The purpose of this thesis is to examine the impact of International Monetary Fund (IMF) loans since the adoption of the governance mandate on overall government capability. The study will explore whether the presence of IMF loans in developing countries enhances state capacity. Administrative capacity is of particular importance because it is a requisite for the integration of state and society in the national political arena and encourages joint involvement of government and citizenry in overall representation of societal interests.

The model designed to test the two primary hypotheses is comprised of a simultaneous system of equations. Despite criticisms of IMF conditionality arrangements, it appears that these programs are largely effective at increasing administrative capacity, an important factor in achieving economic growth and national ownership of IMF development programs.
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CHAPTER 1
LITERATURE REVIEW

Introduction

The International Monetary Fund (IMF) has been criticized by some for the expansion of its original mandate to the arena of “good governance” and long-term economic growth (as opposed to crisis management). Other scholars and policymakers argue for the addition of the good governance criteria in the IMF’s agreements with borrowing countries. They insist that in the presence of widespread corruption and absence of strong and capable institutions, developing countries receiving IMF loans will not be able to pursue economic development efficiently. Without institutional development developing countries may never succeed in economic development without institutional development.

Since 1996 and the IMF’s adoption of the Declaration on Partnership for Sustainable Global Growth, the Fund has explicitly added to its mandate the promotion of good governance in its member countries that are accepting IMF loans. The IMF now targets corruption that might mitigate the effectiveness of loans, and promotes government reform intended to enhance economic growth and help countries correct their balance of payment problems. Although the Fund is concerned with governance only with respect to the formation and implementation of macroeconomic reform, many of the implications of this extended mandate have political consequences. State capacity is a crucial element of governance; it describes the capability of government,

determining the competence of the state in many realms of governance. These include such areas as the facilitation of economic development, the encouragement of civil society and private sector growth, efficient collection of tax revenues, and appropriate allocation of public goods. State capacity is truly a “double-edged sword:” the most desirable configuration of state capacity includes the institutional ability of the state to solve collective action problems in society (including the orderly extraction and distribution of resources in forms such as road construction). The negative aspects of a capable state include the ability of the state to act outside of (institutionally) established rules and processes to favor certain interests relative to the whole of society, and even to behave despotically vis-à-vis its citizenry.

While the effects of IMF loans on economic development and democracy have been studied in some depth in the literature with mixed results as to whether one encourages the other, the question of whether IMF loans increase state capacity has not gained as much direct attention. The purpose of this thesis is to examine the impact of IMF loans since the adoption of the good governance mandate on overall government capability, and to contribute to the growing body of literature exploring the development of the capable state. More precisely, the study will explore whether the presence of IMF loans in developing countries enhances state capacity, defined here as the ability of the government to solve the collective action problems of society within established institutional frameworks, focusing especially on administrative capacity.

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Literature Review

The question of whether IMF loans enhance state capacity in borrowing countries has not been directly explored in the literature, although this avenue of research is important in terms of policy implications for the Fund as well as long-term economic growth in developing nations. Before any predictions can be made regarding the nature of this relationship, however, it is important to review the literature regarding IMF conditionality and state capacity. This chapter also reviews how the IMF governance-related conditionality and state capacity concretely interact in industrializing countries that have borrowed from the Fund.

Within the area of political economy and in political science in general the concept of state capacity has been applied to such a wide range of issues and policy areas that a comprehensive review of all the related literature could fill an entire volume. The term is in fact so broad that it has at times suffered from conceptual stretching, and its definitions range from the more narrow (considering only taxation policy) to broad descriptions of the entire range of variables involved in state building. The literature reviewed in this study allows for the development of theory pertaining to (1) the most desirable configuration of state capacity for developing states; (2) the development of state capacity in new states; and (3) capacity building after an economic or political crisis. It will also outline the implications of state capability for economic

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3 The IMF has, for example, focused on strengthening its technical assistance programs since 1999. Its objective “is to contribute to the development of the productive resources of member countries by enhancing the effectiveness of economic policy and financial management.” (See the IMF’s Articles of Agreement). The Independent Evaluation Office of the IMF recently recommended that the Fund place more emphasis on medium-term objectives; see the IEO’s Evaluation of the Technical Assistance Provided by the International Monetary Fund, available online at: http://www.imf.org/external/np/ieo/2005/ta/eng/013105.htm.

4 See, for example, Peter Smith’s (2005) Democracy in Latin America: Political Change in Comparative Perspective, ch. 8.
issues, highlighting some of the more provocative research areas in political science and economics applicable to the question of whether IMF loans strengthen state capacity.

**Conceptualizing State Capacity**

Verena Fritz (2003) has attempted to address problems of ambiguity in systematically operationalizing state capacity by identifying the key concepts that must be addressed in a proper analysis of the issue. State capacity is important because weak states cannot collect the tax revenue necessary to facilitate economic growth, provide for social welfare, and prevent rent-seeking behavior. Rent-seeking is a common problem in countries where the state is weak relative to society and depends on the most important social groups for regime support and political legitimacy. Specifically, Fritz identifies the potential of an overly strong state to be a source of such problems as corruption, repression, and lack of accountability. Fritz also identifies the state’s ability to influence public opinion regarding the outputs of government, to direct the inner workings of decision-making and policy implementation, and the “control” capacity of the state (i.e. over administrative apparatuses) as being conceptually linked to state capacity. While Fritz’s descriptions are based on the experiences of former socialist states, the issues are common to (if not exhaustive of) quandaries facing developing countries in general.

Her identification of both “positive” and “negative” aspects of state capacity is especially noteworthy. Policy recommendations advocating a blanket enhancement or reduction of government control have been devastating to countries that suffer from
neo-patrimonial practices yet still require capable states in certain policy areas. Such consequences of failed strategies to direct capacity-building call for more complicated adjustments to the power of the state. This question of the “ideal” degree of state capacity, specifically with regard to industrializing states, is a recurring theme throughout the literature.

Tax revenue as share of gross domestic product (GDP) might best capture what Fritz describes as “gaps” in state capacity: areas not under the control of government, whether that area be actual physical territory or “shadow” sectors of the economy. The central government’s ability to extract resources, as well as to distribute necessary public goods, is critical to the institutional and economic development of a country. How revenue is spent after it is collected is equally important, but tax collection performed along efficient institutional lines is an important first step towards building capacity. Developing nations with governments that collect taxes efficiently and use revenue to encourage investment in the domestic economy clearly have a better chance at achieving their development goals than states that have too low of a capacity to gather revenue that can be used in ways other than simply maintaining patrimonial networks. Although Fritz’s work is helpful as a general introduction to the concept of state capacity, she does not attempt an empirical analysis of the importance of tax revenue in such development issues. Her work on state capacity focuses primarily on conceptualization, leaving operationalization and application to future researchers.

The ability of the government to tax society is one aspect of the state’s control capacity. Alexander Motyl (1999) defines state capacity as “the degree to which a polity possesses a coherent bureaucratic and coercive apparatus able to administer, police,
and tax a certain territory and the amount of material resources at the disposal of state elites” (135-6). Motyl limits his discussion of state capacity to its relevance for empire-building, his contribution is strictly theoretical, and his central thesis does not extend far beyond the Russian empire. However, the concept of the core-periphery relationship he develops is connected to the importance of the central government’s ability to effectively control its territory, especially when it comes to implementation of IMF policies. Neo-patrimonial systems in which the government is highly dependent on local authorities for its legitimacy to govern from the center are particularly harmful to a healthy core-periphery relationship. Such a relationship requires that citizens view the central government, rather than only a local intermediary, as the legitimate source of both revenue extraction and distribution of collective goods and services. Motyl’s narrow discussion of state capacity leaves room for empirical testing more generally in the modern developing world.

It is clear in the literature that degree of state capacity cannot be measured along a continuum, nor is it ever generally a “good” or “bad” thing. Fukuyama (2004) argues that while political liberalization requires less state intervention in some policy areas, in others it must be strengthened: “It therefore makes sense to distinguish between the scope of state activities, which refers to the different functions and goals taken on by governments, and the strength of state power” (22). Reforms encouraged by the IMF and the World Bank in developing countries during the Reagan/Thatcher era cut state spending across the board, reducing state capacity in all areas to the detriment of citizens’ general welfare. The consequences of Washington Consensus policies in sub-Saharan Africa reduced the effectiveness of international aid provided by wealthy
nations in the 1980s and 1990s when patrimonial regimes continued to dole out patronage while cutting spending in the rational bureaucratic sector. Fukuyama concludes that the best configuration for economic growth is a strong state (in terms of institutional effectiveness) that is limited in scope. He speculates that encouraging state strength is more important than scope reduction for realizing economic efficiency and long-term economic growth.

Waisman (1991) defines state capacity as “the effectiveness with which policies are made and implemented… independent of political regime” (44), asserting that low state capacity can be partially compensated for by a nascent civil society. His argument concerns certain factors\(^5\) that mitigate the inherent domestic conflict and strain associated with simultaneous economic and political liberalization. Waisman predicts that the liberalization process will generally limit the scope of government intervention while enhancing its capability via specialization of function. He recommends that under an open market and democratic system the state be smaller but its capability stronger relative to society for the sake of efficiency in the areas of extraction, administration, and distribution.

These conclusions dovetail nicely with Fukuyama’s “strength versus scope” conceptualization of the most desirable configuration of state capacity. Waisman’s argument regarding the progression of the liberalization process assumes that the main opponents of liberalization – those who benefit negatively from economic opening – will be effectively marginalized as more economically successful modes of production and industry take hold. Yet Waisman’s theory is somewhat unrealistic in that it may be

\(^5\) According to Waisman, these include structural (stratification of socioeconomic classes), institutional (creation of a social safety net, increased labor market flexibility), and cognitive-ideological (general opening of the public’s minds to liberalism) factors.
difficult for a vibrant civil society to emerge when institutions are weak. Nor does Fukuyama propose a way of achieving the most desirable configuration of state capacity. Waisman’s and Fukuyama’s contributions still leave us wanting for an identification of the specific causal mechanisms of the capacity-building process.

