

**Why It Matters Who Runs  
the IMF and the World Bank\***

By Nancy Birdsall

Abstract

Increasing integration has made the great challenge of reducing poverty and advancing human development more achievable than ever, and more dependent than ever on good global economic governance. In this paper I set out the economic logic for why good global economic governance matters for reducing poverty and inequality in the world, and then develop several arguments for how better representation of developing countries in the IMF, the World Bank, and other multilateral institutions would make those institutions more effective in that task. The arguments include the long-run viability of new financing of the institutions, and their effectiveness in managing the political economy challenges of using conditionality. To illustrate the possible link between better representation and effectiveness, I discuss the example of the Inter-American Development Bank, where the developing country borrowers control 50 percent of the votes and the Presidency. I close with a discussion of the dilemma of reconciling the need for sustaining the financial and political support of the rich country members of these global institutions, with stronger poor country representation to ensure their long-run legitimacy and effectiveness.

\*Previously titled, "Global Economic Governance and Representation of Developing Countries: Some Issues and the IDB Example"

# Why It Matters Who Runs the IMF and the World Bank<sup>\*</sup>

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## *Introduction*

The debate about globalization is fundamentally a debate about who's running the global economy, and in whose interests. It is about politics and power as much as about the technical questions of currency regimes, prudential standards and the financial underpinning of global economic stability. Most economists, finance officials and central bankers agree that the benefits of global, market-based integration can more than offset the costs for the poorest countries and the poor within countries. Most social activists, in contrast, emphasize that so far that potential has not been realized. The more pragmatic among them advocate moving well beyond the current reform agenda for the international financial architecture to broader and deeper reform of the system of global economic governance. Those activists see the Financial Stability Forum, the Bank for International Settlements, the International Monetary Fund, and the World Trade Organization as undemocratic. They see the overall system as controlled by corporate and financial insiders, not by the world's median income voter; by the United States Treasury and Wall Street not middle-income consumers; by Ministers of Finance and Governors of Central Banks not Ministers of Health, Labor, and Social Affairs.<sup>1</sup> They are suspicious of the Bretton Woods institutions, where country votes reflect economic power, compared to the more democratic United Nations, where in the General Assembly at least, every country has a single vote.<sup>2</sup>

Independent of the merits or demerits of these various views, they all contain a core truth, namely that the global economic and financial system overall is not particularly representative of the poor of the world. As a result, even sensible enlightened policies – for example to liberalize further international trade rules and increase market access for the poorest countries -- lack legitimacy and fail to command the energies and commitment of activists around the world.

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<sup>1</sup> Joseph Stiglitz makes this point (2002).

<sup>2</sup> The view of the UN as more democratic (and more friendly to developing countries) is surprising given that its most fundamental decisions are controlled in the Security Council, where six countries have a veto. On security issues, the traditional cleavage has been between east and west, however, not between the “north” i.e. the industrialized countries, and the “south”, i.e. the developing countries, and as a result on some issues, some countries of the north have often been unable to push through decisions they favored.

Were the system of global economic governance more representative of the interests of the poorest countries and of the poor within countries, it might be not only more legitimate but also more effective, and thus more conducive to rapid reductions in global poverty and faster convergence of the income of the poorest countries toward that of the richest. Of course the mechanisms by which better representation would make the system more effective and bring faster poverty reduction are neither obvious nor straightforward. Below I discuss some possible links between poor representation and lower effectiveness for the cases of the IMF and the World Bank.

For those two institutions there has been increasing discussion in the last decade of the poor representation, in terms of voting power, of their borrowing member countries compared to the non-borrowing industrialized countries.<sup>3</sup> Given their mission of reducing global poverty, it does seem that a first step toward better representation of the interests of the global poor in the global economic system would be to increase the influence and representation of the developing countries, where the world's poor are concentrated, in those two institutions. This would not and should not imply a shift to the UN system of one-country, one-vote; in the financial institutions, the greater power of the advanced economies is key to their continued financial commitments. Moreover, even among the developing countries as a group, one-country, one-vote would make little sense given that China and Indonesia have populations and economies thousands of times greater than Sao Tome or Mongolia. It should imply adjustments, however, that better reflect the real changes in the relative weight of the developing countries in the global economy, and the potential to increase the institutions' legitimacy and effectiveness by giving countries most affected by their activities greater power in setting their agendas and policies.<sup>4</sup>

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<sup>3</sup> On the IMF, see Buira (2002). Woods (2000) and Kapur (2002) discuss additional mechanisms besides voting for improving representation of developing countries, including staffing, location of the institutions, use of outside experts, etc.

<sup>4</sup> The European Union (EU) system of representations provides one model for representing countries which differ in population and economic size, while protecting the rights of smaller countries. See Woods (2000) for the relevance of the EU model, including the EU system of double qualified majorities (number of

This is no longer the pipedream it seemed to be a decade or so ago. Public criticism of the peculiar way in which the most recent appointment of the current Managing Director of the IMF occurred is one example; there is now increasing concern in the international community about the potential costs to the global financial system of what is a highly political and thus unpredictable (in terms of the qualifications and experience of the appointee) appointment process, at the World Bank as well as the IMF.<sup>5</sup>

The fact that 24 African nations are represented by only two Board members in the IMF and the World Bank is now often remarked upon.<sup>6</sup> That matters because governance in these two institutions is not only a function of votes but of the technical and administrative capacity to use “voice” in the Board to affect decisions. At the same time, though actual decisions, particularly on lending, are almost always made by consensus in the Boards, the nature of the apparent consensus on many issues is naturally shaped by voting power, even when that power is not explicitly invoked. The G-24 (the club of finance officials of the developing countries) has openly argued for a change in the quota system and thus the representation of developing countries in the IMF. A coalition of non-governmental organizations has been formed to support reform of the governance of the institutions, and some member governments have begun actively discussing the options.<sup>7</sup> Finally, and tellingly, the issue of developing country representation was on the agenda of the 2003 spring meetings of those Bretton Woods institutions.

