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**ECONOMIC POLICY REFORM:  
SEVEN RESEARCH RECOMMENDATIONS  
FOR THE  
AGENCY FOR INTERNATIONAL DEVELOPMENT**

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## Executive Summary

This report fulfills the requirements of a competitively bid contract that asked for interviews of A.I.D. staff to identify research recommendations for improving A.I.D. efforts in economic policy reform. Seven research recommendations are described. Many expressed concern that A.I.D. lacks the resources necessary in this field in spite of a Congressional mandate in the International Security and Cooperation Act of 1985 which states, "United States encouragement of policy reforms is necessary if developing countries are to achieve economic growth with equity." Interviewees stated that non-economists seem unaware of the enormous costs to the poor in the developing world of economic inefficiency. Economic policy reform may be the single most important activity of A.I.D. in promoting broad-based economic growth. For example, in 1991, the World Bank estimated that if "very good" economic policies were followed in a nation instead of "poor" ones, after twenty years, a country with very good economic policies would have nearly twice the income per capita as a country that started with the same income but pursued poor policies.

To organize the research recommendations obtained from the interviews at A.I.D., the author has defined three "approaches" he believes characterize A.I.D. policy reform: the incremental dialogue, the "big bang" and the creation of export processing zones.

### 1. Research to Identify "Local" Benefits of Policy Reform

The highest priority should be studies, sponsored in nations that need economic reform, of the mixture of benefits that policy reform can bring. Research with "local ownership" is needed to show to national leaders and the media the heavy costs of procrastination, especially to the poor. Questionable studies which purport to show the damage to the poor of policy reform need to be answered.

Reform has been misperceived as an externally-imposed austerity program. Interviewees emphasized that research on the benefits of policy reform should address the non-economists in three separate audiences: national leaders in poor nations, senior officials without training in economics, and the editors and reporters in the media of developing nations whose work will reach the public and opposition groups.

"Local ownership" is important for research on the benefits of reform. There is no cookie cutter design for all economies. Competent local analysis may be more persuasive than purely external prescriptions. Interviewees support A.I.D. funding of the World Bank's Africa Capacity Analysis Program.

A.I.D. should fund more projects, both within governments and outside them, that support economic policy research institutes. Interviewees recommended research to identify which nations need to establish new centers and which centers need strengthening.

## **2. Research to Improve Donor Coordination**

A.I.D. officials want to enhance the efficiency of the division of labor with respect to policy reform among A.I.D., other bilateral donors and the international financial institutions. Policy reform is seldom attempted by A.I.D. in isolation from other donors. Yet the most effective division of labor has not been determined on either a general or case by case basis.

Research ought to identify circumstances in which the "leverage" or formal conditionality is so vital to implementing reform that only the international financial institutions have the resources to influence reluctant foreign governments.

Can A.I.D. better assist nations to meet conditions with technical assistance and institution building? World Bank experience with leverage has been mixed, in one study. Only about 60% of the policy changes agreed to as conditions on World Bank loans were actually fully implemented. 40% were not. Of the 30 countries examined, inflation was reduced in only half of them. The Bank had to withhold disbursements in many cases to obtain even this mixed record of compliance with conditionality. Under what circumstances should A.I.D. try to improve this record by providing technical or other assistance?

## **3. Research To Improve Incremental Policy Dialogue**

Several interviewees recommended research to refine the "collaborative" tactics advocated in the A.I.D. Policy Paper issued in 1982 entitled "Approaches to the Policy Dialogue," which constitutes the "established" view of how A.I.D. should conduct its policy reform activities. This "collaborative style" is required by the Foreign Assistance Act Section 102 of which states, "Development planning must be the responsibility of each sovereign country. United States assistance should be administered in a collaborative style to support the development goals chosen by each country receiving the assistance."

Interviewees requested studies of policy reform that would provide "hands on" tactical information to practitioners. For example, an evaluation would be useful of how policy dialogue has been promoted by A.I.D. sponsorship of professional economic research inside the host government's planning ministry or finance ministry. Multi-national comparisons would be helpful.

## **4. Research to Improve "Big Bang" Policy Reform**

Interviewees recommended A.I.D. sponsor research to produce a "checklist of what has worked" to be shared with host nations undergoing bold, sweeping reform. The checklist would come from experiences as diverse as Poland in 1990, Ghana in 1983, Mexico in 1987-90, and Chile in 1973, and possible Egypt and Pakistan in 1991. For example, Professor Sebastian Edwards has reviewed Chilean decisionmaking with inflation in light of the current choices facing Poland.

Such a checklist would contribute to a second research subject: precisely how can an A.I.D. mission best contribute to

design and implementation of rapid reforms when a nation has decided on that course?

A third research subject for drawing lessons from case studies is how to minimize the ability of an opposition to feed on interests harmed by the policy reforms. How can the benefits of big bang policy reform may be generated soon enough to stop erosion of the coalition that launched the reforms? To prevent the collapse of reform, an A.I.D. mission ought to have research results ready to share with a reforming nation to identify and defuse issues that will galvanize opposition alliances. A.I.D. could even sponsor such research by the reformers themselves.

#### **5. Research on The Free Trade Zone Approach to Reform**

Standing between the big bang and policy dialogue approaches is a somewhat risky policy reform tactic: establishing an export processing zone (EPZ) so that its feedback effect will strengthen the chances for policy reform beyond the zone. Not all EPZs will produce such feedback, but some have. One interviewee noted that a World Bank study in June 1991 has endorsed establishing EPZs as a step toward policy reform. The recommended research effort would be to identify, through case studies, when and how to create EPZs to stimulate further policy reform.

EPZs have proliferated in the developing world over the past two decades, not always contributing to policy reform. EPZs have grown from fewer than two dozen in ten countries in 1969 to more than 145 operational in over 45 countries in 1990.

An advisor in Taiwan in the early 1960s recalls the prevalent view that Taiwan could never become a manufacturing exporter. Yet Taiwan's tiny export processing zone generated \$3.5 billion a year of foreign exchange by the 1970s. This is the kind of feedback that changes minds.

The research should highlight examples of when such an approach works, perhaps because the opponents of reform will be complacent as long as an EPZ is tiny. The reformers save their political capital to fight another day, when they will be better armed with persuasive ammunition.

#### **6. Research on Establishing the Democratic, Legal, Regulatory, and Judicial Framework of Economic Reform**

Development Issues 1991 describes the economic benefits of a sound "L.R.J." environment -- the legal, regulatory and judicial framework of a nation. Research is recommended to translate this general prescription into specific "what to do" and "how to do it" guidance. Specifically, what aspects of a nation's L.R.J. framework should be improved first to obtain optimal increases in economic performance? If widespread public corruption characterizes a government, can it really be expected to manage economic reform efficiently?

The Democracy Initiative announced by A.I.D. in December 1990 suggested a related research area. "Accountability" in democracy enhances economic efficiency. Three areas were recommended for study: improving financial management,

prosecuting corruption, and enhancing civilian control of the military, which may forestall military coups sometimes triggered by economic reforms.

#### **7. Research on Performance Indicators of Economic Reform**

A focus on "results" presupposes a performance measurement system. A.I.D.'s regional bureaus use quantitative indicators to assess economic policy. At least five scholarly efforts are presently underway to rank order national economic policy performance. Interviewees want A.I.D., at a minimum, to keep in touch with this work. Some interviewees advocate A.I.D. funding for economic analysis to identify the most "outrageous" policy distortions in the developing world and thereby to "flag" them for extra attention by donors.

#### **Management Issues**

Because the Administrator's new Mission Statement lists economic growth among A.I.D.'s goals, some recommended a study of whether an organizational "home" at A.I.D. is needed for promoting economic growth. A disadvantage of the current decentralized approach is that no official or unit is accountable to the Administrator for monitoring policy reform. This is one reason, some believe, why in 1990 Congress refused to appropriate a \$75 million A.I.D. request for a performance-based discretionary fund for nations reforming their economic policy. This request, modeled on the Development Fund for Africa, would have enhanced A.I.D.'s bargaining power by providing an incentive that could be spent to provide institution building and technical assistance to aid reform.

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This report is based on the premise that promoting economic policy reform is an important part of A.I.D.'s mission to increase broad-based economic growth. This report describes the results of interviews with A.I.D. staff about future research that is needed to make A.I.D.'s efforts in this area more effective. The interviews suggested that A.I.D. can benefit from research on each of its three approaches to policy reform: the incremental dialogue, the "big bang" and the development of free trade zones. The interviews also suggested that no "history" has yet been written of A.I.D.'s successful projects and other activity in support of policy reform. The data base for research is not well organized. There have been twelve studies by teams from the A.I.D. Center for Development Information and Evaluation, but there are no Agency-wide comparisons of which approaches yield success and why. The Bureau of Science and Technology sponsored a book-length study entitled "Implementing Policy Reforms in the Less Developed Countries" which focuses more on the academic literature on policy reform and does not analyze any A.I.D. experiences.

With A.I.D.'s limited research budget, additional research would not be justified unless policy reform actually has a major impact on reducing poverty in the developing world. At the outset, one must ask how important a contribution can economic policy reform make to A.I.D.'s mission. After all, A.I.D. has few employees assigned to economic policy reform. No senior official is in charge of any specific unit that supervises it. Nor is policy

reform one of the eight "functional earmarks" set by the Congress which are mirrored in the organizational structure of A.I.D.

