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# THE POLITICAL ECONOMY OF ECONOMIC POLICY REFORM:

## SUMMARY OF A WORKSHOP*

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**ABSTRACT**

During the fall of 1989, a workshop, "The Political Economy of Economic Policy Reform," was held in Washington, D.C., at which academics and professionals examined how political economy analysis can assist in encouraging and sustaining important policy changes in developing countries; what follows are the proceedings from that event. The workshop attempted to survey the field of political economy and to examine current policy-relevant research. Workshop sessions included "Contributions of Political Economy of Policy Analysis," with Merilee S. Grindle, HIID, Robert Bates, Duke University, and Joan Nelson, Overseas Development Council; "The Politics of Macroeconomic Adjustment," with Stephan Haggard, Harvard University; "Policy Elites and the Process of Reform Decision Making and Implementation," with John W. Thomas, HIID; "A Political Economy View of the Informal Sector," with Jennifer Widner, Harvard University; and "The Political Economy of Policy Dialogue," with Robert Paarlberg, Wellesley College and Harvard University. After each session, panel members responded to participants' questions during open discussion sessions. Lester Gordon, HIID, served as moderator for the program and Merilee S. Grindle, HIID, coordinated the event.

A summary of these proceedings is contained in CAER Policy Briefing Notes No. 1, published by the Harvard Institute for International Development.

**THE POLITICAL ECONOMY OF ECONOMIC POLICY REFORM:**
**SUMMARY OF A WORKSHOP**
**October 6, 1989***

The purpose of the Political Economy of Economic Policy Reform Workshop was to bring together political scientists and professionals concerned with ways political economy can contribute to the task of encouraging and sustaining important policy changes in developing countries. The following key questions dominated the discussion during the day-long workshop:

1) Why do governments adopt or not adopt policy reforms at particular times?
2) How can reforms be crafted with a concern for potential political reactions?
3) What specific steps can AID take to stimulate and encourage economic policy reform?
4) What are AID's limitations in encouraging policy reform?
5) What critical opportunities are available to donors to influence reform initiates?

The workshop's objective was to present an overview of the field of political economy analysis as well as a sampling of work in progress that can contribute useful and policy-relevant insights.

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* The Political Economy of Economic Policy Reform Workshop was sponsored by the Agency for International Development and organized by Merilee S. Grindle of the Harvard Institute for International Development under the Consulting Assistance on Economic Reform Project (CAER).

Merilee S. Grindle, Robert Bates, and Joan Nelson began by addressing the contributions and limitations of political economy for understanding and encouraging policy reform.

Attention was then turned to a sampling of work in progress: Stephan Haggard focused on the politics of macroeconomic reforms; John W. Thomas provided an analysis of reform decision making and implementation; Jennifer Widner examined the local response to reform in the informal sector; and Robert Paarlberg discussed the political economy of policy dialogue.

The sessions were moderated by Lester Gordon of the Harvard Institute for International Development. Alan Batchelder coordinated the workshop at the Agency for International Development.

## Session I: Contributions of Political Economy to Policy Analysis

**Merilee Grindle of Harvard University** maintained that there is growing interest in the work of political economists because of the ongoing economic crisis in much of the developing world and the hope that political economy can shed some light on possible solutions.

To this end, this workshop was organized around three questions.

1) How can political economy analysis be used to understand policy and policy change?

2) In what ways are insights from political economy relevant for policy makers, policy analysts, and donors such as AID?

3) What are the limitations of political economy analysis for considering issues of economic reform?

Grindle maintained there are essentially three clusters of approaches to political economy.

The first cluster is radical political economy, which is derived from a Marxist tradition of analysis. This approach is centrally concerned with how economic relationships determine political outcomes. Policy is an end result of a series of economic relationships which can be altered only with great difficulty. This perspective is not reflected in this workshop, in part because radical political economy views policy as an outcome and, therefore, something that is nearly impossible to alter except through radical social change.

A second cluster of approaches constitutes neo-classical political economy, which is currently receiving much attention. Neo-classical political economy analysis involves the applications of the concepts of neo-classical economics to political behavior. Analysis of political behavior is premised on the assumption that individuals are rational and that they are maximizers of individual self-interest. Out of this perspective comes the literature on public goods, collective action, rent seeking, and political markets. Many of the participants in this

seminar, Grindle said, borrow from this tradition, yet tend to be critical of it.

Participants in the workshop, while representing distinct approaches to issues of political economy, suggested a third cluster that seeks to understand the political basis of economic decision making. Politics define what is possible in terms of reforming economic policy. This perspective focuses not only on political constraints, but also on opportunities within the political arena for shaping options and encouraging change in economic policy. The central unifying themes of these approaches are that 1) political economy analysis is useful and necessary to understand more fully the reform process, and that 2) because policy is not fully determined, choice is possible, and, therefore, political economy analysis is both worthwhile and relevant to policy makers, policy analysis, and donors concerned about influencing policy reform.

Political economy analysis has much to offer those concerned about policy reform. However, there are limitations: there are no recipes for success, no definitive prescriptions, no universal laws that apply in all situations. Political economy analysis is a complex but highly useful endeavor for those interested in encouraging and sustaining policy reforms.

**Robert Bates of Duke University** stated that political economy analysis needs to move away from a strictly macroeconomic conceptualization of the field and to turn toward a plurality of approaches at the microeconomic level.

Much of current mainstream political economy, Bates commented, views the state as mounted on top of markets and intervening in markets through policy instruments. Government is perceived as a unitary actor seeking to secure certain objectives. There are both intellectual and practical dangers to such an approach because it emphasizes a top down planning model and makes the development field uniquely vulnerable to development fads.

International donors often view interventionist government as the disease and the wider role for markets as the cure. Although Bates agrees with the position that the role of the state often needs to be pruned back, he disagrees with the standard view about what roles should be cut.

One very important role for the political economists is to assess where reforms can and cannot take place. For example, government officials will not accept advice that threatens their central state security, and donors will not be able successfully to encourage governments to close down grain marketing boards until they can convince key officials of their preparedness in the event of a grain shortage in the capital city. Nor will the donors be able successfully to encourage governments to abandon export marketing boards until the donors have assured key officials that they will be able to make up for lost tax revenues.