It must be said that increasing representation of developing countries in the global financial institutions, as difficult as it may be to achieve politically, would still be only a modest step toward making those institutions more representative. Even a system that were more “democratic” in representing all countries at the international level would not necessarily be “democratic” in representing well the poor within countries, particularly in the case of the many developing countries that are not themselves mature democracies.<sup>8</sup>

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countries, and proportion of EU population).

<sup>5</sup> Kahler (2001).

<sup>6</sup> See for example, the minutes of recent seminars organized by Ngaire Woods and funded by the Government of Canada (Woods, 2002); and Buira (2002).

<sup>7</sup> The coalition is called New Rules for Global Finance. See Caliri and Schroeder (2003). The Executive Director for Germany at the World Bank has made proposals for change (Deutscher, 2003).

<sup>8</sup> I discuss this point at greater length in Birdsall (2001).

However, it would be a start in the right direction, and is surely necessary if not sufficient.

I proceed with a brief discussion of why good global economic governance matters for reducing global inequality and poverty while sustaining politically a global, market-based economic system (section 1). I then set out the arguments for why better representation of developing countries would make the institutions more effective (section 2). I use the example of the Inter-American Development Bank to bring out some differences in its decisions and in some cases in its institutional effectiveness compared to the World Bank (section 3). I conclude with some comments on the dilemma of reconciling the financial power and resulting accountability of the rich countries in the international financial institutions, with the need for voice and ownership by the poorer countries, if the system of global economic governance is to be effective as well as legitimate.

### *Section 1. Why good global economic governance matters*

One of the great challenges of the 21<sup>st</sup> century is surely to eliminate worldwide poverty. Indeed, in the year 2000, the nations of the world all signed onto the Millennium Development Goals, which include the reduction by half of income poverty by the year 2015. Why does good global economic governance (including improving the international financial architecture), matter for reducing global poverty? Let me suggest two reasons: that the market fails (or as it is more generally put in the textbooks, there are missing markets and market failures); and, ironically, that the market, for the most part, works.<sup>9</sup>

First, markets fail in many domains. The market will never reflect the full social costs of a particular firm's pollution. In the absence of taxes or penalties, local polluters will pollute too much from a social point of view, since they need not internalize the costs to their communities of the pollution they generate. Similarly at the global level,

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<sup>9</sup> This portion is based heavily on Birdsall (2002).

any one country will not necessarily internalize the costs to the global community of its greenhouse gas emissions in the absence of collectively agreed taxes or penalties. In the absence of a market, the rich countries that have historically emitted the highest per capita greenhouse gas emissions can and have imposed costs – of future prevention or of mitigation – on not only their own children and grandchildren but on future generations in the poorer countries. The costs in prevention or mitigation are likely to be relatively greater, as a proportion of total income, in poorer countries. In that sense, the effect of this global public “bad” is asymmetric.

Financial contagion across countries, affecting even those emerging market economies with relatively sound domestic policies, is another example of how market failures can have asymmetric effects. Emerging market economies are less able to manage the same global financial shock as the richer countries. They are less able to borrow domestically, because their own financial markets are relatively shallow. They are more reliant on debt issued in other currencies than their own, creating market doubts about their ability to sustain debt. As a result, they are often forced to resort to tight fiscal and monetary policy to reestablish market confidence, just when in the face of recession they would ideally implement macroeconomic measures to stimulate their economies. Such pro-cyclicality, with its costs in terms of interest rates, unemployment, and reduced spending on social programs, is the opposite of what the industrial economies implement during recessions. In that sense at least, the global market failure creates an asymmetry of greater costs to poorer countries, and to the poor within those countries. We know that the effects of unemployment and bankruptcy can be permanent for the poor; in Mexico, increases in child labor that reduced school enrollment during the 1995 crisis were not reversed, implying some children did not return to school when growth resumed.<sup>10</sup>

The risks of global warming and the problems of global financial contagion are only two examples of market failures that entail asymmetric costs and risks for poor countries and poor people. The same can be said of contagious disease that crosses

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<sup>10</sup> Szekely (1998).

borders, of transnational crime, and of potentially beneficial but risky new technologies such as genetically modified foods. Similarly, poor countries that protect global resources such as tropical forests and biological diversity are paying the full costs but are unable to capture the full benefits of these global goods. Within countries, governments temper market failures through regulations, taxes and subsidies, and fines; and they share the benefits of such public goods as public security, military defense, management of natural disasters and public health through their tax and expenditure decisions. Ideally the latter are made in a democratic system with fair and legitimate representation of all people, independent of their wealth. In nations, such political systems seldom work perfectly (as the proponents of campaign finance reform in the U.S. would argue). In the global community, a comparable political system just barely exists.

Ironically, it is also the case that because markets work reasonably well, the poor and weak can be left behind. Markets that are bigger and deeper reward more efficiently those who already have productive assets: financial assets, land, physical assets, and perhaps most crucial in the technologically driven global economy, human capital. For that reason, markets alone do not necessarily generate equal opportunity. This is true not just across people but across countries too. Countries that are already ahead – with stable political systems, secure property rights, adequate banking supervision, reasonable public services, and so on – are better able to exploit new opportunities generated by the global market. Countries without these institutional assets can be caught in an “institutional poverty trap”. One symptom of such traps is the reality that global capital goes where it is already most abundant rather than most scarce, because it is in the former not the latter that its return is highest. That turns out to be settings where governance is reasonably good and other institutional assets are adequate to ensure a reasonable return to capital. Indeed, in a global financial system, even local financial capital will go abroad if expected returns are too low at home. Thus most foreign direct investment goes to developed countries, and little if any to sub-Saharan Africa (Lucas, 1990).