State Capacity in Developing Nations

The “beginning” of state capacity, that is, of the very notion of government, lies in the state’s ability to tax citizens, to begin an engagement of state and society: a reciprocal relationship in which the state performs its critical functions and citizens sacrifice a portion of their incomes to government in the form of taxes. Such a polity allows for a more effective handling of political and economic crisis, a capability that many poorer nations lack. Some of the literature reviewed here examines the range of responses available to industrialized nations when responding to exogenous shocks. This is contrasted with other work describing the conditions in less capable, developing states which are much more limited in their “coping” mechanisms.

Ikenberry (1986), in an argument regarding the driving force behind the responses of industrialized nations to oil shocks in the 1970s, identifies four policy instruments available to governments with high levels of state capacity. The “organizational” instrument determines the degree of influence the government is able to exert over industrial investment and production. The “credit” instrument determines the degree of influence the government can exert over the private sector via credit provision. The “spending” instrument describes government influence with respect to tax and spending. The “market” instrument concerns government influence over the
rules of the game with respect to the economy (distinct from direct government intervention). Ikenberry concludes that re-imposition of the market after deep intervention may be a powerful demonstration of state capacity, given that states are bound to past policy commitments. He also makes the case that more capable states may choose to withdraw from economic regulation rather than continue intervention when faced with crisis, given that state capacity is determined more by the flexibility of state action rather than degree of economic intervention. While not all of these instruments are at the disposal of developing countries, Ikenberry insists “all states have the fiscal tool. Indeed, its presence is central to the very concept of ‘stateness’” (130).

By assuming away the ability of the government to tax and to set fiscal policy, Ikenberry restricts the scope of his argument to more developed or industrialized countries and ignores some of the foundations of problems in poorer countries. Administrative capacity is a central aspect of state capacity, as it proxies the very roots of some of the more sophisticated aspects of the capable state. However, developing country governments may be less able to tax citizens and to influence large private sector corporations (by withholding credit, etc.) if they are dependent on private sector groups for political support. Ikenberry’s descriptions illustrate how crucial state capacity is when it comes to dealing with financial crisis, even if he does not offer a solution for states with weak administrative capacities. While a less capable state may be unable to sustain fiscal austerity measures when faced with financial crisis, a more

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6 For example, one of the reasons why Kim Dae Jung’s negotiations with the chaebol in South Korea in the wake of the 1997 Asian financial crisis were successful was his lack of political entanglement with the large business conglomerations (unlike his political predecessor). In this sense, an autonomous government will be a more capable government when it comes to dealing with financial crisis such that the state is able to streamline spending, curb inflation, and, when necessary, reform the financial sector.
capable state might choose to refrain from controlling prices and exchange rates as a mechanism for managing financial crisis in favor of monitoring the money supply.

The United Nation Development Program’s Capacity 2015 project supports the advance of technical capacity in developing states pursuing the most appropriate sustainable growth policies for their economies. Mate (2001) describes one solution available to governments with insufficient capacity to provide the framework and policies necessary for environmentally sustainable growth programs. A few such governments have dealt with unsustainable raw resource extraction industries (specifically mining) by receiving aid and technical assistance from the Capacity 2015 fund. Mate’s discussion of the mining industry’s impact on local communities in Latin American and Africa is representative of the key actors (government, society and corporations) whose relationships must be properly defined in order to build a strong, effective, and non-repressive state capacity. The fact that programs such as Capacity 2015 are beginning to take hold at a global level indicates the importance of aiding states in pursuing development goals in a way that encourages a strong state with a limited governmental scope. Growth strategies that allow the private sector to flourish and exporting sectors to achieve international market competition (without excessive current account imbalances) must go hand-in-hand with policies designed to strengthen administrative, institutional, technical, and political capacity.

The Impact of Patrimonialism on State Capacity

The discussion thus far has concerned a conceptual examination of state capacity as well as some operationalization possibilities with respect to the necessary

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7 For more information visit: http://www.capacity.undp.org.
conditions for administrative capacity. These issues must be taken into account when examining the effects of IMF loans and associated conditionality arrangements in states with potentially lower levels of state capacity. The development of theory regarding the relationship between IMF loans and state capacity also requires the consideration of domestic politics in developing nations. The effects of domestic corruption on state capacity are highly detrimental to the strengthening of government capability. IMF conditionality agreements, created to promote good governance, are intended to reduce corruption in borrowing country governments. In order to consider how conditionality arrangements might impact state capacity, it is necessary to describe the specific mechanisms through which corruption is a domestic source of influence on state capability.

Strong but narrow state capacity and neo-patrimonial systems are incompatible with one another in the long term, inevitably leading to the undermining of technical-bureaucratic government. When political leaders are more concerned with patronage networks than effective policymaking and governing, all forms of state capacity are fatally undermined. In a discussion of such a connection, G. Shabbir Cheema (2003) describes how corruption leads to a weak and inefficient legislative body, an unaccountable and overbearing executive, a dependant and poorly functioning judiciary, and poor allocation of tax revenues, inimical to economic development. Far from strengthening the governing capability of the state, corruption turns collective goods into private pay-offs, leading to an unstable form of governance such that when state coffers run dry neo-patrimonial regimes are no longer able to function along patronage lines. Cheema’s discussion paints a dire picture in terms of building capacity out of
entrenched corruption. Understanding how such corruption and neo-patrimonialism are affected by IMF conditionality agreements is thus critical to analyzing the effects of IMF loans on state capacity.

Marta Muço (2001) carries the discussion of state capacity to the Balkans, a region about which she conducts a qualitative study examining the failure of reform after the end of socialist rule. The Balkan states are plagued by problems Muço identifies as indicators of low state capacity including corruption, tax evasion, low tax revenue as percent of GDP, and widespread unreported and unrecorded economies. Markets do not function well, and states are incapable of supporting institutions or enacting policies to provide the necessary legal framework and enforcement of law to successfully enact institutional reform. Again plaguing developing countries with low state capacity are individual leaders that are strong relative to state institutions, as well as extensive rent-seeking behavior.

Muço’s study provides some (rather dispiriting) support for the aspect of Waisman’s argument that low state capacity may allow civil society to compensate for deficiencies in the polity, as organized crime has emerged in the Balkans to fill the void left by governments inability to enforce the rule of law. Muço explains how the social strain associated with widespread corruption and structural reform interacts with vulnerability to exogenous economic shocks to further exacerbate overall instability in the region. The indicators she examines include tax revenue, level of foreign direct investment, corruption, level of industrialization, and infrastructure development. She concludes that the Balkan states should pursue market liberalization and reform, improve government transparency and accountability, and strengthen institutions and
law enforcement. She emphasizes the importance of the eradication of corruption and the strengthening of the judiciary.

While Muço’s analysis points out some potential indicators for measuring level of state capacity, her policy recommendations are somewhat unrealistic. These recommendations lack direct political incentives to autonomous government leaders to engage in political and economic reform. A survey study conducted and analyzed by Cummings and Nørgaard (2004) in Kazakhstan and Kyrgyzstan provide evidence that “informal networks and personal relationships [within the polity] continue to be of importance” (698). The study offers concurring evidence for the preceding arguments that associate neo-patrimonialism and patronage with low state capacity: a pattern of strong individuals within a government that tends to result in low levels of state capacity, especially politically and institutionally. Indicators used to measure level of state capacity should certainly include tax revenue, but also regime durability (a measure of regime strength) and some measure of accessibility to government or government responsiveness to citizens’ demands such as infrastructure.

Another group of policy-oriented scholars focuses on the question of how to properly “build” state capacity by focusing on the determinants of the capable state. In this regard, Englebert (2000) insists that “state legitimacy breeds state capacity” (11), that is, that legitimate states are more capable states. His theory implies a causal, rather than simply correlative, relationship. He points out that in African nations where political leaders emerged in the imported state systems without pre-colonial political foundations, central authorities lacked the proper legitimacy to rule and were faced with a different set of strategic options. This resulted in a relative lack of power payoffs from
pursuing policies of economic development. In the absence of popular legitimacy leaders secured power through the adoption of neo-patrimonial strategies rather than development policies. His conclusion is that when politicians can secure votes through patronage rather than constitutional means, state capacity is fatally undermined.

Although Englebert’s explanation of the determinants of state capacity in Africa confirm the importance of path dependency in explaining contemporary levels of state capability, it is not directly useful for developing practical policy recommendations regarding how to strengthen a less capable state. Crook’s piece provides an ironic confirmation of the debilitating effects of patronage systems on state capacity and economic growth in even the most promising political and economic circumstances. While helpful in establishing one of the primary policy “enemies” to state capacity (neo-patrimonialism), Englebert’s findings (and lessons from Crook’s false predictions) must be supplemented by solutions to the problem. Simply advocating that politicians pursue liberalization policies unfortunately does not outline political incentive structures for government leaders, and seems to assume a relatively high level of state capacity. Capacity building must start somewhere, and must lead to a strong but narrowly focused government.

