The World Bank's Disclosure Policy Review and the Importance of Transparency and Democratic Participatory Processes in Achieving Successful Development Outcomes

United States House of Representatives
Committee on Financial Services

Testimony by
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September 10, 2009

Let me thank you for this opportunity to discuss reforms in the governance, transparency, and accountability of the World Bank. While I will focus on the World Bank, I should add that most of what I have to say is equally relevant to other international financial institutions (IFIs).

I will begin be reiterating what I said in my testimony before this committee on May 22, 2007:

1. America, and the world, has a strong interest in contributing to reducing poverty and promoting growth in the developing world. Aid can be an effective instrument in achieving these objectives.
2. The multilateral institutions (of which the World Bank is the premier institution) play an important role in this global effort. For a variety of reasons, assistance administered through the World Bank (and other multilateral institutions) can be even more effective in achieving our objectives than assistance provided by the U.S. directly.

Multilateral aid is often more effective than national assistance, in part because it is not so closely linked with the agenda of any particular country; that makes the aid more effective and the advice more readily accepted. Moreover, by bringing the brightest researchers in development from around the world together, there is a chance of greater progress in addressing what in some parts of the world seems an almost intractable problem. When multilateralism works well, the whole can be greater than the sum of its parts. Moreover, multilateralism helps "teach" democracy by showing how countries can act together, democratically, to advance common ends: it provides an example for others to follow.

3. It is therefore in our interest that the World Bank remains strong, credible, and effective.
4. The Bank has rightly emphasized good governance and corruption, but the Bank can only be effective if it is seen as having good governance itself. Good governance—a commitment to basic, democratic values—requires, for instance, that the head of the institution be chosen in an open and transparent process; it should be the most qualified

person for the job, regardless of race, gender, or nationality. It is in America's interest that the head of the institution not simply be chosen by the President of the United States.
5. There are other important changes in the governance of the World Bank and other multilateral institutions that will increase their effectiveness. These include more democratic accountability, increased transparency, and strengthened procedural safeguards.
6. It is important for the U.S. Congress to take an active role in reforming the World Bank and the policies which it pursues, if necessary by imposing conditionality in the provision of funds to the World Bank. Such reforms should include principles which should receive bipartisan support, e.g. that the multilateral institutions should be especially careful in imposing as conditions (or more broadly, even pushing) policies which have been rejected in the United States and that the World Bank can only be effective in conveying a message of good governance if there is a belief that its own governance conforms to the standards that it demands of others (including standards relating to the choice of personnel and due process).

This morning, I want to elaborate on a few issues related to governance and transparency. The importance of the issue of transparency was brought home to me during my visit in the last couple of days to Iceland. The country has had a bank collapse of unprecedented magnitude. It followed the deregulation and liberalization policies that had become the fashion in the past quarter century—policies, which, by the way, were often advocated and pushed by the international financial institutions. As in the U.S., inadequate regulation has imposed a huge cost on society, a cost that will be borne for years—perhaps even decades to come—by Iceland's citizens. The IMF helped support Iceland with a program which was unusual: it provided more fiscal space than it had elsewhere and allowed, even encouraged, them to impose capital controls. But the well-educated citizens of Iceland are well-informed about what the IMF has done elsewhere. There is, at least in the very large number of individuals I talked and interacted with, little confidence in the transparency of the institution. They worry that there are secret yet to be disclosed conditions. They view the pressure that they (rightly or wrongly) believe is being imposed by the IMF in shaping their response to the crisis (including with respect to the treatment of foreign creditors) as a violation of their economic sovereignty, and they resent it. A widely shared sentiment is that, while the IMF approach may work in dealing with a less democratic and less educated society, it is totally unsuitable for a vibrant, engaged, and educated citizenry such as that of Iceland. Whether the accusations and concerns have any validity is not the point I want to raise. It is that the legacy of the past haunts the present. This is why it is imperative that reforms be made quickly.

Some reforms have already occurred. It may seem strange that it is considered a major victory in democratic governance in the twenty-first century that the G-20 has agreed, at last, that the head of the international financial institutions should be chosen on the basis of merit, but we should celebrate the victory—and hope that this decision gets implemented.

Because these institutions have no system of direct democratic accountability, it is all the

more important that there be confidence in their governance, that they be transparent, and that attention be given to a variety of other forms of accountability.