At the individual level, the best example of how healthy markets can generate unequal opportunities is the rising returns throughout the world to higher education. The



effect of having a university education compared to secondary education or less has been increasing for almost two decades everywhere. This is true despite the fact that more and more people are going to university. In the global economy, with the information and communications revolution, the supply of university-educated people has apparently not been keeping up with ever-increasing demand. In the United States the highly educated have enjoyed healthy earnings gains for three decades, while those with high school education or less have suffered absolute wage losses. In Latin America, between 1991 and 1995, the period of intense liberalization, the wage gap between the skilled and unskilled increased for six of seven countries for which reliable wage data are available. In Eastern Europe, with the fall of Communism, the wage difference between those with and without post-secondary education has widened considerably.<sup>11</sup> In most settings, education has been reinforcing initial advantages instead of compensating for initial handicaps.

The global market for skilled and talented people is another example of how markets can hurt the already weak. In today's global economy the highly skilled are highly mobile. Indian engineers can quadruple their earnings by moving from Kerala to Silicon Valley, and Indian Ph.D. biochemists from Delhi to Atlanta or Cambridge. For the individuals concerned, this is a good thing, and eventually this brain drain can generate offsetting remittances and return investments if the institutional and policy setting in India and other poor countries improves.<sup>12</sup> In the short run, however, it makes the task of poorer countries, trying to build those institutions and improve those policies, tougher. The annual loss to India of its brain drain to the U.S. is estimated at \$2 billion, about equal to all the foreign aid it receives.<sup>13</sup> The farmers and workers whose taxes finance education in poor countries are subsidizing the citizens of the rich countries -- whose tax revenues are boosted by the immigrants' contributions (and whose cultures by

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<sup>11</sup> For more on the United States see Levy (1998) and Cline (1997); on Latin America see Duryea and Szekely (1998), and Behrman, Birdsall and Szekely, (2001); on Eastern Europe see Terrell (2000) and Terrell and Garner (2001). Of course it is also true that the emigration of unskilled workers from poor to rich countries constitutes a windfall for the latter, since they arrive at an age when they can contribute to the economy.

<sup>12</sup> Kapur and McHale (forthcoming, 2004).

<sup>13</sup> UNDP (2001) and UNDP India (1998).

the way are also greatly enriched).

In modern market economies, national governments provide for the regulatory, taxing and subsidy arrangements for mitigating market failures. These are not always perfect – indeed there is always the question about whether some intervention is better than none – but the governance structure exists should the commonweal decide to use interventions to minimize the problems market failures entail. In varying degrees, modern market economies also have social and other policies explicitly designed to temper the excess inequalities of income and opportunity that efficient markets easily generate. The resulting social contract may not be perfect, but it exists at the national level. Progressive tax systems provide for some redistribution, with the state financing at least minimal educational opportunities for all and some social and old age insurance.

There is never likely to be an exact analogue of the domestic government with its regulatory and taxing authorities at the global level. But global asymmetries underline the need for a system of global economic governance which would minimize the costs and risks of global market failures and through transfers would help ensure something much closer to equal opportunity for the world's poor than we currently have.

The World Bank and the IMF are among the global economic institutions that represent a start in that direction.<sup>14</sup> I turn now to a discussion of whether and how better representation of the poor within them (through better representation of developing countries) might increase their effectiveness in these tasks.

## *Section 2. Linking representation and effectiveness*

How might better representation of developing countries in the World Bank and the IMF make those institutions more effective? There is no simple way to address such a question, since there is little agreement on the definition of the institutions' effectiveness

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<sup>14</sup> Others include the World Trade Organization and the various UN agencies that finance technical assistance and other transfer programs in developing countries.

in first place.<sup>15</sup> However, imagine a simple definition of effectiveness as maximizing global poverty reduction by raising and efficiently allocating as much of members' political and financial resources as can be used at positive rates of return (in reducing poverty). With that in mind, I suggest four possible arguments linking increased developing country representation to increased institutional effectiveness.

The first has to do with the ability of an institution to acquire additional resources in the face of real additional needs. In the case of the IMF, Buira (2002) notes that limited representation of developing countries has contributed to a stalemate among shareholders regarding any increase in its resources. That has made the Fund less able to play its stabilizing role; its resources have declined from 58 percent of world trade to less than 6 percent today (and a smaller proportion still of capital flows). Many of the larger emerging market economies, such as Brazil and Korea, have lower quotas and fewer votes than Belgium and Denmark, though the former two countries now have a greater potential impact on the global financial stability that the IMF is charged to protect. But the industrial countries have resisted any increase in the capital (or quotas), in part because negotiating the allocation of such an increase would open the Pandora's box of restructuring possibilities, at possible cost to their own influence and power. With any increase there would be pressure to restructure the quota system so as to better align economic size and voting power, allowing Korea, Brazil, and South Africa for example, to increase their quotas and thus their contributions to the Fund's resources.<sup>16</sup>

This argument applies less well to the World Bank (and the other multilaterals) where there is less immediate concern on the part of the borrowers that they could

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<sup>15</sup> One oft-used measure is the proportion of lending operations that are reported to be "satisfactory" during implementation and in project completion reports, as in the Wapenhans 1992 report of the World Bank. But this project-level assessment is itself a narrow measure of overall effectiveness, since the domestic policy environment appears to be a critical factor affecting project success. Thus comparisons over time between these internal measures of projects would almost certainly show little difference between the World Bank in Latin America and the Inter-American Development Bank, as long as country allocations over time were similar.