Building State Capacity

Another group of writers focused their research on the question of building state capacity. Haggard (1990) brought the role of politics and domestic institutions into the scholarly discussion surrounding the success of the newly industrializing East Asian countries, whose export-led growth policies won their governments praise from
neoliberal economists and admiration from the world in general. While the Latin American countries pursued import substitution industrialization (ISI) strategies that ultimately proved unsustainable and produced uncompetitive industries, the East Asian NICs pursued export-led and entrêpot (in smaller countries lacking an agrarian base) growth policies. Haggard explores the causal mechanisms stimulating the evolution of these strategies. While he admits that international pressures provide the strongest incentives to reform and that social groups exert influence as well, Haggard focuses on the role of politicians and politics in pursuing economic reform. His central argument is that the trajectory of growth has a determinative impact on how a country responds to exogenous shocks. A large country with extensive natural resources pursuing ISI will prefer to focus inward, while primary-product-export and entrêpot strategies will generally be strongly motivated to pursue export-oriented growth.

The second component of Haggard’s argument, and the one most relevant to the discussion of state capacity, emphasizes the way in which state structure (and state capacity) constrained the options of self-interested political elites. Haggard identifies these constraints as the primary explanatory variable for the way in which economic reform was pursued in East Asia. Three such constraints include state autonomy, cohesiveness of the decision-making governmental body, and means available to leaders for achievement of political ends. Governments with higher degrees of state autonomy were key in transitions such as the primary-product-export phase to ISI and all of the transitions to export-led growth in East Asia. Haggard argues that although social forces can penetrate authoritarian governments, such coalitional forces generally will have a stronger influence in democracies than strong authoritarian regimes.
Second, economic transition will be easier when the level of cohesion within the
decision-making structure is stronger due to high levels of cooperation between
politicians and bureaucrats and more consistent policies. Finally, the tools at the
disposal of political leaders (e.g., financial repression via exerting undue influence on
financial institutions to extend credit to nonviable but government-favored corporates)
comprise a third constraint that helps determine the way in which economic reform is
pursued. All three determinants of growth trajectory – autonomy of the state relative to
society, cohesiveness among decision-makers, and available policy instruments – are
elements of degree of state capacity. In general, political leaders will have the most
freedom to pursue their own policy interests when the state is more autonomous, the
decision-making body is not fragmented, and more tools are at the government’s
disposal to exert influence over society and the private sector.

Although Haggard gives examples of how countries responded to exogenous
shocks before the 1990s in the second portion of Pathways from the Periphery, a more
interesting application of his theories might be to compare them to the outcomes of the
continually refers to the importance of state capacity in explaining the variation in the
East Asian governments’ ability to cope with the 1997 financial crisis, especially with
regard to modifying the “social contract” in East Asia to provide social insurance to the
poor (a most acute necessity during and after times of economic crisis). Haggard’s rich

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8 In South Korea, a united government with a strong degree of state autonomy allowed Kim Dae Jung to
cope with the financial crisis most successfully relative to other East Asian economies. In Indonesia,
Suharto and Habibie were unable to maintain control over a divided government, an oppositional elite,
and widespread social unrest, and overall state capacity was insufficient to allow for the successful
implementation of the financial and political reforms necessary to bring the country out of crisis. Malaysia
was the only state to not undergo a regime change as a result of the crisis: Mahathir was able to maintain
elite support as well as popular legitimacy, which sustained his rule despite few reforms. In Thailand, a
description of each the four selected cases from the financial crisis lacks theoretical thrust. However, arguments put forth in his 1990 book regarding how the constraints on political leaders help determine the direction of economic growth (and, by extension, the way in which the state deals with a financial crisis) explain how state capacity can impact political economy in such a manner.\(^9\) The extent to which a state exerts a high level of institutional capacity is crucial to its ability to react to crisis and to effectively and efficiently manage resources.

Haggard’s prediction and account of state response to economic crisis and how a developing country government will select a strategy for economic growth illustrate that the incentive and constraint structures available to political leaders (largely determined by state capacity) are of prime importance in calculating the behavior of the state in these situations. The incentive structures for political leaders to “take ownership” over structural adjustment programs has not gained sufficient attention from the IMF, and should be considered more carefully when forming conditionality agreements.

Ikenberry’s analysis of the responses of industrialized nations to economic crisis and his predictions for developing states’ responses centers on the argument that a state’s capacity will largely determine its policy response. Haggard finds the determinant of leaders’ choice to lie in political incentives. Haggard’s prediction and account of state response to economic crisis and how a developing country government

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\(^9\) An interesting counterfactual (at the individual level of analysis) might concern what the case would have been in South Korea if Kim Dae Jung had not been in power. Such a remarkably capable leader was critical in a country where the central government had a considerably high level of control capacity, and in the hands of a more corrupt chief executive the outcome of the situation South Korea might have been worse.
will determine a strategy for economic growth illustrate that the incentive and constraint structures available to political leaders (largely determined by state capacity) are of prime importance in calculating the behavior of the state in these situations. The political economy literature is essential for building strong theoretical connections between economic dynamics and political behavior, and is particularly helpful in examining the effects of IMF loans and associated conditionality arrangements on strengthening state capacity.

Based on the literature, it is clear that to “build” state capacity, political leaders pursuing economic growth must take personal responsibility for the success or failure of development programs, including structural adjustment programs associated with IMF loans. Bird (1996) asserts that national governments in fact do not have sufficient feelings of ownership over policy development and implementation, citing this factor as a significant reason why the majority of IMF programs break down, and argues that the monetary balance of payment policies employed by the IMF set unrealistic goals, politically and administratively speaking, for many developing nations. He argues that inappropriate targets and incompletion of lending programs due to allegedly poorly chosen conditionality terms are inefficient and frustrating for both national governments as well as the IMF, and diminish the overall efficacy of multilateral lending.

Studies show that a decrease in public investment (required by IMF conditionality, which demands reduction in overall government spending) is typically followed by a fall in private investment (Butkiewicz and Yanikkaya 2005). This problem of complementarities only exacerbates problems of overcoming economic crises and building state capacity in countries that receive IMF loans. Arguments opposing (and
supporting) IMF governance-related conditionality on the grounds of capacity building and national ownership must be supported by illustrating the exact mechanisms through which Fund lending programs affect state capacity and the incentives for political leaders to take responsibility for the programs’ success or failure.

**IMF Conditionality: A Brief Introduction**

State capacity is an important concept in political science because it helps determine the trajectory of state building and of economic growth. Weak states are less capable of collecting taxes, providing social welfare, and curbing corruption than more capable governments. Theoretically, the most effective form of state capacity combines strength with specialization, and administratively relies on a rational bureaucracy rather than patronage networks. The ability to collect taxes, the prime component of administrative capacity, is the very foundation of state capacity. Capacity building proceeds from this basis, and how states cope with exogenous shocks during the process of political and economic development is largely determined by state capability. Corruption and patronage can be fatal to the development of strong but narrow capacity. The IMF has the opportunity, through its lending programs, to create political constraints and incentive structures that encourage leaders to pursue development and capacity building along institutional lines. By studying the nature of IMF governance-related conditionality, hypotheses can be devised regarding expectations of how well the IMF encourages the capable state.

State capacity is important conceptually with respect to economic development and IMF lending because an incompetent or incapable state will be unable to pursue
long-term development goals and achieve political stability while implementing painful austerity measures and wide-reaching financial and economic reforms. IMF conditionality agreements, included in IMF lending programs since 1996, complicate the theoretical discussion further because they (are intended to) increase the overall effectiveness of borrowed funds. An evaluation of IMF conditionality should be treated as its own area of study, but the focus will be narrowed quite a bit here for the purpose of identifying the mechanisms through which IMF conditionality affects state capacity.

The definition of conditionality, as described by the IMF, is as follows:

When a country borrows from the IMF, its government makes commitments on economic and financial policies – a requirement known as conditionality. Conditionality is a way for the IMF to monitor that its loan is being used effectively in resolving the borrower’s economic difficulties, so that the country will be able to repay promptly, and make the funds available to other members in need. In recent years, the IMF has worked to focus and streamline conditionality, in order to promote national ownership of strong and effective policies.\(^\text{10}\)

The role of the IMF in maintaining international economic stability underwent a significant metamorphosis during the 1980s from focusing primarily on macroeconomic issues to consideration of structural concerns, reflecting the IMF’s increasing involvement in areas previously considered to be the traditional domain of the World Bank. Despite explicit revisions to the purpose, implications, and procedural elements

of conditionality, its staff in many ways has not executed the IMF’s goals to substantively enhance the “ownership” aspect of national governments involved in conditionality agreements. National ownership of IMF-advocated policies is not only a normative issue concerning sovereignty, but one that is imperative for the strengthening of state capacity and regime legitimacy. According to the basic logic of IMF conditionality, corruption (previously considered to be exclusively a political factor and thus outside the purview of IMF economists) has a profound negative impact on economic development, and must be taken into account when disbursing loans and providing technical assistance to countries that borrow from the Fund.

The IMF has paid special attention to capacity-building efforts in Africa, especially with respect to institutional capacity and technical assistance, embarking on such programs as the Africa Capacity-Building Initiative. The Fund has made clear its objective to ensure that post-conflict African countries receive the assistance necessary to repair extractive and distributive capacities. IMF Managing Director Rodrigo de Rato has commented specifically on the acute need to improve financial sector reform and tax administration processes in Africa.¹²

Joseph Stiglitz (2003), former Chief Economist of the World Bank, highlights four significant problems of IMF conditionality. The first such problem refers to fungibility which occurs because money lent by the IMF frees up government resources for use in other areas, including satisfying political gains on behalf of opportunistic leaders. The second problem relates to the claim that the IMF has frequently imposed unrealistic or

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inappropriate requirements in its conditionality terms in unsuitable environments. These requirements usually include contractionary fiscal policies in economies that are experiencing long-term or more severe crises that could, according to Stiglitz, benefit more from expansionary measures. Thirdly, Stiglitz argues that IMF conditionality terms are often politically unsustainable, since policies are commonly abandoned with the installment or rise of a new leader. Finally, according to Stiglitz, conditionality itself has frequently been driven by external politics, as opposed to purely technical or economic decision-making. He cites the example of the contrast between lending terms extended to Russia and Kenya, where seemingly preferential treatment and easier stipulations were placed upon the Russians than the Kenyan government despite similar economic conditions. While Stiglitz’s negative evaluations of IMF policies are not without their own critics, these denunciations of governance-related conditionality agreements present some possible explanations for any perverse effects of IMF loans on state capacity.

