Policy Loans Are Not a Productive Form of Borrowing

In the early months of 1991, when negotiations began for financial assistance to respond to the balance of payments crisis in Barbados, both the World Bank and the Interamerican Development Bank were involved with the IMF in the discussions. Barbados had recently reached a level of per capita income above the cut off point for World Bank loans, but there remained an amount of US$40 million in finance that had been approved for school construction, which had not yet been disbursed. In order to facilitate the World Bank's participation in the assistance package for balance of payments support, it was decided to convert this financing to a policy loan, a type of lending which was then relatively new to the Bank. I recall suggesting at the time that this was not a good idea.

In the event, the World Bank did not participate in the funding package which was agreed with the IMF and IADB, mainly because a devaluation of the Barbados dollar was not part of the adjustment strategy. However, since that time it has become commonplace for the IMF and development banks to offer policy loans in similar circumstances. This type of lending has not lived up to expectations. The failure of lending for policy change is reflected in the fact of the widespread and enduring complaints, everywhere in the Caribbean, about "implementation deficits". It turns out that disbursements of policy loans have not been reflected in improvements in the capacity of Caribbean governments to devise and implement strategies to improve international competitiveness, to replace imported fossil fuels with renewables, or to pursue any of their announced policy objectives.

Foreign borrowing does not increase a country's capacity to purchase necessary consumables and inputs from abroad. On the contrary, it reduces that capacity. If an individual borrows $100 to pay this month's rent, they make themselves poorer, because they have no money to pay next month's rent, and in addition they now owe an extra $100 plus interest. Borrowing, for an individual or a country, only makes sense if it increases your spending power in the future, through an increase in earnings or by savings on purchases.

The rationale for policy loans is that improved implementation of economic policies has the potential to make the country a more attractive destination for foreign investment. Such investment would increase the country's capacity to earn - as in the case of new hotel construction - or save foreign currency, as for investment in renewable energy. However, in order to raise the national capacity to devise and implement better policies, you need to recruit and equip public servants with higher levels of expertise and experience, a process which involves an increase in recurrent expenditures, in contrast to a one-time project such the building of a new hospital or rural access road. When the loan matures the need for finance continues, because the new staff still have to be paid their monthly salary. Just like an individual who borrows to pay rent, a government that secures a policy loan to improve skills and implementation capacity in the public service is weakening the government finances, compared with the alternative of financing such upgrades out of tax revenues. Expenditure on skills upgrades to improve public sector productivity is an urgent priority, but it must be provided for out of tax revenue.

To make matters worse, in the Caribbean, more often than not, there is no measurable improvement in competitiveness or productive capacity that can be attributed to policy loans. There are many practical, political, institutional and managerial reasons why there has been no improvement public sector productivity in the Caribbean; these are not problems that loan finance can solve.

Experience suggests that a prudent government should borrow only to finance infrastructure and capital projects. All other expenditures are to be funded from tax revenues, including spending to raise public sector productivity. Policies to improve productivity come with increases in current expenditures because of the greater remuneration needed to secure the services of persons with higher levels of skill. For that reason, such policies are sustainable only if they are financed with revenues, and not with borrowed funds.