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Briefing Paper

Applying Economics to Economists:
Good Governance at the International Financial Institutions

By Mark Weisbrot and Dean Baker[1]

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CENTER FOR ECONOMIC AND POLICY RESEARCH 1611 CONNECTICUT AVE., NW, SUITE 400
WASHINGTON, D.C. 20009 (202) 293-5380 <WWW.CEPR.NET> EMAIL: CEPR@CEPR.NET

[1] Mark Weisbrot and Dean Baker are co-directors of the Center for Economic and Policy Research. Alan Cibils, Debayani Kar, and Todd Tucker gave helpful comments on earlier versions of this paper.

Executive Summary

Economists generally believe that it is important for workers to be held accountable for the quality of their work in order to maintain high levels of economic efficiency. In particular, International Financial Institutions (IFIs) such as the International Monetary Fund and the World Bank have been strong advocates of weakening regulations that limit the ability of companies to dismiss workers. While there is clearly some validity to this view, it is not clear that it has been applied to the economists at these institutions.

This paper outlines a proposal for increasing the efficiency and effectiveness of these institutions by institutionalizing mechanisms of accountability. There are four basic principles to the proposal:

1) Well-specified goals – the expected outcome of a specific policy should be clearly stated before borrowing countries begin to implement it;

2) Frequent evaluations – the IFIs should at regular intervals indicate whether the country is on course to meet the stated targets. If it appears to be failing to meet the targets, then it should be clearly indicated whether the failure is due to the country not following through with the specifics of the program, whether unforeseen events had occurred, or whether the program was poorly designed for the circumstances.

3) Identify the responsible economists and their supervisors – policies should be clearly associated with specific economists, as well as the people who oversee them. If policy recommendations turn out poorly, because they were badly designed, it should be possible to hold the authors accountable.

4) All the reports should be fully public. The IFIs should also take steps to ensure that they are widely available in the affected countries. This is essential to ensuring that the public in these countries is fully informed on the factors determining key policy decisions and the reasons for their success or failure.

If the IFIs follow these principles in monitoring their programs, it should allow for greater internal accountability, as well as providing client countries with a better basis to assess recommended programs. For example, if a program is proposed by an economist with a poor track record, countries should be aware of this fact before they adopt the program. Steps towards increased accountability should lead to the more efficient operation at the IFIs and better policy.

Introduction

Economists at the International Monetary Fund and World Bank have long touted the importance of incentives to motivate workers to perform well. They have also emphasized the importance of discipline mechanisms and dismissal as a means to sanction poor performances or simply to remove workers who are not competent in their jobs.

In this spirit, the International Monetary Fund (IMF) and the World Bank have both frequently advocated weakening regulations in countries that make it difficult for employers to dismiss workers.[2] They have argued that restrictions on dismissals discourage employers from taking on new workers and often leave them stuck with unmotivated and/or incompetent employees.

While the International Financial Institutions (IFIs) are clearly correct in noting that the possibility of dismissal can both encourage workers to perform better and also provide a method of removing workers who do not perform adequately, it is questionable whether these institutions have applied the same standards internally. In other words, it is not clear that the economists and professional staff at the IFIs are held accountable for their performance in the same way as they advocate other workers should be held accountable.

This short paper proposes a mechanism that would seek to increase accountability at the IFIs. The purpose is to ensure that when their policy advice to developing countries turns out poorly, the people who designed the policies are held accountable. The professional careers of those who proffer bad advice should be negatively affected. By making career advancement more clearly dependent on the success of the policies put forward, the IMF and World Bank should become more effective in designing policies that meet the needs of developing countries.

The basic rules for the increased accountability of IFI staff are very straightforward. They involve four principles:

1) Well-specified goals – the expected outcome of a specific policy should be clearly stated before developing countries begin to implement it;

[2] For example, see Kruger, A. 2004. "Meant Well, Tried Little, Failed Much: Policy Reforms in Emerging Market Economies," International Monetary Fund Roundtable Lecture, Economic Honors Society, New York University, New York, March 23, 2004 http://www.imf.org/external/np/speeches/2004/032304a.htm; Singh, A. 2004, "Latin America: Sustaining Reforms and Growth," Remarks by Anoop Singh, Director of the Western Hemisphere Department, International Monetary Fund Delivered at investors' meetings in Lima, Peru at the time of the 45th Annual Meeting of the Inter-American Development Bank Lima, March 27-28, 2004, http://www.imf.org/external/np/speeches/2004/032704.htm ;International Monetary Fund 2003, World Economic Outlook, April 2003. Washington, D.C.: International Monetary Fund, chapter 4.

