Chapter 14

Supranational Governance and the Challenge of Democracy: The IMF and the World Bank

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Governance and the Democratic Deficit: Assessing the democratic legitimacy of governance practices

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1. Introduction

The aim of this chapter is to assess the democratic deficit of two institutions that represent supranational governance, namely the International Monetary Fund (IMF) and the World Bank. The democratic legitimacy and accountability of these institutions has been questioned, as evidenced by the protests and riots that have accompanied annual meetings in recent years, and also by a debate in the literature on reforms of the governance of these institutions (Dahl 1999; Stiglitz 2003; Verweij and Josling 2003; Rapkin and Strand 2005). On the other hand, given the attention paid to these institutions in recent reports calling for more development aid for Africa and for achieving the Millennium Development Goals (Commission for Africa 2005; UN Millennium Project directed by Jeffrey D. Sachs 2005), the positions of the Word Bank and the IMF in the development community seem firmly established.

Democratic control of supra-national institutions is always a difficult issue. First, they are governed by *delegates* of member governments, which means that democratic representation and accountability can be indirect at most (Dahl 1999). And second, for reasons related to public choice theory, staffs of international bureaucracies tend to have even more power vis-à-vis politicians who are supposed to control them than domestic bureaucracies have (Frey 1991).

This paper argues that in the case of the IMF and the World Bank, this “natural” democratic deficit of supra-national institutions has increased over time. In fact, both institutions have expanded in objectives and scope of activities. In contrast, decision making within IMF and World Bank is still largely as it was when the two institutions were established, implying that Central Bank Presidents and Finance ministers (in the case of the World Bank: Finance ministers and development cooperation ministers) of member countries make decision, while each countries’ voting power is determined by the size of the countries’ economies. Given the changes in mandate and tasks of the two institutions, this means that in fact, a majority of rich countries determines policies that mainly affect poor and middle income countries.

The chapter will show that the original democratic deficit was mainly a problem of input legitimacy, but that the changes and expansions of tasks have added substantial problems of throughput and output legitimacy, while also changing the nature of the input legitimacy problem. In response to growing criticisms, both institutions have taken measures to improve their transparency and accountability since the mid-1990s. The greater transparency is evident from the extensive websites of both institutions. Examples of increased accountability include the establishment of the World Bank Inspection Panel in 1993, and the creation of an Independent Evaluation Office (IEO) in the IMF.[1] Both institutions are also engaging more in public debate about their policies, including debates with international Non Governmental Organizations.

At the same time, while many proposals have been suggested to further increase legitimacy and accountability of these institutions, they have not been implemented so far. While these proposals often involve fundamental changes in governance of the IMF and the World Bank, they tend to overlook the relationship between the nature of the democratic deficit of these institutions, and the practice of ever expanding tasks and responsibilities. I argue that this relationship is important and must be taken into account when assessing the possible effects of proposed changes in governance.

[1] The World Bank already had an independent evaluation department, the Operations Evaluation Department (OED), recently renamed the Independent Evaluation Group (IEG).

This chapter is structured as follows. In the next section, I describe the origins and aims of the two international financial institutions , as well as their evolution over time. In Section 3, I assess the democratic deficit and analyze the particular problems of legitimacy and accountability. In Section 4, I examine the consequences of the increase in tasks and responsibilities of the institutions, and the increasing legitimacy problems. In Section 5, I examine the changes implemented and their effects on reducing the democratic deficits, and the more radical proposals for improving input and output legitimacy that have not been implemented yet. Section 6 contains my conclusions.

2. The Origins and Evolution of the IMF and the World Bank

Both the World Bank and the International Monetary Fund (IMF) were established in 1944 during a conference in Bretton Woods, USA. For this reason, they are also called Bretton Woods Institutions (BWI). The principle aim of the IMF was to secure the flow of international payments by guaranteeing exchange rate stability. This was motivated by the disastrous experience of the 1930s, when all countries sought their way out of the crisis by putting up trade barriers and by devaluing their exchange rates. In the end, this "beggar-thy-neighbor policy" led to a negative spiral in the world economy and worsened the economic situation of all countries .

The International Bank for Reconstruction and Development (IBRD, or World Bank) was meant to be an international bank that would provide financing for the reconstruction of Europe after the Second World War. When the US government announced the Marshall Plan, this financing was no longer necessary and the Bank began financing investment projects in other parts of the world, mainly developing countries. The International Finance Corporation (IFC) that lends to the private sector of developing countries, and the International Development Association (IDA) that provides credit at very soft terms to the poorest developing countries also belong to the "World Bank Group".

The IMF and the World Bank were originally established by 39 countries, but membership has gradually expanded and by 2006, it includes 184 countries. Countries must be a member of the IMF before they can become a member of the World Bank Group. Members of the IMF must pay a contribution, called "quota", which is based on the strength of a country's economy (Gross Domestic Product) and its share in world trade (exports and imports of goods and services). Members must pay 25% of their quota in internationally usable currencies or Special Drawing Rights (SDRs)[2], and they may pay the other 75% in their own currency.

Countries may draw on the IMF resources an amount of up to 25% of their quota without any policy conditions. This is the so-called reserve tranche, but this borrowing seldom occurs. If they want to borrow more, the IMF sets policy conditions. Originally, countries could borrow up to 100% of their quota. This was officially expanded to 300% in the 1970s but in some recent crises – for example, Mexico in 1995 (Bakker 1996)– countries have been able to borrow up to 600% of their quota. The policy conditions of the IMF are meant to warrant a good use of the IMF´s resources so that the money can be paid back. They are also meant to secure an orderly adjustment process with limited welfare losses, both for the country in need and the world at large (Guitian 1995).

In 1944, at the same Bretton Woods conference, a system of fixed exchange rates was set up with all currencies pegged to the US dollar. The dollar, in turn, would be exchangeable for gold at a fixed price. Devaluations or revaluations of exchange rates could only take place in situations of extreme balance of payments disequilibria and in consultation with the IMF.

[2] This is a currency created by the IMF in the 1970s. Its value is based on a basket of the five major currencies in the world.