A recent World Bank study estimated how much improvement in GDP growth rates per capita could result by the year 2000 if "very good" economic policies were followed in a nation instead of "poor" ones. The Bank cautions "no one can know for sure" about long-term growth because of international conditions and other "external factors," but the Bank's estimates of the impact of policy reform provide illustrative magnitudes for changes that are possible. The Bank's projections say that the difference between poor and very good policies is worth, on the average, 3.5 percentage points of growth a year, per capita. This means, for example, instead of 1 % annual growth, 4.5% annual growth. After ten years, with compounding, a country with very good policies would be more than 40 percent better off than another that started with the same income but pursued poor policies. If that growth advantage were sustained, the first country would have nearly twice the income of the second after twenty years.

Three years ago, A.I.D. economists prepared a report in 1988 which, like this World Bank study, describes the growth benefits obtained by nations with good economic policy performance scores. It was summarized in two charts in the "Woods Report." Then in 1990, A.I.D. presented to the Development Advisory Committee of the OECD in Paris the results of a similar study of how differences in economic policy performance have affected growth rates per capita. Among the 42 nations that were rated, a long term growth rate

increase of about 1 percent per capita had occurred in nations with higher quality macroeconomic policies in contrast to those with lower policy scores.

These studies are statistical and do not address the subject of this report: can research suggest ways to improve the effectiveness of A.I.D.'s policy reform efforts?

There is an extensive academic literature on policy reform, but it is not aimed at improving A.I.D.'s effectiveness, nor was it designed to provide A.I.D. with "hands on" or "how to do it" advice. Therefore, this report was requested to obtain the views of the practitioners of economic policy reform on their "research needs," as distinguished from what the academic world has been studying. It is based entirely on interviews with A.I.D. economists and other practitioners at A.I.D. with experience in economic policy reform. The contract requested the following:

"Economists (and others at A.I.D.) will be interviewed about the lessons they believe are relevant to future policy reform and also the research they believe A I.D. needs for such efforts."

The interviews for the report focused on the three subjects:

1. "an examination of lessons learned from past A.I.D. policy reform efforts,"
2. "conclusions reached by A.I.D. practitioners as to the prioritization of policy reform efforts by sector and/or their sequencing," and
3. "based on A.I.D. practitioner interviews, a prioritization

of critical research topics necessary to improve the effectiveness of policy reform assistance efforts."

The main focus of this report quickly became the third subject, the identification of critical research topics necessary to improve policy reform efforts. The initial interviews on the first subject of "lessons learned from past A.I.D. policy reform efforts" produced clear consensus about only one "lesson learned." Economic policy reforms are much more difficult to implement than was anticipated a decade ago when A.I.D., the Bank and the Fund started to promote policy reforms. In 1981, the unwarranted expectation at A.I.D., the World Bank and the International Monetary Fund was that policy reforms would produce dramatic benefits with a few "quick fixes" that could essentially be decreed by a government and be implemented almost immediately. First, the country had to "get prices right" (by ending price controls and price subsidies) while simultaneously stimulating exports (by ending the distortions caused by overvalued currencies and trade barriers). Even these two seemingly simple policy reforms proved elusive. Still more difficult to implement quickly were complex reforms such as the sectoral reforms required for efficiency in the finance, reduction of government spending, and the privatization of large state-owned enterprises. Interviewees suggested that progress has surely been made, but the massive inefficiencies of Third World economies have not been quickly "fixed," largely because of problems of "implementation." Therefore, a number of

interviewees recommended research designed to improve the implementation phase of reform.

Initial interviews on the second subject ("conclusions reached by A.I.D. practitioners as to the prioritization of policy reform efforts by sector and/or their sequencing") produced no clear conclusions or consensus at all. No one interviewed believes there is a clear, precise blueprint for the sequencing of economic policy reform. Interviewees were aware of a number of academic articles that have advocated postponing privatization of the largest state-owned enterprises until after improvements in price distortion and foreign exchange convertibility have been achieved. Some thought agricultural sector reforms should be accomplished before financial sector reforms. Generally, however, no interviewees held firm views on this subject. Rather, many suggested that the political and institutional feasibility of specific reforms would always in practice determine the priority and sequence of reform efforts. These initial interviews suggested that the most productive focus for this report would be identifying future research needs in the area of increasing A.I.D.'s own effectiveness rather than designing ideal types of reform sequences that might stand no chance of implementation.

It is important to note at the outset two caveats expressed by many interviewees. Some doubted the validity of a report prepared without input from A.I.D. staff in missions overseas. For budgetary reasons, no Mission Directors were interviewed for this report. Yet under the system of decentralized management in effect

for the past two decades, several interviewees said that economic policy reform has been left solely to the discretion of Mission Directors and A.I.D.'s field staff. A.I.D. Headquarters in Washington has no role to play, in the extreme version of this view. A second caveat is related to the first. Decentralized management has meant that the regional bureaus of A.I.D. together with the Mission Directors (not any central bureau) have responsibility for determining when or how best to promote economic policy reform. Therefore, a key premise in the contract for this report was challenged by some interviewees. It states:

Each bureau has developed its own approach (to policy reform). There is no common framework or theoretical basis for determining when interventions to support policy reform are likely to succeed, or what factors are critical to its success or failure. Ad hoc responses to targets of opportunity may have been appropriate in the past, but data are now available for a more systematic review of A.I.D. experience.

Many of the interviewees believe that the most effective policy reform by A.I.D. should be limited to "ad hoc responses to targets of opportunity." Few would welcome a cookie cutter approach from the top down that does not recognize the inherent political realities of economic policy reform. They would prefer the decentralized approach in part because of two difficulties inherent in promoting economic policy reform. First, it is extremely staff intensive, at a time when there are roughly 1800 projects in the A.I.D. annual budget administered by roughly 2000 staff overseas. Second, it is difficult to quantify the results or benefits caused by policy reform at a time when A.I.D. emphasizes performance and tangible results. Interviewees stated that

measurable results may not be apparent for many years. For example, several of the 12 impact evaluations by CDIE of A.I.D.-funded policy reforms state that a period of two to four years is not sufficient time to see any results of major economic reforms.

### Research to Identify "Local" Benefits of Policy Reform

Many interviewees suggested that the highest priority research on policy reform should be studies that would lay the factual basis for dramatic demonstration of the mixture of benefits that policy reform can bring in particular cases. Conversely, useful research would show the heavy costs of procrastination, especially to the poorest citizens of nations with inefficient economies.

Surprisingly few studies like this exist, except the two World Bank and A.I.D. studies mentioned above that were described as "dry" and "mainly statistical." Interviewees recommended that the mixture of benefits and costs that policy reform brings to particular groups should be identified and if possible quantified through research. Some said that at present policy research which purports to show the damage to the poor rather than the benefits to the poor seem to dominate the research agenda.

Many economists involved in policy reform apparently assume its benefits to be self evident. But the benefits of reform -- and the costs of procrastination -- are not at all self evident to those "stakeholders" who may be harmed by reforms and may be in a position to block or delay them for many years.

Macroeconomic reform is often resisted strongly and persistently in part because the reform package is often widely misperceived as a general belt-tightening, externally-imposed austerity program. The reform package may not be well explained to the public. Few national leaders are trained market-oriented econ-

omists. The Third World press seldom has the background to explain the benefits of economic reforms. It is possible that, as in Zambia in 1984, reform will be portrayed to the public as satanic suffering inflicted on an innocent nation by the "twin devils," the IMF and the World Bank. Many interviewees warned that there is also a political risk to a public perception that the American government is behind the belt-tightening aspects of policy reform. To avoid this risk, A.I.D. recommendations for policy reform have sometimes been shelved. The recommended research could lay the factual basis for national leaders to use in defense of policy reform and its expected benefits.

Interviewees emphasized that research on the benefits of policy reform should not be addressed to economists. To be useful, research on the payoffs of policy reform must sway the doubters, the skeptics and the opponents of reforms. The audience for such research lies with the non-economists who make up the vast majority of the world's leaders. One target audience should be specific government officials whose resistance can block either design or implementation of policy reform. Some Interviewees envision three separate audiences: the highest level of national leadership in poor nations, senior officials without training in economics. and the editors and reporters in the media of developing nations whose work will reach the public and opposition groups.

Another purpose of such research would be to persuade skeptics located not only in developing nations but also some in donor nations. How to allocate scarce foreign assistance is an issue that

some interviewees believe would benefit from studies showing how the rate of return on foreign assistance is affected by improvements in macroeconomic policy, broadly defined.

All interviewees believe that policy reform is worth doing, but they emphasize that non-economists seem unaware of the benefits of policy reform and the enormous costs to the developing world of continuing policies and activities that economic inefficiency. Non-economists seem not to appreciate that macroeconomic policy reform may be the single most important activity of A.I.D. in promoting broad-based economic growth. From the viewpoint of A.I.D.'s economists, a major challenge to policy reformers is the lack of appreciation by non-economists. One interviewee lamented that economic policy reform is unappreciated and extremely difficult to implement, but is extremely important to A.I.D.'s mission to promote broad-based economic growth.