Bates maintained that at the micro level there is much room for policy intervention in which the government can play a

positive role. Therefore, the often blanket condemnation of government may be only half right. Although government should retreat from many interventions at the macro level, the government can be very promising with intervention at the micro level.

Bates stressed the need to utilize more fully non-market oriented branches of political economy such as law and economics, theories of contracting, property rights, and theories of industrial structure.

For example, in Africa the issue of tied contracts is important to understanding any reforms of agricultural marketing boards. Marketing boards in the rural areas often serve as a form of tied contract. Farmers use the crops they sell to the marketing board as security for the loans they receive. If the marketing board is dissolved, credit costs will rise dramatically, and the farmer's ability to get credit will go down because the security for loans has been cut back. This relationship is often ignored when there is talk of dismantling the marketing board. But, if you ask farmers, Bates maintained, one of their central concerns is who will guarantee their loans if there is no marketing board. The farmers often cannot use their property to guarantee the loan because there are few well-defined property rights of land ownership.

Privatization is another area where it is important to focus on non-market political economy. Bates holds that domestic capitalists often do not want the state to privatize, once again

because of the lack of well-defined property rights. In a situation where individuals do not have clear property rights, having the government as a partner is very valuable. A lot of the corporate forms that donors condemn have arisen because of incomplete markets for insurance. Having the government act as a partner in an enterprise is one way of indirectly buying that insurance.

The radical intervention at the industrial level in many Pacific rim countries to encourage technology transfer is part of the reason for the record rates of growth. It is critical to examine these non-market interventions related to industrial structure and industrial organizations.

Focusing on these new non-market areas of political economy, such as property rights, contract theory, and industrial structure, will allow donors to become involved more effectively at the micro level in ways that will assist governments in encouraging enterprise formation and growth at the local level.

**Joan Nelson of the Overseas Development Council** focused on a series of political economy questions that international actors, such as AID, are asking:

1) Why will governments not accept our advice?
2) When our advice is accepted, why is it often carried out so poorly or not at all?
3) Even when our advice is adopted and the government has made a bona fide effort to carry it out, why are the results often so very different from what we had hoped?

The first question focuses on the motives and perceptions of decision makers. The second question focuses on how governments work and interact with various institutions and groups in society. The final question suggests that the problems may lie with bad economic analysis but also highlights a failure to anticipate adequately the response of groups whose behavior donors are hoping to change.

The final question also focuses directly on the perceived and actual costs and benefits to affected individuals and groups. These costs and benefits may or may not be economic. For example, important non-economic costs and benefits include loss or gain of political power or political support.

The perceived flow of costs and benefits should be examined from the point of view of those affected. Individuals or groups may acquiesce to short-term losses if they believe the government has a plausible game plan and that they will reap their fair share of any long-term gains.

These perceptions are often related to how groups are tied into formal or informal political systems. For example, Nelson described her study of urban squatters in the early 1970s. She examined the conditions under which squatters organized and took action against the government. One simple explanation is that they organized when threat of eradication was imminent, and they believed organizing was their sole recourse for preventing eradication.

Nelson emphasized the value of a simple framework that starts from the perspective of key actors involved in a particular policy reform. First, what priority do key actors assign to any particular reform policy? What do they perceive as their options and constraints? An external agency like AID needs to ask: To what degree do key actors share AID's perspective on the priority of this particular reform?

This simple framework, applied to particular reform situations in particular countries, can shed much light on why things have not worked as expected. It can also be useful in identifying and overcoming obstacles to policy reform.

**Discussion:**

**The political economy approach: Is it something more than simply wise counsel?**

Grindle described people working in the field of political economy as taking different cuts at the problem of policy reform. Some examine specific types of policy, such as structural adjustment, sectoral, or organizational reforms; others examine the role of key actors in the agenda-setting, decision-making, and implementation processes; others focus on political constraints and opportunities; and others look at how individuals and groups interact in the policy environment. Each approach provides different, but often complementary, insights that are useful to policy makers and to donors interested in encouraging policy reform.

Bates stressed that many governments have systematically been doing things wrong because they were using their economies to solve political problems. This has cost their societies a great deal.

Bates used an analogy. The traditional state-led development model was like monocropping: there was a single solution, a single crop, and everyone had to plant it. Now that macro-policy adjustments are starting to take hold, a new genetic diversity model for helping the development process is probably more useful. This model recognizes lots of local varieties and a host of local level experiences that are useful.

Therefore, external agents interested in influencing policy need to address a new set of questions: What interests should be safeguarded to give governments the flexibility to assemble new coalitions and, therefore, new policy possibilities? How can local initiative be encouraged and sustained? How can local-level incentives safeguard investments and mobilize community resources?

External agents can offer alternatives, rather than forcing one development cure. This approach will need to be more reactive, drawing on micro-level experiences, and will involve work in fields such as economic anthropology, market and non-market fields of microeconomics, and the relationship between law and economics.

Nelson suggested the political economy model is not yet comparable to the specificity of the neo-classical economic

model, and it probably never will be. However, political economy approaches respond to demonstrated inadequacy of neo-classical models to explain how things operate in developing countries. Neo-classical models are powerful and can explain many things but have also failed to explain others. Therefore, we need to query further in order to fill in the missing pieces.

**When attempting to undertake structural adjustment, for example, is it better to try to do everything at once, a "big bang" approach, or to do things gradually, the "death by 1000 cuts" approach?**

Nelson suggested that it is necessary to specify the particular policy and situation in the country. However, political economy is concerned with getting a better handle on the factors one wants to take into account when deciding the timing for introducing a particular reform and predicting the likely reactions to a reform. Political economists still do not predict very well but do have a good handle on factors that influence political and economic responses. Political economists are working on a number of methodologies that better explain how these factors work in particular circumstance.

**What are the rewards of good policy?**

The macroeconomists act as if good policy is its own reward; if fiscal deficits go down and real exchange rates are right, the macroeconomists are pleased. However, politicians are not so easily satisfied. The failure to take into account what people

perceive as the reward for those policies often deflects macroeconomic policy.