According to the Principles of Agreement by which the IMF was established, the IMF had three objectives (Riesenhuber 2001):

- Surveillance of the world financial system
- Provision of temporary balance of payments support
- Maintenance of a system of international trade and payments

According to the original idea, the IMF would come into action in situations of both balance of payments deficits and balance of payments surpluses. Both deficit and surplus countries could be called upon to adjust so that equilibrium could be maintained. In practice, the IMF has only been active for deficit countries. The most important facility by which the IMF has provided this temporary balance of payments support is the Stand-By Arrangement. This can be given for 18 months and the annual interest rate is around 5%.

In the years after the Second World War, most countries' currencies could not yet be purchased and sold on a free market, so international trade was still limited. This changed in 1961 when most European currencies became fully convertible for current account operations. The system as designed in the Bretton Woods conference became operational. Although capital movements were still not allowed, speculative capital flows came into being and gradually increased. They were based on expectations that exchange rates could not always be maintained and that the IMF would not be able to supply sufficient amounts to avoid changes in exchange rates. Speculative flows further increased as a result of the huge budget and balance of payments deficits incurred by the United States as a result of the Vietnam war in the 1960s. In 1971, several currencies began to float and the system finally collapsed when the US government announced that it would no longer maintain a fixed gold price in US dollars. This decision implied that not only the dollar, but all other currencies would begin to float.

For the IMF, this development meant that it lost most of its functions. There was no longer a need to provide short-term balance of payments assistance in order to maintain stable exchange rates or to achieve orderly and limited devaluations. Exchange rates would now adjust automatically in response to changing supply and demand for a currency. The surveillance function also became less important. As countries began to rely on private capital flows, their macroeconomic policies would be assessed by international private financial agents.

This could have led to the end of the institution, but the reality was different. Two years before the system of fixed exchange rates collapsed, it was already evident that world trade and capital movements were increasing so much that it was feared that there would not be sufficient international reserves available. The Board of Governors of the IMF therefore decided to create the Special Drawing Rights. However, the amount of SDRs was limited since decisions on the number of SDRs to be created depended on a 85% majority vote and the rich countries feared that too much world liquidity would create inflation (Riesenhuber 2001).

In 1972 the Board of Governors decided to set up a Committee of 20 members in order to elaborate proposals for the reform of the international monetary system (Riesenhuber 2001). This Committee produced a report two years later, but there was no substantive proposal for reform. In contrast to the situation in 1944, countries had very different views on and objectives for international monetary policies. In addition, the world economic environment changed rapidly. In 1973 the oil crisis broke out, world inflation rose, and private flows of trade and capital continued to increase rapidly, thereby weakening the influence of governments or central banks on international monetary developments. Among the limited reform proposals that were also adopted were the creation of an Interim Committee of 24 countries represented by their central banks or finance ministries that would

meet every six months, and the strengthening of the IMF's role in surveillance of national monetary policies. From that point on, the IMF would make annual or biannual assessments of monetary and macroeconomic policies of all members -- not only the members in financial trouble.

Since there was no common agreement on abolishing the IMF or on a substantial reform of the institution, the staff managed to take advantage of changing world circumstances in expanding its tasks. The oil crisis produced large balance of payments deficits in developed countries, and many applied for support to the IMF. Since these problems could not be solved in the 18 months of the Stand-By Arrangement, the IMF created the Extended Fund Facility. This provided money for three years in order to solve more structural balance of payments problems. The debt crisis of the 1980s resulted in more countries approaching the IMF. Since the amount of support that the IMF could provide was too limited to solve the payment crisis in itself, the IMF began to negotiate with the banks on new finance and on restructuring debt payments while at the same time negotiating macroeconomic policies and structural reforms in the debtor countries. A program with the IMF in which a country promised to carry out policy reforms therefore became an official condition for debt rescheduling and forgiveness. Furthermore, an agreement with the IMF also became condition for official aid donors who wish to provide freely spend-able funds, for example in the form of balance of payment support or budget support.

In 1986 a new IMF facility was created for the poorest countries with balance of payments and debt problems, the Structural Adjustment Facility (SAF). The IMF and World Bank began to work together in designing a program of structural reforms. In 1987, this facility was expanded with the Enhanced Structural Adjustment Facility (ESAF). An ESAF program is, in principle, for three years and countries can borrow up to 255% of their quota (Bakker 1996). In 1999, the name of ESAF was changed into PRGF, Poverty Reduction and Growth Facility. Contrary to other IMF facilities, SAF, ESAF and PRGF carry very low interest rates (0.5%). They are only available for countries that qualify for IDA credits, implying that annual GDP per capita must be below $895.[3]

In the aftermath of the fall of the Berlin wall and the collapse of the Soviet Union, the IMF again expanded its tasks. It was considered beneficial for the IMF to provide money and advice to these countries on how to reform their economies into market economies. The Systemic Transformation Facility was created, under which these transition countries could borrow up to 50% of their quota (Bakker 1996).

The expansion of tasks and activities of the World Bank was of a slightly different nature. Over time, the amount of loans and credits by both the IBRD and IDA expanded enormously. However, in the early 1980s there was also a qualitative change. Until then, the Bank had provided loans for projects, often large infrastructural works but also projects for social infrastructure. With the developing country debt crisis, the Bank began to move into conditional lending. There was an increasing awareness that macroeconomic policies mattered for the success of individual projects. In addition, countries with debt problems needed large amounts of – freely spend-able – balance of payments support with which to feed their populations and provide inputs for their production capacity. At the same time, absorption capacity for yet other investment projects was limited (Toye 1994). From then on, the Bank began to provide balance of payment support in the form of Structural Adjustment Loans or Sectoral Structural Adjustment Loans, on the condition that the country would carry out structural policy reforms. The Bank began to work together with the IMF on the formulation of these policy conditions. While the IMF, in principle, focused on fiscal and monetary policies that addressed the demand side of the economy, the Bank focused more on the