Research that comprehensively catalogued the benefits of policy reform in non-economic terms would help with some of A.I.D.'s constituencies for another reason. Unfortunately, the success of A.I.D. is judged by Congress on the basis of the appreciation expressed by host governments for tangible development success. There are no letters thanking A.I.D. for placing policy reform conditions on its assistance. No policy reform practitioners receive medals for it. One interviewee observed that there are annual Presidential awards for overcoming hunger, and glossy, color annual reports are sent to the U.S. Congress on the tangible achievements of A.I.D. programs for child survival, population and

tropical forestry, and even breastfeeding. Yet A.I.D.'s policy reform achievements go unsung and unappreciated, and are actively resented in many circles.

Research on the benefits of policy reform was justified by one interviewee who suggested a metaphor to illustrate how host nation reaction to A.I.D.'s policy reform efforts could be better understood. A medical patient feels the pain of a needle injecting him with an important vaccination from which there is no immediate visible benefit. The pain will be tolerated only because the patient has faith in the physician's esoteric knowledge about how medicine "works" to preserve health. If the "patient" is the leader of a sovereign nation who lacks knowledge of the benefits of policy reform, he will tolerate few painful "injections." The longer the course of major reforms requiring painful injections over several years, the more useful will be research demonstrating how the tangible benefits were achieved elsewhere. Without such research, will A.I.D. mission directors be permitted to initiate or continue this "painful" work? A widely disseminated CDIE evaluation notes the removal of a mission director at the request of foreign government because he was overzealous in pushing for the implementation of signed agreements on policy reform. Research can teach "patients" not to remove their "doctors." Ideally, persuasive research could teach the patients to become their own health care practitioners.

Research on the benefits of policy reform can help in another area. Many interviewees expressed frustration that an "anti-policy

reform" perspective often called the "UNICEF view" has gained popularity in the past three or four years. In this view, policy reform initiatives are seen as misguided efforts directed by insensitive, uncompassionate economists. Policy reform harms the world's poor while at best helping only the richer inhabitants of Third World nations, in this view. The "UNICEF view" would save the world's poor instead with increases in foreign aid flows.

A model for the A.I.D. sponsored-research on the benefits of policy reform has been suggested by a World Bank study in July 1991 which reviewed 1200 Bank projects in 58 nations. For the Bank, the existence of undistorted policies made an investment at least one and a half times as productive. It would be a powerful argument for policy reform if A.I.D. could claim on the basis of its research that the World Bank's findings also apply to A.I.D. projects. One interviewee suggested that other bilateral donors could be urged to carry out similar research on their projects.

Interviewees suggested that a sample of A.I.D. projects and non-project assistance should be examined to see what rates of return have occurred in nations with and without efficient economic policy, focusing on the economic rate of return in relation to the economic policy environment. As in the Bank study, A.I.D. "policy indexes" would have to be established to measure policy distortions or inefficiency in exchange rates, interest rates, and trade restrictions. Statistical sensitivity tests would be run with other variables.

Some interviewees suggested that "local ownership" is important for research on the benefits of reform. Developing nations' own policy analysts might produce similar findings, if programs were started to train analysts. Several interviewees were optimistic about the impact of developing local "ownership" of policy studies. Therefore, they support A.I.D. funding of the World Bank's Africa Capacity Analysis Program. Africa lacks its own policy analysis capability, according to this view, so a new generation must be trained in policy skills such as economics and other social sciences. The explicit premise of the Africa Capacity Analysis Program is that it may take 20 years to produce sufficient numbers of local policy analysts. One interviewee pointed out that this is the same twenty years during which the per capita income of a nation could be doubled if it pursues very good economic policies. Hopefully, it will not take that long to improve "local" policymaking.

The converse of research on the benefits of reform is analysis that would vividly show the high cost of failing to reform distorted policies, especially to some large groups such as the poor. Many interviewees believe not enough has been done in this area. One pointed to a May 1991 article describing the unintended, harmful effects of procrastination in economic policymaking. The article is one of the first studies of the A.I.D.-funded Institute for Policy Reform. If further developed, the article provides hypotheses that suggest why policymakers in developing nations may have a strong propensity to resist the implementation of economic

reforms unless they can learn to calculate the future costs of procrastination. Some interviewees added that studies of the costs of failures to reform should be aggressively released in press conferences and distributed to opposition parties in countries with distorted economic policies.

Another suggestion for research on the benefits of reform is that Americans should not have the monopoly on it. A.I.D. should sponsor carefully selected foreign scholars or research organizations in the developing world whose perspective supports policy reform, but whose lack of resources prevent them from undertaking significant research or publishing their findings to reach a large national audience. A few A.I.D. funded projects like this have already created policy research institutes in Africa in the Sahel nations, in Central America and in Bolivia. Interviewees recommended research to identify which nations still need such centers. These problems are noted in "Economic Policy Making: Lessons from Costa Rica" by the former president of the Central Bank of Costa Rica, which was published by the A.I.D.-funded International Center for Economic Growth.

Several interviewees recommended tailoring research efforts to address the benefits of policy reform in specific nations. They doubted that anyone in A.I.D. or other donor agencies has ever surveyed how little has been done to promote understanding of the benefits of policy reform, especially in those nations with the most distorted policies where the climate of intellectual opinion still runs against the free market, even after Mikhail Gorbachev's

resignation from the communist party. "Market research" in nations with poor economic policies could identify how both the public and policymakers can better understand the benefits of policy reform (and the losses caused by procrastination).

## 2. Research to Improve Donor Coordination

Several A.I.D. officials believe carefully designed research could identify options to enhance the efficiency of the division of labor with respect to policy reform among A.I.D., other bilateral donors and the international financial institutions. Policy reform is seldom attempted by A.I.D. in isolation from other donors. Yet the most effective division of labor has not been determined on either a general or case by case basis. In many developing nations with policy reform programs underway, a World Bank representative chairs a Consultative Group (CG) through which donor coordination occurs, sometimes in Europe, or the UN sponsors a roundtable usually in the host nation. For several years, A.I.D. has sought enhancement of this system either through formation of additional CGs in other nations or strengthened policy analysis capacity in existing groups. But there has been no systematic review of lessons learned for future use to more effectively coordinate multiple donor contributions to policy reform.

Interviewees requested a study which would identify on a case by case basis the circumstances in which A.I.D. should play a leading role in policy reform, at one extreme of a spectrum of options. The other extreme case to be considered would be severely curtailing the role of A.I.D. so that the international financial institutions (the World Bank, IMF and the regional development banks) would have sole responsibility not only for providing assistance conditioned on improvements in economic policy, but for

all other aspects of implementing policy reform.

Research ought to identify the circumstances in which the "leverage" or formal conditionality is so vital to implementing reform that only the international financial institutions have the resources to influence reluctant foreign governments. Another empirical question is the extent to which America's relations with developing nations may suffer from playing a leading role in reform.

Interviewees mentioned that this type of review of cases could test the validity of the assumption that the only large aid transfers can provide the necessary leverage for implementing policy reform. If so, should A.I.D. consider devoting larger resources to policy-conditioned aid? If not, are technical assistance projects (such as building policy analysis capacity) better use of aid funds?

Behind this research recommendation is a concern whether A.I.D. ultimately lacks the leverage to take on a challenge best left to the Bank and the Fund. If so, only the U.S. Congress could mandate further policy reform initiatives through specific legislation. Otherwise, A.I.D.'s role in policy reform may be limited to its sectoral technical expertise in projects in finance, privatization, agriculture, the environment, health, education, and population.

A trade off study may also show that a clear role for A.I.D. is in mitigating the undesirable side effects of policy-based lending by the Fund and the Bank. Apparently, the IMF and to a

lesser degree the Bank are perceived to be less competent in designing projects for poverty alleviation than A.I.D. staff.

Why are measures to protect the poor during policy reform seen as an appropriate role for A.I.D.? Some believe A.I.D. has a comparative advantage here. For example, former Mission Director Sidney Weintraub argued:

My own sense is that A.I.D. can be more effective in certain areas than either the IMF or the World Bank. These include poverty alleviation . . . compensation is possible only when it is clear which groups bear the brunt of stabilization-adjustment programs. This analysis is rarely carried out by the persons devising these programs. Their interest is macroeconomic. A.I.D. Missions are far better situated to understand the distributional aspects of broad programs.

A cost-benefit analysis of the trade off between A.I.D. and the international financial institutions should have a longitudinal dimension. A.I.D.'s predecessors were also involved in policy reform. The former President of Panama, who now heads an A.I.D.-funded program on policy reform, pointed out that both the Marshall Plan and the Point Four programs were policy-based and required specific reviews of the macroeconomic policies of the recipient nations. U.S. Government economists participated in these programs and reviewed macroeconomic policy variables that each country planned to pursue. Similarly, the Alliance for Progress of the Kennedy administration also had an economic reform component and attempted to persuade recipient nations to improve economic policy in the 1960's.

Both the Bank and the IMF have acquired extensive experience

in policy-based lending. The term "conditionality," introduced in the late 1940s, initially referred to practices governing the use of Fund resources that became necessary when a country faced severe macroeconomic distortions such as excessive inflation or an unsustainable deficit in the balance of payments, or both. IMF interventions have focussed on a few central targets, according to the research department of the IMF. IMF programs are essentially short term, however, in accordance with its Articles and Charter. More recently, the IMF has introduced a practice in which a policy framework paper (PFP) drafted by the country (with the aid of the Fund and World Bank staff) lays out a specific set of short term policy steps including privatization, foreign exchange adjustments, tax reform, tariff reduction, and reduction of subsidies and price distortion. A.I.D. does not have a similar practice.