<sup>16</sup> Recognition of the increasing stake of the emerging market economies in the global economy, and their potential to affect its growth and stability, has led to efforts to include them in discussions of the international financial architecture, through creation of the "G-20" (G-7 plus Argentina, Australia, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, South Korea and Turkey).

effectively use more capital for their traditional loan operations. However, any recurrence of the pressures for financial support that the financial crises of the late 1990s created, when the World Bank (as well as the Asian Development Bank and the Inter-American Development Bank) were called upon to commit loans to Korea and later Brazil and Argentina, to supplement the IMF commitments, might add to the view that the banks, because they are short of sufficient capital, are ineffective in providing the kind of countercyclical support that emerging market economies with fragile financial systems need in an increasingly volatile global system.<sup>17</sup>

A second argument is implicit in the view of those who believe the institutions are unduly powerful and “intrusive”, especially in the poorest countries most dependent on them, and end up pushing for reforms that are not politically sustainable and are thus ineffective.<sup>18</sup> This view is most often associated with critics of so-called Washington Consensus (or “neoliberal”) policies, who argue that the IMF and the World Bank have actually done borrowers’ harm by using loan conditions to pressure them into capital market liberalization before their financial sectors were resilient enough, or into privatization programs that ended up enriching corrupt insiders.<sup>19</sup> In this view, implicitly if not explicitly, better representation of developing countries on the boards of the institutions would give the borrowing countries more influence in resisting pressure for constant liberalization of their markets, and might create pressure to hire more professional staff with broader backgrounds, including more non-economists and more economists trained in other than the mainstream Anglo-Saxon neoclassical tradition.

A related argument, widely held even by many who endorse the general direction of the institutions’ policy advice, is that the imbalance of power makes them prone to

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<sup>17</sup> Fernandez-Arias and Hausmann (2000) and Griffith-Jones and Ocampo (2001) argue that the lack of sufficient transfer of capital from the rich to the poor world is a fundamental problem. The Meltzer Commission (2000) took the opposite view.

<sup>18</sup> Woods and Narlikar (2001) describe the “new intrusiveness” of these organizations in the context of growing concern about the merits of their advice. The tendency to insist on universal recipes is one way to interpret Stiglitz’s (2002) critique of the IMF’s emphasis on fiscal austerity in East Asia during the financial crisis of 1997-98, and its emphasis (along with the U.S. Treasury and the World Bank) on rapid privatization in Russia in the early 1990s. The evidence that opening the capital account prematurely can exacerbate the vulnerability of emerging market economies to financial crises is another example.

prolonged reliance on universal (and in some cases, possibly wrong-headed) “recipes” for economic reform, and less open than they otherwise would be to home-grown approaches taking into account local institutional and political constraints.<sup>20</sup>

(Of course, the merit of these related points linking poor representation of developing countries to their ineffectiveness rests, in fact, on highly contentious positions about what policies and strategies are in fact most conducive to growth and development strategies, which clearly cannot be resolved here (!))

Oddly enough, a third argument is based on the evidence that as intrusive as these institutions may seem to be in recipient countries’ policies and programs, in fact in the end they are not powerful at all but weak and ineffective. The evidence of weakness and thus ineffectiveness comes from the long record in many borrowing countries of repeated failures to implement agreed programs, compounded by the institutions’ providing repeated waivers of pre-agreed loan conditions and continuing to disburse loans (Willett, 2003). This may be because the borrowers are gaming the system (what Willett calls “strategic renegeing”), i.e. signing up knowing conditionality will not be enforced; or because they fail to anticipate the difficulties of undertaking agreed programs when circumstances change (what might be called willfully myopic behavior); or because there are different actors in the recipient government, and “reformers” who hoped to use the leverage of external conditionality to implement changes, subsequently fail. In any event, the fact is that in the poorest countries of Africa, where the record of program implementation is weakest, the institutions have often seemed powerless, politically or bureaucratically or both, to cut off lending,<sup>21</sup> and that has raised questions about their overall effectiveness, given that their lending is not associated with implementation of the programs they are trying to support.

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<sup>19</sup> Stiglitz (2002) describes the IMF as both intrusive and wrong.

<sup>20</sup> Rodrik (2001) is particularly critical of the imposition of universal approaches implied in WTO-agreed disciplines. See also Rodrik (2003). For an eloquent argument for greater reliance on home-grown institutions, see Hausmann and Rodrik (2002).

<sup>21</sup> Birdsall, Claessens and Diwan (forthcoming, 2004) show this is a particular problem in the case of low-income countries with high accumulated debt to the multilaterals; those countries have been able to borrow independent of the quality of their own policies.

The response of the institutions to the accumulating evidence that borrowing countries were not implementing programs successfully has been to emphasize the need for borrowing countries to demonstrate “ownership” of their reform programs, in the hope that will make the governments’ decisions more likely to be sustained politically. That creates the new need for staff assessment of whether a government is likely to fulfill its promises (independent of whether it is willing to sign on to such promises, given the past record of repeated failures of programs followed by renegotiations).<sup>22</sup> The only sense in which this new requirement has been specified has to do with the idea of “participation” of citizens through civil society groups in discussion of the proposed programs. Staff in the World Bank are required to confirm to the Board that there has been such participation when bringing a country’s “Poverty Reduction Strategy Paper” (PRSP) and debt relief programs to the Board for approval.

In fact, ownership on the part of the citizenry, even if adequately reflected in “participation”, is only one dimension of the issue. In most settings the political sustainability of an agreed program will be related to the relative power and influence of the executive and the legislature, the positions of any relevant political parties, the interplay of various interest group pressures, and the likelihood that beneficiaries of a policy change (such as future exporters benefiting from a more open trade regime) will themselves have political influence. As a result, the new standard actually requires much more than an assessment of the role of civil society groups in discussing a program; it requires acknowledging more explicitly that borrowing governments are making political as well as technical decisions, and increasing the staff time and resources needed to do the necessary political impact analysis.