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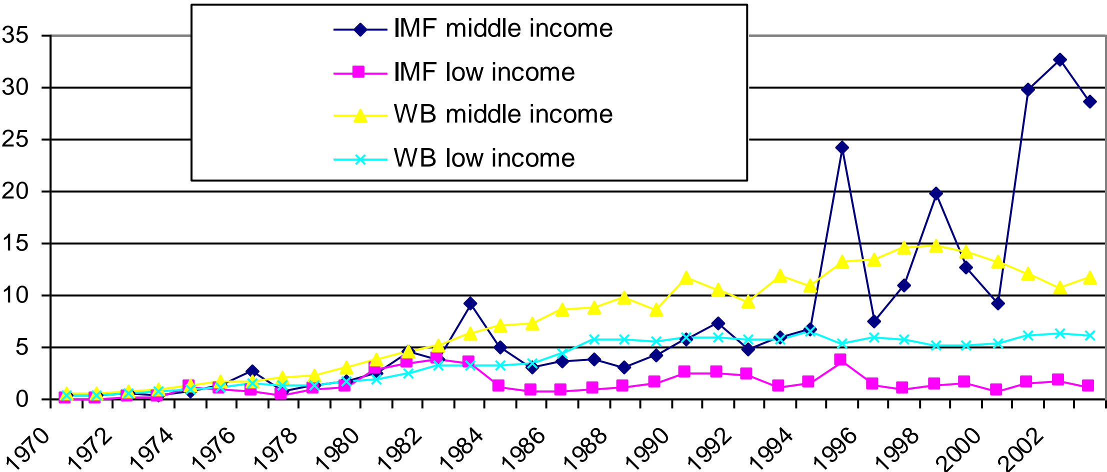
[3] This is the amount in early 2006, based on 2005 GDP per capita .

structural policies that addressed the supply side of the economy. An IMF agreement was always a condition for the structural adjustment loans of the Bank. In 1999, the name of these programs was changed into Poverty Reduction Support Credits (PRSCs).

In the course of time, the nature of the policy conditions has changed as well. While structural measures like liberalization of domestic prices, abolition of subsidies, liberalization of foreign trade, privatization of state enterprise including public utilities, and financial liberalization and banking reform are still on the list (if applicable – i.e., still due), other conditions have been added. There is increasing attention for governance-related conditionality, especially the more technical aspects of it, for example related to public finance management or fighting corruption. In addition, countries are expected to combat poverty. In order to qualify for the Heavily Indebted Poor Country (HIPC) initiative that was set up to solve the debt problems of the poorest countries, countries must write Poverty Reduction Strategy Papers and show that they implement these strategies.

Figure 1. Gross disbursements of IMF and World Bank 1970-2003, to middle income and to low income countries, in US$ billions



Source: World Bank, Global Development Finance 2005.

In sum, both the IMF and the World Bank have vastly expanded their scale of activities in the course of time. Figure 1 shows that the amount of disbursements has steadily increased, with peaks for the IMF in the mid-1970s (oil crisis), in the early 1980s (debt crisis) and again in the 1990s and in 2001-02 (Mexico in 1995, then Asian crisis, and then large packages for middle income countries Brazil, Argentina, Russia and Turkey). The scope of the policy conditions has also expanded far beyond the resolution of temporary balance of payments problems. They now include many structural policy reforms. While this had already been occurring for a long time with respect to low-income countries and countries in transition, it attracted broad attention and critique when the IMF also began to prescribe similar conditions to East Asian countries during the 1998 crisis (Wade 1998; Stiglitz 2002). The IMF was much criticized for the scope of its policy conditions, especially since these countries had experienced high growth for a long time and – according to many observers - only experienced a temporary loss of confidence. In practice, the objective of IMF programs has expanded far beyond fixing

short-term monetary disequilibria such as inflation or a balance of payments deficit. As is also evident from the name of the facility recently created for poor countries (PRGF), economic growth has become the central objective of the IMF.

Another significant change is that since 1976, when Italy and the United Kingdom were the last developed countries to borrow from the IMF, no rich countries have drawn upon the IMF resources. All IMF finance has been directed to developing countries and countries in transition. This means that the equilibrium within the IMF has been distorted. It is no longer an institution in which all contributors may also be beneficiaries.

3. The Democratic Deficit

International institutions such as the IMF and the World Bank make decisions on behalf of the participating countries and their populations in order to promote the public good for which they have been created: stability of the international monetary system and financing development in less developed countries. The question is to what extent their decision making power and their decisions are legitimate. To what extent are these institutions accountable to governments of participating countries and ultimately to their populations?

In this book a distinction has been made between input, throughput and output legitimacy. Table 1 visualizes the distinction between these three. With respect to the IMF and the World Bank, there are legitimacy problems of all three kinds. In this section I first describe the governance structure of the two institutions and the accompanying, almost inherent, legitimacy problems as they existed when these organizations were created. Subsequently, the changes in the nature of the legitimacy problems will be analyzed. These changes are related to the alterations and expansions in the tasks of these institutions as described in the previous section.

Table 1. Forms of legitimacy

Input	Throughput	Output
Participants in decision making	Rules and procedures for decision making	Decisions

The governance structure of IMF and World Bank is broadly similar. The highest decision making body in the IMF is the Board of Governors, consisting of the Central Bank presidents or finance ministers of the member countries. This Board meets once a year. In practice, most power has been delegated to the Executive Board which meets several times a week. The chair of the Executive Board is the Managing Director of the IMF, who is also head of the staff. There are 24 Executive Directors, and in total they represent all member countries. The eight largest countries in terms of GDP and participation in world trade have their own Executive Director,[4] all other countries have formed constituencies: groups of countries that elect an Executive Director and an alternate. In practice, executive directors have an office in the IMF with a small staff originating from the member countries of the constituency. The Executive Board decides on the IMF facilities to be granted. These decisions are prepared by the Managing Director and his staff.

The World Bank also has a Board of Governors, but here the countries are represented by their finance ministers or ministers of development cooperation. The Executive Board also has 24 Directors elected by the same constituencies as in the IMF. The chair of the EB is the

[4] USA, UK, France, Germany, Japan, China, Russia and Saudi Arabia

President of the World Bank who is head of the staff. The Managing Director of the IMF has always been from European origin, while the Bank's President has always been a US national. Staff of both institutions has expanded dramatically in the course of time. By 2006, the IMF has about 5,000 employees and the World Bank over 10,000, including more than 3,000 in offices in developing countries.