After identifying the comparative advantages of A.I.D., other bilateral donors, the Bank and the Fund, the recommended study would have to recommend when each would be the best instrument to achieve which types of policy reforms.

For example, the World Bank was established to provide project loans, not to compel policy reform through conditions on its lending. A decade ago, in response to the sharp rise in oil prices, the World Bank began to require policy changes as part of "structural adjustment loans" which required changes in relative prices and institutions designed to make the economy more efficient, more flexible and thereby to engineer sustainable long-term growth. Within a decade, these World Bank structural adjustment

loans exceeded 25% of total bank lending. The United States had originally opposed non-project lending by the World Bank, but later became an enthusiastic supporter of structural lending and requires it as a condition for capital increases.

The study would contrast this large portion of World Bank resources devoted to policy reform with the relatively small portion of A.I.D. resources actually available for policy reform. The U.S. economic bilateral assistance program of \$6-7 billion does not compare with the roughly \$18 billion in loans extended each year by the World Bank. Even the IMF, a revolving pool of currencies, has more than \$8 billion in outstanding funds and an undrawn balance in existence of over \$4 billion. These figures understate the influence of the Bank and the Fund in encouraging commercial banks and other foreign commercial funding sources to enter a country whose economic policy reforms have been approved by the IMF. Very little of the A.I.D. \$7 billion budget would be available in any event for policy-based activities in light of because of Congressional earmarking.

In addition to resource levels, the study would review the weaknesses of the IMF and the Bank in comparison to A.I.D.'s strengths. World Bank experience in this field has not been totally successful. The Bank initially thought only three to five years of policy-based lending per country would be required, yet it continues a decade later to the same countries. One Bank study concluded that only about 60% of the policy changes agreed to as conditions on World Bank loans were actually fully implemented.

That means 40% were not. The most successful areas were reforms of exchange rate management, energy pricing, agricultural pricing, financial markets, and reduction of public sector expenditures. Even in these areas, "reform" usually meant "some" improvement, leaving much more to be improved next year. The areas of greatest resistance were tax reform, state-owned enterprise reform (privatization) and industrial policy reform. Of the 30 countries studied, inflation was reduced in only half of them. The Bank had to withhold disbursements in many cases to obtain even this mixed record of compliance with conditionality. Almost three-quarters of adjustment lending tranche releases were delayed by the World Bank because of alleged failures by a country to meet its loan conditions, although almost all tranches were eventually released.

### 3. Research To Improve Incremental Policy Dialogue

Several interviewees recommended research to refine the tactics advocated in the A.I.D. Policy Paper issued in 1982 entitled "Approaches to the Policy Dialogue," which constitutes the "established" view of how A.I.D. should conduct its policy reform activities. The goal of this research would be to gather case studies of A.I.D. efforts in the missions that contain sufficient details to permit a "feel" for how individual A.I.D. staff have approached "policy dialogue" in various nations. Interviewees noted that several CDIE studies of policy reform have been useful in suggesting operational guidelines, but are generally required to be so abstract that additional research is recommended to provide "hands on" tactical information to practitioners.

The 1982 Policy Paper on policy dialogue stresses the need not to antagonize host country officials and to pursue what the Foreign Assistance Act calls a "collaborative style," even in the face of governments determined not to implement economic policy reform. Thus, research to highlight successful innovative tactics within this restrictive framework would be useful. The Policy Paper outlines the characteristics of the gradual approach based on education and persuasion. Ideally, for example, host country officials can be persuaded to see the enormous costs of setting of farm gate prices too low when farmers often account for two thirds or more of the population. Similar "dialogue" can focus on the benefits of eliminating fertilizer subsidies or state run transportation systems which add to economywide inefficiencies.

The type of recommended research that would enhance the gradualist approach to policy dialogue can perhaps best be illustrated by a lengthy description from a rare case study provided by an A.I.D. economist at his own initiative to the biannual conference of A.I.D. economists. His case study shows how A.I.D.'s unique field mission structure often puts its staff in a position to form relationships of mutual trust with host country officials over two or three year periods.

Advocates of additional research note how one innovative and persistent economist can successfully use a gradualist approach to policy dialogue under certain fortunate circumstances. Fred Winch was the Associate Director for Economic Policy at the U.S. A.I.D. Mission in Khartoum, Sudan in 1983 and half of 1984. (See Box 1)

Five factors accounted for Winch's success in Sudan. The total U.S. aid program of \$200 million exceeded the World Bank's. Sudan had defaulted on an IMF standby agreement and was no longer in contact with the IMF. Although the Sudanese initially took the position that macroeconomic conditionality could not be a covenant in the C.I.P. Agreement, they eventually accepted it. The quality of Winch's economic analysis was persuasive. In one important case, Winch's analysis differed from that of the IMF and was more persuasive to the Sudanese. In the diesel study, the Finance Minister himself spent several hours going over the study with the A.I.D. staff and ultimately accepted the conclusion that raising diesel prices would end the scarcity and be more efficient for all concerned. Winch's efforts in Sudan in 1984 may illustrate the

gradual approach at its best. Yet 6 years later, Sudanese policies were worse than in 1983.

A few interviewees recommended a survey be undertaken to identify whether a successful policy dialogue type of program ought to be "cloned" in additional nations. The gradualist approach to policy dialogue may often be promoted through "local ownership" of policy analysis by setting up research institutions of professional economists with A.I.D. funds, usually in project form, to ensure that an alternative economic viewpoint is put before political leaders or opposition leaders. The institute may even disseminate publicly detailed reform plans that otherwise would not be drafted.

There is a major flaw in the strategy of the gradualist policy dialogue which becomes apparent when carefully reviewing how A.I.D. staff and publications proudly present their "success stories" of policy dialogue. Many small policy reform "successes" may be achieved over a decade, but the overall economy can remain almost as inefficient. Unfortunately, individual success stories of policy dialogue may seem impressive but are actually meaningless without a broader analysis of how much the reform improved the efficiency of the entire economy. A nation may implement a few steps to improve its economic policies, yet continue to operate an inefficient, distorted economy if the steps were not salient to the overall performance of the economy.

One solution to the problem how to measure success achieved by A.I.D. through policy dialogue will be addressed below as part of the research interviewees recommended to develop specific

measures of policy reform.

## Box 1: Case Study of Policy Dialogue in Sudan

This account illustrates well the established A.I.D. policy dialogue approach--a classic use of technical economic analysis to implement reform, with a few extra twists based on a skillful "feel" for bureaucratic factors. Sudan in 1983-84 had an overvalued exchange rate and the price of bread was heavily subsidized. Winch decided to obtain data to determine the wheat-bread cost price structure. He concluded that bread was being subsidized by as much as 30%. At the same time, a large assistance program was providing wheat at \$50 million a year. He met with officials from the Ministry of Commerce, Cooperation and Supply (MCCS), the government body responsible for importing wheat and establishing the subsidized prices. Based on the interview, Winch determined that the budget subsidy was approximately \$30 million a year at the prevailing official exchange rate. He presented these facts to the Mission Director who recommended he present justification for eliminating the budget subsidy at the next meeting of the U.S. Embassy Economic Council. After the discussion it was decided by the U.S. Ambassador that A.I.D. should not pursue the proposed price change. He did not want the U.S. Government to be responsible for a bread price increase. Winch reportedly went back to the drawing board. "I decided I had made a strategic error . . . positive economics could not be sold to the Ambassador." It was clear an alternative approach was required: a political economy framework. A well-known economist from Stanford University then worked for the A.I.D. Mission as a consultant on agricultural policy. The consultant from Stanford recast the presentation to give more weight to the political benefits, and he presented the case again to the Ambassador. However, this time he approved.

After five negotiating sessions which centered on the trade-offs between the budget subsidies and opportunity costs for subsidy elimination and the foreign exchange costs of increased imports of wheat, the Sudanese government ministry decided to remove the \$30 million bread subsidy, in July 1983 by the device of reducing the size of the loaf from 320 to 230 grams.

Winch next decided to "tackle" the implicit foreign exchange rate subsidy which resulted in a hidden tax built into the wheat price structure due to an overvalued exchange rate. At the end of this next round of negotiations, the Minister of Commerce decided to hold the nominal price fixed but reduced the size of the loaf again from 230 to 170 grams. This agreement to eliminate the implicit foreign exchange rate subsidy was a self help measure under the P.L. 480, Title III \$30 million program under which the government agreed to cut the loaf size thereby increasing the price.