A subtext of this argument that local politics matters arises from its relevance for the ability of the institutions to be effective in their primary objective, i.e. reducing poverty by ensuring that the programs they support ultimately benefit the poor. Most

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<sup>22</sup> Willett (2003) notes that the IMF Managing Director has the duty of certifying that he believes that not only is the policy to be supported good, but that the prospects for its implementation are good.

programs supported by the IMF and the World Bank implicitly assume a common interest of the lender and the country policy makers; on the other hand the use of conditionality makes no sense if there is not some conflict of interest (Drazen, 2003). Coate and Morris (2003) note that conditionality may simply induce a government to shift the way it allocates its resources, in order to comply with an agreed loan condition, but in the direction of a less efficient (and presumably even less transparent) transfer mechanism.

Coate and Morris emphasize the overall reduction in efficiency. But it is easy to imagine that the new “transfer mechanism” would protect (in many cases continue to protect) powerful entrenched interests, not the poor. Vreeland’s analysis (2002) suggests that such “misfires” on the part of the IMF or World Bank in terms of conditionality have ended up hurting the poor. In the same spirit, Birdsall and James (1993) apply the theory of public choice to social spending in developing countries. They observe that prior to any particular allocation of resources there is a political equilibrium; if the advice or resources (or conditions) of the World Bank or any other external force leads to pressure to increase public spending on the education sector so as to put more poor children into school and make the distribution of public expenditures more progressive, there is likely to be a countervailing reaction to return to the initial equilibrium – for example via reductions in the overall tax burden on the wealthy, or an increase in spending within education on universities that meet the needs of better-off households.

Classic examples of such misfiring are when a government agrees to a program of fiscal reform, which then ends up leading to expenditure cuts that harm the poor while insulating the rich (made famous in the 1987 UNICEF –sponsored study Adjustment with a Human Face) and when a government undertakes a trade opening which leads to the collapse of local production on which the poor and unskilled relied for jobs and income. Whether particular examples are true or not (or in the short run but not the long run), the implication is that effectiveness requires explicit understanding of the political economy of borrowing country governments, and what might be called “political impact analysis” of the efficiency and the equity implications of agreed policy and program changes. Since

agreed reforms can be manipulated by entrenched interests, such analysis seems absolutely key to the institutions' effectiveness in reducing global poverty.

My final argument takes as given the institutions' partial loss of legitimacy in the last decade or two, and links loss of legitimacy to reduced effectiveness. The perception that the institutions have been not only ineffective in helping the poor, but worse actually harmful, has contributed to the questioning of their legitimacy on the part of many groups who are committed to global social justice. A similar process occurred earlier, especially for the World Bank, on environmental issues. If the IMF and the World Bank become the scapegoat for failure, that in turn risks a further loss of effectiveness. A worrying example is the attack on the institutions on the part of the indigenous peoples' movement in Latin America, who see Washington, America, the IMF and so on as illegitimate in their apparent defense of international financial and corporate interests. To the extent IMF and World Bank programs become a political liability for local leaders, and are associated with political uncertainty and the risk of political instability, they will discourage rather than encourage local and foreign creditor and investor confidence.<sup>23</sup> This is a particular problem for the IMF, whose effectiveness is closely linked to its ability to trigger confidence in an economy by agreeing to its economic program, particularly when the programs it endorses in fact rely on the private confidence they are meant to trigger.

The institutions have and are responding to these incursions on their legitimacy. The question is whether such incremental responses as the emphasis on "participation" and the increased rhetoric about poverty reduction (such as the IMF's renaming of its Enhanced Structural Adjustment Facility as the Poverty Reduction and Growth Facility) will make a difference in themselves, as long as the prevailing doubts about legitimacy

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<sup>23</sup> In Ecuador recently, as reported by Reuters from Quito and described in the daily summary of news issued by the IMF, "President Lucio Gutierrez pleaded with Congress to . . . keep the IMF loan deal on track. 'I want to ask lawmakers to reflect. This is not a bill imposed by the IMF . . . This is a necessity for Ecuador.'" In Bolivia, the leaders of the indigenous group movement that succeeded in forcing President Sanchez de Lozada of Bolivia to resign in October of 2003, were in part objecting to his record of reform supported by the U.S. and the Bretton Woods institutions, and associated with encouraging foreign investment and engagement.



extend to the imbalance in their governance itself.

On the one hand, it is not obvious that better representation of borrowing member countries in the governance of the institutions would translate directly into more “ownership” of institutional programs by borrowing member governments, or into greater savvy about the political economy situation of borrowers as it bears on ability and willingness to carry out reform and investment programs. Nor is it clear, as noted above, that greater representation of developing countries through their political leadership would translate into better effective representation of the needs of their own poor. On the other hand, it would be wrong to write off the possibility just because it is not easy to demonstrate, or to adhere to the status quo because the right move away from the status quo is politically difficult to imagine. I turn now to a discussion of the Inter-American Development Bank as an example of the possible effects of better representation of borrowers on institutional effectiveness, and how it might operate.

### *Section 3. Representation and decisions at the Inter-American Development Bank*

The Inter-American Development Bank (IDB) has a number of characteristics that make it, among the five major multilateral banks – World Bank, African Development Bank, Asian Development Bank, European Bank for Reconstruction and Development, and IDB – and the IMF, the institution in which the developing countries and the poor within developing countries are probably best represented. These include the following:

- 50 percent of the voting shares are controlled by the borrowing members.
- The President is effectively elected by the borrowers<sup>24</sup>.
- Of the 14 chairs of the Board of Executive Directors, nine are held by the borrowers.
- All country members of the IDB are democracies.

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<sup>24</sup> The election of the President requires a majority of the regional member countries. The U.S. and Canada are regional members, but of course the effective majority is with borrowers.

A comment on the last point is needed. Activists are concerned, often with good reason, that even when poor countries have adequate representation in international institutions, the poor within those countries may not be represented well. Obviously those who represent their countries in official fora are among the best educated and trained a country has. The question is whether their views reflect narrow interests or the interests of their countries as a whole. To the extent that all members of the IDB are democracies, of course at varying stages of maturity, there is a somewhat better case that their representatives speak for a larger majority of their countries' populations.