Grindle agreed that a central issue is sustaining policies once a decision has been made. Furthermore, good policy prescriptions are often not enough to get decision makers to adopt particular policies. Sensitivity to decision makers' perception of costs and benefits is essential to effective policy dialogue.

Bates stated that it is in the interest of governments over time to be concerned about these issues. When a government is running policies that are not economically sustainable, the government becomes the primary victim.

**Does the form of government bear on economic policy reform?**

Nelson suggested that there is a consensus among most political scientists that the relationship between regime type (democratic or authoritarian) and success of adjustment performance is weak. There are examples of both democratic and authoritarian governments that have pushed ahead and made major gains and examples of both types which have failed. However, established democracies and established authoritarian regimes were often more similar in their ability to carry out adjustment program than governments in transition that had special difficulties, especially those in transition to democracy.

However, there are characteristics of a political system that do bear directly on the government's ability to carry out adjustment programs. For example, a government with some

centralization and autonomy of its economic authority was more likely to be able to carry out a vigorous and broad-gauged adjustment program than a government whose economic authority was decentralized.

Grindle also pointed out some intangible characteristics of political systems, such as the strength of the state, its autonomy, bureaucratic capacity, and political leadership, that were critically important to its ability to carry out adjustment programs.

## Session II: Approaches to the Political Economy of Reform: Works in Progress

### "The Politics of Macroeconomic Adjustment"

**Stephan Haggard of Harvard University** suggested that policy reform revolves around three policy axes: 1) establishing a set of supply-side policies, such as reducing public intervention and inefficiency; 2) orienting the economy toward a more outward direction; and, 3) stabilizing the economy to bring demand more in line with resources.

Haggard believes that the first two types of reform are critically contingent on the success of the third -- the establishment of a stable macroeconomic environment -- for the following reasons:

1) Private agents will not act on the basis of new incentives or policy reforms unless they believe the conditions will be sustained. New productive

investment requires the commitment of irreversible capital assets. If the basic macroeconomic environment is uncertain, the response to policy reform -- whether they be laws governing direct foreign investment or changes in the interest rate -- will be weak.

2) There are close links between micro and macroeconomic reforms.

3) Finally, inflation tends to heighten distributional conflict over income shares. In Latin America, particularly at the very high levels of inflation witnessed this decade, "economic activity" is often nothing more than trying to hedge against inflation. Although there are multiple causes for inflation, in most developing countries it is clear that fiscal policy is central. Because the ability to tax is not very flexible, savings rates are not easily manipulated, and because the capacity to borrow abroad is drying up, fiscal deficits are likely to be financed by money creation and inflation.

For all these reasons, it is critical to focus on conditions under which macroeconomic stability can be achieved.

The basic political problem in getting the macroeconomic environment right is that benefits tend to emerge over the medium to long term, while the costs are often immediately apparent. A government in the process of stabilization will most likely face a slowdown in the general economic performance. Furthermore, any

attempt to cut public spending will harm some political coalitions that are benefiting from the existing public spending policies, and the government will have to face possible resistance from those coalitions.

The time horizons over which politicians calculate the costs and benefits of reform are crucial. If the time horizon of politicians is short term, they are more likely to delay costly stabilization or pursue inflationary practices than if their time horizon is longer.

This suggests certain lessons for outside agents interested in encouraging policy reform:

1) Timing is essential. A combination of outside pressure and support is more effective when politicians are relatively free from other political constraints and are likely to have a longer time horizon. For example, immediately following an election, politicians' freedom to maneuver is the highest, and outside agents may get effective results by pushing hard for policy reform. However, if politicians are more constrained, such as immediately before an election, or if they feel threatened by a possible coup, outside agents should probably go slower in pushing for reforms. Careful sequencing of reforms will likely play an important role at these times.[1]

2) The importance of doing nothing. There are times it is counterproductive to try to push for reform. Outside

agents will undermine the credibility of the reform process if they try to initiate reform against a political backdrop in which they are likely to fail.

3) Even if the timing is right, there is still the question of managing opposition. Every attempt at reform involves the interests of powerfully favored groups, powerfully disfavored groups, and usually a swing group in the middle. It is important to try to develop for any proposed reform a political map of the distributional consequences. On the down side, it is important to know who are losers; it does not make sense to tell politicians to attack core members of their political constituency. It is also worthwhile to think about compensation, even if undesirable from an economic or equity basis. This is a controversial point, but it may be worthwhile to buy someone off, if that person is capable of derailing an entire program. Compensation can be costly, but compensation is often a crucial element why some reforms work and others do not.

4) Packaging of reforms. When the time horizons of politicians are short, outside agents may want to think about packaging reforms in a way that does not generate widespread opposition. This may involve concentrating, rather than spreading, the cost of these adjustments, and then thinking about how reforms can be sequenced,

so patterns of compensation and resistance can be managed.

5) Focusing on who wins. Most political analysis focuses on costs to losers and how politicians can manage losers. It is also very important that political elites be aware of who is going to benefit. Political analysis too often views politics as interfering with reform, when part of the positive role political analysis can play is trying to identify winners. For example, in the case of macroeconomic policy reforms in Indonesia over the last two decades, President Suharto was supportive of the reform package because he was convinced that these reforms would cement political support in the outer islands, among exporters, and among the peasantry -- all groups that were of major political concern. Identifying groups that will benefit is often a crucial component of selling these reforms to political leaders.

6) Highlighting the importance of institutional reforms. Political actors respond to market incentives as well as to a complex series of institutional relationships. There is currently disenchantment with the area of institutional reform.[2] However, government credibility is generated by the nature of its institutions. Economic agents are aware of institutions that are not capable of generating credible economic policy. If the

government announces plans to trim the budget deficit, but the budget process structure is so permeated that it is going to generate deficits, desired policy responses are unlikely.

Haggard hypothesizes that the comprehensiveness of the budget has a lot to do with the government's ability to sustain stable policies. If a government does not have a consolidated public sector budget, it tends to limit severely the ability of government to use fiscal policies to stabilize. Because stable macro policy rests crucially on the ability to match expenditures and revenues, <u>governments that combine planning and budgeting functions are more likely to reconcile these objectives than governments where the two bureaus are split</u>.