A frequent criticism of multilateral lending (especially with regard to the IMF) is that it increases the moral hazard problem, in which debtor as well as creditor nations are provided the incentive to either borrow or lend more frivolously, knowing that international financial institutions will effectively “bail them out” if the situation causes a borrowing country to default on a loan. Lane and Phillips provide an argument against the moral hazard problem causing facetious borrowing,¹³ but do not prove that the moral hazard problem does not affect creditor behavior. According to Butkiewicz and Yanikkaya (2005), lending by the World Bank and IMF insures commercial lenders

against losses, but does not protect private investors. Private investors face a high risk associated with investing in developing nations, financing more freely during times of apparent security and prosperity with at least some level of assurance that they will not face overwhelming losses in the event of a downturn or shock. Governments in borrowing nations typically fail to allocate their own resources to areas of infrastructure, but instead focus on political gains (leading to a negative effect of multilateral lending on public investment as discovered by Butkiewicz and Yanikkaya). Such activities serve the interests of bankers and elites in developed as well as developing countries, while leaving the citizens of borrowing nations with rising unemployment, worsening standards of living, and millions of people living below the poverty line ($1 or $2 per day).

Rodrik’s (1995) empirical analysis reveals a pattern of IMF multilateral lending following private flows, which he admits may provide some support for the “bail-out” theory. If private loans attract IMF and World Bank loans, rather than the converse, the moral hazard argument would be very difficult for international financial institutions to dismiss as conspiratorial and insignificant. However, proving causation from such a correlation is a great step that most researchers have not gone so far as to openly assert that private flows lead multilateral lending. Stiglitz (2003) also mentions the moral hazard problem that he claims leads to the bail-out of international (primarily western) creditors, and points out the conflicting objectives of the IMF of achieving international financial stability (specifically by providing funds for states in crisis) while serving the interests of the international financial community.
When framed in terms of moral hazard, the IMF’s goals of promoting stability while serving the economic interests of both the industrialized and industrializing nations are seemingly impossible to achieve simultaneously. It is difficult to see how borrowing country governments have an incentive to improve their technical or administrative capacities if IMF lending agreements are designed with the commercial or private lender in mind. By focusing on repayment of debt, rather than directly promoting economic development in borrowing nations by building infrastructure and reducing poverty, the IMF has attracted criticism from development economists. While several studies conducted by IMF critics and IMF proponents have focused on lending patterns as a function of GDP and private flows, the impact of a state’s governing capability has not been directly examined. Since state capacity is clearly an important component of political and economic development, it is essential that this relationship be analyzed empirically.

Effects of Conditionality on Governance and State Capacity

Kapur and Webb (2000) are critical of the emphasis on governance in IMF and World Bank lending. They predict that the main effect of governance-related conditionalities will be to increase the role of international financial institutions as economic policy-makers in borrowing states. They reason that the IMF (as well as the World Bank) supports the political interests of the industrialized countries, the donor nations for these international financial institutions, and that the interests of industrialized countries thus influence governance-related conditionality programs. Kapur and Webb warn that governance-related conditionalities will fail to have a positive
effect on governance. They based their predictions in part on what they consider to be unrealistically short time horizons and overly burdensome expectations for economic growth performance outlined in the financial agreements for developing nations. They argue that the additional requirements that these countries also implement good governance measures make already difficult conditionality requirements even more burdensome.

Kapur and Webb doubt the novelty of good-governance reforms included in conditionality arrangements. They compare them to policies of international financial institutions that tried and failed in the past to adopt policies facilitating rapid growth and increasing state capacity in order to allow for developing country governments to enforce unpopular austerity measures and deflationary macroeconomic policies. They argue that more country- (or at least region-) specific rules should be implemented to provide for a better policy “fit” in different political and economic structures of the highly diverse group of countries known as LDCs. Before conditionality can work, Kapur and Webb insist that the IMF and the World Bank must focus on society as well as the state, since governmental institutions are in part reflective of society, and private actors (to varying degrees across countries) may have important impacts on the economy, especially when it comes to corruption and clientelism.

Though Kapur and Webb make a helpful contribution to the literature concerning international financial institutions and state capacity, their argument is overly simplistic. While parsimony is certainly valuable, it is not always preferable to thorough analysis. It is also necessary to examine more closely the effects of IMF loans (and associated conditionality agreements) across various regions. Likewise, it is imperative to examine
whether these effects are in fact perverse, or merely (as Kapur and Webb suggest) require some “fine-tuning” in certain political circumstances, and to explore how the Fund can work more effectively with borrowing country governments to pursue sustainable development policies that contribute to a strong but limited state capacity. There is no doubt that civil society must be encouraged to play a positive and active role in the capacity-building process; but it is arguably more difficult for a collectively beneficial civil society to flourish under corrupt and incapable governments.

Stephen Knack (2004), in a study on whether foreign aid (including IMF loans) increases democracy, points out that aid can actually diminish government accountability due to the fact that it strengthens government relative to society. Taxation of a nation’s citizenry is certainly a requisite condition for true government accountability, and it is possible that funds which would otherwise be forced to go to correct balance of payment problems that are “freed up” by IMF loans might result in a diminished need for the state to extract funds from the public, leading to less government accountability. This would certainly be a negative, albeit indirect, effect of Fund loans. Although IMF governance-related conditionalities are not explicitly aimed at developing state capacity in borrowing countries, it is in the interests of the Fund for these national governments to strengthen their extractive and distributive capacities since more capable states are better adept at achieving self-sustained economic growth. However, if state capacity building is not directly pursued in IMF lending programs, there may be a lack of political incentive structures in place such that leaders will not take the initiative to improve governance in this respect.
Karen Remmer (2004) analyzes the relationship between foreign aid and size of government in developing nations. She observes that despite a general increase in foreign aid to developing nations over the period 1970 to 1999, debt in these countries has increased as well. She hypothesizes that, contrary to the market-oriented reform goals espoused by international donors, external assistance will expand the size of government due to a lack of political incentives to reduce state spending while increasing revenue from domestic sources and decreasing dependence on foreign aid. Although the political costs of spending tax dollars are relatively high, the presence of revenue from external sources promotes the survival of “rentier” states and diverts funds from the pursuit of long-term development goals and a capable government. A robust empirical model supports Remmer’s hypothesis in support of the “flypaper effect” (that international financial transfers, rather than reduced taxation, increase spending): aid does appear to have a positive effect on government expansion in the long-term. Moreover, she finds that after 1980, the presence of international aid correlates with a decrease in tax revenues, suggesting that the increased spending by governments is not a result of taxes but rather external financing, the classic problem of aid fungibility (as described by Stiglitz). She does distinguish between different types of international aid in her study.

Remmer’s analysis suggests that conditional aid to developing states has failed to create the proper political incentives to actually reduce the size of the state and pursue fiscal austerity measures. Governments in low- and middle-income nations actually spend more and raise less in the presence of finance from external sources, a perverse consequence that avoids using aid to promote economic development.
Remmer argues that state capacity building should be a more explicit IMF priority rather than good governance in general. She suggests that the type of state capacity strengthening that might be helpful in fostering political incentives to pursue economic growth might be institutional capacity. Such capacity would include a rational bureaucratic sector operating independently from the political interests of the decision-making body of government, allotted funds to develop infrastructure and other projects to encourage long-term growth. This would prevent aid and government revenues from being wasted in private and public consumption of external funds through rent-seeking behavior and patronage.

The United Nations Development Program (UNDP), which created the Agenda 21 initiative in 1992 and Capacity 21 in 1993 (created to meet the goals of Agenda 21), since replaced by Capacity 2015, prefers a more holistic approach to building national capacity. Fukuda-Parr, Lopes and Malik (2002), in an overview of an independent assessment of the UNDP’s involvement in capacity-building in developing countries, highlight some of the most severe obstacles to the effectiveness of aid assistance in strengthening national capacity. They attribute the persistence of common criticisms of technical cooperation to “development as displacement” (importation of programs that work without addressing existing capacities in weak states) and the “asymmetric donor-recipient relationship” in which the nature of lending is not mutual cooperation and equal partnership, but rather control of the development process by donor countries. The billions of dollars of aid sent to developing nations every year intended to help build state capacity has not produced the desired results: knowledge transfer has not resulted in rapid economic growth; recipient countries in many cases become dependent upon
donor governments rather than propelled into situations of self-sustaining economic growth; and “human resource development” has resulted in brain drain and college graduates working as manual laborers.

Fukuda-Parr et al. maintain that, in order for capacity-building aid to be effective at creating independent nations capable of good governance and self-sustaining economic growth, recipient governments must have a sense of ownership in development projects such that leaders are fully committed to achieving the adjustment priorities they have set for their countries. This independent publication critiquing the UNDP’s efforts to help developing nations strengthen state capacity is not only a helpful summary of general trends in international aid aimed at capacity building. It also helps illustrate how it is possible that IMF loans might have the perverse effect of failing to enhance effective state capacity by creating dependence on loans and not implementing policies that borrowing country governments are firmly committed to in accordance with their own political self-interest, at least in some cases.