Decision making power within both institutions is based on membership contributions, so it is a system of weighted voting power. Contributions to the IMF are called quota. The quota allocation is decided upon by the Board of Governors and is based on the strength of the country's economy (GDP) and its participation in world trade (exports and imports of goods and services). Each member has 250 "basic votes", plus one vote for each 100,000 SDRs subscribed as quota. Many decisions of the IMF, however, including changes in the original articles of agreement but also the amount of quota for each member, have to be made with a qualified majority of 85% of the votes. Since the US has almost 18% of the total votes, the US has effective veto power.

A first general problem is that accountability of decision makers in these international institutions is at best indirect (Dahl 1999). There is no direct voting for the governing boards of these institutions. Governments send their representatives to make these decisions. To the extent that member countries have some kind of democratic system in which governments are elected by populations, populations can only indirectly, through parliaments, influence their representatives at international institutions. In practice, the policies of representatives in the Boards of governors and in the Executive Boards are prepared by staff in the ministries of finance, foreign affairs or development cooperation, and in Central Banks. Parliaments can discuss policies and actions of their countries' representatives in the Board of Governors (to the extent they are ministers), but cannot discuss directly with the Executive Directors. This means there is a lengthy accountability chain between decision makers and populations (Stiglitz 2003).

A second problem is the limited control of the member governments via their representatives in Board of Governors and Executive Board over the staff. The Board of Governors only meets once a year.[5] In these meetings the important policy decisions are made, such as quota revisions or decisions on new facilities. Daily operations of the institutions must be approved by the Executive Boards. Members of the Executive Board are employed full-time. In principle, this guarantees extensive oversight on behalf of member governments of the staff's actions.

However, in practice staff has substantial power vis-à-vis both Governors and Executive Directors. Politicians in general tend to have limited power over bureaucracies (Niskanen 1971). Staffs of government bureaucracies have a monopoly position with respect to politicians who control them. As a result of asymmetric information, bureaucracies will exaggerate the needs for their services as well as the resources needed to supply these services. This leads to a weakening in both allocative efficiency (the government supplying too many goods and services) and in X-efficiency (too large budgets for the amount of services supplied (Leibenstein 1966)). In a national context, however, politicians (ministers) also have a monopoly position with respect to "their" bureaucracies and they have the power and the incentive to check their growth.

In international institutions both the *opportunity* and the *incentives* to control bureaucracies are more restricted (Frey 1991; Vaubel 1991). First, the possibility to monitor and control is weakened because it is more difficult to define and measure the output of international institutions as compared to the output of national bureaucracies. There are often conflicting views on the main objectives, and views on necessary activities and costs to meet

[5] In practice they meet bi-annually; the other meeting is formally a meeting of the "Interim Committee" established in 1974.

these objectives are even more diffuse. This increases the information asymmetry between staff and controlling bodies. Second, the incentives to control are weakened because each member country only pays a small share of the costs of the organization. There is no incentive to be harsh to the organization since this would just mean a nasty conflict with other member countries, while the benefits for each individual member are small.

As a result of the lack of clarity of official objectives and desired outputs and their measurement, staffs of international institutions have only weak incentives to work for the official goals of the organizations. They tend to enhance their own goals and the goals of the bureaucracy itself. This means they are always trying to increase their tasks, activities and budgets. In the absence of measurable output, the organization also tends to confuse means with ends, implying that there will be a high degree of red tape and adherence to formal working procedures. For all these reasons, bureaucracies of international organizations tend to grow more than is warranted by increases in need, and they tend to have a high degree of X-inefficiency.

This application of public choice theory on international organizations has also been confirmed empirically for the cases of the World Bank and the IMF. Vaubel (1996) found that personnel costs of the IMF and the World Bank increased faster than staffs in other institutions. In principle, personnel budgets can be expected to expand in proportion with increases in needs, in labor costs and in increases in X-inefficiency. For the IMF, need was operationalized by the size of current account deficits and by losses in foreign reserves, and for the World Bank by the number of new loans. As a measure for X-efficiency, the quota share of the ten largest countries was taken. It was assumed that the higher the share of the ten largest countries, the more incentive they will have to control the efficiency of the institutions. As the number of member countries expanded in the course of time, the quota share of the ten largest countries has shrunk over time. It turns out that the quota share is the only significant factor in a regression to explain the increase in staff budgets for the IMF. For the World Bank, labor costs also proved to be significant (Vaubel 1996). The variables used to measure need did not influence staff budgets at all. This means that the incentive to control is indeed a factor that influences the internal efficiency.

Vaubel (1996) also found that both institutions engage in “hurry-up lending”. IMF lending significantly increases in the last year before the decision on quota revisions, which is done once in every five years. In the case of the World Bank, a similar development was visible with respect to the decisions on the IDA Replenishment Fund. These decisions are usually made once in the three years. In the year before that the volume of IDA credits always increases significantly (Vaubel 1996).

So far we have shown that the staff of both institutions is relatively powerful as opposed to the representatives of the member governments. This tends to reduce accountability in general, so implying an input legitimacy problem. It also tends to cause an expansion of tasks and activities of these institutions – more than is justified by objective needs.

In the case of the Executive Directors who, with their staffs, are supposed to act on behalf of participating governments, we can even question the extent to which they truly represent these governments. Their offices are located in the premises of the two institutions, where they occupy the highest and most luxurious floors, and their salaries are also paid by the two institutions. In fact, one can assume that their interests are very closely related to those of the staff: they also have an interest in expanding tasks and budgets, as they will directly benefit from that (Riesenhuber 2001). To some extent, this also holds for the relevant staff in the ministries and Central Banks within the member countries themselves. Their jobs, status and prestige are also related to the importance assigned to the international institutions, which they are supposed to control and influence. The more tasks and influence these

institutions have, the better it is for those who prepare policies for them. This implies that the drive toward the expansion of tasks, budgets and activities of the two institutions is very strong and there are hardly any checks on the system.

