help relax them. In general terms, programs may need to offer short term compensation to groups that are disadvantaged by policy reform. The duration of compensation will depend on how quickly the benefits of the program in terms of economic performance materialise and translate into relatively strong political support from other sectors of society. This in turn means that to the extent that programs have a near term adverse effect on living standards, the duration of this effect needs to be minimised. To make viable programs that are primarily aimed at stabilization, there needs to be the foreseeable and credible prospect of an increased rate of economic growth.

Not unconnected to future growth prospects, IFI-supported programs may need to concern themselves with domestic institutions in as much as these affect the power and influence of special interest groups and the scope for resistance to policy reform. By enhancing growth prospects and reducing the politically strategic importance of SIGs, the design of IFI-supported programs could induce a double effect on viability. However, the precise nature of appropriate institutional reform may be less than clear out. Part of it may be to reduce political influence over economic policy by measures such as granting independence to central banks. But political reform in the direction of greater democracy may cut both ways. While it may reduce the disproportionate influence of some SIGs it may also provide greater opportunity for others to voice opposition to the policies incorporated in IFI-supported

programs. It is perhaps unsurprising therefore that the empirical evidence on the connection between program implementation and democracy is ambiguous.

There is also the fundamental issue of the extent to which the IFIs should become involved in reforming domestic institutions. From one point of view this may be seen as excessive interference and erosion of national sovereignty which lies well beyond the terms of reference of IFIs. From another, however, it may be seen as a necessary step towards improving the viability of programs in which the IFIs have a legitimate interest.

More broadly, the analysis of viability suggests that the IFIs may on occasions rationally elect to support programs that are perceived as technically inferior. There will be little point in advocating programs that are clearly inconsistent with the viability constraints identified in this paper. A technically good and politically viable program will overall be superior to a technically better but politically non-viable one. Of course a central problem here relates to evaluating the factors that impinge on viability; do the IFIs have enough information on them and are they qualified to make judgements on them? Scientific precision may be impossible, but there remain ways in which issues of political economy could be taken into account in a more structured way than they are at present. And taking them into account must surely be preferable to ignoring them if the objective is to improve viability.

The analysis in this paper also sheds light on other policy issues. For example, it helps to explain the observed tendency towards over-ambition in terms of the predicted effects of many IFI-supported programs. To overcome participation constraints (both in terms of

governments and the IFIs) it is logical to talk up the positive growth effects that will confer benefits on the general public and enhance the country's ability to repay the credit received, and at the same time talk down the size of cuts in government expenditure and the size of fiscal correction which may erode existing rents. The problem is that although over-ambitious projections enhance viability by increasing the probability of participation, they also diminish viability in the sense of increasing the probability of failing to deliver on expected outcomes. The general public may be less supportive of a program of economic reform that is associated with increased economic growth of x per cent if they are led to believe that the growth effect will be greater than this. Furthermore, in terms of delivery on promises relating to economic performance, the viability of programs will be reduced by negative shocks. This implies that programs will be more viable when they are effectively 'insured' against such shocks.

Can the recent initiative towards 'streamlining' conditionality and broadening participation be explained in terms of the analysis conducted here? By stipulating fewer conditions there is perhaps less chance that programs supported by the IFIs will directly confront powerful SIGs that can prevent reform. At the same time, an approach that is seen as less invasive may further relax participation constraints by allowing governments to retain a larger degree of national sovereignty over the design of economic policy. Broader participation could in principle have a two-edged effect depending on the form it takes. Where it allows genuine dialogue enabling programs to be modified in ways that reduce resistance to reform, it will have a positive effect. Where it is largely cosmetic and does little to change minds on either side it may have little effect. Indeed its effect on viability may, in principle, be negative

where those consulted perceive the process as 'window dressing' and as having little or no effect on the final design of programs.

The general notion that policy reform relating to IFI-supported programs needs to be built upon their effects on viability, and their impact on the structure of incentives facing participants could be extended to cover issues such as the amount of finance provided, the phasing of finance over time and in relation to the extent of reform undertaken, and the ease with which modifications, waivers and replacement programs can be negotiated. Additional finance may enable governments to better deal with incentive incompatibility. Flexibility in the timing of program execution (floating tranches) may enable them to retain overall political support and to avoid a situation where a loss of such support leads to the permanent abandonment of a program. A stricter approach to replacement programs may, on the other hand, strengthen a government's incentive to implement an existing program and to address factors threatening its viability. As reflected by the above discussion, policy reform relating to IFI-supported programs may need not only to recognize and accommodate political economy factors that impinge on their viability, but also to encourage governments to seek to alter the contemporary political economy factors that threaten policy reform.