Joan Nelson (1988) further describes how development policies must be politically sustainable to ensure successful completion of lending programs. In order for development policies to be politically sustainable, argues Nelson, political leaders must possess a strong commitment to the development program, the government must have sufficient capacity to carry out development policies, and the public must be convinced (or coerced) to support development programs such that the state is not forced to end them prematurely. The political elite must be united and cohesive, the bureaucracy well controlled and able to maintain budget discipline, and the government able to preserve its political support base if programs are to be completed.
The difficulty in creating the kinds of programs and policies described by Nelson is in properly administering technical assistance. Problems of inappropriate allocation of aid cannot simply be attributed to corrupt governments: the public sector cannot be the only actor to support development programs. Moreover, it is difficult to see how coercing or convincing the public will be effective in the long-term; financial sector reform cannot be ignored in the capacity building process, domestic savings must be appropriately invested in the economy, and society in general (especially the private sector) must be a key player in the development process. If the state is not encouraged to be accountable to society while improving state capacity and implementing economic reforms (in accordance with IMF conditionality requirements), IMF lending programs will be politically sustainable.

Summary and Introduction to Hypotheses

The literature reviewed in the preceding section underscores two issues that are critical in the encouragement of capacity building: that of political (and thus economic) incentives and political legitimacy. While state building and economic development will inevitably be pursued along lines that benefit political leaders, popular legitimacy must be established for regime survival and economic growth in the long-term. Stability is certainly at least a necessary condition for economic growth, and hinges on the survival of a popularly accepted system of governance. Englebert and others have demonstrated the fatal long-term impact of neo-patrimonial systems on political legitimacy and state capacity: even constitutional checks on the central leader are
ineffective if patronage is the accepted standard of governance.\(^{14}\) Although international efforts have at times been detrimental to certain development situations (such as, arguably, the 1997 Asian financial crisis), the international community seems to have learned from its mistakes in the structural adjustment policies of the 1980s and are emphasizing the importance of strengthening the positive aspects of state capacity crucial to building a capable government.

The literature suggests a clear link between economic development and state capacity: a capable state is more able to effectively implement IMF-proposed structural adjustment policies, to control corruption, to “sell” liberalization policies to constituents, and to collect the necessary tax revenue to sustain economic development while correcting balance of payment problems through the use of IMF loans. Nevertheless, it is also apparent that IMF loans do not necessarily have a positive effect on the generation of the most desirable form of state capacity (a strong state with a narrowed focus); financial assistance carries with it the danger of creating dependency, and circumstances in which recipient nations become reliant on donors for technical assistance can impede effective capacity building. I will explore the validity of claims regarding the Fund’s potential impact on state capacity-building in order to further analyze the links between governance and state capacity and attempt to make a theoretically helpful contribution to the ever-expanding policymaking debate surrounding the appropriate formation and implementation of IMF governance-related conditionality arrangements.

\(^{14}\) Although institutional change is arguably the most difficult, the impact of individual leaders in developing nations is difficult to overstate: they can be as beneficial to the transformation process as Kim Dae Jung in South Korea, or as destructive to the state as Niyazov in Turkmenistan.
The facet of state capacity known as administrative capacity refers to the ability of the state to manage the daily operations of government. This is distinct from political capacity, which concerns the ability of the government to influence public opinion; from technical capacity, concerning the ability to create policy (e.g. fiscal or monetary) conducive to development; and from control capacity, which refers to policing and security. Administrative capacity is best measured by what Ikenberry refers to as the “fiscal tool… central to the very concept of ‘stateness’” (see above discussion, p. 10), as this is the foundation of government and of its ability to manage the operations of the state.

The direct relationship between the International Monetary Fund’s lending programs and the administrative capacity of borrowing states has not been closely examined in the political science or political economy literature. This gap in the theoretical literature thus affords the opportunity to make a contribution to studies concerning state capacity of developing countries by studying the impact of IMF loans. The following chapter includes the development of testable hypotheses regarding the nature of the short-run relationship between the aspect of state capacity pertinent to this study (administrative capacity) and IMF lending programs that address corruption. The hypotheses are based on the theory that IMF lending, although not directly intended to build administrative capacity, does result in a borrowing state’s strengthened ability to govern, and that state capacity in turn attracts Fund loans.

Kauffman, Kraay, and Zoido-Lobatón (1999) support the IMF’s position on governance-related conditionality, insisting that good governance is the key to economic performance. The indicators presented in their analysis provide evidence for the theory
that organized, effective government with strong administrative capacity is required to effectively implement IMF policies and programs. Strong, specialized state capacity would thus seem to be a necessary condition for a successful IMF lending program, supporting the argument that IMF governance-related conditionality should help improve state capacity. The overall impact of IMF conditional lending programs on the administrative capability of the state could nevertheless be ambiguous at the international level of analysis. It is likely the case that regional or national effects mitigate the effectiveness of IMF lending in areas where state capacity is relatively low and in areas where state capacity is relatively high.

Fund critics such as Stiglitz, Remmer, and Kapur and Webb argue that, since aid is inherently fungible, international lending in general and IMF lending in particular are subject to abuse by borrowing country governments, the loan funds misallocated and essentially wasted to the detriment of developing societies. However, governance-related conditionality-based IMF loans are intended to address such problems in a manner that still preserves the economic focus of Fund lending programs. IMF lending as a source of external financing could reduce a borrowing country government’s need to tax its citizens, thus leading to a decrease in tax revenues as a consequence of IMF lending, but governance-related conditionality is intended to monitor government accountability in matters beyond the purely economic realm. IMF governance-related conditionality agreements are intended to promote good governance, irrespective of regime type, by reducing corruption and strengthening government activity along institutionalized lines. Such programs should increase both the narrowness and
specialization of government, making government more accountable to the public as a result of direct taxation by the government.

Criticisms that IMF lending programs are overly burdensome and fail to encourage national ownership of reforms imply that, rather experiencing strengthened and more specialized administrative capacity as a result of IMF lending programs, the state becomes dependent on Fund loans in order to support government operations. Since IMF programs are generally unpopular among the citizenry of borrowing countries whose welfare suffers under the contractionary effects of devaluation and austere fiscal policies, state capacity might be undermined if the state’s ability to govern is overwhelmed by political problems, leading to an increase in such a country’s reliance on external sources of financing and technical assistance. Thus, it is important to empirically test the effects of IMF lending on the growth of state capacity.

It should be noted that any quantitative change in state capacity could be cogently attributed to IMF lending only in the short run for two reasons. First, governance-related conditionality-based lending has been a part of IMF lending arrangements for barely a decade, limiting the ability of quantitative research to test long run effects of such programs. Second, a borrowing country’s technical capacity may improve due to technical assistance from the IMF, and if a borrowing country does not cancel or end its lending program prematurely overall state capacity may increase as development enters a stage of self-sustaining growth and political institutions mature and improve. Such medium- and long-term effects of a country’s relationship with the IMF are outside the testable scope of this thesis.
As the central government implements reforms and deregulation and as corruption is targeted as per the requirements IMF conditionality arrangements, it is possible that the distribution of services and resources to the public will be interrupted. Neo-patrimonial systems certainly lead to less efficient distribution of services than a system based on an efficient rational, technocratic bureaucracy in the long run. However, as corrupt networks are interrupted or dismantled during the period of economic and governance reform following the introduction of an IMF lending program, systems based on patronage may be rendered less capable of distributing public resources as a consequence of conditionality-based lending programs. The more active patrimonial systems have been in providing public services, the more difficult it may be to build state capacity in the face of governance reforms.
CHAPTER 2
HYPOTHESES AND METHODOLOGY

The question under investigation in this thesis is whether IMF loans enhance state capacity and, in turn, whether state capacity attracts Fund loans. This problem is addressed empirically by testing six hypotheses concerning the relationship between IMF loans and state capacity, including several intervening factors expected to influence state capacity as well as Fund lending patterns. The hypotheses are tested in a system of equations. The first equation’s dependent variable is state capacity measured as rate of change in the variable tax revenue as percent of GDP. The independent variables are disbursed IMF loans, a measure of democracy, regime durability, GDP, land per capita, and road construction. The second equation’s dependent variable is approved IMF loans. The independent variables for the second equation are rate of change in tax revenue, democracy, regime durability, GDP, land per capita, and road construction.

Hypotheses and Model

The following hypotheses are based on the premise that, despite the arguments of IMF critics regarding the overall effectiveness of governance-related conditionality agreements, such agreements (along with IMF technical assistance programs) will be effective in building state capacity by strengthening government and narrowing its focus with respect to administrative capacity. Taxes and payments that may have once gone to local or regional patrons will be collected by the national government, thereby building the foundation of “stateness:” the fiscal tool.
\[ H_1: \text{Conditionality-based IMF loans have a positive impact on state capacity with respect to the government’s ability to extract resources from the public.} \]

The first hypothesis examines the effect of IMF conditionality-based lending programs on the administrative state capacity of a country accepting loans from the IMF. Tax revenue as percent of GDP is a reasonable indicator to approximate the extractive capacity of the state, and the conventional proxy used in the literature. The administrative aspect of state capacity is measured using tax revenue data from the World Bank’s World Development Indicators. Rather than regressing the independent variables against the simple mean value of tax revenue as percent of GDP, the tax revenue rate (using all available data from 1996 through 2003) has been calculated for each country by regressing (annual) tax revenue as percent of GDP against each year available. By measuring the rate of change, rather than average value, the overall effect (positive or negative, and to what degree) of IMF loans during the period in question is better approximated. Thus, rate of change in tax revenue is the dependent variable used in the first equation.