Decision making rules and procedures within the institutions add to the legitimacy problem. Staff prepares the proposals for country programs in the case of the IMF, and for overall country lending strategies and concrete lending activities in the case of the World Bank. Internal disagreements among staff are resolved before they are brought to the Board (Woods 2001). Board meetings are secret, but it is generally known that voting hardly ever occurs. Although Executive Directors do make remarks and comments, the Executive Board usually "rubber stamps" the decisions of the staff.

Similarly, IMF programs and World Bank loan proposals are only brought to the Boards once there is agreement between staff and recipient country governments. Staffs negotiate with governments of recipient countries on the policy conditions, but if the recipient country is in crisis or very poor, it is heavily dependent on an IMF program or a World Bank loan, and its position is weak. The substance of the policy conditions is never discussed during Board meetings, which means that recipient countries do not have the possibility of appealing through their representatives in the Executive Board (Riesenhuber 2001). This can be called a problem of throughput legitimacy. It further increases the power of the staff in relation to controlling bodies.

On the other hand, there is one exception to the rule that staff is more influential than representatives of shareholder governments. The United States as biggest shareholder has a direct influence on the staff. Staff will simply not bring any proposals to the Board if the US government opposes them. This has occurred, for example, with countries like Vietnam and Mozambique in the (1960s and) 1970s, with Nicaragua in the 1980s[6] and with Haiti during the more recent Aristide government.

4. How the Democratic Deficit has Increased since the 1980s

The changes and expansions in tasks and activities of the IMF and the World Bank have exacerbated the input and throughput legitimacy problems. At the same time, they have also created an output legitimacy problem.

Increased Input and Throughput Legitimacy Problems

The expansion in membership of the IMF has led to quota increases. But the current quota distribution and consequently voting power does not adequately reflect the strength of countries in the world economy (Kelkar *et al.* 2004). First, quota increases have not been accompanied by a change in the number of basic votes that each country has – the votes that are not proportional to the quota. In 1944, basic votes amounted to 11.26 percent of total voting power but this share diminished to 3.02 percent in 1995. As a result, the relative voting power of small countries has decreased. Second, quotas are calculated on the basis of variables that measure the country's economic strength (output measured by GDP), and variables that measure its potential need for resources, based on its openness to trade (exports, imports), the variability of its export receipts and its volume of international reserves. However, GDP is measured in a common currency, for example, the dollar, on the basis of prevailing market exchange rates. The disadvantage of market exchange rates is that they do

[6] Striking evidence of this is given, for example, in Leogrande (1996).

not reflect variation in purchasing power parity of these exchange rates. As a result, the GDP of low and middle income countries is usually underestimated, which further reduces the voting power of these countries. Kelkar *et al.* (2004: 729) show that the relative voting power of small but rich countries like the Netherlands and Belgium is higher than that of India and Brazil, while even at market exchange rates, the GDPs of the latter countries are higher. If computed at purchasing power parities, they are much higher.

The relative reduction in voting power of low and middle income countries is in sharp contrast with the fact that, since 1977, all beneficiaries of IMF programs are precisely these countries. This means that a minority of rich countries decides on programs for poorer countries. Decision making power is concentrated among the creditors, and is very limited among the beneficiaries of the programs (Woods 2001).

The change in the objectives of IMF programs has created a further problem with input legitimacy. As long as the IMF focused on maintaining exchange rate stability and solving short-term balance of payments problems, it was justified that decision makers within the IMF came from central banks and ministries of finance. However, the IMF has shifted from being primarily a monetary institution to an institution that aims to foster growth and development. The dominance of central banks and ministries of finance has therefore become odd. The new tasks require other areas of expertise (Stiglitz 2003).

The original problem with respect to throughput legitimacy, namely that the contents of policy conditions is not discussed in Executive Boards, has been exacerbated over time as the volume and scope of conditions has increased. While a typical IMF program had six quantitative performance criteria in the 1970s and ten in the 1980s, it had 26 in the 1990s (Kapur and Webb 2000). This means that staff of the IMF has become ever more intrusive in recipient countries' policies.

In recent years, Executive Boards (EB) have attempted to improve their extent of control over the staff. They have demanded additional information on program countries, for example more extensive assessments of past programs in countries demanding new IMF assistance. However, since the EB's information processing capacity is always more limited than that of staff, this has led to more *formal* control but not always to more *actual* control (Cottarelli 2005). At the same time, the size of some recent IMF programs, the perceived non-technical nature of the conditions, and the criticisms of IMF effectiveness have led to a movement away from the Executive Board to the capitals in a few rich countries. While the United States has always been able to influence staff directly (see above), the Boards of Governors and Executive Boards are now often bypassed by the G7 meetings (Cottarelli 2005).[7]

In conclusion, input and throughput legitimacy problems have been exacerbated as a result of the expansion of activities of the two institutions. Low and middle income countries have minimal voting power in the Boards while they are the principal clients, and the power of the Boards themselves has also been reduced.

Questionable Output Legitimacy

To some extent, output legitimacy may compensate for a democratic deficit on the input side. If the BWI deliver the intended international public goods effectively, there is less need to worry about input or throughput legitimacy. However, although space is lacking for a thorough analysis, there are many indications that output legitimacy is also problematic.

[7] For example, many high income non-G7 countries were unhappy with the "announcement" of the 100% multilateral debt relief proposal in the July 2005 G7 summit in Gleneagles.

An overview of many empirical studies shows that IMF programs may have a beneficiary effect on the balance of payments – not surprising given that money is flowing in with a program – but that growth is often not forthcoming (Bird 2001). Several more recent studies have also shown that IMF programs have not succeeded in fostering economic growth (Przeworski and Vreeland 2000; Bird 2001; Dreher 2004; Butkiewicz and Yanikkaya 2005). Barro and Lee (2005) find that a higher use of IMF loans[8] reduces economic growth, even if corrected for the factors that led to IMF involvement in the first place. They focus on the use of Stand By Arrangements and Extended Fund Facilities, i.e. middle income countries. The negative effect on growth is stronger if all IMF programs are taken into account (Barro and Lee 2005).