Given, for instance, the large role that finance ministries play, it is not surprising that the institutions advocated liberalization and privatization policies that have served so many developing countries so poorly. What is striking is how little basis there was in either theory or evidence behind the policies that they pushed. When the IMF attempted to change its charter to give it greater scope to push capital market liberalization, I asked where the evidence was that it promoted either growth or stability. There was ample evidence, even at that time, that it led to more instability—evidence which has since mounted. When the IMF finally conducted some studies on the impact on growth, it corroborated earlier studies (such as that done at Harvard by Dani Rodrik) that questioned the impact on growth, at least for many countries. My own theoretical work had helped explain why there might be a negative impact on growth and volatility.

I recite this example at length only to highlight two points: the institutions have pushed a variety of policies whose benefits—either for development or poverty alleviation—are questionable; and there may be a link between these failures in policy and the systems of governance. Had there been more transparency and better systems of accountability, perhaps the voices that were raised against these policies might have had more impact.

Improving Governance and Accountability

While the reforms that have been agreed to among the G-20 are steps in the right direction, it should be clear that the pace of reform is slow and the reforms on the table are likely to have limited impact and are insufficient to address long standing criticisms. For instance, while giving emerging markets more voting rights is desirable, there is little reason to believe that it will result in fundamental changes to the behavior of the institutions. More fundamental reforms, e.g. double majority voting, should be considered.

Other ways of increasing accountability of the international institutions need to be explored. While proposals to strengthen "reporting" to a more politically accountable body, such as a Council of Finance Ministers, might seem to do this, such reforms may have the opposite effect: if the Finance Ministers are insufficiently engaged, it would, in effect, give more autonomy to the bureaucracy.

The World Bank poses a particular problem, as it is not really a bank but a development institution. Meanwhile, Finance Ministries (such as the US Treasury) are not development agencies, so there is a double problem: not only are some of the policies which are pushed more reflective of the distinctive perspectives of the financial sector, but also there is really not a depth of understanding of what makes for successful development. Moreover, many critics of current governance are skeptical of the commitment of finance ministries to the major objectives of the World Bank, including alleviating poverty and assisting developing countries in the provision of global public

goods. Growth, by itself, need not lead to poverty alleviation; growth pursued the wrong way—with policies, for instance, that increase instability—can even increase poverty.

Moreover, what is in the interests of some in the financial sector may run counter to stability, growth, and poverty reduction, especially in developing countries, as we have all learned in the recent crisis at great expense. Americans are now glad that they did not succumb to arguments for privatization of social security. Had they done so, the security of the aged would be in even greater jeopardy, and the magnitude of the downturn would have been even worse, as savings would have had to increase even more to make up for the loss in household wealth. However, the international financial institutions pushed privatization of social security in many countries. Privatization may generate more fees (more income) for the financial sector, but these gains for the financial sector come at the expense of the elderly, who see retirement benefits diminished and who face increased insecurity.

Not everyone may agree with the argument that I have just put forward, but the point I want to make here is different: the international financial institutions should not be pushing what might be viewed as a special interest agenda. They should be working to strengthen democratic decision-making processes, not selling questionable policies.

There is no simple way of addressing these concerns. I want to put forward four sets of governance reforms. One of the underlying problems when we talk about improved systems of governance and accountability is *accountability to whom.* Systems of accountability do affect behavior. A thought experiment might help clarify what is at stake: if the World Bank had to report to a Council of Labor Ministers, there might be more concern about ensuring that the World Bank is pushing the acceptance of core labor standards, adequate levels of a minimum wage, enforcement of workplace health and safety standards, and other forms of job protection. These are not part of the core concerns of finance ministers. Indeed, in some cases, they (perhaps mistakenly) even see these as antithetical to increased profitability of the financial institutions that are their core constituency.

The first set of governance reforms should increase the voice of the developing countries and emerging markets. The international financial institutions and the policies which they push can have a large impact on these countries. As a result, both the governments and the citizens of these countries are more engaged in the policies and practices of the IFIs. Few Americans may even know what conditionality means or what a structural adjustment program entails, but they are at the center of life in many developing countries. The consequence of the lack of broad engagement in many (but not all) of the advanced industrial countries is that special interests are given wider scope for pursuing their own agendas. Even in developing countries, finance ministries may actually have views that are more in tune with financial markets than with other sectors of society, but what they do and say may be more circumscribed than ministers in advanced industrial countries.

There are several ways in which the voice of developing countries may be enhanced. (Let me reiterate—I believe that doing so would enhance the effectiveness of these institutions, which would be in the interest of the U.S.) As I suggested earlier, the proposed reallocation of voting rights is likely to have only marginal effects. There are, however, a number of forms of double majority voting which would bring about more fundamental change: ensuring that a majority of developing (borrowing) countries support a policy will result in broader "ownership" of bank and fund policies, which in turn may strengthen support of their policies in the countries with IFI programs.