The three standard types of IMF loans are included in the dataset: the Poverty Reduction Growth Facility, Enhanced Structural Adjustment Facility, and Stand-by Arrangement loans. IMF approved loan amount is calculated as the total amount of loans per country in millions of special drawing rights (SDR), an accounting measure used by the IMF in reporting lending amounts. Disbursed IMF loans are calculated as the total approved loan amount less any undisbursed amount. Information on IMF loans
for each country are published in the IMF Annual Reports, and listed in the index.\textsuperscript{15} Loan values were calculated by hand from these reports.

I expect that the overall effect of IMF loans on state capacity varies by a number of country-specific conditions, including gross domestic product, land area per capita, level of democracy, regime durability, and infrastructure. A discussion follows explaining the rationale behind the inclusion of each of these variables in the model system.

\textit{H2: Democracy positively impacts administrative capacity in countries accepting IMF loans.}

Hypothesis 2 is intended to capture the mitigating factor of the political regime on the relationship between state capacity and IMF lending programs, as well as the effect of democracy on capacity-building in borrowing countries. It is expected that a more democratic (and thus, popularly legitimate) regime will be more effective at capacity building than a less democratic regime.

A government making use of IMF loans that is more democratic may enjoy a higher level of legitimacy, contributing to the state’s ability to govern effectively and to build administrative capacity while undergoing reforms mandated by conditionality agreements. Thus, democracy is expected to have a positive impact on rate of change in tax revenue in a country undergoing governance-related conditionality reforms. This is another way of saying that the impact of IMF lending programs on state capacity may vary according to the source of legitimacy for the central government. A relatively

\textsuperscript{15} Viewable online since the 1996 Annual Report at: \url{http://www.imf.org}. 
autocratic government will face a different set of incentives and strategies when adjusting to reforms mandated by the IMF and any changes in the economy that have deleterious welfare effects (due to the implementation of what are often contractionary economic policies) than a government that is more democratic. If voting is free and fair in a democratic country, for example, the government will be more accountable to its citizens than in the case of an autocratic country that governs by a combination of repression and patronage. Thus, it is plausible that the impact of IMF lending on state capacity varies by regime type, as the state’s ability to govern effectively through existing institutions might be affected differently by the impact of IMF lending programs on citizens.

If political institutions are fairly open, opportunities for political participation and dissent are largely available, and the government is not forced to violently suppress political opposition in order to maintain control, the state’s ability to govern will be less hindered by the unpopularity of IMF lending programs among the citizenry than in an autocracy that is forced to suppress and control dissent or employ similarly coercive measures to maintain control.

The measure of democracy used in this study is taken from Marshall and Jaggers’ Polity IV Project dataset, the level of democracy for each country calculated as the mean value of “Democracy” for the years 1996 to the most recent (2003). Each composite indicator has a numeric range of 0 (low democracy) to 10 (high democracy); the Democracy Score is a measure of general openness of institutions. There are three standardized codes representing periods of special circumstances not well defined on the 0 to 10 composite scale. Years representing years of transition are coded as “-88,”
years of complete political authority collapse as “-77,” and years of interruption (such as foreign occupation during war) as “-66.” The democracy variable is calculated as the mean value of a country’s Democracy score from 1996 to the most recent year available (2003).

$$H_3: \text{A more durable regime positively affects administrative capacity.}$$

The durability of a regime, one indicator of overall regime stability, is also expected to positively impact rate of change in tax revenue since a regime that has been in power for a relatively longer period of time is expected to be more efficient in tax revenue collection and capacity-building in the face of IMF governance reforms. The variable used is “Durability,” a continuous value representing the number of years the current regime was in power as of 2003 (the most recent year available), also taken from Marshall and Jaggers’ Polity IV Project dataset.\(^{16}\)

$$H_4: \text{Countries with relatively high levels of state capacity are more likely to receive larger IMF loans than countries with relatively low levels of state capacity.}$$

Scholars have found some evidence for selection bias in IMF loan distribution (Rodrik 1995, Stiglitz 2003); it might also be the case that countries with relatively high levels of state capacity seeking loans from the IMF are more likely to be granted approval than countries with relatively incapable governments. Since state capacity is not necessarily an economic issue per se, if countries with relatively high levels of state

\(^{16}\) Polity IV Project homepage: http://www.cidcm.umd.edu/inscr/polity/.
capacity are more likely to receive IMF loans than countries with relatively low levels of state capacity, it is plausible that such a pattern of bias might be present in IMF lending.

When a country enters into a lending program with the IMF, the size of the loan is sometimes small relative to the country's GDP and population size. This may lead some to the conclusion that such IMF loans are more symbolic than substantive such that, for example, acceptance into an IMF lending program (followed by positive reports of progress) serves as a signal to other nations to trade, invest, and lend to the country borrowing from the IMF. That the actual loan funds are not sufficient to make a direct impact on development renders such a loan largely symbolic. A substantive loan, on the other hand, implies that the IMF is doing more than taking a country on as its pupil; rather, the IMF has judged that the country can make effective use of a substantive loan that has the potential to have a direct effect on development. State capacity would seem to be a significant factor in deciding the size of loan to grant a borrowing country; a state able to govern more effectively would seem a likely candidate for using substantive IMF loans most efficiently. Conversely, a state that with a lower level of administrative capacity would be less capable of effectively utilizing a sizable loan than a state that is not capable of carrying out such basic functions of government. The dependent variable here is approved amount of IMF loans (the total amount approved from 1996 through the most recent year available, 2005). The state capacity variable used to test Hypothesis 4 is the same as the variable used in Hypothesis 1: rate of change in tax revenue (const 2000 USD) as percent of GDP.

Hypothesis 4 essentially reverses the hypothesized causality of the relationship between IMF conditionality-based lending and state capacity; rather than IMF loans
(and the associated conditionality arrangements required since 1996) affecting state capacity, state capacity could be said to affect the size of the loan granted. Such a pattern would imply that the IMF takes state capacity into consideration when deciding whether to grant substantive loans, perhaps allocating resources where they are likely to be used most efficiently and effectively.

\[ H_5: \text{A larger domestic infrastructure attracts a greater amount of approved IMF loans.} \]

A country with a more developed infrastructure and the associated ability to use loans more effectively may be viewed as a more attractive candidate for substantive loan amounts. For the purpose of testing Hypothesis 5, infrastructure is measured as total network of roads in kilometers (average of all available observations from 1996 to 2005). It is expected that the total network of roads positively affects the total amount of approved IMF loans.

\[ H_6: \text{A more durable regime is a more attractive candidate for sizeable IMF loans.} \]

The impact of regime type on IMF lending patterns may be ambiguous, as the Fund purportedly does not take such factors into account. Regime durability should be viewed as positive from the IMF’s point of view, as a more stable government is likely a more responsible steward of loan funds. A more durable regime is likely a more stable regime, all else equal, and may be better equipped to manage more substantive IMF
loans. The variable used to measure regime durability is the same as the variable used in Hypothesis 3.

The six sets of hypotheses described above are designed to better elucidate the relationship between IMF lending programs and state capacity. Although conditionality reforms targeting corruption are a more desirable alternative to the pre-1996 IMF lending arrangements in which governance concerns were not included in loan agreements, it is important to consider the impact of governance-related conditionality on borrowing countries’ ability to govern effectively while pursuing both structural adjustment as well as government reform.

The following models are designed to test the above hypotheses:

**Model 1:**

\[
\text{Rate of Change in Tax Revenue}_i = \beta_0 + \beta_1 \times \text{IMF Loans (Disbursed Amount)}_i + \\
\beta_2 \times \text{Democracy}_i + \beta_3 \times \text{Regime Durability}_i + \beta_4 \times \text{GDP per capita}_i + \\
\beta_5 \times \text{Land Area per capita}_i + \beta_6 \times \text{Roads (total network)}_i + \epsilon_i
\]

**Model 2:**

\[
\text{IMF Loans (Approved Amount)}_i = \beta_0 + \beta_1 \times \text{Rate of Change in Tax Revenue}_i + \\
\beta_2 \times \text{Democracy}_i + \beta_3 \times \text{Regime Durability}_i + \beta_4 \times \text{GDP per capita}_i + \\
\beta_5 \times \text{Land Area per capita}_i + \beta_6 \times \text{Roads (total network)}_i + \epsilon_i
\]

Hypothesis 1: \(H_0: \beta_1 \leq 0, H_A: \beta_1 > 0\)

Hypothesis 2: \(H_0: \beta_2 \leq 0, H_A: \beta_2 > 0\)
Hypothesis 3: $H_0: \ 3 \leq 0, \ H_A: \ 3 > 0$

Hypothesis 4: $H_0: \ 1 \leq 0, \ H_A: \ 1 > 0$

Hypothesis 5: $H_0: \ 6 \leq 0, \ H_A: \ 6 > 0$

Hypothesis 6: $H_0: \ 3 \leq 0, \ H_A: \ 3 > 0$

Summary of Expected Signs:

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<th>Model 1</th>
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<tr>
<td>IMF Loans Disbursed</td>
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<td>IMF Loans Approved</td>
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<tr>
<td>Democracy</td>
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<td>Regime Durability</td>
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<td>Roads (total network)</td>
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Methodology

The structural form of the equations derived from the preceding theory constitutes a system of equations because the dependent variable in Model 1 appears as an endogenous regressor in Model 2. Endogeneity bias is similar to the presence of a stochastic error term,\(^{17}\) violating an ideal condition of ordinary least squares (OLS). The appearance of an endogenous regressor renders parameters estimated using OLS inconsistent in the second model, necessitating the use of a system method of estimation for Model 2 (but not Model 1, since it does not contain an endogenous regressor). Three stage least squares (3SLS) is used in this statistical analysis to produce unbiased and consistent estimation parameters. 3SLS is essentially a generalized form of two stage least squares (2SLS), controlling for correlation among residuals in the system such that the parameter estimates are asymptotically efficient. Although 2SLS produces unbiased and consistent estimates in a system of equations, it does not necessarily produce efficient estimates because the standard error of each model increases as more observations are added. 3SLS corrects this asymptotic inefficiency.