Further analysis showed that the domestically produced wheat was underpriced. By showing these calculations to the Ministry, an agreement was reached to adjust that price too. Winch's investigations a few months later showed him that the Food Research Center at the University of Khartoum had undertaken a pilot project on the feasibility of mixing sorghum with wheat flour for bread

making. This composite flour for commercial bread making was also made a self help measure for the next P.L. 480 agreement. A commercial trial was conducted of the composite flour among private sector bakers over a six month period. A.I.D. agreed to provide local currency support for this trial. These self help measures were written into the \$20 million P.L. 480 agreement. Winch next calculated that agricultural exporters were being harmed by the overvalued foreign exchange rate. During the next negotiating session with officials from the Ministry of Commerce, Cooperation and Supply, the Ministry informed A.I.D. that the issue of exchange rates could only be discussed with the IMF. Winch took the position that economic analysis could not be undertaken without consideration of the exchange rate and revised his approach to revised price increases for other commodities based on the correct free market exchange rate. At the next negotiating session, Sudanese officials argued that if farmers were paid higher prices they would produce less. In the end the Ministry agreed to a 25% increase in the price for ground nuts and sesame and the import and export of Sudan gum arabic. The final self help measure agreed to under the Title III negotiations was to insist on the involvement of the private sector millers in inland transport. This had previously been handled by public sector entities with great delays. Meetings with the private sector millers had indicated they wanted to form a Millers Federation and deal with the private sector trucking industry to achieve economies of scale and get the government out of the wheat import business. This reform also was agreed to by the Sudanese government.

Winch then turned his attention to petroleum which was the single most critical imported commodity influencing Sudan's productive capacity. Petroleum was 25% of the import bill. The government rationed petroleum consumption and fixed its retail price below the international price. In the meantime Sudan could not meet its obligations under a \$9 billion debt, so it had no credit to import petroleum. The black market raged along in petroleum with prices 2-3 times the administered government level. Winch estimated that the total losses due to public sector allocation of petroleum and shortages could be \$100 million annually. At a Consultative Group meeting, A.I.D. proposed a policy reform of purchasing fuel by competitive bidding of retailers, while moving the price of diesel off the overvalued exchange rate to the higher free market rate. Although this idea was accepted in principle by all donors and the Sudanese government, its implementation soon stalled because of disagreement among the donors about who would fund the changes.

Sudan never considered either a big bang approach of sweeping reforms nor an Export Processing Zone. By 1991, its exchange rate remained highly distorted, price subsidies continued, and it remained in arrears on international loans.

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#### 4. Research to Improve "Big Bang" Policy Reform

Several interviewees recommended research to improve the big bang approach to policy reform. There are no comprehensive studies of this rarely used approach. When the opportunity arises for an extensive and rapid macroeconomic reform, the challenge places a premium on preparedness by A.I.D., in contrast to the circumstances of gradual policy dialogue such as in the Sudan case study. The big bang is no time for trial and error. A comprehensive checklist of what to do and what has worked in the past is needed. Interviewees recommended that A.I.D. sponsor research to produce such a "blueprint" document and that it be updated over time. Several academic articles have outlined the issues, such as Professor Sebastian Edwards' comparison of Chile's policy in the 1970s to the problems Poland now faces with respect to hyperinflation.

What should be identified in an "emergency checklist" for the big bang approach? If it is the secret fantasy of some economists to play the role of philosopher-king in re-designing an economy, then the big bang approach to policy reform represents this dream come true. The most frequent recommendation was for research to compare and contrast examples of big bangs. Four possible cases are Poland in 1990, Ghana in 1983, Mexico in 1986-88, and Chile in 1973.

Interviewees defined "big bang" in terms of these cases, in which a new leader had come to power who faced economic disaster. In a brief period, the new leader initiated drastic changes in

economic policy. After the bold initiative, the leader stayed the course and made minor adjustments as needed as inflation fell, investment increased, and exports grew. A crucial feature of the big bang is that there be no effective opposition to the bold, rapid reforms.

The research effort should clarify why, in many cases, national leaders may listen to economists during a crisis period and even initiate a comprehensive set of economic policy reforms only to gradually return to former policies as political opposition to the reform increases, or as powerful members of the legislature or others harmed by the reforms bring their influence to bear. As protest demonstrations break out and unemployment increases, the leadership may begin to lose faith in its economists, especially if the economists have not prepared the politicians to expect such disturbances. The benefits of the economic policy reforms may not come fast enough to stop this erosion. The coalition that launched the reforms may fall apart or a concerned military leader may launch a coup to restore order in the streets.

How do leaders accomplish such changes without opposition? It is clear that boldness is part of the success of a big bang. According to several interviewees, anyone familiar with the sluggish resistance of many nations to price reforms in the 1980s, would be impressed with the Polish "big bang" decision in January 1990 to decontrol nearly all prices. A large currency devaluation went into effect; the black market in foreign exchange ended. A positive real interest rate went immediately into effect at the

state-owned banks. The national budget was quickly put in balance. Many subsidies were eliminated. A privatization law was passed in July 1990 with the expectation that up to 200 firms would be privatized in 1991. Fifty percent of the retail shops went private by May 1991, when a stock exchange was opened in the old Communist Party headquarters building with staff wearing red suspenders provided by an American Wall Street firm. The Government proposed to Parliament a foreign investment law permitting both 100% transfer of earned profits abroad and 100% foreign-owned joint ventures.

Korea and India provide dramatic examples in the 1960s of the big bang approach in which A.I.D.'s role has been documented. Richard Cooper, Stephen Haggard and Amicus Most have shown in separate papers the important role played in 1964 by A.I.D. economists in advising the Korean military leadership how to restructure the economy, after a credible threat to cut off PL 480 food aid unless reforms was made. In India, it was not the Mission Director or the American Ambassador or even the Administrator of A.I.D. who played the key role in setting conditions for Indian agricultural policy reform and currency devaluation as a condition for American food aid. It was the President of the United States, Lyndon B. Johnson, who got personally involved over a period of two years. President Johnson thought he knew something about agricultural policy and farming. He sent his Secretary of Agriculture Orville Freeman to New Delhi for a month, according to a memoir of an A.I.D. official then in India, John P. Lewis.

President Johnson personally decided to hold up food aid twice to persuade India to agree to reforms that some but not all Indian officials favored. This reform bang , however, was not as big or extensive for the Indian economy as a whole as the other cases.

Two new candidates for examples of the big bang approach may be Egypt and Pakistan in the spring of 1991. After a decade of limited success through gradual policy dialogue, the Egyptian government decided to accept twelve IMF and World Bank reforms which would have seemed impossible in earlier years. The Egyptians promised to:

- 1) reduce their budget deficit from 20% of GDP to 5% within three years,
- 2) cut their annual monetary expansion from 40% to 20% in the first year,
- 3) deregulate interest rates on loans and deposits so interest would be positive and above inflation,
- 4) free the foreign exchange market from government control,
- 5) increase farm gate prices for cotton to move toward the world market price,
- 6) deregulate industrial goods pricing, to move toward private ownership of some public enterprises and to use private market standards for others,
- 7) reform the banking system and move for international standards, portfolio management and financial disclosure,
- 8) increase energy prices to reflect production costs and world market prices,
- 9) liberalize foreign trade by reducing quotas and some duties,
- 10) eliminate unequal legal treatment of public and private enterprises,
- 11) develop a nontraditional export program, and a streamlined investment code,
- 12) eliminate government monopolies in agricultural marketing,
- 13) eliminate most government subsidies and remaining price controls.

It remains to be seen how rapidly these classic "big bang" reforms will be implemented.

Research comparing cases should clarify how a sudden bold set

of reforms may minimize the ability of an opposition to form slowly by the coalescing of each separate group whose interest will be harmed by the policy reforms. Some speculate there may be a kind of natural law that the slower the pace of policy reform, the more rapid is growth of opposition to it. If the benefits of the reforms do not accumulate as rapidly as expected, the reform coalition may collapse, lacking the means to sustain itself in power. If this is so, it becomes crucial to identify for each specific nation what which issues may most galvanize opposition alliances.

One focus of the recommended research should be to identify which policy reforms may most threaten the leadership coalition: High inflation benefits some groups, overvalued currency benefits others. High tariffs benefit parastatals and inefficient industries. Foreign exchange allocations benefit parastatals. artificially low agricultural prices benefit urban workers. Parastatals may be the source of patronage for the dominant political party. Will step-by-step reforms unite urban workers with parastatal employees in an anti-reform coalition before the beneficiaries of the reforms have become aware that they have a stake in continuing the reform process? How can groups that would benefit from reform increase their political effect? Case studies could clarify for future use what A.I.D. learned in the past about how soon the sequence of steps in the big bang affected the growth of opposition. Although the book drew no lessons for A.I.D., this general issue was addressed in an edited collection published in

1989 by Joan Nelson entitled Fragile Coalitions: The Politics of Economic Adjustment. What is needed now, according to several interviewees, is specific material tailored to the challenge A.I.D. faces in Eastern Europe as well as potential future candidates for big bang reform. A.I.D. could even sponsor such research by the reformers themselves, who may need it the most for their own survival.

## 5. Research on The Free Trade Zone Approach to Reform

Standing between the big bang and policy dialogue approaches is a somewhat risky policy reform tactic: establishing an export processing zone (EPZ) so that its feedback effect will strengthen the chances for policy reform beyond the zone. Not all EPZs will produce such feedback, but some have. One interviewee noted that a World Bank study in June 1991 has endorsed establishing EPZs as a step toward policy reform. (See Box 2) The recommended research effort would be to identify, through case studies, how creating EPZs may stimulate the political forces for policy reform rather than dampening them. A World Bank study hypothesized EPZs had such an effect in Sri Lanka. Establishing an EPZ may be a desperation effort A.I.D. might propose in nations with highly distorted economic policy whose political leadership firmly resists economic reforms.