7) <u>Recognizing that procedural reforms are also very important</u>. Relatively minor regulations that give public institutions relative freedom can create whole incentive structures to all public agencies to borrow independently and create their own clientele.[3] These are often little more than accounting issues, but they have enormous implications. According to Haggard, when the Argentine military was overthrown, there were stacks of loan agreements sitting in the hallway of the Finance Ministry that no one in the ministry had even seen.

In conclusion, three objectives emerge as a prerequisite for effective macroeconomic adjustment management: credibility, predictability, and sustainability. When the environment is stable, there tends to be a much greater response to other policy incentives. The implications for the importance of stabilization programs is obvious. However, institutional reforms, which are often slower and more difficult to undertake than discrete policy changes, are also critically important. Institutional design and capacity is central to establishing credibility, which is one of the keys to obtaining macroeconomic stability.

**Discussion:**

**In terms of effectively implementing policy, should AID be more concerned about winners or losers?**

Nelson said that two important issues are raised: 1) the real or perceived balance of costs and benefits, and 2) the political organization of those who lose or gain, and their ability to translate their reactions into effective support for or opposition to the government.[4]

**What implications does this political economy framework have for the United States as it develops a response to the situation in Poland?**

A number of participants, while disclaiming any expertise on the Polish situation, suggested ways in which these political economy frameworks could be useful in crafting policy.

Nelson suggested characteristics that were present when governments adopted broad and sustained stabilization and structural reform programs: there was widespread economic disintegration, coupled with rising political tension, which was perceived as a threat to the country's economic well-being and to its fundamental civic stability; there was a perception about need for major change, even if not a consensus about the direction of the change; and, in most of the cases, there was a new government with the opposition repressed or in disarray. (Examples include Chile in the 1970s, Turkey, Bolivia, Ghana, Mexico, and Jamaica in the 1980s.)

Poland, at the present time, Nelson suggested, seems to have many of these characteristics. However, in the Polish case, much of the opposition to reforms is from within the government. Poland is also a regime in transition, and any regime in transition faces the problem of hold-over bureaucrats. What do you do with the established bureaucracy that continues to run most of the government's business?

In the case of Poland, expectations for quick benefits are probably dampened, and there may be a "honeymoon factor." However, this will be very strongly conditioned by the belief that there will be benefits later. Therefore, credibility for the program is key and will have a great deal to do with whether people are willing to postpone their demands.

Haggard hypothesized that it is best to push hard on reform when legitimacy is highest and to compensate political groups

which are hurt. If this hypothesis is correct, then Poland is the type of situation where it may be effective to push hard for reform, provide lots of money (an obvious constraint), and include strict conditionality, attempting to tie conditions to very specific reforms.

Bates suggested that literature on European countries at the time of the oil shocks and massive recession might be relevant. This literature examines the political and institutional factors that allowed countries to adjust or not to adjust to the economic recession. Frequency of strikes, levels of unemployment, and the quickness of return of income levels were all measured. Two key variables in the countries' ability to adjust quickly were related to the structure of the labor union and the governments' ability to plan at the sectoral level:

1) When unions were more centralized and more closely associated with government (or within the government), there were more strikes and protracted costs of adjustment. Real incomes went down and stayed down quite a while.

2) When planning was done only at the macroeconomic level using aggregate variables (such as average prices), there was a similar inability to adjust quickly. However, when there was sectoral job planning, there was the ability to intervene to ease the adjustment in specific industries, by measures such as targeting job retraining and providing short-term credit to ease

people out of declining industries and to move them to expanding industries. Countries with sectoral/ industrial level planning were able to make side payments and compensate or ease transition.

Bates said that this literature suggests that useful policies to quicken the adjustment process would include unemployment insurance, job retraining, creating new export industries, relocating jobs to growing areas, and keeping influential industries alive during a period of transition and then running them down.

**What is AID's role in initiating reform versus encouraging reform?**

Most of the participants agreed that pushing for change from outside, when there is no host government support, is doomed to fail.[5] Bates said that external agents need to find the reformist impulse and encourage it -- they cannot start it themselves. If governments are against it, they will find a way to avoid it.

**What are different roles that donors can play?**

Robert Paarlberg suggested that even when the government wishes to pursue particular reforms, the role that the donor plays can vary significantly. The donor can play the role of foreign scapegoat, in cases where the government knows the reforms are necessary but does not want to take public responsibility for them. In other situations, the donors can play the "sugar daddy" by rewarding the government for reforms it

wants to do anyway. These roles are often not the donor's choice. If the government is comfortable assuming responsibility for reform in the face of its own society, then the government is most likely best served by a "sugar daddy." If the government is uncomfortable in selling reform, they may need a scapegoat. Donors should be sensitive to the needs of the government.

**When and where is conditionality most effective?**

Nelson stated that the World Bank has made several efforts to assess which areas of conditionality have been most successful in carrying out a reform to which the government had agreed. Pricing policy reforms were clearly the most successful. These "stroke of the pen" reforms were much easier to implement because this usually required only a small group of centralized economic authorities to carry out, unlike the more complex reforms that required participation and cooperation of many agencies and could only be carried out in a series of sequential steps. Strict conditionality is more appropriate for the first type of measures, while sustained efforts of persuasion and incentives will likely be more effective for the second set.

In the 1980s, country after country attempted to implement adjustment programs. However, decisions taken by centralized economic authorities on macroeconomic measures were not backed by broader institutional and procedural reforms that were necessary. Nelson stressed the importance of combining conditionality, where appropriate, with a wide range of persuasive efforts conducted

with respect to macroeconomy but also to the sectoral, institutional, and procedural levels.

**Striking when the timing is right.**

Nelson cited the case of Turkey, which in the early 1980s successfully undertook major macroeconomic reforms. Tremendous analysis and planning was completed before there was a Turkish government willing to carry out such a plan. Advisors, however, were ready with a plan when the opportunity was right and took full advantage of the change of governments in the early 1980s to carry out their plan.