4. CONCLUDING REMARKS

In seeking to make programs of economic reform supported by the IFIs more successful it is important to try and ensure that they are viable. Will governments be persuaded to participate? Will they be encouraged to see programs through to completion? Will the IFIs be prepared to allocate resources to assist the borrowing countries that seek help? If the answer

to any of these questions is 'no', then programs will not be viable. A government's participation will largely depend on its perception, at signing, of the effects of the program on its ability to retain power. Will the additional political support from those who benefit from economic reform be sufficient to outweigh the loss of support from special interest groups that have enjoyed the rents from previous economic distortions? The implementation of programs then depends on how the costs and benefits actually pan out. Thus a program that is thought to be viable at its outset, because of its expected effect on economic growth and the political pay-off from this, may turn out not to be viable where the growth effect does not materialise. Meanwhile, the IFIs need to be confident that the loans they are making will be repaid. They will therefore be interested in the government's degree of commitment and the factors upon which this depends. Without the relevant information there will be informational asymmetries which would permit a government to present a program as being viable when in practice it is not. The IFIs will also need to be realistic about the effects of programs of economic reform on economic growth.

This paper discusses first in general terms and then more formally the factors influencing the viability of IFI-supported programs. It analyses the constraints on participation in programs as well as on their implementation. It shows how viability depends on the compatibility of the incentives that face governments and the IFIs. It therefore provides an analytical framework within which program viability may be conceptualized. It is in the nature of the model constructed here that a fairly narrow approach to viability is adopted, and the model is therefore presented as suggestive rather than comprehensive. For example, in reality there may be domestic informational asymmetries as well as asymmetries between domestic

governments and the IFIs. Moreover the structure of the model may be contrasted with analyses that emphasise the screening and signalling role of IFI-supported programs.

This having been said, even the relatively simple analysis of program viability offered here clearly identifies the threats to viability and the direction that reform should take to make programs viable. Contemporary reform seems to be heading the right way, but the analysis delineates the circumstances in which it might prove insufficient. It also suggests other reforms that could contribute to improving the performance of IFI-supported programs in the future.

The viability of programs may be better assessed than in the past by more formally considering whether governments receive compensating political support as a consequence of pursuing IFI-supported programs in exchange for the loss of support from previously advantaged special interest groups. Elements entering into the calculus include; how special interest groups have benefited from the lack of reform, and their bargaining power, as well as the extent to which the durability of the government depends on the sentiments of the general public, and the effectiveness of programs in generating improved living standards.

REFERENCES

Bird, Graham, 2004, 'The Implementation of IMF Programs: A Conceptual Framework and Policy Implications,' Surrey Centre for International Economic Studies, Working Paper.

Bird, Graham, and Thomas D. Willett, 2004, 'IMF Conditionality, Implementation and the New Political Economy of Ownership,' *Comparative Economic Studies*, 46, 423-450.

Dixit, Avinash, 2000, 'IMF Programs as Incentive Mechanisms,' mimeo, International Monetary Fund (June).

Dixit, Avinash, 2001, 'Some Lessons from Transaction-Cost Politics for Less-Developed Countries', Olson Memorial Lecture delivered at the University of Maryland, October 26. Available at: http://www/bsos.umd.edu/umccc/olson_memorial_lecture_series_schedule.htm

Drazen, Allan, 2002, 'Conditionality and Ownership in IMF Lending: A Political Economy Approach.' *IMF Staff Papers* (Special Issue) 2002.

Grossman, Gene M., and Elhanan Helpman, 1994, 'Protection for Sale,' *American Economic Review,* 84, (September), 833-50.

Grossman, Gene, M., and Elhanan Helpman, 2001, *Special Interest Politic*s, Cambridge, Mass: MIT Press.

International Monetary Fund, 2001a, "Conditionality in IMF-Supported Programs—Policy Issues" (February 16). Available at http://www.imf.org/external/np/pdr/cond/2001/eng/policy/index.htm.

International Monetary Fund, 2001b, "Strengthening Country Ownership of Fund-Supported Programs" (December 5). Available at http://www.imf.org/external/np/pdr/cond/2001/eng/strength/120501.htm.

Ivanova, Anna, Wolfgang Mayer, Alex Mourmouras and George Anayiotos, 2005, "What Determines the Implementation of IMF-Supported Programs?" In Ashoka Mody and Alessandro Rebucci (Editors), *IMF-Supported Programs: Assessing Program Design, Implementation, and Effectiveness*. Washington, DC: International Monetary Fund (forthcoming).

Mayer, Wolfgang, and Alex Mourmouras, 2002, "Vested Interests in a Positive Theory of IFI Conditionality, *IMF Working Paper,* 02/73 (April).

Mayer, Wolfgang, and Alex Mourmouras, 2005, 'On the Viability of Conditional Assistance Programs,' manuscript, IMF and University of Cincinnati.

Mody, Ashoka, and Alessandro Rebucci, 2005, *IMF-Supported Programs: Assessing Program Design, Implementation, and Effectiveness*. Washington, DC: International Monetary Fund (forthcoming).