EPZs have proliferated in the developing world over the past two decades, not always contributing to policy reform. EPZs have grown from fewer than two dozen in ten countries in 1969 to more than 145 operational in over 45 countries in 1990. The standard EPZ incentives package reads like a list of IMF or World Bank policy reform conditions:

- Tax reductions for business expansion
- Exemptions from customs duties on imports used for export production
- Relief from all foreign exchange controls
- Creation of one-stop regulatory approval centers
- Permission to establish firms with 100%

foreign ownership which may repatriate 100%  
of profits  
--"Public services" provided by private firms.

The recommended research should identify why, in practice, many countries initially apply free market-oriented policies to only a small fraction of their territory by designating one or two free zones, then later, after the initial high profile success of the first zone, adopt more widespread economic reforms or set up many more zones. The Dominican Republic with a population of 6 million began with a single zone in 1969 and today has 16 operational zones employing a total of more than 120,000 workers.

The research should explain why the EPZ reform strategy often has a political impact out of proportion to the small (10% or less) share of exports it generates. It is possibly based on a political dispute many developing nations face. Some leaders may be ready for nation-wide policy reform, while other equally influential leaders doubt the validity of free market principles. Rather than force a dangerous and divisive test of strength between these two viewpoints, A.I.D. may propose establishing an export processing zone to serve as an empirical experiment on which the two viewpoints may agree. Opponents of the free market and privatization (who benefit from import substitution and other economic distortions) will not object to an export processing zone with no tariffs as long as it is located a long distance from their turf. Opponents of policy reform tend to underestimate the inherent dynamic in export processing zones that will build a constituency for further policy reform. Opponents may not anticipate that, even-

tually, the free trade zone experiment could expand to affect the entire county because of its success.

The recommended research should also identify how soon the benefits of an EPZ can be expected to appear. As with big bang reform, how the EPZ reform is initiated may be crucial to its sustainability. The small scale EPZ avoids potential controversies in a nation whose leadership is not yet united behind policy reforms.

Policy reform through free trade zones is based on the concept of a feedback loop. The feedback system produces information over time on both positive and negative outcomes of policy steps. A possible slogan for the policy reform via EPZ approach could be "nothing succeeds like success." This is especially the case when the institutions established to oversee free zone programs become effective advocates of liberalization of trade and advocates of free market reforms. Their allies may be those in the nation who create political pressures for additional EPZ designations within the country. Economic policy reform can then operate on a voluntary basis in bringing its benefits first to those who are wise enough to ask for it, rather than being imposed by foreigners from the IMF and World Bank. Unfair as it may be, the import substitution, crony capitalists may be left to stagnate in their region of the country, hiding behind their high tariffs and unproductive public enterprises while other areas grow prosperous.

If the export processing zone succeeds, if private firms located in it are highly profitable, if government tax revenues of

workers in the zone grow rapidly, if nontraditional exports are developed that otherwise had seemed impossible, if a constituency forms that asks the government for additional export processing zones elsewhere in the country, then skeptics of economic policy reform will slowly be won over. An advisor in Taiwan in the early 1960s recalls the prevalent view that Taiwan could never become a manufacturing center because of centuries of tradition that Chinese were traders and merchants, not industrial manufacturers. Yet Taiwan's tiny two mile square export processing zone generated \$3.5 billion a year of foreign exchange by the 1970s. This is the kind of feedback that changes minds. Those whose faith rests in high tariffs, import prohibitions, and the nobility of state-owned enterprises may be undermined by the demonstration effect of EPZs.

The key in this recommended research is to identify how A.I.D can use export processing zones to produce a disposition for more comprehensive policy reforms. The demonstration effect caused by the success of the EPZ may be only one of the mechanisms at work. In China, for example, conservative skeptics still claim the special economic zones are just enclaves of privilege for foreign investors which should not be a model for Chinese economic policy. They are seen merely as a device to obtain technology and foreign exchange. However, even China's skeptics later agreed to increase the number of zones. An entire Chinese province became a free zone, and an increase was approved in the central government budget to improve infrastructure in all the zones.

A part of the demonstration effect seems to be the experience

gained by the senior officials who are responsible for the establishment and maintenance of the EPZ. It is these officials and their allies who will learn that foreign investment, increased tax revenues, and large amounts of foreign exchange will come from the market-oriented alternative to the old policy of import-substitution that was once standard in developing countries.

Several interviewees hope that research and case studies can identify how, over time, these senior officials come to see that inward-looking policies tend to hold back growth and modernization by making it possible for business interests to resist moves toward becoming internationally competitive. Skeptics learn that the free zone offsets distortions which restrict access to foreign exchange and which constrain the efficient movement of goods and services. At the micropolicy level, senior officials learn from personal observation that the theoretical policies economists had been talking about actually work in concrete terms. The important point is that it may sometimes be easier to persuade the President of a country to try one export processing zone in a remote location than to put his own political future at risk by undertaking economic policy reforms that have sometimes caused the fall of the political leader who attempted them.

Of course, the tactic of policy reform through EPZs should not begin with a straightforward proposal boasting about how the feedback loop is going to convince the national leadership to listen to its free market economists. On the contrary, the best arguments that favor launching an export processing zone should be

the immediate benefits of employment gains and tax revenues. The host nation leadership may be persuaded by learning exactly how profitable the zones have been in other countries, and how easy it is to start one or two. Here are some examples.

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Box 2: Export Processing Zone Experience

Taiwan

Taiwan has been a leader in free zone development since 1965. In the past fifteen years its three zones of less than two square miles have generated more than \$3 billion U.S. dollars annually in net foreign exchange earnings while employing more than 60,000 workers. With A.I.D. support, these zones played a central role in Taiwan's reorientation from inward to outward-oriented growth policies. The ministry responsible for free zones has since extended free zone tax reductions and trade incentives throughout the country.

Ireland

In Ireland the free zone program helped transform a stagnating economy into an attractive center for export manufacturing and services. The 300 acre Shannon free zone accounts for more than 20% of Ireland's manufactured exports, helping Ireland as a whole to develop a highly competitive export sector.

Sri Lanka

In Sri Lanka, spurred by the performance of the free zone which accounted for nearly 20% of national export earnings in 1982, the government enacted measures to improve the domestic investment climate economy-wide. Perhaps the best example of a feedback loop.

Jamaica

In Jamaica the Montego Bay free zone total workforce has grown from 1500 to 5000 over the past five years and is the scene of many privatization initiatives, but this EPZ is not as successful as most.

Dominican Republic

The hemisphere's most successful free zone program is the Dominican Republic where zone employment has risen from 20,000 to more than 50,000. This was an A.I.D.-supported project.

Turkey

In Turkey two publicly developed zones opened in 1987 compete with two zones developed by private firms on a build-operate-transfer basis. Some zones such as in the Dominican Republic have pioneered in "debt for equity conversions" to reduce national debt burdens while stimulating jobs and exports. Another benefit of these zones is that land values alone can rise by 10 to 30-fold following designation of the area as a free zone. This too has an obvious demonstration effect in creating institutional support for outward-looking policies.

Malaysia

Sometimes cited as a negative example in which export-oriented policy reforms were delayed because the EPZs absorbed the demand of reform-oriented investors with little "feedback."

Philippines

The World Bank Research Observer in January 1989 found negative returns in the Bataan zone, in contrast to high rates of return elsewhere in Asia in Indonesia's Tanjung Priok zone, Malaysia's Penang zones and Korea's Masan zone. The only other

poorly performing EPZ in Asia is in India. These two (at least short-term) failures in India and the Philippines suggest that three minimum criteria for successful EPZs may be a suitable exchange rate, a positive trade policy, and a legal-regulatory environment favorable to business, at least in the EPZ itself. Some economies may be so distorted, even an EPZ cannot start a positive feedback loop.

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Ideally, the research recommended by several interviewees should clarify the circumstances under which a gradual policy dialogue is not promising (and a big bang is out of the question), so that the A.I.D. mission staff has little choice but to approach allies in the host government who might prefer to introduce comprehensive economic reforms on a national basis but have been blocked by entrenched bureaucracy and privileged interests. Rather than settling for nothing, interviewees believe A.I.D. economists ought to know when an EPZ could be established to demonstrate how sweeping policy reforms even in a small area will still produce dramatic effects, especially in generating foreign exchange and tax revenues.

The research should highlight examples of when such an approach works, perhaps because the opponents of comprehensive economic reform may agree to go along because only a small portion of territory and population is affected. No institutions or special groups with a stake in the status quo need to mobilize in opposition if the economic reforms apply only to a limited area. The allies of comprehensive reforms save their political capital to fight another day a few years down the road, when they will be better armed with persuasive ammunition. Taiwan and South Korea were originally followed import substitution policies. One factor is their decisions to shift to export-oriented policies was the success of their EPZ programs. This point is seldom noted in

accounts of the "Asian tigers" impressive economic growth records. Hong Kong, was originally in fact a kind of EPZ that the British established in 1842 in China to avoid the policy regime of the mainland.

Research could focus on what has begun already. The World Bank has provided loans for many EPZs including those in Mauritius, Jamaica, Columbia and the Dominican Republic. A.I.D. has been active in Central America and the Caribbean, after initiating zones 20 years ago in Taiwan, Singapore and South Korea. The Overseas Private Investment Corporation (OPIC) has assisted zones in Togo and Cameroon, the first in Africa besides Kenya so far.