These negative outcomes may be due to several factors: IMF conditions are not implemented, the amount of financing is too limited, IMF programs do not lead to the expected inflow of other, additional resources, or the IMF sets the wrong conditions, i.e. conditions that do not support growth. There is some evidence for all of these.

There is a large body of literature showing that IMF conditionality is not effective in insuring that prescribed policies are carried out. Programs are often interrupted for being “off-track” (Killick 1995; Bird 2001) Countries do what they intended to do anyway, and other than this, they only implement cosmetically or with substantial delays (Killick *et al.* 1998; Dijkstra 2002). Domestic political economy factors are more decisive than IMF and World Bank conditionality (Dollar and Svensson 1998). In practice, IMF conditions are often not “owned” by the country and are therefore not implemented.

The size of an IMF loan is usually relatively small in relation to the balance of payments deficit. It is expected that the existence of an IMF program with its accompanying conditions will work as the seal of approval that leads to capital inflows from other sources. However, IMF programs have proven to be unsuccessful in catalyzing private capital flows (Bird and Rowlands 2000). Given that IMF conditionality is ineffective, it is not surprising that the catalyst function does not work. It is not possible to “buy reforms” and to have credible conditionality at the same time (Collier *et al.* 1997).

On the other hand, during recent currency crises, some middle income countries have received huge volumes of IMF assistance (East Asian countries, Russia, Brazil, Argentina, Turkey, see the peaks in Figure 1). In some of these cases, there have been accusations of political motives for the large lending volumes. Barro and Lee (2005) have empirically shown that countries with more intensive political and economic relations to the United States and large European economies receive larger and more frequent loans from the IMF (Barro and Lee 2005). These packages have also been criticized for their inducement of moral hazard among private creditors (IFIAC 2000). In fact, the IMF money allowed private creditors to get most of their money back during these crises, with negative incentive effects for future private investment decisions.

With respect to the contents of the conditions, the IMF programs and advices in countries in transition and in East Asia (before the 1998 crisis) have been criticized for their premature privatizations and liberalizations and lack of attention for institutions (Stiglitz 1998). The fact that the OECD and the IMF pushed for capital account liberalization in East Asia in the early 1990s is generally seen as a cause of the later crisis. The IMF has been called part of the Wall Street-Treasury-Complex, even by a prominent defender of free trade and globalization such as Bhagwati (Bhagwati 2004). When the Asian crisis broke out, criticisms were directed at the too restrictive fiscal policies that exacerbated the recession. In addition, in

[8] Use of loans is defined as the fraction of months during a five-year period that a country participated in an IMF program.

calling for substantive structural reforms, the IMF was screaming fire in the theatre which fuelled the outflow of foreign capital (Wade 1998; Stiglitz 2002).

In general, conditions of the IMF reflect the neo-liberal ideology of the rich countries, but this ideology is only pushed on low and middle income countries, while the rich countries themselves do not practice it. For example, during the 1998 Asian crisis, the IMF required an increased flexibility of labor markets that went far beyond what most industrialized countries accomplish in this area (Kapur and Webb 2000). Long before the Asian crisis, it was already evident that the IMF called for elimination of all trade barriers in developing countries so that rich countries could export their computers, machines, and commercial services, while there is no IMF pressure on rich countries to reduce protection for those sectors in which developing countries potentially compete, such as agriculture and textiles.

Another problem is that the extensive conditionality of the IMF and World Bank in many poor countries that are heavily dependent on aid tends to undermine domestic accountability processes (Verweij and Josling 2003). The IMF and the World Bank often require "laws to be approved", for example on tax reform or on health policies. It will seldom be the case that parliament fully agrees with these laws. It may approve them if there is a lot of pressure, but the chances of implementation are low. These laws will not be owned by the country. In addition, this practice weakens domestic legal processes and public confidence in them, with potentially serious long-term consequences. This is one the "paradoxes of conditionality" (Dijkstra 2002): donors push countries to have better governance and be more democratic, but they require the same countries to approve certain laws.

Finally, there is critique on the conflicting interests of the IMF in low-income countries. Poor countries with high debts need an IMF program in order to get debt relief and foreign aid. The IMF program is the seal of approval that opens the way to debt relief, grants and concessional loans. In this area of official and concessional finance, the catalytic function of the IMF is successful. But at the same time, the IMF is the creditor, and thus has an interest in a new program that brings in finance for repaying the old debts (White and Dijkstra 2003). The conflicting interest between the gatekeeper and the creditor role may lead to adverse selection: countries with worse policies receive more aid. Empirically, it has been shown that countries with higher multilateral debts receive more aid (Birdsall *et al.* 2003; Marchesi and Missale 2004).

As for the World Bank, the econometric evidence on the relationship between World Bank loans and economic growth appears to be more positive than that for the IMF (Butkiewicz and Yanikkaya 2005). However, the Meltzer report is very critical the results of World Bank lending, concluding that there is a 55-60% failure rate of projects (IFIAC 2000).[9] The same "Meltzer report" also established that the World Bank loans are directed to higher middle income countries that also have access to private credit markets.

The World Bank is also subject to criticisms on the proliferation of conditions and the large extent of non implementation due to lack of ownership (Mosley *et al.* 1991). In addition, some of the conditions that have been implemented have proven wrong. For example, state banks have been privatized before regulatory and supervisory frameworks were in place, and trade reforms have been carried out that led to great losses for the economy while the benefits accrued to other, less poor countries that did not carry out the same reforms.[10] For a long time, the World Bank has also been criticized for its lack of transparency, for negative social and environmental consequences of its projects, and for lack of attention of social and institutional factors in development.

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[9] The independent evaluation office of the Bank, OED (Operations Evaluation Department) generally concludes that one-third of projects is successful, one-third has satisfactory performance, and one-third fails.

[10] The abolition of export taxes on raw cashew nuts in Mozambique, for example, led to the collapse of Mozambican cashew nut processing industries while India maintained these taxes and handsomely benefitted.