This may even be more so if there is some form of institutional support (e.g. to an independent developmental policy think tank) that enhances the capacity of developing countries to make more informed decisions and more persuasive arguments in favor of their positions.

The second set of reforms relates to who represents the United States. In spite of the important contributions that USAID has made in many important areas of development, I think it is fair to say that it has not had the impact of, say, UK's development agency, DfID, or that of some other countries. USAID has pursued a number of particular agendas but has often been less engaged in the broader developmental agenda, including in some of the key policy debates. Were there more confidence in America's development agency, one might argue that the US agency best equipped to exercise oversight over the World Bank, which is a development agency, is the US development agency.

Moreover, there is a risk that an American (or any other) aid agency might simply try to replicate on a global scale America's bilateral aid agenda. However, there is a distinct difference between national aid policies (which are often mixed with national geo-political or geo-economic issues) and the policies that should be pursued by an effective multilateral institution.

Perhaps one way of balancing these conflicting perspectives is to create a system of accountability to multiple agencies (an interagency process). The World Bank is involved in education, health, the environment, etc., and it would be a mistake not to draw upon this expertise in the oversight of the various programs of the World Bank.

There is a third pillar of improved governance: accountability to parliaments (Congress). Many citizens care passionately about the issues, for instance, of poverty reduction in the developing countries, and they communicate that concern to their Congressmen (Parliamentarians). I have spoken to the UK all-party parliamentary group on aid, trade, and debt, which is, I believe, the largest such parliamentary group. Somewhat surprised by its size, I asked the head for an explanation. The answer was simple and said a great deal: our constituents care deeply about these issues.

Issues of labor rights and the environment may not be central to the agenda of finance ministries, but they are central to the concerns of many citizens around the world. The strength of democracies is that Congressmen (parliamentarians) reflect what is of concern

to their constituents. Having some form of accountability to an international Committee of Parliamentarians could make a major difference to how these institutions conduct themselves.

I want to come to the fourth, and perhaps the most important but the most complex pillar of improved governance. I described before the problems facing the U.S. in deciding to whom the World Bank should be accountable. Other countries face similar problems. The difficulties arise because successful development is "comprehensive" and entails multiple sectors—education, health, finance, energy, and agriculture. Our governments are designed have cabinets or agencies (ministries) that focus on only one of these areas. Today, by the same token, most of the decision-making in the international context is conducted in "smokestacks," with trade ministers talking with trade ministers, finance ministers with finance ministers, etc. Inevitably, issues are approached from an excessively narrow perspective, in which cross-cutting issues get short shrift (and concerns of special interests move to the center).

There is, within most countries, only one person that looks at matters from a "national" or "global" perspective, and that is the "leader." Reporting to G-20 leaders might be helpful, at least on certain key decisions such as the extent of conditionality in lending or the role of the international institutions in promoting global public goods.

There is a more fundamental change in perspective which may serve to diminish the significance of the IFI-governance reforms: recasting the IMF and World Bank as "implementing" agencies, which implement global economic policy on behalf of the international community with policies set by the political *leadership* of the international community. It is important that the responsibility be set at the "leaders" level, for only they can break out of the silos into which decision-making, especially at the international level, has been cast.

The hard part of this reform is deciding who the new policy body should be. It would be a natural function of the Global Economic Coordination Council, recommended by the UN Commission of Experts on Reforms of the International Monetary and Financial System, which I chaired. The size of the GECC would be similar to that of the G-20 but based on the "constituency" principle, where certain countries would speak not just for themselves but also represent the interests of their constituent countries. The determination of the constituencies is a matter of discussion and deliberation. Most could be regional, but there could be one or more representing countries in particular situations, e.g. there might be one representing the least developed countries. Terms would be sufficiently long that relationships would develop, maintaining the continuity that seems to be one of the strengths of the current G-20.

An alternative would be reporting to a slightly more "legitimized" G-20, which itself could be viewed as a consensus building, broad-based caucus within the UN.

The leaders themselves are not likely to be in a position to set policy, so they will inevitably delegate. How that delegation is done is critical. Given that the G-20 is

concerned largely with economic matters, and in fact grew out of a Finance Ministers' meeting, there may be a temptation to delegate to a *financial* body like the Financial Stability Board. There is a risk in doing so, simply because that body may reflect perspectives of the financial market (paying less attention to concerns, say, of labor, business, technology, etc.). This might replicate some of the problems to which I have already referred.