Table 1 provides summary indicators of the governance structures of the six international financial institutions. The other institution with a governance structure similar to that of the IDB is the African Development Bank. However most lending commitments of the latter bank (more than 40 percent) are made from the highly concessional ("soft") window which is financed by the non-borrowing OECD members. Thus AfDB lending is highly dependent on the continued support of those countries. The non-borrowers have in effect a short leash over the shareholders as a group. In contrast, only about 5 percent of annual lending commitments are made from the IDB soft window. The bulk of IDB lending is financed not by contributions but by the bank's borrowing in the global capital market. This borrowing is backed primarily by the paid-in capital and guarantees of non-borrowers, which constitute a more permanent and largely irreversible commitment of the non-borrowers (Table 2). It is best thought of as a much longer and looser leash.

In addition, at the time of the seventh capital replenishment of the IDB, in 1989, the shareholders agreed that a defined group of the smallest countries in the region (many but not all of which are among the poorest countries as well) should have a quota of a minimum of 35 percent of all lending from the Bank. No doubt this decision was pressed upon all the shareholders by a coalition of the non-borrowers and the small countries; presumably the non-borrowers wanted to prevent the larger borrowers (Mexico, Brazil, Argentina, Venezuela) from crowding out access of the smaller countries. Its result in

terms of governance is that it is the weak equivalent of secured minority rights, and in that sense ensures somewhat greater access and voice for the small and usually relatively poorer countries in the institution.

Table 1 indicates that the United States is by far the largest single shareholder in the IDB. The U.S. has substantial power by reason of its voting share and the financial commitment that it represents (though by no means an outright veto on lending from the hard window). That power, however, is primarily negative. The U.S. can easily prevent lending and policy changes it opposes, but except in the context of negotiating new capital infusions, it is constrained to comment and suggest as opposed to making demands. It was at the time of the third capital replenishment that the U.S. secured the IDB's collaboration in helping to finance the adjustment programs in Latin America under the Brady Plan, with the kind of conditionality that the World Bank began imposing in the late 1980s.<sup>25</sup> It was at the time of the fourth capital replenishment, in 1994, that the U.S. introduced and pushed through such changes as the introduction of greater disclosure and the implementation of the independent inspection procedure, both of which had been introduced at the World Bank through the normal Board decision-making process. But except for the leverage it had in the context of contributing to the capital of the Bank, the U.S. can only prevent damage at the IDB, not promote new initiatives or policies.

Perhaps the best evidence for the difficulty the non-borrowers including the U.S. have in pushing their own agendas at the IDB is that the big borrowers (Mexico, Brazil, and others) have successfully resisted the transfer of net income from ordinary capital lending (the hard window) to the IDB's soft window, which is similar to the IDA window of the World Bank and lends on highly concessional terms to five of the region's poorest and most indebted borrowers. Such transfers are made regularly in the World Bank. The large borrowers object to such transfers since they raise their costs of borrowing (essentially by reducing the potential for increasing reserves); in their view such transfers

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<sup>25</sup> During much of the 1980s, the IDB had continued lending, but generally with fewer demands on governments for fiscal and other reforms.

amount to their bearing a burden of foreign aid that the rich countries ought to be bearing completely. Similarly, the big borrowers in the IDB have resisted use of net income to finance the IDB's obligations for debt relief and reduction under the HIPC (heavily indebted poor country) initiative.<sup>26</sup> The HIPC obligations have been covered only after extensive and contentious negotiations among IDB shareholders, finally with the big borrowers securing other benefits in return for their willingness to "give up" some of the control they had earlier negotiated over use of IDB resources held in their countries in the local currency of their countries.

A second manifestation of borrower power in the IDB has been the borrowers' interest in restraining growth of the IDB's administrative budget. The reason is the same; an increase in the administrative budget for a given amount of outstanding loan assets, implies a higher cost that must be borne by the borrowers to sustain the same level of reserves, provisions and so on. Budget restraint on the part of the borrowers explains the much lower spending in the IDB compared to the World Bank on research and on economic and sectoral studies that are not clearly tied to loans. In the mid-1990s such budget restraint meant that in real terms the IDB administrative budget was declining slightly, while in the World Bank, the shareholders through the Board agreed to management's proposal for a "Strategic Compact" which involved a substantial increase in the real administrative budget (admittedly designed in principle to be one-time).

These points are evidence not of greater effectiveness but of the fact that voting power and other formal arrangements of governance matter to institutional decisions, even in institutions where the critical decisions regarding programs and lending all seem to result from "consensus". (Indeed some would argue that the IDB would be *more* effective if its large borrowers had agreed to transfer some profits to its concessional window, or if more of its administrative budget had been spent on research over the years.)

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<sup>26</sup> The big borrowers might well agree to higher costs of borrowing if they had more control over the subsequent use of the incremental net income higher charges would generate – for example for increased

Is there evidence that the IDB has been more effective than it might have been as a result of its relatively greater borrower representation compared say to the World Bank? Without a counterfactual, it's not possible to answer systematically. However here are several points that at the least suggest the question is not unreasonable.

First, the ownership issue. The IDB is widely seen as closer to its borrowers. The regional borrowers for all practical purposes set the agenda in the IDB; it was their influence that led to a heavy emphasis from the IDB's founding on support for regional integration and for lending for social programs. (The IDB began immediately lending for water and sanitation in 1961, and for many years heavily supported higher education when the World Bank did not.) The Presidents of the IDB can and have used the institution as a platform for shaping new priorities at the regional level; early in the 1990s President Iglesias brought together leaders of the judicial sector and defined with them a set of priorities for judicial reform and anti-corruption programs – before these issues now discussed under the rubric of “governance” became prominent on the international development agenda. The IDB also does seem to secure, and its loans seem to reflect, substantial “ownership” by its borrowers of the programs for which they are borrowing. Conditionality in IDB loans in the 1990s did suffer (as at the World Bank and IMF) from overkill. But the general impression is that borrowers had more control over the details of conditions in the IDB setting, and often saw conditionality as useful in signaling to private creditors their commitment to the reforms supported by IDB loans. Much of the time it was probably the staff more than the Board that was demanding in terms of conditionality and agreement to waivers of conditionality for release of tranches.