5. Recent Changes and Reform Proposals

Since the mid-1990s and in response to the criticisms, both the IMF and the World Bank have introduced several changes in how they operate. These changes have been related, in particular, to improving throughput and output legitimacy. However, most of the implemented changes have only been carried out half-heartedly or cosmetically and have had limited real effects. On the other hand, far-reaching proposals have been suggested for changing internal governance in order to improve input legitimacy – but they have not been implemented so far. This section will first describe and analyze the changes that have been adopted, and then examine possible effects of the proposals that have *not* been implemented.

Changes Implemented

Both institutions have become far more transparent in their operations. Nowadays, the websites of both institutions give access to a huge amount of information on lending policies and actions. Subject to borrowing country approval, a large amount of information is also available on the developing country situation and on the nature of the institution's country program.

Both institutions but in particular the World Bank, have also opened up to debates with their critics, and in particular with local and international NGOs. In principle this is positive, but it also has some drawbacks. Some small developing countries complain that they have less influence on the Bank than the big international NGOs. Within borrowing countries, the activities of World Bank and other donors to stimulate civil society participation has induced politicians to "moonlight NGOs" in order to have more influence (Woods 2003).

The increased exchange of views with NGOs has led to the establishment of several independent or joint Bank-civil society committees to review bank policies and enhance public accountability. These include the Structural Adjustment Participatory Review Initiative (SAPRI), the World Commission on Dams (to review the large number of dam projects of the Bank), and the Extractive Industries Review (similarly, in order to examine loans for oil and gas exploitation). These Committees came to critical conclusions and recommendations, but so far to very little effect (Bello and Guttal 2005).

The creation of the World Bank Inspection Panel in 1995 was another result of the increased pressure from international civil society organizations, particularly in the areas of environmental protection and human rights (Fox 2000). The Panel consists of high-level independent experts. Citizens of developing countries can apply to this Panel with complaints about environmental or social costs of Bank projects. Although this is an important step in promoting accountability, an assessment of the Panel's effectiveness results in a mixed judgment. While it raised the internal profile of the Bank's "minimal safeguard policies"[11], it did not lead to sanctions in cases of non-compliance nor to changes in actual lending policies (Fox 2000).

In the same vain of improving throughput legitimacy, the IMF established its first Independent Evaluation Office (IEO) in 2002. So far, the IEO has produced several important reports and these have sometimes led to (small) changes in IMF policies (see below). But not all the recommendations have been implemented by Board of Governance or Executive Directors.

[11] These are the policies about protecting the rights of people and of the environment.

With respect to output, there have been some attempts to reduce the number and scope of IMF conditions, but on balance the results have been limited. When former Managing Director Horst Köhler took office in 2001, he announced that the IMF would return to its core business, i.e. examining fiscal and monetary policies only. However, in 1996, the Board of Governors required the IMF to include a concern about "good governance". In particular, the IMF was asked to "promote good governance in all its aspects, which include ensuring the rule of law, improving the efficiency and accountability of the public sector, and tackling corruption, as essential elements of a framework within which economies can prosper". This is certainly not the core business of the IMF. Yet, almost two-thirds of the Letters of Intent (the agreed upon conditions) concluded between January 2002 and April 2003 proved to include conditions related to good governance.[12]

In 1999, the adoption of the Heavily Indebted Poor Countries (HIPC) Initiative implied the obligation for these countries to elaborate Poverty Reduction Strategy Papers (PRSPs) with broad civil society participation. It was expected that these strategies would form the basis for lending and granting by all donors, so that no further conditions would be required. They would increase domestic and broad-based ownership in the recipient countries. Later on, the requirement of writing and implementing PRSPs was also attached to the new IMF facility for poor countries, the PRGF, and to the WB loans that replaced the earlier structural adjustment loans. However, in practice the earlier structural adjustment conditionality did not disappear (fiscal and monetary stabilization policies, structural reforms), so the requirement of elaborating a PRSP with participation implied an expansion of conditionality (Dijkstra 2002). In addition, the extent of actual participation in, and of national ownership of the PRSPs are not assessed favorably by the independent evaluation offices of both institutions (IEO 2004; OED 2004). In general, macroeconomic policies have not been discussed at all in the context of PRSPs and have been taken from earlier concluded ESAFs or PRGFs in which IMF staff has been dominant.

Since 2002, the IMF adopted a policy to "streamline" conditionality, implying fewer conditions and a heavier focus on core conditions that are really needed to improve macroeconomic stability, thus leaving out the so-called structural conditions. But the evidence on practice is mixed. The number of structural conditions may have gone down slightly, but they have often been taken over by the World Bank (Bird 2005). On the other hand, core conditions still comprise only two-thirds of the total, and if conditions related to governance are excluded from this "core", only 45% (Martin and Bargawi 2005).

In September 2005, the complaints of the conflicting interests in the IMF role in low income countries led to the introduction of a new facility that separates the gatekeeping function from the lending function for low income countries. Countries in need of a seal of approval but without balance of payments difficulties can apply to the Policy Support Instrument (PSI), implying the usual monitoring of macroeconomic policies but without any lending. By March 2006, it has been applied in two countries, Uganda and Nigeria.[13] It remains to be seen what the effects of this facility are. In countries without payment obligations to the BWIs, it may solve the conflict of interest but the gatekeeper role tends to be accompanied by tensions of itself: withholding the seal of good behavior has such severe consequences for the country (by losing access to budget support, in particular) that this will hardly ever been done.

The increased transparency, the WB Inspection Panel and the IMF's IEO are certainly important improvements. They can be seen as attempts to "deliberately democratize" the institutions (Verweij and Josling 2003). But they have not brought an end to the demands for

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[12] IMF Fact sheet "The IMF and good governance", April 2003, downloaded from www.imf.org on 28 March 2006.

[13] Fact sheet and press releases downloaded 28 March 2006 from www.imf.org.

(further) improving legitimacy and accountability. Attempts to reduce the number and scope of IMF conditions have so far not been very successful.

More Fundamental Proposals

The proposals to fundamentally increase democratic legitimacy of the institutions can be broken down in two broad categories. The first group of proposals aims to improve the input legitimacy of the IMF and the World Bank by changing its internal governance. The second group focuses on the output side, and in particular aims at reducing the output of the organizations.