## 5. Research on Establishing the Democratic, Legal, Regulatory, and Judicial Framework of Economic Reform

Several interviewees praised the chapter in Development Issues 1991 for its innovative analysis of the economic benefits of a sound "L.R.J." environment -- the legal, regulatory and judicial framework of a nation. The next step is to translate this general prescription into useful and more specific guidance for A.I.D. missions. First, for example, what are the diagnostic criteria and best ways to measure which aspects of the L.R.J. framework are most in need of improvement? The research most desired would go from the general discussion in Development Issues 1991 to specific what to do and "how to do it" guidance for missions overseas.

What are the highest priority aspects of a nation's L.R.J. framework that should be improved in order to enhance economic efficiency? What steps would pay off with optimal increases in economic performance?

It is possible, some interviewees stated, that the World Bank's efforts to improve the institutional framework of economic policy reform may also suggest a means to diagnose what parts of the L.R.J. system need immediate attention. A Bank study by Geoffrey Lamb (Managing Economic Policy Change: Institutional Dimensions, May, 1990) points out that it is the government not the private sector that must implement most economic policy reforms, yet the IMF and Bank seldom require measures to strengthen the

specific government agencies that will have to implement the reform. Lamb states,

Institutionalizing stronger policy processes involves tracking the (reform) policy process through governmental structure, identifying weak points or bottlenecks in the flow of essential decisions, and devising appropriate action. As this policy process analysis gets down to concrete cases, the need is to identify quite specific units or parts of institutions which are involved in a particular reform policy (for strengthening).

Following Lamb, a useful research project might attempt a case study to identify omissions from and barriers within the legal, regulatory and judicial framework that will most harm policy reform implementation if not corrected.

Aside from the L.R.J. area, a number of interviewees drew attention to the need for research on the relationship between economic policy reform and the Democracy Initiative announced by A.I.D. in December 1990. "Accountability" in democracy promises a major potential payoff for economic efficiency. In other words, projects designed under the auspices of the Democracy Initiative may have the potential (with small modifications) of contributing to economic policy reform as well.

Three L.R.J. areas were recommended for study: improving financial management, prosecuting corruption, and enhancing civilian control of the military to reduce the possibility of military coups which in the past have sometimes been triggered by economic reforms. Each of these may play a role in some cases of policy reform implementation. For example, if widespread public corruption characterizes a government, can it really be expected

to manage economic reform efficiently? A.I.D. may wish to fund research to design optimal accountability such as establishing measures to reduce corruption and better procedures for financial accountability specifically in the institutions that will implement policy reform. Such steps are already contained in the Democracy Initiative which, as democracy becomes a factor for performance based budgeting decisions in the regional bureaus, will make possible joint democracy/economic reform efforts. That is one of the reasons why some interviewees recommended research to identify what types of L.R.J. reform promise the optimal payoffs for economic growth.

## 6. Research on Performance Indicators of Economic Reform

A focus on "results" presupposes a performance measurement system. Similarly, performance-based budgeting requires a system of indicators of "performance." For these reasons, several of the regional bureaus have for several years used quantitative indicators to assess economic policy. However, these systems are designed to serve other purposes than purely scoring the "policy" performance of the national government. In addition to standard macroeconomic variables such as inflation rate, real interest rates, government deficit spending as a portion of GNP that all regional bureaus use, the Africa bureau adds a measure of "need" (the nation's size and infant/child mortality rate) and weights that measure 50% of the total score. Obviously, national size and infant mortality are not under the control of the economic leadership, so the "performance" being measured is not that of economic policymakers, or of the impact of A.I.D. policy reform assistance.

The other regional bureaus also factor in additional "performance" concerns such as the prevalence of birth control, adherence to human rights, and the degree of political freedom (as scored by Freedom House or the State Department). As important as these matters are, they are not under the direct control of the economic policymakers. Therefore, the final scores used by the regional bureaus are not measurements of the quality of economic policy.

At least five scholarly efforts are presently underway to measure economic policy performance. Interviewees want A.I.D., at a minimum, to keep in touch with this work. Some interviewees would go further, advocating A.I.D. sponsorship in the field. Such work would not necessarily replace the performance budgeting scoring of the regional bureaus. It would have an entirely different goal, namely to identify the most "outrageous" policy distortions in the developing world and thereby to "flag" them for extra attention by donors. For example, economic analysis of Egypt has long identified its subsidized electrical power prices as a wasteful distortion. But how much does such a "micro" inefficiency subtract from total GNP? As much as the inefficiency of the largest Egyptian parastatals? Which areas of inefficiency are worthy of the most urgent attention?

Another very different approach to performance measurement is the effort to rank order all developing nations in terms of their scores on a scale or index of economic liberty. The Simon Fraser Institute in Canada has sponsored three conferences and three books on this quest. (See for example Economic Freedom: Toward a Theory of Measurement which contains extensive and positive comments by Milton Friedman.) The U.S. Chamber of Commerce has contracted with the Futures Group for such an index. The Heritage Foundation has recommended that Congress require an annual report from A.I.D. called the Index of Economic Freedom. The Senate (but not the House) has approved this Heritage proposal several times at the initiative of Senator Mack of Florida.

Such an index would also have some diagnostic usefulness in showing the global rank order of national "economic freedom," but governments with distortions in their economies might not be moved by the public embarrassment of receiving a low score. On balance, research that would pinpoint distortions caused by policy failures and weight the costs of these distortions would be more useful to A.I.D. However, it is possible that the strong recommendations for research on the benefits of policy reform (and the costs of procrastination) could be effectively dramatized for the public in some nations by a global scoring system if it were as objective and quantitative as possible.

## Annex 1. Clarifying Congressional Intent on Policy Reform

This annex provides excerpts from the U.S. Foreign Assistance Act to illustrate Congressional intent about policy reform. Because Congress has never earmarked funds for policy reform, A.I.D. officials expressed uncertainty about whether the U.S. Congress has given A.I.D. a mandate in policy reform. Because of the "mixed messages" from Congress, some believed that A.I.D.'s policy reform activities may even violate the Congressional mandate known as the "basic human needs legislation" enacted in the early 1970s.

A few A.I.D. officials stated Congress intends that A.I.D. main mission is to assist the poorest of the poor directly without regard to the overall economic framework. They point out that the first of four principal goals enumerated in the Foreign Assistance Act is "the alleviation of the worst physical manifestations of poverty among the world's poor majority." Section 102 states, "the Congress declares that the principal purpose of United States bilateral development assistance is to help the poor majority of people in developing countries." The statute enumerates sixteen principles for bilateral development assistance, two of which directly address the poor again. First, U.S. assistance must give "high priority to undertakings submitted by host governments which would directly improve the lives of the poorest of their people. . . ." Second, the statute mandates that American development assistance, "shall be concentrated in countries which will make the most effective use of such assistance to help satisfy basic human needs of poor people through equitable growth, especially in those countries having the greatest need for outside assistance."

Other A.I.D. officials were aware that along with these "mandates" concerning the poor, the Foreign Assistance Act contains provisions aimed at promoting economic growth and sound economic policies in the developing world.

The clearest example is in Section 301 of the International Security and Development Cooperation Act of 1985, principles 13 and 14:

United States encouragement of policy reforms is necessary if developing countries are to achieve economic growth with equity.

Development assistance should, as a fundamental objective, promote private sector activity in open and competitive markets in developing countries, recognizing such activity to be a productive and efficient means of achieving equitable and long-term economic growth.

In the 1961 Foreign Assistance Act, Section 601 "Encouragement

of Free Enterprise and Private Participation" reads:

The Congress of the United States recognizes the vital role of free enterprise in achieving rising levels of production and standards of living essential to economic progress and development. Accordingly, it is declared to be the policy of the United States to encourage the efforts of other countries to increase the flow of international trade, to foster private initiative and competition, to encourage the use of cooperatives, credit unions, and savings and loan associations, to discourage monopolistic practices, to improve the technical efficiency of their industry, agriculture, and commerce, and to strengthen free labor unions; "

In a mixed message, the Foreign Assistance Act mandates A.I.D. both to focus on the basic human needs of the world's poor majority and to promote economic growth through sound economic policies. In fact, Chapter One of the Foreign Assistance Act in Section 101 entitled "General Policy" begins with the oft-quoted goal of alleviating poverty, but continues with three other goals which are more closely related to policy reform activities. These three less frequently cited goals are:

The promotion of conditions enabling developing countries to achieve self-sustaining economic growth with equitable distribution of benefits;

~~The~~ encouragement of development processes in which individual civil and economic rights are respected and enhanced; and

~~The~~ integration of the developing countries into an open and equitable international economic system.

The statutory language here calls on A.I.D. to promote conditions for economic growth, to encourage development of economic rights, and to integrate developing countries into the world trading system. The implication of this statutory language is that some governments of the developing world will not adopt such policies on their own. Otherwise, there would be no need for American development assistance to promote such goals. Unfortunately, the legislation is silent about how far A.I.D. should go when a developing country resists such policies. Should aid be cut off, even when that nation's poor are already suffering because of the policies of its leaders?