External agencies cannot prepare a plan, but they can work with individuals and groups who want to do the type of analysis that could be put in place when the time is right.

**So, which government officials should be addressed?**

Lester Gordon presented a general proposition that people at AID do not think of governments as a unitary actor or a group of underlying coalitions, but as key officials within governments. The "trick" to encouraging change is to decide what you think should be done and find those in people in government with power (or the promise of power) who agree with your position. The strategy is to support "right thinking people" in economic policy in the government.

Nelson suggested that this can be misinterpreted as spending much time talking with one's friends, who, unfortunately, are often powerless friends. There are other important actors out there. The degree to which AID can generate a broader, better-

informed, and multi-sided debate regarding policies, the more successful they will be. There are many ways to do this, both formally and informally. One obvious way is to commission research.[6]

Haggard stressed that there is no alternative to high-level political support. In the case of Korea, AID had liaisons with their Korean counterparts in the 1950s, but there was no political support at the top. Not until later did many of the reform proposals that had been generated in the 1950s come to light. The key to their successful implementation was the high-level political support.

Paarlberg said that if AID alone selects right thinking people, they are likely to talk with powerless reformers. For example, most of the "right thinking people" in the field of agriculture are inside ministries of agriculture. However, these people do not control food and agriculture policy. To influence policy effectively, AID needs to talk to people in ministries of finance, planning, and supply.

Paarlberg suggested a threefold strategy: try to pick winners; persuade them of what right thinking is; and then, once they have been picked, do not destroy them with too close an embrace.

**"Policy Elites and the Process of Reform Decision-Making and Implementation"**

**John Thomas of Harvard University**, reporting on work in progress with Merilee Grindle and Stephen Reifenberg, began by describing the important role policy makers and policy managers play in determining the timing, content, and success of efforts to implement policy and institutional reforms. Research on instances of macroeconomic, sectoral and organizational reforms in developing countries consistently highlighted the central role played by these "policy elites." They were critical in deciding that action be taken on particular issues; frequently they worked to put together coalitions of support for change. Their perceptions and preferences were central to the type of reforms introduced, when they were initiated, and how they were carried out. These findings distinguish their work from other works which emphasize timing, interest groups, regime types, or analysis of winners and losers as central to the policy reform process.

This research suggests that the <u>perception of circumstances of a crisis or politics-as-usual by policy elites</u> has a significant impact on the dynamics of decision making and the degree of change considered appropriate for the reform to be effective. More specifically, when reformist agendas are established under circumstances of perceived crisis, there will be strong pressure for change from non-governmental actors; the stakes for the government in power will be perceived as high

(even to the point of imperiling the continuity of the regime); high level officials will be closely involved in making decisions; there will be strong concern to make significant changes from existing practice (innovation); and there will be a sense of urgency about the need to act.

A situation of crisis exists when 1) decision makers believe one exists; 2) there is general consensus among them that the situation of crisis is real and of a threatening nature; and 3) they believe that failure to act will lead to even more serious economic and political realities.

When policy elites did not believe that the failure to take action in the short term would result in severe political and economic consequences, reformist agendas were often established under politics-as-usual circumstances. In circumstances of politics-as-usual, reforms are likely to be chosen by the decision makers themselves, who tend to view the stakes as relatively low; the reforms will tend to get less attention from senior officials, who will seek marginal or incremental changes in existing practice and will feel little urgency about introducing reform.

Research based on more than twenty cases developed from the experience of the policy elites directly involved in the reforms have shown that policy makers' views on reformist initiatives are affected by four types of considerations: their technical analysis; the impact of their choices on bureaucratic organizations and actors; the implications of change for

political stability and political support for the existing regime; and the influence of international actors on the process. However, the salience of these four decision criteria differs depending on the crisis or politics-as-usual circumstances by the key decision makers. Thus, Thomas proposed that 1) in crisis-ridden reforms, decision making tends to be dominated by concern about major issues of political stability and control; 2) while in politics-as-usual reforms, decision making outcomes tend to be dominated by bureaucratic and micropolitical concerns.

Thomas maintained that key reform characteristics -- the distribution of costs, the distribution of benefits, the nature of the administrative and technical content, and the duration of implementation -- help to determine the kind of reaction that will be engendered by efforts to implement changes.

If the public is broadly affected and the change is highly visible, reform tends to generate reactions in the public arena. In such a situation, the stakes will be high for the regime and for the leadership undertaking the reform, and considerable resources will be required to sustain the reform.

If the public is not broadly affected and the changes are not as readily apparent to the public as they are to insiders in the government, reforms tend to lead to a response in the bureaucratic arena. In this situation, the stakes will be lower for the regime and the leadership, but the resources needed to sustain the reform will also be substantial. The real issues are whether government capacity exists to implement the reform and

whether there is support for the reform that will cause the bureaucracy to comply with the intention of the decision. Whatever happens, the issue is the viability of the reform and not the survival of the regime.

Two characteristics of reform emerged as particularly salient in determining the arena of reaction. More simply put, asking who gets hurt (distribution of costs) and when plays a significant role in determining the arena of reaction.

The development of a series of worksheets based on the framework for analysis (to be used by policy makers considering the initiation of reform initiative) can help specify intuitive knowledge, systematically structure the thinking of policy makers considering reform, and predict the likely arena of reactions. This will provide important information about the resources necessary to undertake and sustain the reform.

**Discussion:**

**What are examples of a response in the public arena and in the bureaucratic arena?**

Examples of a public reaction are typically devaluations or the removal of subsidies from consumer goods where, once the decision has been made to undertake the reform, they are nearly self-implementing. The public sees the results of the reform nearly immediately. Almost any organizational reform results in a bureaucratic response.

**How does this analysis help in understanding packages of reforms?**

Reforms in the 1980s have tended to be linked and come in packages. These inter-linked reforms will often affect a larger number of groups, thus providing more opportunities for public reactions. Furthermore, it is likely that more and more reforms will generate responses in both public and bureaucratic arenas. As responses in both arenas become more common, analysis of the types of responses also becomes both more important and more complicated. For example, in the packaged reform typical of this decade, policy makers have needed to anticipate public reaction for some components and bureaucratic responses for others. Thus, one would expect that a structural adjustment package that includes a major devaluation, as well as organizational reforms, would likely have both a public reaction and a bureaucratic response. Such a case highlights the importance of disaggregating different components of reforms and examining them individually.