The fact of greater borrower ownership is, perhaps ironically, most evident in the periodic concern of World Bank staff that the IDB is “too close” to the borrowers and thus all too willing to lend, independent of the merits of the program being financed. In the 1980s the IDB made a series of “program loans” to support public spending of countries struggling to reduce fiscal deficits and increase trade surpluses as they adjusted following the debt crisis early in the decade, at a time when the World Bank was agreeing

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financing of regional public goods. See Carnegie Endowment 2001, for discussion of this issue.

to such budget support only in the context of highly conditional structural adjustment loans. Similarly the IDB supported more willingly spending on university programs in Latin America, at a time when the World Bank was pushing for relatively greater spending on primary and secondary education, and for imposition of tuition fees at the university level. These differences in policy on the part of the two banks almost certainly reflected the differences in governance.<sup>27</sup>

Second, because the IDB is seen as more closely reflecting the needs of its borrowers, it does not seem to have suffered the same loss of legitimacy as have the IMF and the World Bank. That it is smaller and less visible has almost certainly helped; still the fact is that it is much less associated with, for example, the “Washington Consensus” among the critics of the neoliberal interpretation of that consensus. That may have helped preserve its ability to remain effective in encouraging certain difficult and unpopular reforms – though there is no obvious way to demonstrate this.

Third, the IDB is seen as politically savvy, at least relative to the World Bank. Its longstanding support for university education, for example, could be interpreted as implicit recognition that it was better to reinforce a program that had domestic political salience, even if second best, than to push for changes that would create a more costly backlash, or the kinds of countervailing pressures mentioned above, for example a decline in taxpayer support for public spending on basic education. More important is the likelihood that IDB staff and the Board, because they are more familiar with the local political economy in more countries, will better anticipate the risk that conditionality will misfire to the detriment of the poor, as described above. Unfortunately it is impossible to distinguish between the effects of truly better political understanding, and the greater likelihood of less “tough” conditionality in general.

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<sup>27</sup> It is in fact much less clear today than was understood within the institutions at the time that domestic policy including emphasis on import substitution industrialization were for all purposes the only underlying cause of the debt build-up and subsequent lost decade in Latin America; today somewhat more emphasis would be put on the effects of external shocks interacting with domestic policy shortcomings. Similarly in the case of education, it is much less obvious today that there are not unmeasured positive externalities or spillovers associated with university education, and that, though reform of university financing is critical, political realism dictates broad-based reform of the kind initiated now in Brazil, not only or primarily an immediate imposition of higher tuition.

One reason for at least the potential for more savvy political understanding is that in the IDB the borrowers are better represented at the senior staff level. There are many staff at the senior level in the World Bank from borrowing member countries. But in contrast to the IDB they are not likely to be working in their own regions of origin, and much less likely to speak the language of the borrowing country governments with which they are negotiating. Indeed Latin American countries are said to have resented the dominance of World Bank staff from Asia in work on their countries during the late 1980s and much of the 1990s, though not objecting to the particular persons, all of whom were seen as smart and committed. In the last few years, under James Wolfensohn, the World Bank does seem to have made efforts to have more staff from Latin America working in the region, and similarly to have made senior appointments in the Africa region of staff from that region.)

In part the difference between the two banks is the simple result of the fact that staff in the IDB working on Latin America have not and will not ever work on Africa or Asia. However there is more to it. World Bank staffing and promotions are highly meritocratic and largely apolitical. Staff are thus relatively isolated from their own countries; indeed success, including promotions in the World Bank, requires that staff spend a considerable amount of time interacting with each other. In the case of the IDB, many more senior staff from borrowing countries are appointed from outside the bureaucracy itself. Their appointments are more likely to reflect political pressures from their own countries, who have relatively more political sway in the IDB because of their greater representation on the Board. Ironically, as a result those senior staff are more alert to their own countries' interests and policies and politics, and less concerned with proving their merits inside the IDB bureaucracy. Their careers are after all likely to be determined elsewhere. The IDB is thus more "politicized" than the World Bank, but that has its benefits; it is also more porous and its staff are more client-oriented - - and possibly more effective.

Fourth, the IDB is highly supportive of what might be called regional public

goods. As in the World Bank, there is no good instrument for supplying global or regional public goods. The “loan” is the IDB’s most important product, and cannot easily be made to finance a public good with benefits to many countries because of the problem of allocating costs across the various countries. However, much more than the World Bank, the IDB has found ways to support regional trade agreements, including for the past nine years substantial technical work on the Free Trade Agreement of the Americas; cross-border infrastructure projects (including the electricity grid in Central America); and the strengthening of sub-regional banks including the Andean Development Bank<sup>28</sup> (the CAF --Corporacion Andina de Fomento) and the Central American Development Bank (CABEI – the BCIE Banco Centroamericano de Integracion Economica).<sup>29</sup> Much of this support has come from the very scarce concessional funds available (but not from net income as noted above). The weight of regional programs is not simply the result of the IDB being itself a regional rather than a global institution. The Asian Development Bank (where the Presidency is controlled by the Japanese) and the African Development Bank (where the borrowers are more dependent on the non-borrowers to finance their relatively large concessional lending program) came relatively later to regional programs and have not committed as much on regional programs as a portion of total commitments (though regional programs in all the banks are small).