A properly constituted International Experts Panel, to which the IFIs might report, would be able to exercise some check against possible distortions. It would have the further advantage that it would bring to the table expertise that might challenge that of the IFIs. (The UN Conference on the World Financial and Economic Crisis and its Impact on Development in June 2009 endorsed the idea of such a panel.)

These alternatives should be seen not as mutually exclusive but complementary. The fact that these are complex institutions that have an enormous impact on the well-being of the billions living in developing countries makes the task of designing accountability systems both difficult and important.

Economists emphasize that incentives matter, and that may be as true for those in the public sector as in the private. Within national governments, we have become aware of the problems posed by conflicts of interest, especially those associated with revolving doors. It is, of course, more than a matter of conflicts of interest. If the government hires someone from the financial sector, who returns to the financial sector after his public service, he will view the world before, during, and after his public service from the distinctive perspectives of finance—and that may not be the most appropriate for advancing poverty reduction and development.

Transparency

Transparency is an important ingredient in good governance. It is hard to hold an institution accountable if one doesn't know what it has done. The less well-informed one is of the choices confronting the decision-making and the circumstances under which the decisions were made, the less one will be able to assess performance. Indeed, both insiders and outsiders are less able to learn from the mistakes and correct them. Furthermore, as I illustrated in my prefatory remarks, lack of transparency generates lack of trust and undermines the effectiveness of the institutions.

Elsewhere, I have written of a citizen's basic right to know, as implemented in the United States by the Freedom of Information Act. In recent years, we have been particularly thankful of the access to information that this act has provided, as a check against government abuses.

The basic principle underlying this right is that government works for the people, and those that they were working for have a right to know what is being done supposedly on their behalf. As the expression goes, sunshine is the strongest antiseptic. Lack of

transparency hides actions which benefit some groups at the expense of others and is also used as a way of a hiding mistakes and misguided policies.

There are certain exceptions to full transparency. One might not want to instantaneously disclose information about the weakness of a bank if the institution can quickly repair the deficiencies, as it might lead to a run on the bank. There is also a national security exception. However, as the late Patrick Moynihan pointed out in his great book *Secrecy: The American Experience*, that exception has been abused, and that has its costs which may exceed the benefits.

Much of the lack of transparency (secrecy) practiced by governments and international financial institutions has little justification. Central banks have become more transparent, and none of the fears of those advocating secrecy have materialized. There was a great deal of reluctance by the Fed to disclose the recipients of the AIG funds. The disclosures made clear why they were reluctant, with the largest recipients being Goldman Sachs and a couple of foreign banks. With so much of the money going to systemically significant institutions, questions were obviously raised about the supposed rationale for the massive bailout.

Many developing (and developed countries) have commercial contracts, especially with natural resource extraction (oil and mining) companies, the terms of which are not fully disclosed. It is argued that this is standard commercial practice. However, that is unacceptable: the citizens of the country are the owners of the natural resources, and they should be able to assess whether they are being cheated—which is the natural suspicion when the terms are not made public. That is why there is a global initiative to demand more transparency in the extractive industries.

It makes little sense for the World Bank to be putting money into a country if that country is pouring money out in sweetheart deals with mining and oil companies, but without transparency, one cannot tell whether that is being done.

This brings me to a difficult question: the countries say that they have no choice and that the mining companies insist on secrecy. But the international institutions sometimes say that they also have no choice and that it is up to individual countries to make their own disclosure decisions.

For the most part, I have expressed strong reservations against traditional policies of conditionality. Such conditionalities often undermine the effectiveness of programs and democratic processes and often are counterproductive because they impose the wrong policies. Obviously, those giving money to others have to have some assurances the money will be well spent. Some conditionality is inevitable, and conditionalities that strengthen democratic processes may have double benefits. That is my view on conditionalities associated with transparency. The citizens of the United States, I believe, have a right to know what the World Bank and the IMF are doing, and they have a right to know whether the countries to which they are providing assistance are giving money

away in sweetheart deals to mining companies. Unlike other forms of conditionality, this transparency conditionality will strengthen democratic processes.

Of course, some countries may decide that they would rather not have a World Bank program than to allow their citizens to know the terms of the contracts. Some mining companies might say they would rather not have a business venture in a country that allows its citizens to know the terms of the contract. These are likely to be the exceptions. I believe such pressure would help set a new global norm in openness and transparency.