Methodologically, when more than one reform is initiated as part of a package, it will be useful to separate the different components of the reform package and analyze each independently. The analysis of the separate reforms will then need to be assessed in relation to other initiatives in the reform package to gain a clearer picture of their interactions. Matrices may be useful to decision makers as they weigh the implications of

undertaking a reform package and assess and mobilize the resources necessary to sustain the reform.

Another observation was that there are times when one or a few individuals so dominate the reform process that other policy elites are of little consequence.

**"Local Responses to Policy Reform: The Informal Sector"**

**Jennifer Widner of Harvard University** examined the impact of public policy on social, economic, and political relationships in the informal sector in three secondary Kenyan towns. Widner defined informal sector enterprises as those having fewer than nine employees -- with low initial capital requirements -- using indigenous materials, and employing labor-intensive, adapted technology; this includes enterprises which are both legal and illegal. The people who operate in the sector typically do not have the formal protection afforded most entrepreneurs in society, hence contracts tend to be unstable.

Widner divided the individuals she examined into four groups, ranging from those with the lowest capital requirements to those with the highest: 1) hawkers or shoeshiners; 2) tinkers, such as those who sell containers or hardware; 3) tailors or people who fix watches; and finally, 4) carpenters or metal workers.

Typically, policy problems in the informal sector are viewed as a labor market problems. The argument goes as follows: informal sectors develop in economies experiencing rural-to-urban

migration, where entry into modern sector manufacturing and commerce is restricted by regulations that heighten initial capital requirements and limit availability of credit. Informal sector entrepreneurs are trying to accumulate the capital necessary for "graduation" into the formal sector. Policy prescriptions therefore include expanding credit availability and reducing government regulations, such as the cost of obtaining licenses. These policy interventions are believed to produce three benefits; they will: 1) create an employment boom; 2) distribute income more equally; and, 3) generate a group of people who will lobby for reduced government regulation of the economy and other policies, benefiting the low income population.

According to the Kenyan survey, however, neither the analysis of the informal sector environment nor the policy prescriptions seem valid. When asked about the obstacles they faced in starting or expanding their businesses, entrepreneurs in the informal sector usually did not cite harassment by police or the costs of obtaining licenses. Instead, most considered competition from similar businesses and the high cost of labor as the major deterrents to achieving higher earnings levels. Obviously the conventional view has missed key elements in understanding the informal sector.

Widner described four structural features of the informal sector that potentially change the nature of the prescriptions for policy.

1) <u>Diversified Portfolios</u>: Entrepreneurs in the informal sector often have other substantial holdings and are involved in a variety of economic occupations. About two-thirds of the entrepreneurs surveyed had access to land and supplemented their incomes with agricultural incomes. They made resource and investment decisions on the basis of what makes sense in reference to their overall welfare levels and not just on a particular part of their operation. For example, labor may be taken away from a manufacturing enterprise during crucial agricultural seasons.

Therefore, expanded credit might be used to increase the productivity of an agricultural plot and not to boost the productivity of the informal business enterprise. In this case, although there would be an improvement in the general welfare of the entrepreneur, there might not be an increase of employment, as the conventional view would suggest.

2) <u>Institutional Prescriptions and Patterns of Trust</u>: People in the informal sector operate in an environment of high risk. Existing laws do not offer much protection. "Buy at your own risk!! These stalls are temporary," warns a sign in front of a stall of a container salesman in one of the Kenyan towns Widner visited. Since there is a limited ability to guarantee

contracts, there are few people willing to lend money or enter into cooperatives.

To compensate, institutions might be created to reduce risk. Wealthier entrepreneurs, in fact, do buy up suppliers and distributors, participate in backyard vertical integration, and create associations to set and enforce rules. However, the lifetimes of these institutions are surprisingly short, from eighteen months to three years. There is also a problem with revolving credit funds because people who receive the loans first often back out of the fund after they have benefited, leading to a rapid breakup of the credit fund. At present, there are few ways to back up contracts using formal mechanisms.

One way to limit risk, entrepreneurs have found, is to invest in location associations. These are small associations, recognized by the government, acting as banks in some cases and sponsoring the development of distributorships. They are usually homogenous with respect to clan. The consequence is that informal sector markets are often segmented along ethnic lines.

3) Sector Differentiation: The standard view defines the informal sector as having relatively low entry barriers and unhampered competition. However, data indicates that those who have access to greater resources will have a strong competitive edge and will seek to limit

entry of new firms. For example, informal sector businesses with higher earnings levels have access to comparatively more land, are more likely to participate in voluntary associations to seek government assistance and regulate prices, and are also more likely to have the means to secure police tolerance of their activities.

Businesses with lower earnings levels conversely have access to comparatively less land, are less likely to participate in voluntary mutual aid associations, and have a harder time maintaining organizations to fix prices and control market entry.

4) Elite Capture: There is a growth of elite participation in the informal sector. For example, government officials may see opportunities in the sector for supplementing their own paychecks, often resulting in "elite capture" of the informal sector. This is one explanation of why so few people thought licensing or harassment by police was a problem. Many have a stake in health of shops and other formal sector enterprises which receive the favor of government bureaucrats.

There are at least five policy consequences of this analysis:

1) It is difficult to target credit to create a boom in employment. Improved access to credit will not

necessarily expand employment within the informal sector. Capital obtained through foreign-supported credit programs may simply replace the funds the entrepreneur would ordinarily have invested, permitting the enterprise head to use available funds for school fees or to purchase farm machinery that frees household labor for other work. Therefore, while their overall welfare level may improve, the ability of the informal sector enterprise to hire more people may not.