In line with the earlier criticisms of the low decision making power of the developing countries vis-à-vis the main shareholders, the most important proposals to improve input legitimacy include:

- Changing the quota system in the IMF so that poorer countries obtain more voting power (Woods 2001; Stiglitz 2003; Kelkar *et al.* 2004)
- Changing the distribution of executive directors so that more of them originate from poor countries, based on the idea that voice is surely as important as voting power (Woods 2001; Askari 2004)
- Leaving the quota system as it is, i.e. based on strength of the respective economies, but requiring a double majority for important decisions: one according to current voting rights, another based on member of countries (Rapkin and Strand 2005)
- Changing the area of expertise of the Governors in the IMF to include more individuals with expertise in development (Stiglitz 2003)
- Changing the rules and customs for electing the Managing Director of IMF and the President of the World Bank, so that they can originate from developing countries (Birdsall 2003)

The proposals that focus on the output side stress that the IMF has taken on too many tasks. It should restrict itself to its core business of resolving temporary balance of payments problems and currency crises. In these crisis countries, however, the IMF should refrain from extending the scope of its conditionality. Conditions should be limited to some core monetary and, if necessary, fiscal targets. According to Woods (2003), an independent agency is needed to monitor the already existing guidelines to streamline conditionality. Going back to the core business also implies that the IMF should no longer be involved in low-income countries with structural, development problems (IFIAC 2000; Birdsall *et al.* 2002; IOB 2003; White and Dijkstra 2003).

Analysis

The Under-Secretary of State Adams of the United States has said that the US will not give up its quota share and that an eventual redistribution towards fast growing emerging economies must come from the shares of other high income countries.[14] He suggested that the European Union countries consolidate their chairs in the Executive Boards, reducing the number of Directors from the ten that now represent the 25 European Union countries. This is unlikely to happen in the near future. Recent appointments of the Director of the IMF and the President of the World Bank have shown that rich countries are not willing to give up their priority

[14] IMF Survey, 17 October 2005.

position here, either. The call for representatives from other constituencies in the Board of Governors of the IMF is bound to conflict with the still dominant idea of the IMF as a monetary institution and not a development institution. The other proposals will also meet fierce opposition from the United States and other major high income countries.

But given the analysis above, one can doubt whether these proposed changes in internal governance would have much effect anyway. They are all related to formal decision making power in the Board, while it has been shown above that actual decisions are made by the staff and, in really important matters, by the governments of the major shareholders. The expansion of tasks of, in particular, the IMF, has to a large extent been the result of the lack of control of the member countries over the staff of these organizations. The Executive Board, which is supposed to exert this control on behalf of member countries' governments, is almost part of the staff: it has the same interest in growth of the organization. At the same time, we have shown that a coalition of staff and Executive Directors has succeeded in expanding the scale and scope of activities of both the IMF and the World Bank. In turn, this extension of activities has made the United States more concerned about exerting its influence on the institutions.

The IMF has become an instrument of the rich countries to impose policy conditions on low and middle income countries. The contents of the conditions reflects the neo-liberal ideology of the rich countries – more precisely, the neo-liberal ideology of central banks and ministries of finance of the rich countries. As Stiglitz convincingly shows for the United States, there are checks and balances that prevent this ideology from dominating national policies within the rich countries (Stiglitz 2002). But in the context of IMF and World Bank, there are no checks and balances. The two institutions have a monopoly position towards countries in financial crisis and towards all low-income countries that are dependent on foreign aid. The strong position of the staff is enhanced by the procedural rule that the content of policy conditions is never discussed in the Executive Board. Recipient countries therefore cannot appeal to their representative in the Board in order to change these policy conditions.

This analysis implies that not much can be expected from changes in the composition of Executive Board members, voting power or the selection of the Director or President. The real power will continue to be exercised behind the scenes and will directly influence the actions of the staff. The democratic legitimacy problems will also continue to exist. For all these reasons, the proposals to substantially reduce the tasks of the IMF appear to be more effective for solving the legitimacy problems.

6. Conclusion

This chapter focuses on the democratic deficit of the IMF and the World Bank. While large bureaucracies always suffer from problems of input and throughput legitimacy, these problems are generally more severe for supranational bureaucracies. Democratic control can be indirect at best. Member countries have fewer incentives and fewer opportunities to control these big organizations. This usually leads to an expansion of tasks, and the chapter shows that the two BWI expanded the scale and scope of their activities enormously. The lack of effective control by the member states through the Executive Boards has facilitated this expansion. In fact, EB members and the constituencies in their home countries (staff working on the institutions in central banks and ministries of finance) had an interest in expanding the tasks and responsibilities of these institutions.

In turn, the expansion of tasks has exacerbated the democratic legitimacy problems of the two institutions. Relative voting power of low and middle income countries has diminished even though these countries have always been the only beneficiaries of World

Bank loans and have now become the single beneficiaries of IMF programs as well. The expansion in conditionality and recently the enormous size of individual loan packages for middle income countries has led to an increased dominance of the United States and some few other major shareholders in decision making. This asymmetric decision making has influenced the contents of conditions and reduced their fairness. This has led to severe problems of output legitimacy. There is also increasing evidence of lack of effectiveness of, in particular, the IMF – especially with respect to the main aim that the institution has taken on in recent years, namely, promoting economic growth.

Both the World Bank and the IMF have become more transparent during the last ten years or so, and they have implemented some other changes in how they operate. In particular, they are more open to debate with NGOs, the World Bank established an Inspection Panel to which citizens affected by projects can complain, and the IMF now also has an Independent Evaluation Office. In a way, the institutions have attempted to solve their democratic deficit by moving into a deliberative democracy model. However, the fundamental problems of input and output legitimacy continue.

Many proposals have been advanced for giving more formal voting power and influence to low and middle income countries in the Executive Boards. They are not likely to be implemented. More importantly, given the above analysis, they are unlikely to be effective in reducing the democratic deficit. In fact, real power is not with the Board of Governors or with Executive Boards, but instead with the staff and with the G7 or sometimes the G1 (the United States). All of this leads to the conclusion that the radical proposals for reducing the scale and scope of activities of the IMF are more likely to reduce the democratic deficit effectively.

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