2) Frequent evaluations – the IFIs should at regular intervals indicate whether the country is on course to meet the stated targets. If it appears to be failing to meet the targets, then it should be clearly indicated whether the failure is due to the country not following through with the specifics of the program, whether unforeseen events had occurred, or whether the program was poorly designed for the circumstances.

3) Identify the responsible economists and their supervisors – policies should be clearly associated with specific economists, as well as the people who oversee them. If policy recommendations turn out poorly, because they were badly designed, it should be possible to hold the authors accountable.

4) All the reports should be fully public. The IFIs should also take steps to insure that they are widely available in the affected countries. This is essential to ensuring that the public in these countries is fully informed on the factors determining key policy decisions and the reasons for their success or failure.

These principles, and their implementation, are described in somewhat greater detail below.

Establishing Clearly Defined and Quantified Goals

The IFIs should explicitly describe exactly what any program is expected to accomplish. This will make it possible to determine whether or not the costs are worth the expected benefits before the program is implemented, and whether the goal was met after the fact.

In determining costs beforehand, most IFI policy will involve both economic and political costs. For example, a fiscal austerity policy may lead to higher short-term unemployment. This may be a cost worth paying if the long-term result is more growth and eventually lower unemployment, but governments and populations would have to have a clear idea of the expected benefits, in order to determine if they outweighed the short-term costs. However, to balance benefits and costs, the public must know exactly how much more GDP should be expected to grow as a result of an austerity policy. Increasing growth by 1.0 percentage point may justify some short-term pain, increasing growth by 0.1 percentage point may not.

The Congressional Budget Office (CBO) in the United States provides an excellent model for these sorts of projections in its annual *Budget and Economic Outlook*. It draws up a baseline for the budget and the economy assuming policy is held constant. This baseline can be readily compared with the projections from other government agencies and private forecasters. (In fact, CBO actually publishes these projections and includes them in the *Outlook*.)

Similarly, the restructuring of public pension systems could have long-term benefits, but the process will generally involve high short-term political costs, as segments of the population see their pensions reduced. Again, it is necessary to specify the nature of the expected benefits in order for a government to determine whether the policy is worth pursuing in spite of the political costs involved. The prospect of increasing participation rates in social security systems by 20 percentage points may lead a government to endure some short-term political costs. Increasing participation rates by 2 percentage points probably would not be worth paying much of a political price.

The benefits should be clearly and precisely specified (e.g. increases in GDP growth, the number of people brought out of poverty, the increase in coverage rates and/or the percentage increase in retirement income resulting from pension reform) so there is no ambiguity about the goals of the policies. This means that there should be an explicit baseline that assumes the policy is not implemented, and then a projection that shows the benefits of the policy. By making the baseline assumptions available, policy analysts will be able to compare the IFI projections with those available from other sources to ensure that they accurately reflect the information available. Then, assuming that the IFI baselines are consistent with independent projections, policymakers and the public at large in the affected countries would be able to evaluate the projected benefits that could be gained from specific policies.

Frequent Progress Reports

The economy never moves exactly as predicted. When policies either come up short or turn out better than expected, it is important to be able to determine the extent to which the gap between outcomes and expectations is attributable to the policies not being followed, the policies being inappropriately designed, or unexpected and unforeseeable events. The only way to ensure that the credit or blame is properly attributed is for the IFIs to make frequent assessments of the progress of each program. These assessments could be short, but they must be done frequently (e.g. six month or at most annual intervals) to avoid the possibility of making judgments retroactively.[3] In other words, if a government is or is not deviating from a policy design in an important way, the IFI economists supervising the program should make this known explicitly at the time – not raise it as an issue after the fact. (The appendix includes examples of projection and evaluation forms that should help clarify the precise intent of this proposal.)

For example, if the IMF economists felt that Argentina was dooming itself to failure in the late nineties by keeping its currency pegged at too high a level, then they should have said so explicitly at the time. In this way, the country (both the government and the population as a whole) would have had the benefit of the IMF's judgment at a time when it may have still been possible to rectify a disastrous policy. Of course, if this was not the IMF's assessment at the time, then it would be desirable to have this fact clearly on the record.

[3] Crisis situations may require more frequent evaluations, possibly on a quarterly basis.

Of course, in many cases policies will fail because of events that could not have been foreseen. But it is important to keep track even in these cases. Unforeseen events should lead to worse than expected outcomes half of the time and better than expected outcomes the other half. If unforeseen events always lead to worse than expected outcomes, this suggests a bias in projections. Ideally, this bias should be corrected; however if it is not correctable, then policymakers and the public should be fully cognizant of this bias when they evaluate the merits of IFI policy proposals.[4]

Holding Economists and Supervisors Accountable

The IFIs should set out a clear and open chain of authority that establishes responsibility for every program. This means that the identities of the economists who are directly responsible for designing and overseeing a program should be readily available to any interested parties. This should make it easy for analysts to determine whether particular economists have a good track record in designing policies that meet their targets. While the IFIs may want to use this information internally to determine the career paths of their economists, the countries considering programs should have easy access to the track record of the person presenting the advice. This should be a very important factor in their willingness to follow through with a specific program.