Some guidance may be found in Section 102 entitled "Devel-

opment Assistance Policy" which states:

development is primarily the responsibility of the people of the developing countries themselves. Assistance from the United States shall be used in support of, rather than substitute for, the self help efforts that are essential to successful development programs and shall be concentrated in those countries that take positive steps to help themselves. (Underlining added.)

This statute seems to conflict with the emphasis on the need to provide assistance primarily to the poorest of the poor. Nevertheless, yet another principle for U.S. development assistance directs that there be no confrontation with foreign governments, apparently even those determined to harm their poor by following unsound economic policies. Section 102 states:

(2) Development planning must be the responsibility of each sovereign country. United States assistance should be administered in a collaborative style to support the development goals chosen by each country receiving the assistance.

Thus, a major question has been raised but ultimately left unanswered by the Foreign Assistance Act. How far can A.I.D. go to promote economic growth, economic rights, and an orientation toward trade, given this requirement of a "collaborative style" that would hardly be possible if a foreign government were determined to resist these economic reform policies?

Suppose the poorest of the poor are dying in large numbers due to distorted policies. Must the A.I.D. mission still pursue a collaborative style?

Another example of a Congressional "mixed message" is seen in the fact that the Foreign Assistance Act lists criteria for measuring progress which omits any mention of economic policy reform:

The President shall assess the commitment and progress of countries in moving toward the objectives and purposes of this chapter by utilizing criteria including, but not limited to the following:

- (a) Increase in agricultural productivity per unit of land through small-farm, labor intensive agriculture;
- (b) Reduction of infant mortality;
- (c) Control of population growth;
- (d) Promotion of greater equality of income distribution, including measures such as more progressive taxation and more equitable return to small farmers;
- (e) Reduction of rates of unemployment and underemployment; and
- (f) Increase in literacy.

Congress also omitted the question of economic policy reform in an amendment two years ago to the foreign aid statute. Section 593 of the FY 1990 Foreign Assistance Appropriations Act requires A.I.D. to develop indicators of poverty reduction to show how A.I.D. program objectives produce results by increasing the income levels, child survival rate, and literacy of the world's poor.

Twenty four pages of the FY 1992 Congressional Presentation Document reported country-by-country on the three specific dimensions of poverty that Congress had specified -- income per capita, child survival, and literacy. A.I.D. provided copies of a study commissioned by the Bureau for Program and Policy Coordination entitled "Development Assistance to Reduce Poverty: Defining and Measuring Progress" to Congressional offices. According to the Congressional Presentation Document, "this paper will, in turn provide a framework for analyzing our approaches to poverty reduction." No mention was made of any contribution that economic policy reform might make to poverty alleviation.

Chapter 10 of the Foreign Assistance Act entitled "The Development Fund for Africa" seems to stress the need for economic reforms. Yet it requires A.I.D. annually to provide a description of the progress made during the previous fiscal year in carrying out activities in sub-Saharan Africa which appears to highlight basic human needs instead of economic reform. It is understandable that the 1991 A.I.D. report on the DFA emphasizes these needs rather than progress in economic reform. The most recent report states that, "the way that A.I.D. has responded to the problems and opportunities unique to each country is reviewed, with particular emphasis on the following issues which the legislation requires us to address:

- The nature and extent of consultation to ensure local perspective;
- The degree of involvement of local people in projects having a local focus;
- The extent to which there has been expansion of the participation and integration of women in each of the critical sectors noted in the DFA legislation;
- Program assistance provided i.e., non project assistance in support of reform, including consideration of how vulnerable groups were protected from possible negative consequences of these reforms; and
- A description of the assistance for the critical sector priorities, including the amounts obligated."

The DFA annual report happens to be the sole report Congress requires from A.I.D. on economic policy reform, yet it mainly stresses poverty, the integration of women, local consultation, and basic human needs rather than the progress of policy reform. It is

easy to see why some interviewees believe Congress has been hostile or skeptical toward A.I.D.'s policy reform efforts.

## Annex 2. Research to Improve Management of Economic Policy Reform

A number of interviewees recommended that a management study be undertaken to address the issue of how the Agency should most effectively administer its mandate to promote economic growth. Although the Administrator's new Mission Statement lists economic growth among A.I.D.'s goals, some interviewees were concerned that there has never been an organizational "home" for economic policy reform or any Agency-wide long-term strategic plan to achieve market-oriented economic policy in recipient nations.

Interviewees suggested that such a management or organizational study should address how A.I.D. should optimally coordinate the efforts of the many different elements now responsible for various aspects of economic policy reform. One focus of the study would be the benefits of the present situation of decentralization and limited, purely informal coordination. Another focus would be the possible benefits of a new approach by the Administrator to restructure some elements of policy reform that are at present decentralized.

A managerial study could address a number of trade offs. For example, should there be a central "critical mass" of economists? At present, most of the 40 to 50 economists in the Washington headquarters are assigned to regional bureaus. Therefore, each of the regional bureaus has several economists familiar with policy reform issues. In addition, the bureau of Science and Technology sponsors research on policy reform management. The bureau of Private Enterprise has several projects directly related to policy reform, including IRIS, the Institutional Reform and Informal Sector. Another project, the International Center for Economic Growth has for several years been managed by the economic affairs unit of the former bureau of Policy and Program Coordination.

Several interviewees pointed out that one disadvantage of the decentralized approach is that no one is responsible to the Administrator for tracking and monitoring multi-year policy reform implementation across regions. No one is assigned responsibility to refine strategies based on field experience and "lessons learned."

Several interviewees felt that a managerial study should address the benefits to the Administrator of a larger role for policy reform considerations to be brought in to the project approval process. Some interviewees were concerned that without such a managerial study, A.I.D. would have no choice but to yield its mandate to stimulate economic reform entirely to the IMF and the World Bank. They were concerned that the Congress would criticize the Administrator for neglecting A.I.D.'s statutory mandate to stimulate economic growth. Some noted that the A.I.D. Inspector General had already issued criticism of lax implementation of conditional policy reform. Both the Leahy Commission and the GAO are scheduled to study A.I.D. management of its programs

in 1991-1992. Because of this, some interviewees were concerned that the Leahy Commission and GAO studies might criticize the Agency's 1991 managerial reforms because the reorganization neglected important issues central to A.I.D. Mission Statement such as promotion of economic growth.

Other interviewees recommended that such a managerial study should address other subjects in addition to the question whether there should be any centralized unit responsible for Agency-wide efforts to obtain policy reform in developing countries. These interviewees stated that the study should also consider whether A.I.D. needs to develop new vehicles for keeping the missions and regional bureaus abreast of relevant developments in the strategy and tactics of policy reform, particularly in the difficult implementation phase. Dissemination of information should also include "success stories" that could be used to design initiatives by Mission Directors and their staffs.

Several interviewees thought a managerial study should evaluate the benefits of expanding and formalizing the biannual conference of economists. In the past, policy reform has been one subject of these conferences, which have been attended by roughly 100 economists from headquarters and the missions. Some believe that a larger annual conference would be useful if the participants were policy reform practitioners from the World Bank, IMF, and major bilateral donors. A goal would be exchange of information on reform strategies, regional progress, and whether various donors have particular areas of comparative advantage. Such a conference could also explore the problem of one donor undercutting another's efforts at policy reform by providing assistance without conditions, as has happened with Japan in Indonesia and the Philippines, and with several Scandinavian donors in Africa, as discussed above with respect to research on improving donor coordination.

Several interviewees suggested that a managerial study of policy reform at A.I.D. should address the issue of how the Agency would administer the special performance-based fund that A.I.D. unsuccessfully requested from the Congress in 1990. That concept was based on the Development Fund for Africa legislation. Such a discretionary fund would have enhanced A.I.D.'s bargaining power in trying to encourage policy reform. Otherwise, A.I.D.'s persuasive power is limited to the logic of its arguments. If Congress would approve such a performance-based fund, then the nations that have decided to undertake economic policy reform could receive an incentive that could be spent to provide institution building and technical assistance. Some interviewees believe Congress did not authorize the fund in 1990 for regions other than Africa because of uncertainty about how it would be administered.

A few interviewees suggested that a management study on how A.I.D. should manage policy reform should also design a process for identifying research needs common to missions and the regional bureaus. Research results could be funded centrally, and disseminated to relevant missions and interested bureaus. The Institute for Policy Reform may be one promising source for such research, especially if its work is coordinated with the centrally funded

projects of the International Center for Economic Growth and the Institutional Reform and Informal Sector now managed by PPC and the PRE Bureau, and with the Implementing Policy Change project of the Science and Technology bureau.

A few interviewees were concerned that there is at present no research agenda focused specifically on developing better strategies for initiating and implementing policy reform in countries where the leadership opposes comprehensive reform or has engaged in backsliding.

Interviewees who favor a study of how a central unit could manage policy reform suggested that such a study should have a personnel focus as well. It should address development of an explicit set of incentives for Mission Directors to promote policy reform, especially in nations not eagerly seeking it. At present, there is apparently a substantial disincentive to Mission Directors stationed in nations likely to resist policy reform to undertake any significant reform role. As mentioned above, they could suffer the fate of the Mission Director in Jamaica who was summarily transferred at the request of the host government specifically for his excess zeal in trying to enforce written reform conditions that had been clearly violated.