The method consists of first estimating the reduced-form equations, in which in any endogenous regressors (in this case, rate of change in tax revenue as percent of GDP) are expressed only in terms of exogenous variables. The predicted value(s) of the endogenous regressor(s), rather than the actual value(s), are then used to construct the parameter estimates in the second stage, thereby eliminating any correlation

\(^{17}\) Although, strictly speaking, endogeneity is not defined as correlation between the regressor(s) and the error term; see Greene (2000), p 656-7.
between regressors and the residual. These steps essentially describe the 2SLS method. 3SLS goes on stage further by applying a generalized estimator\(^{18}\) to the system of equations in order to provide asymptotically efficient parameters.

What is known as the identification problem in econometrics with respect to the presence of (an) endogenous regressor(s) refers to the need to solve for the parameters of the structural equation from the parameters of the reduced form equation (described above). A model is exactly identified if, for each of the parameters in the structural equation (there are fourteen in the system under study here: \(0, 1, 2, 3, 4, 5, 6, 0, 1, 2, 3, 4, 5, 6\)), there is a single unique solution based on the parameters in the reduced form equations. In order for the model to be identified, both order and rank conditions for identification must be satisfied. The order condition states that \(K^*\) (the number of exogenous variables in the system excluded from a particular equation) must be greater than or equal to \(G - 1\) (the number of endogenous variables included in the same particular equation). Thus, for the model to be either exactly identified or overidentified (either allows the system to have at least one solution), \(K^* \geq G - 1\).

For Model 1: \(G - 1 = 1 - 1 = 0\),\(^{19}\) \(K^* = 0\), and therefore \(K^* = G - 1\); thus, Model 1 is exactly identified.

For Model 2: \(G - 1 = 2 - 1 = 1\), \(K^* = 1\), and therefore \(K^* = G - 1\); therefore, Model 2 is exactly identified.

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\(^{18}\)Kmenta (1971) applies Aitken's generalized estimation to the equation system, given by \(= (X'^{-1}X)^{-1}(X'^{-1}Y)\), where \(= \text{E}(\_\_\_\_\_\_)\) such that it is a matrix containing all of the information regarding correlation among the error terms across equations (see p. 519 for a description of Aitken's generalized estimator, p. 574-5 for how it is used to obtain \((\text{est.})\), the three-stage least squares estimator. \((\text{est.})\), the asymptotic covariance matrix, will be a singular matrix if the system of equations is underidentified such that there are more observations (endogenous regressors) than equations.

\(^{19}\)Note that if Model 1 did contain an endogenous regressor, \(K^*\) would be less than \(G - 1\) and Model 1 would be underidentified: \((\text{est.})\) would be singular and the system could not be solved.
This satisfies the order condition for identification of both equations in the system. The rank condition requires that both equations be independent; since neither equation is a linear function of the other equation, the rank condition is satisfied and each equation has one unique solution. Both equations are identified because each meets the rank and order conditions for identification such that each of the structural parameters has a unique solution. 3SLS may thus be employed to produce unbiased, consistent, and asymptotically efficient estimates for Model 2. The OLS method is used for Model 1, since it does not contain an endogenous regressor and is linear, and parameter estimates produced using OLS are unbiased, consistent and efficient.
CHAPTER 3
FINDINGS

The data used in this analysis is cross-sectional, with country as the unit of observation. The three stage least squares estimation method is employed to measure the relationships among the variables in the system used in the study. The structural form of the two equations below model the relationships described in the second chapter.

Model 1:

Rate of Change in Tax Revenue\(_i\) = \(\beta_0 + \beta_1\)IMF Loans (Disbursed Amount)\(_i\) + \(\beta_2\)Democracy\(_i\) + \(\beta_3\)Regime Durability\(_i\) + \(\beta_4\)GDP per capita\(_i\) + \(\beta_5\)Land Area per capita\(_i\) + \(\beta_6\)Roads (total network)\(_i\) + \(\epsilon_i\)

Equation 1 is designed to test Hypotheses 1, 2, and 3: that IMF loan disbursements, as well as democracy and regime durability, positively affects state capacity.

Model 2:

IMF Loans (Approved Amount)\(_i\) = \(\beta_0 + \beta_1\)Rate of Change in Tax Revenue\(_i\) + \(\beta_2\)Democracy\(_i\) + \(\beta_3\)Regime Durability\(_i\) + \(\beta_4\)GDP per capita\(_i\) + \(\beta_5\)Land Area per capita\(_i\) + \(\beta_6\)Roads (total network)\(_i\) + \(\epsilon_i\)
Equation 2 is designed to test Hypotheses 4, 5, and 6: that state capacity, as well as infrastructure and regime durability, positively affects IMF loan approval amounts (thus influencing IMF lending patterns).

Impact of IMF Loans on Administrative Capacity

Table 1, shown below, presents the results of the OLS estimation of Model 1.

Table 1  
EFFECT OF IMF LOANS ON TAX REVENUE

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>0.3774 **</td>
</tr>
<tr>
<td>Disb. Loans</td>
<td>0.0117 ***</td>
</tr>
<tr>
<td>Democracy</td>
<td>0.0154 ***</td>
</tr>
<tr>
<td>Durability</td>
<td>-0.0177 **</td>
</tr>
<tr>
<td>GDP per capita</td>
<td>-0.0098 **</td>
</tr>
<tr>
<td>Land per capita</td>
<td>4.9319 **</td>
</tr>
<tr>
<td>Infrastructure Network</td>
<td>-0.0021 ***</td>
</tr>
<tr>
<td>R-square (adj.)</td>
<td>0.3688</td>
</tr>
<tr>
<td>General F</td>
<td>6.45 ***</td>
</tr>
</tbody>
</table>

*** significant at the 99% level of confidence  
** significant at the 95% level of confidence

Table 1 presents the regression results of the first dependent variable, which suggests that state capacity is determined by IMF loan disbursements, as well as democracy and regime durability. It reports the statistical relationship between the rate of change in tax revenue as percent of GDP and disbursed IMF loans (in hundreds of special drawing rights (SDR)), level of democracy, regime durability, GDP per capita (real USD, hundreds), land area per capita (sq km) and total network of roads as a measure of infrastructure (km, thousands). The table shows that all the variables are
highly significant (\( p = 0.05 \) or better), sufficient for one-tailed hypothesis testing and thus allowing for an interpretation of the variables that encompasses direction as well as magnitude of effect. It suggests that an increase in the average IMF loan amount (since 1996) of one hundred SDR leads to an increase in the rate of tax revenue change by 1.17\%, \textit{ceteris paribus}. This finding permits the rejection of the null hypothesis of Hypothesis 1, lending support to the theory that the use of IMF loans does increase state capacity. This result suggests that, all else equal, the amount of money disbursed by the IMF does have a statistically significant positive effect on administrative state capacity. The table further proposes that an increase in democracy score of one point increases the rate of change in tax revenue by 1.54\%, positively affecting state capacity building in the manner predicted in the theory. The statistically significant positive coefficient on the democracy variable strongly supports Hypothesis 2.

Table 1 demonstrates that regime durability does not have the anticipated positive effect on rate of change in tax revenue, however: an increase in the length of time the 2003 regime was in power by one year corresponds with a decline in rate of change in tax revenue by 1.7\%, all else equal. However, it is important to note that this does not suggest that regime durability negatively affects tax revenue; rather, the average rate of change is generally less (not necessarily negative) than a less durable regime. A more durable regime may have less of a need to increase tax revenue collection, whereas a regime that has been in power for less time may have a greater rate of change in tax revenue as percent of GDP, if not a greater proportion of tax revenue in general. Thus, the nature of the regime durability variable renders its overall effect on state capacity somewhat ambiguous.
The parameter estimate of GDP per capita suggests that an increase in GDP per capita of one hundred USD (real) leads to a decrease in rate of change in tax revenue by 0.98%. The negative coefficient on the variable is a consequence of the dependent variable’s unit of measure. As GDP per capita increases, tax revenue as percent of GDP may increase at a slower rate; thus, even though tax revenue may increase, it may not do so at the same pace as GDP growth.

The positive, statistically significant (above 5%) coefficient on the variable measuring average land per capita suggests that an increase of one square km. per person causes an increase in the rate of tax revenue by 4.93%. This may be interpreted as suggesting that as citizens have more of an opportunity to be productive (i.e. access to land), rate of change in tax revenue increases. A country with citizens who have more of an opportunity to increase individual wealth will contribute to the tax revenue of a country borrowing from the IMF at a faster rate than a more densely populated country.

An increase in the total network of roads by one thousand km. decreases the rate of change in tax revenue by 0.2%. Although the magnitude of effect of this variable is relatively small, its negative coefficient suggests that infrastructure has a slightly negative effect on the rate of change in the proportion of GDP that comes from tax revenue. This may be another case of a greater level of development being associated with a slower rate of change in tax revenue. This may suggest that a more modern country may have a rising GDP with which the rate of change in tax revenue as percent of GDP does not keep even pace.
The goodness of fit statistics for Model 1 reported in Table 1 are good for cross-section data. Nearly 37% of the variance in the dependent variable (controlling for degrees of freedom) is explained by the independent variables in the model, and allows for the rejection of the null hypothesis that, as a group, the regressors do not explain the dependent variable at a confidence level of less than .0001. The overall fit of Model 1 is excellent judging by these fit statistics.