2) Credit expansion may not lessen skews in income distribution. Credit schemes are not likely to reach those who are least well off. Evidence suggests that many of those who participate in the informal sector have substantially greater holdings than conventionally assumed; there is substantial differentiation. Often the people engaged in the most remunerative of informal sector enterprises have personal or economic ties to the formal sector or governing elites who may divert capital to their operations.

3) Achieving equity requires umpires. There is a role for the public sector to provide insurance, to develop mechanism for guaranteeing contracts, and to improve the legal status of people in the informal sector. Market umpires and insurance schemes may be necessary before cooperatives, revolving credit associations, and other kinds of partnerships can form and last.

4) Know the self-interests of recipient policy makers. Some senior policy makers maintain personal economic stakes in the informal sector. These people are likely to accept those policies that improve their own businesses and reject those that bolster the positions of competitors. Win-win proposals for aid and intervention are needed that enable them to accept some measures that jeopardize their interests in one sector while perhaps benefiting them in another.

5) Finally, a caution. Not all informal sectors are the same. There is an enormous diversity among informal sectors, depending on the specific characteristics of the country. Furthermore, what was true in these three secondary Kenyan towns may not necessarily be true in the capital city. Much country specific analysis will be necessary to understand the differences better, which will also vary over time. This study is a snapshot; it will not predict what the informal sector in these three towns will look like ten years from now.

**Discussion:**

**How does this description of the informal sector relate to the informal sectors of countries with major drug activities?**

Widner suggested that some of the drug operations are probably doing what location associations are doing in Kenya. They are providing a reduction in risk to their favored producers

and distributors, as well as protecting them from competition and supplying them with a steady source of credit.

**Given the nature of the diversified portfolios of individuals in the informal sector, what insights are gained into the impact of structural adjustment on the informal sector?**

Widner cited evidence from Nigeria suggesting that when people are faced with sudden shortages or dramatic commodity price swings that accompany structural adjustment, people begin to invest in kinship networks. There is also an exceptional growth in the informal sector at the time of the adjustment.

Nelson suggested that there have been traditionally sharp divisions between the formal and informal sectors. A spectrum that takes into account relationships and links among activities and firms, requiring less capital and skills and those requiring more, is more helpful. These links between informal and formal can be very extensive.

Furthermore, it is assumed that structural adjustment is hard on certain sectors of the formal economy but that it is generally good for the informal sector. However, many people in the informal sector see themselves as the suppliers or sellers to formal sector people, firms, and institutions. Therefore, while they may or may not perceive some benefits from structural adjustment programs, they certainly perceive some immediate costs.

**Is it then important to get more credit to low-income groups?**

Widner suggested that there is a role for credit, but it is important to be aware of the kinds of distributional skews it can create. There needs to be research to show the relationship between receipt of credit and the ability to generate increased earnings or higher levels of employment.

Bates suggested that people cope with risk through two mechanisms: one is by holding portfolios and the other is by getting into situations where their reputations can be developed through repetitive behavior. Reputations are often created in the context of families, ethnic groups, or religious communities. Opportunities to develop reputations break down when individuals do not have opportunities for repetition, such as when they are involved in forming a single big investment that then dries up. There is a need to try and find ways to repeat the interactions by setting up capital markets and spreading the risk widely so everyone holds a small part. Government people also need to be stockholders in the endeavor.

**Are these mechanisms already in place for contract enforcement?**

Widner said that if there was contract enforcement, you would expect to see violence after the breaking of a contract in credit agreements. Although there are some episodes, this does not emerge as a pattern.

**"The Political Economy of Policy Dialogue"**

**Robert Paarlberg of Wellesley College/Harvard University** began with the question: If the goal in policy dialogue is to secure policy reform in the recipient country, how much leverage is needed from the foreign assistance that is provided?

The literature of international political economy provides two different answers. First, a naive answer, which says that economic assistance can provide a great deal of leverage. A second, more sophisticated answer, which promises less for policy dialoguers, but is more accurate.

The naive answer says that resource flows, especially foreign aid, represent unexpended political power over recipient country governments and their policies. The recipient should be willing to embrace politically unpopular policy reforms in proportion to the aid flow.

In this broad view, the current degree of economic interdependence is key. The donor is presumed to have usable leverage over the dependent recipient. This is naive because the leverage has already been expended by the time aid flows begin. Most likely it has been expended by top-level foreign policy or political leaders, not by foreign aid officials, and probably for political rather than economic policy reform purposes.

Trying to purchase more policy reforms with the same aid flows can be compared to finding an apartment, negotiating the rent, signing the lease, moving in, and then asking the landlord

to remodel the kitchen, on the assumption that he is dependent on one's monthly rental payments.

Any aid-for-reform relationship will go through the following three phases:

1) Promise-making Phase: Before aid flows begin, the donor government may enjoy some unexpended bargaining leverage. Unfortunately for AID policy dialoguers, the decision as to how to expend this leverage is usually made by top-level officials whose goals are political or diplomatic rather than economic policy reform.

2) Promise-keeping Phase: AID officials usually have a much larger role in this phase. Some naive observers may see the large assistance flow and incorrectly assume that there is some leverage yet to be expended. But asking the recipient country government for additional agreements on reform can risk the underlying diplomatic or political relationship that the donor bought with aid the first time.

3) Promise-breaking Phase: Donors who can credibly threaten to reduce or terminate assistance may regain some power over the recipient, including power to ask for economic policy reform. But promise-breaking authority is rarely delegated to foreign assistance bureaucracy.

However, there are exceptions to this three-phase pattern. For example, in the mid-1960s, when India was still heavily

dependent upon U.S. economic assistance, the U.S. and the World Bank pressured India to undertake certain politically painful, but constructive reforms, designed to address India's food crisis. Considerable leverage was available to the U.S. because, for two years in a row, India had experienced inadequate monsoons and a severe drought. In 1965 the U.S. government began to link the delivery of expanded food aid to India to these macroeconomic and agricultural policy reforms. This linkage produced results; virtually all reforms the U.S. requested were accepted by the Indian Cabinet and subsequently implemented. Indian agricultural production surged when good weather returned after 1967. Between 1965 and 1970, Indian wheat production nearly doubled, and India went from the single largest net importer of wheat to an occasional net exporter of wheat.