*Concluding note: A dilemma*

Increasing global integration has made the challenge of reducing global poverty and inequality and advancing human development more achievable than ever, and more dependent than ever on the legitimacy and effectiveness of the two global institutions with the particular responsibility for those tasks – the World Bank and the IMF. Yet their legitimacy and effectiveness are being increasingly questioned – in part because

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<sup>28</sup> The Andean Development Bank no longer relies on borrowing from official sources to finance its lending operations. It now borrows on the private capital market. It is a notable example of a multilateral that has captured the benefits of a cooperative, since it now has a higher credit rating than any single one of its members, all of whom are borrowers.

<sup>29</sup> The IDB is able to make loans without the recipient government or governments guaranteeing repayment; this has made it easier for it to provide loans to the subregional development banks. On the other hand, it is likely that the heavy presence of borrowers on the Board of the IDB has made it easier to secure approval of these loans.



developing countries, whose governments and peoples are the main objects and the beneficiaries of this task, are poorly represented in their governance structures.

Governance of the two institutions reflects the historically greater financial capacity of today's richer countries, and their governance has had the advantage of securing the continuing financial and political support of the rich countries. But times have changed. The developing countries have become a bigger factor in the global economy (as the financial crises of the late 1990s suggested all too well); they affect and are affected by the stability and prosperity of the global system much more than they did five decades ago. In addition, the demands of the global economy have gradually increased the role of the IMF and the World Bank in advising and influencing domestic economic policy in the borrowing countries. As a result, the people of those countries, including the poor, are increasingly affected by decisions made at the international level. Finally, there has been increased attention from an increasingly global civil society movement to the two institutions, with greater scrutiny of their roles and increased questioning of their legitimacy.

The dilemma at the global level is reconciling the continuing need for financial support of the rich countries with the ability of the institutions to remain legitimate and effective in a changing world. There is at least some evidence that their effectiveness is reduced directly for lack of developing country influence, and indirectly because that dearth of influence reduces their legitimacy. The evidence, based loosely on the effects of greater influence of borrowers in the Inter-American Development Bank, is not only that the developing countries need the multilateral institutions, but that institutions can benefit from their greater influence.

In short, it is possible that in the long run, the institutions' legitimacy and effectiveness in their vital task of addressing the challenge of reducing global poverty will be increasingly at risk, in the absence of some change in their governance structures. The issue thus should no longer be whether any change at all is warranted, but exactly what that change should be and how to overcome the political gridlock that is preventing

it.

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**TABLE 1: INTERNATIONAL FINANCIAL INSTITUTIONS (IFIs):  
GOVERNANCE STRUCTURE**

IFI	Voting Share (%)				Directors					President
	US	Other G-7	Other non-borrowers	Developing country borrowers	US	Other G-7	Other non-borrowers	Developing country borrowers	Total	
<b>IMF</b>	<b>17.1</b>	<b>28.2</b>	<b>16.7</b>	<b>38.0</b>	<b>1</b>	<b>6</b>	<b>6</b>	<b>11</b>	<b>24</b>	Non-borrower
<b>WB</b>	<b>16.4</b>	<b>26.6</b>	<b>18.2</b>	<b>38.8</b>	<b>1</b>	<b>6</b>	<b>7</b>	<b>10</b>	<b>24</b>	Non-borrower
<b>IADB</b>	<b>30.0</b>	<b>15.7</b>	<b>4.3</b>	<b>50.0</b>	<b>1</b>	<b>4</b>	<b>0</b>	<b>9</b>	<b>14</b>	Borrower
<b>ADB</b>	<b>13.0</b>	<b>27.4</b>	<b>14.6</b>	<b>45.0</b>	<b>1</b>	<b>4</b>	<b>1</b>	<b>6</b>	<b>12</b>	Non-borrower
<b>EBRD</b>	<b>10.1</b>	<b>46.5</b>	<b>30.2</b>	<b>13.2</b>	<b>1</b>	<b>6</b>	<b>12</b>	<b>4</b>	<b>23</b>	Non-borrower
<b>AFDB</b>	<b>6.6</b>	<b>21.0</b>	<b>12.4</b>	<b>60.0</b>	<b>1</b>	<b>4</b>	<b>1</b>	<b>12</b>	<b>18</b>	Borrower

Sources: 2002 Annual Reports, ADB and EBRD. Website data on shares, AfDB, IADB, IMF and WB.

Notes:

IFI = International financial institutions; IMF= International Monetary Fund; WB= World Bank; IADB= Inter-American Development Bank; ADB= Asian Development Bank; EBRD= European Bank for Reconstruction and Development; AFDB= African Development Bank.

**TABLE 2: INTERNATIONAL FINANCIAL INSTITUTIONS (IFIs): SELECTED INDICATORS  
(2001)**

	Total authorized capital US \$ billions	Non- borrowers' capital US \$ billions	Non- concessional lending commitments % total (1)
IMF (2)	289	176.3	86.7%
WB	189.5	98.5	73.3%
IADB	100.9	49.1	94.4%
ADB	48.4	32.3	74.5%
EBRD	20.2	2.6	99.1%
AFDB	22.3	8.9	58.4%

Source: IADB Annual Report(2001); WB Annual Report (2002); IMF Annual Report (2002); Asian Development Bank Annual Report (2001); African Development Bank Annual Report (2001); Gwin (2002).

Notes: IFI = International Financial Institution; IMF= International Monetary Fund; WB= World Bank; IADB= Inter-American Development Bank; ADB= Asian Development Bank; EBRD= European Bank for Reconstruction and Development; AFDB= African Development Bank.

(1) Percentage of non-concessional annual lending commitments during 2000-2002 (concessional lending figures obtained from : International Development Agency at the World Bank – IDA; Heavily Indebted Poor Countries Initiative – HIPC at the IMF; Fund for Special Operations at the IADB; African Development Fund at the AFDB; Asian Development Fund at the ADB; Special Funds at the EBRD).

(2) IMF's financial resources (closest equivalent to capital).



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