Influence of Administrative Capacity on IMF lending patterns

Table 2, shown below, presents the results of the 3SLS estimation of Model 2.

<table>
<thead>
<tr>
<th></th>
<th>Effect of Tax Revenue on IMF Lending</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>-41.9079**</td>
</tr>
<tr>
<td>Rate of Change in Tax Revenue</td>
<td>104.1308***</td>
</tr>
<tr>
<td>Democracy</td>
<td>-1.6390***</td>
</tr>
<tr>
<td>Durability</td>
<td>1.8152**</td>
</tr>
<tr>
<td>GDP per capita</td>
<td>1.0262**</td>
</tr>
<tr>
<td>Land per capita</td>
<td>-445.1540*</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>0.2532***</td>
</tr>
</tbody>
</table>

System Weighted R-Square 0.8222
System Weighted MSE 25.0829

***significant at the 99% level of confidence
**significant at the 95% level of confidence
*significant at the 90% level of confidence
The regression results of the second dependent variable presented in Table 2 suggest that state capacity, as well as infrastructure and regime durability, positively affect IMF loan approval amounts.

The effects of the rate of change in tax revenue, infrastructure, democracy, durability, GDP per capita, and land per capita on approved amounts of IMF loans are presented in Table 2. All variables are statistically significant, although land per capita is significantly only at the 10% level of confidence. Rate of change in tax revenue as percent of GDP is highly significant and indicates that an increase in the rate of change in tax revenue by 1% leads to an increase in total amount of approved IMF loans by 104 million SDR. Table 2 supports Hypothesis 4 that strong administrative capacity attracts greater IMF loan approval amounts, and allows for the rejection of the null hypothesis that strong administrative capacity does not attract greater IMF loans.

The coefficient on the democracy score indicates that democracy has a strongly significant negative impact on IMF loan approval amounts. An increase in democracy by a value of 1 (on the 0 to 10 scale) decreases loan approval amounts by 1.64 million SDR. This statistical relationship may reflect the diplomatic relationships among democracies of the world: indebted democracies may be able to attract aid from wealthier democracies, and be less in need of IMF loans. Rather than a bias in IMF lending, there may be a preference among indebted democracies to accept loans from wealthier democracies that may offer more favorable incentives rather than difficult governance reform conditions.

As expected, Table 2 makes it clear that the estimated parameter for regime durability is positive and highly significant: an increase in the durability of a regime by
one year increases the total IMF loan amount by 1.82 million SDR. This supports Hypothesis 6. A polity’s overall stability appears to be a factor in deciding IMF loan approval amounts, perhaps making a more durable regime appear to be a sounder investment, all else equal.

GDP per capita is highly significant and positive such that an increase in GDP of one hundred (real) USD increases a country’s loan approval amount by 1.03 million SDR, \textit{ceteris paribus}. Although the IMF’s primary mandate is to create and maintain stability in the international financial system, a country in crisis, heavily indebted or very poor is less likely to receive the standard loans included in the data, and may be eligible for loans designed to address more dire situations such as the Heavily Indebted Poor Country (HIPC) Initiative.

The estimated coefficient for the land per capita variable is statistically significant at the 10% level of confidence and indicates that an increase in land area per capita by one square km. decreases a country’s IMF loan approval amount under governance-related conditionality lending programs by 445.15 million SDR. The magnitude of this effect is very meaningful, suggesting that the IMF lends more to densely populated countries.

An increase in total road network by one thousand km. increases approved IMF loan amounts by 255 thousand SDR, suggesting that a larger infrastructure (and perhaps a greater ability to effectively use IMF loans) is attractive to Fund lenders. The highly significant p-value on the test statistic justifies the rejection of the null hypothesis that total road network does not increase IMF loan approval amounts, and supports Hypothesis 5. This is theoretically consistent with the positive and significant coefficient.
on land per capita, suggesting that the borrowing countries with a dense population (more people necessitate more roads) are much more likely to receive loans from the IMF.

The weighted R-square statistic shows that 82% of the variation in IMF lending programs is explained by the group of regressors included in the model. This measure indicates that the overall fit of the model is excellent, and bodes well for the reliability of the estimated parameters.

Of the six hypotheses developed in the second chapter, only one of the null hypotheses (associated with Hypothesis 3) failed to be rejected based on the results of the statistical analysis. However, the central theory of the thesis primarily concerns the relationships tested in Hypotheses 1 and 4, that of the effect of IMF loans on state capacity and of state capacity on IMF lending patterns. This study provides empirical support for the argument that state capacity and IMF lending are mutually reinforcing, a finding consistent with the theoretical predictions formed in the first and second chapters.
CHAPTER 4
CONCLUSION

The findings in Chapter 3 confirm the central proposition of this study that IMF governance-related conditionality programs support administrative capacity, even as the administrative aspect of state capacity is an important factor in IMF lending patterns. The model designed to test these two primary hypotheses in addition to other factors accounting for IMF lending behavior and state capacity is comprised of a simultaneous system of equations, allowing for the causal story concerning the IMF and state capacity to be told in both directions. Despite criticisms of IMF conditionality arrangements, it appears that these programs are largely effective at increasing administrative capacity, an important factor in achieving economic growth in the long run and national ownership of IMF development programs in the short run.

The first hypothesis asserted that conditionality-based IMF loans have a positive impact on state capacity with respect to the government’s ability to extract resources from the public. This alternative hypothesis was strongly supported by the statistical analysis, and suggests that the use of IMF loans with the associated good governance reforms results in stronger state capacity. Although it is not clear that the governance-related reforms were the cause of capacity building (or whether state capacity would have been stronger in the absence of IMF lending programs), this finding does not give encouragement to Fund critics the accuse the IMF of failing to enhance national ownership of development programs.
Hypothesis 2 stated that democracy positively impacts administrative capacity in countries accepting IMF loans. This hypothesis also found strong support in the data, lending credence to the idea that democracy supports capacity building in countries accepting IMF loans.

The testing of Hypothesis 3 failed to result in support for the theory that a more durable regime positively affects administrative capacity. Regime durability does not appear to support administrative capacity in borrowing countries, suggesting that regime stability alone does not strengthen administrative capacity.

The fourth hypothesis, tested in Model 2, claims that countries with relatively high levels of state capacity are more likely to receive larger IMF loans than countries with relatively low levels of state capacity. This hypothesis finds strong empirical support in the data: countries aiming to attract more substantive IMF loans should work on increasing their administrative capacity in order to enhance their likelihood of being approved for higher amounts of Fund loans.

Hypothesis 5 was also supported by the statistical findings. A larger domestic infrastructure attracts a greater amount of approved IMF loans. Although the Fund supports economic development, it seems that a more modern country with more accessibility between the state and the people is a more attractive candidate for sizeable loans from the IMF. There may be a connection between this finding and the support for Hypothesis 4.

Hypothesis 6 asserted that a more durable regime is a more attractive candidate for sizeable IMF loans. The null hypothesis was indeed rejected, supporting the idea
that regime durability, although it may not support state capacity, does increase the amount of IMF loans a country is approved for.

The variable designed to measure state capacity – rate of change in tax revenue (as percent of GDP) – was believed by the researcher to be a superior measure of administrative capacity than simply tax revenue as percent of GDP because it better approximates the change in state capacity over the period under study than the simple mean value of tax revenue over the time period 1996 through 2005. Although the empirical results of the analysis are quite promising, future researchers may want to repeat the study using pooled cross-section time-series data in order to better elucidate the relationship between IMF lending and state capacity over time. Such research may help to determine whether the effects of governance-related conditionality programs on state capacity have changed since the adoption of the “good governance” mandate in 1997, and how state capacity has influenced lending patterns.

Another avenue suggested by this study for further research is the exploration of other areas of state capacity, such as control, political, and technical capacity. Examining state capacity in the theoretical as well as the applied (policy) literature would improve the definition of state capacity and open new areas of research for political scientists to contribute to studies regarding the International Monetary Fund’s (and other institutions’) impact on capacity building activities of the developing world. A third promising research possibility is to examine how state capacity affects and is affected by multilateral and unilateral lending other than IMF lending. The relationship between state capacity and loans from countries as well as other international financial institutions and international organizations might be helpful in explaining a myriad of
research questions such as which crisis countries receive aid, the political motivations behind lending, and strategies for aid organizations and distribution.

Critics of the IMF should be encouraged to support their claims with strong empirical evidence, evaluating the medium-term results of modern IMF policy rather than recounting the mistakes of the past or the temporary welfare effects of lending programs. The IMF must continue to actively pursue capacity building in areas other than technical capacity, which would be especially beneficial for accomplishing the goal of borrowing country governments’ “ownership” of Fund-directed development programs. This study has contributed to the discussion concerning an aspect of the consequences of IMF lending and the Fund’s impact on the developing world that has distinctly political consequences.

This thesis provides evidence that the relationship between state capacity and IMF lending is a mutually positive one. It should be noted here that painful austerity measures and structural adjustment reforms make it politically difficult for leaders to follow IMF programs through to completion, and technical assistance (in the form of development as displacement) often gives borrowing countries a fish or two, but does not keep them “fed for life.” The focus of IMF lending programs should be on economic development and correction of balance of payment problems as well as state capacity building; a competent government is vital to ensuring that borrowing countries are able to maintain political stability and thus complete reform programs. The incentive structure for encouraging state capacity building should demonstrate that a competent and strong government in the “right” policy areas (such as tax administration, infrastructure development, maintenance of law and order, and corruption-free
governments) provides strong assurance of political stability; it is easier for a society to accept austerity programs and currency devaluation when the trains run on time, government is generally perceived to be legitimate, and institutions are strong.
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