We should demand that the multilateral institutions themselves adopt a transparency policy consistent with the best global practices, at least as strong as America's Freedom of Information Act. We should consider whether this should be a condition for our providing continued support to these institutions.

Consequences

In the remaining few minutes, I want to provide two illustrations of how inadequate disclosure may have abetted distorted advice and decision-making.

The battle over the CPIA governance indicators at the World Bank illustrates in part what is at issue. It made sense for the World Bank to try to allocate funds to those countries where aid would be most productive—where, say, the marginal returns in poverty reduction would be the highest. The objective was lofty. (There are other factors, such as need, which of course also should play an important role in aid allocation.)

The Bank hypothesized that the countries with better governance would use the funds better and sought to construct an index which would measure good governance. Such a measure has played an important role in IDA aid allocations. But for many years, both the indicators and how they were constructed were kept secret. This made it impossible for outsiders to judge whether in fact they provided a good basis for aid allocation. After the disclosure, research has cast serious doubt on the use of these measures. Indeed, it appears that in some cases and at some times, they have been used as a form of hidden ex ante conditionality—worse even than the conditionality that has been the subject of so much criticism. Because of the lack of transparency, there was little "learning" that countries could do as they strove to improve their governance (or at least their governance scores). In some instances, good governance seemed to mean little more than doing what the World Bank and the IMF told them to do. Acceding to demands for privatization, liberalization, or so-called labor market reforms might lead to better governance scores, whether those policies were good for development or not.

Current research is addressing the relevant question, do these governance indicators provide information about marginal returns to aid that is additional to the information that would have been provided by the use of publicly available data on country performance? The preliminary answer suggests that they do not. They do not even provide a better

forecast of future growth performance. The costs relative to the benefits of using these still not fully transparent (though at least now disclosed) indicators has thrown doubt on the desirability of their continued use.

A second example is the Doing Business indicators. The Bank's own internal review has explained well many of the deficiencies in these widely cited indicators. The most important critique is the suggestion that countries should strive to get higher scores on these ratings, because by doing so they will attract business and thereby grow faster, and by growing faster, poverty will be reduced and societal well-being enhanced. Almost every step in this logic is questionable. Of course, everything else being equal, companies like lower taxes. One doesn't need to pay an outside consultant to make that observation. But everything else is never equal—and the task of economic analysis is to explore the general equilibrium ramifications. This is notably absent in the Doing Business Report. Investments in education, infrastructure, technology, etc. can yield high returns, but these have to be paid for. Obviously, it is possible that there will be overinvestment in these areas, with the rates of return lower than the cost of capital. That is what an economic analysis would try to assess. Few of the World Bank clients are in that position. Thus, the suggestion that countries should strive to lower the overall tax burden is totally misconceived.

The question is, what is the best way of raising revenues? This is, of course, the subject of intense discussions among public finance economists. Most would agree, however, that there should not be a negative tax on private investment—that risks distorting the economy. However, some of the provisions that can give a high score on the Doing Business indicators can give rise to such distortions.

The employment indicators of the past have been rightly subject to criticism. The more that has been learned about them, the more dubious the indicators seem—to the point that I believe the IMF has decided not to rely upon them.

It is not just that the World Bank failed to take into account a broad perspective on societal values—the kinds of perspectives that underlie debates within our democracies about the kinds of social protections that are desirable. They even got the economic analysis wrong. Their analysis is predicated on the kind of market fundamentalism that this crisis has shown is so fundamentally flawed. My own research has shown that there are circumstances in which some forms of job protection, appropriately designed, can lead to greater efficiency and higher output.

Concluding Comments

The World Bank and the IMF should not be encouraging countries to adopt labor market policies, tax policies, or financial market regulatory policies that are based on a particular ideology—especially one that has been put into question by the recent crisis. World Bank pronouncements often seem to suggest that it is clear what is meant by "good policy." If countries only adopted those policies, they would grow well and poverty

would be reduced. But we now recognize that some of the policies that they argued were good policies were in fact not so good. This should induce some humility and lead to more caution. It should also strengthen our resolve for the importance of democratic debate. However, this kind of debate can only occur if there is openness and transparency. Citizens need to know what policies are being advocated, the economic models underlying those recommendations, and the possible social consequences.

The international institutions have emphasized the importance of good governance in the advice they have given to others, and transparency, openness, and disclosure are an important component of good governance. Now is the time for the institutions to take their own advice and improve the governance of the institutions themselves. I hope my remarks this morning may provide some useful suggestions and guidelines for how this may be done.