For example, if an economist has a track record of recommending policies that governments do not adhere to adequately (in the economist's own view), then it would be reasonable for a government to conclude that it might also be unable to adequately adhere to the program being recommended by this economist. Alternatively, if an economist has a track record in which unforeseen events have consistently led to worse than expected outcomes, then a government may reasonably assume that the economist has an optimistic bias in his or her projections. Of course, if the economist has a track record of poorly designed policies (again, by his or her own assessment), then governments would presumably not want to trust his or her advice.

Listing the chain of authority on each program will encourage the IFIs to remove under-performing economists and their supervisors. If a supervisor's record stands out as being especially bad, then this listing will make that fact clear. If the top leadership of these organizations retains and promotes economists and supervisors who consistently design poor policies for developing countries, then they should be held accountable themselves. The basic point here is very simple -- when a country follows IFI programs, many of which require major social transformations – children in that country should not be the

[4] See Baker, D. and D. Rosnick, 2003. "Too Sunny in Latin America? The IMF's Overly Optimistic Growth Projections and Their Consequences" Center for Economic and Policy Research [http://www.cepr.net/IMF_Growth.htm] This paper compared IMF growth projections for Latin America with actual economic performance for the years from 1986 to 2002. It found that the growth projections were higher than actual growth in 13 of the 16 years. The average error was 1.6 percentage points, with the error being highly significant in a simple regression.

only ones put at risk. The economists and IFI bureaucrats who design and promote the policies should also have their careers at risk. Anything less is unfair, and bad economics.

Appendix

Sample Macroeconomic Program Projection

Baseline Projection						
	Year 1	Year 2	Year 3	Year 4	Year 5	Years 6-10
GDP Growth						
Unemployment Rate						
Inflation Rate						
Budget Deficit						
Current Account Deficit						
Short-term interest rate						
Long-term interest rate						

Program Projection						
	Year 1	Year 2	Year 3	Year 4	Year 5	Years 6-10
GDP Growth						
Unemployment Rate						
Inflation Rate						
Budget Deficit						
Current Account Deficit						
Short-term interest rate						
Long-term interest rate						

Country Officer(s) ________________________________
Immediate Supervisor(s) ___________________________
Secondary Supervisor(s) ___________________________

Macroeconomic Update Projection

Program Projection						
	Year 1	Year 2	Year 3	Year 4	Year 5	Years 6-10
GDP Growth						
Unemployment Rate						
Inflation Rate						
Budget Deficit						
Current Account Deficit						
Short-term interest rate						
Long-term interest rate						

Revised Projection						
	Year 1	Year 2	Year 3	Year 4	Year 5	Years 6-10
GDP Growth						
Unemployment Rate						
Inflation Rate						
Budget Deficit						
Current Account Deficit						
Short-term interest rate						
Long-term interest rate						

Reasons for Revisions:

1) Policy differences from program (list):

a)
b)
c)

2) Forecast Error (list sources):

a)
b)
c)

Country Officer(s) ________________________________
Immediate Supervisor(s) ___________________________
Secondary Supervisor(s) ___________________________

Sample Program Projection – Social Security Reform

Baseline Projection						
	Year 1	Year 2	Year 3	Year 4	Year 5	Years 6-10
Participation Rate						
Average Replacement Rate (new retirees)						
Poverty Rate (new retirees)						
Administrative Costs						

Program Projection						
	Year 1	Year 2	Year 3	Year 4	Year 5	Years 6-10
Participation Rate						
Average Replacement Rate (new retirees)						
Poverty Rate (new retirees)						
Administrative Costs						

Country Officer(s) ________________________________
Immediate Supervisor(s) ___________________________
Secondary Supervisor(s) ___________________________

Program Update and Assessment

Program Projection						
	Year 1	Year 2	Year 3	Year 4	Year 5	Years 6-10
Participation Rate						
Average Replacement Rate (new retirees)						
Poverty Rate (new retirees)						
Administrative Costs						

Revised Projection						
	Year 1	Year 2	Year 3	Year 4	Year 5	Years 6-10
Participation Rate						
Average Replacement Rate (new retirees)						
Poverty Rate (new retirees)						
Administrative Costs						

Reasons for Revisions:

3) Policy differences from program (list):

a)
b)
c)

4) Forecast Error (list sources):

a)
b)
c)

Country Officer(s) ________________________________
Immediate Supervisor(s) ___________________________
Secondary Supervisor(s) ___________________________