The keys to success in this policy dialogue would be hard to replicate in other cases. During the promise-making phase, President Johnson personally took charge but broke with the pattern by deciding to pursue recipient-country government policy reform rather than to buy a better political or diplomatic relationship. During the second, or promise-keeping phase, Johnson did not trust the Department of State or AID to enforce the terms of his aid-for-reform agreement strictly. He insisted on approving every food aid shipment himself, one month at a time. He did this only after it could be shown that the government of India was still implementing the agreed-upon policy

reforms. This resulted in a considerable worsening of U.S.-Indian diplomatic relations.

This highly unusual case can be contrasted with the case of U.S. policy dialogue with the government of Egypt in the 1980s. Egypt in the 1980s has been just as dependent, in its own way, on U.S. economic assistance as was the government of India in the 1960s. However, throughout the 1980s, USAID has been given the task of conducting policy dialogue with the government of Egypt, with frustrating results.

For example, between 1984 and 1987, the government of Egypt received a total of $927 million, explicitly under the rubric of policy dialogue. In return, AID received mostly promises. At one point, the government of Egypt did offer a thirteen-point reform program, but the program was never implemented. A new Egyptian Cabinet actually backed away from some of the earlier reform commitments that had been made, but the cash transfers continued because of what the AID mission in Cairo labeled "overriding political considerations."

In the case of Egypt, a political considerations bargain was struck in 1974 and 1975 between Henry Kissinger and Anwar Sadat concerning Egypt's future military and diplomatic posture towards the U.S. and Israel. If the U.S. were now to attach conditions of economic policy reforms to this bargain, the Egyptian government would have every right to reconsider the whole bargain. Not wanting to put the basic diplomatic bargain at

risk, the U.S. government allows the aid to Egypt to continue even when Egyptian reform efforts fall short.

Paarlberg suggested that AID policy dialoguers who are mostly excluded from the vital promise-making and promise-breaking stages of the process, and placed only in charge of the less potent promise-keeping stage, may not really have much to learn from the literature of international bargaining.

However, the promise-keeping stage does provide a modest increase in access to important ministries inside the recipient country government. Instead of foreclosing that access or contaminating it with heavy-handed or futile efforts to buy reform, it is possible to use such access to promote politically-sensitive, well-timed technical assistance to the recipient country government. Technical assistance has a long period of gestation. It does not promise the overnight miracles, but it can positively influence the reform process.

**Discussion:**

**Do these comments have any implications for the IMF and the World Bank?**

Paarlberg suggested that the IMF and World Bank have the luxury of not conducting the foreign policy of a foreign power in a region such as the Middle East. Therefore, if they do not like Egypt's performance in the agricultural sector, they can deny a loan, which they have done.

**What about the role of small donors in small countries?**

Gordon raised the issue that the capabilities for exerting leverage through bilateral aid may be increasing as a result of smaller donors in small countries. When AID is one of many actors (in countries where the U.S. does not have high political priorities), AID can more effectively focus on a narrower range of areas, such as reform of the fertilizer sector or reform of a parastatal.

**Are there other ways AID can encourage policy reforms?**

One participant suggested that the distribution of resources within countries may provide opportunities to encourage reform. Since AID can direct resources to a level of government or sector that has been neglected, the opportunity to "offer a new bargain" emerges. Another example of "offering a new bargain" has been utilized by the African Development Fund over the last five years. AID's Africa Bureau puts aside about ten percent of its resources in a development assistance account, which is neither budgeted to specific countries or promised ahead of time. The bureau then attempts to allocate these resources on the basis of economic performance to those countries that are doing well.

Paarlberg reiterated that AID resource flows can provide access to governments, and AID can contribute most effectively to the policy reform process through the utilization of that access of well-timed and politically sensitive technical assistance and other policy suggestions.

## ENDNOTES OF SPECIFIC CASE EXAMPLES

1. According to Haggard, for example, in the first eighteen months of the new government of President Aquino in the Philippines, it seems that policy reforms implemented immediately were the most successful; trade and tax reforms implemented immediately resulted in major gains. However, privatization and land reforms were slow and less successful, in part, because of the nature of the resistance to these reforms, but also because they were not addressed quickly and decisively.

2. The second review of structural adjustment lending by the World Bank study showed that only forty-eight percent of all public sector reforms in Sub-Saharan African were implemented. The report argued these reforms take an enormous amount of time and resources, and the World Bank should not concentrate in these areas.

3. In Costa Rica in the 1970s, there were over 500 autonomous public institutions which enjoyed near financial independence. They could simply write their own checks. This fact certainly exacerbated Costa Rica's fiscal problem in the late 1970s. In Argentina, public institutions borrowed without the Finance Ministry having any centralized knowledge of the liabilities that were being accumulated.

4. In Ghana, where a number of major structural reforms have taken place since 1983, external agencies have assumed that the reforms have benefited certain farmers. Nelson says "assumes" because the sharp increase in the official price paid to producers may or may not translate into gains to producers, since some of them were effectively smuggling crops. Their current "gains" with the higher official price may be relatively small. However, in the process of reform the government of Ghana has alienated many of the groups that originally supported it. The critical question is: Can the government devise new institutional arrangements and procedures to capture this presumed new support in the countryside? The government is experimenting with district councils and other measures. If the country moves to open elections, the government is worried that the more mobilized, vocal opponents in the city will outweigh the new supporters. The case of Ghana highlights both the issue of actual versus perceived costs and benefits and the translation of those perceptions into political support.

5. Bates described Kenya at a time when Kenya was experiencing a terrific drought and widespread famine (early 1970s). Budget goals were abandoned because resources were needed to import food. Never had Kenya been in such economic hardship, and never

was the international community more insistent on reform. The Kenyans, however, never did undertake the reforms the international community were encouraging them to make.

6. For example, the mission in Costa Rica sponsors seminars where people are encouraged to participate broadly and present research often representing different viewpoints. For a time, the Jamaica mission set up informal gatherings of government and opposition economists to discuss policy. The degree to which people in the country are involved in examining and researching these issues, even if this takes more time and the results are less polished, will further support the reform process.