

Reforms in a World with Limited Domestic Policy Options

- 73 The global economy creates a fundamental disconnection between national political institutions and their policies to control economic events on the one hand and the international economic forces that have to be controlled. In a world where national policies guide economic forces, the global economy gives rise to a world in which extra national geoeconomic forces dictate national economic policies. With globalisation, national governments lose several of their traditional levers of economic control.
- 74 In the global economy, anything can be made anywhere and sold everywhere. In present post-Cold War circumstances this means performing each economic activity where it can be most cheaply done and selling the resulting products wherever profits are highest. With the end of the communist threat, sentimental attachment to some geographic parts of the world is no longer part of the system.
- 75 As a result of improvements in technology, transport and communication costs have fallen dramatically and the speed with which both can be operated has risen exponentially. Research and design groups can be co-ordinated in different locations; components can be made wherever it is cheapest to do so and transported to assembly points that minimise costs. Sales can be global.
- 76 Globalisation now shapes everyone's view of the world and alters the way the individual thinks about the world. In the new reality there is mutual interdependence with linkages in new and different patterns of supply and demand that may not otherwise have existed. Powerful institutions – transnational banks, multinational firms, international institutions – have come into existence with a vested interest in maintaining themselves and their environment. In a very real sense the global economy has become physically embodied in the present mind-set.
- 77 Since economic activity will migrate to the places with the fewest regulations and the lowest social charges, national governments are forced to compete with each other to persuade businesses to locate in their jurisdiction. In a global economy, high-tax, high-spending economies lose out to low-tax, low-spending ones. In the process, the former lose tax revenues and possibly employment to the latter. This has far reaching implications for fiscal policy. Business taxation to finance government expenditures that benefit business, such as those that finance training or infrastructure, is acceptable; but business taxation for consumption benefits that go directly to the citizens becomes increasingly difficult.
- 78 The era of national government regulation of business is simply over. Activities go to where they are not 'over regulated.' Moreover, the relocation need not involve anyone physically moving – insurance and financial activities can be electronically performed in Bermuda or

the Bahamas, while almost all those involved are sitting in their offices in London.

- 79 In a global market all the pressures are to harmonise downwards, i.e. competition to induce business through the offer of tax breaks. Jurisdictions with many and demanding regulations or high taxes come under extreme pressure to reform or pay the penalty of loss of revenues, and possibly employment, in the event of actual physical relocation. Thus, developing countries, where codes of business behaviour are not transparent and taxes are high, find it difficult to attract new businesses.
- 80 At the same time, world regulation is not about to replace national regulation. There is no agreement yet as to who, what or how to regulate. In any case, whatever might be agreed upon, there would always be an incentive not to implement the agreed-upon policies. Opting out carries the reward of attracting firms to locate in that jurisdiction with obvious economic advantages. Globalisation encourages free riding.
- 81 International pressures to regulate and tax less may appear welcome. The current system of business regulation, however, reportedly grew out of two real world experiences – the ‘robber barons’ era of the second half of the last century and the financial collapses and Great Depression of the 1920s and 1930s. It would appear tragic to have to endure some major disaster before the world wakes up to the need for some form of regulation.
- 82 Co-operative policies are needed to make the global economy work; co-operation, however, will require the surrender of a lot of national sovereignty, and that is undemocratic. It is undemocratic rule by foreigners or, even worse, rule by international bureaucrats. An elected world government appears to be the only acceptable solution and yet many would have serious reservations about that prospect.
- 83 The world’s financial markets can now move so much money around the world so quickly that monetary policies have to be adjusted to their dictates and not to the domestic needs of the economy. In order to protect themselves against sudden capital outflows, governments are forced to raise interest rates when slack domestic demand and unemployed productive resources would call for precisely the opposite.
- 84 The economic strength and ability to postpone adjustment varies considerably from country to country. The weakest are therefore compelled to undergo adjustment irrespective of the costs involved. A global and co-operative adjustment strategy in which both deficit and surplus countries adjusted, as appropriate, could reduce hardships to deficit countries and at the same time promote sustained growth of output and trade for all.
- 85 A global policy stance in which surplus countries do not follow expansionary policies imparts a deflationary thrust on the world economy. Access to markets becomes relatively more difficult as protectionist pressures remain high and possibly rise. Adjusting deficit countries must consequently adopt, or have forced upon them, programmes with larger expenditure-compressing and less expenditure-switching components. These adjustment programmes are consequently relatively more painful in terms of output and employment losses than might have been necessary.

- 86 In a world where the stronger economies are more concerned with disinflation policies, with little regard for their impact on adjustment efforts on weaker countries, adjustment is forced to proceed in an inhospitable environment. Such adjustment is not only unduly painful, it also takes longer to produce the desired results. To add to the pain of it all, it is often postulated that where the international situation turns out worse than anticipated under the SAP, the adjusting country must strengthen its adjustment effort – deflate some more – to compensate for the deterioration in the world environment.
- 87 It has been argued persuasively, and there is empirical support for this at least in the context of sub-Saharan Africa, that the failure of expenditure-switching policies is not to be blamed so much on difficulties with market access. It is more to do with the absence of complementary policies to elicit the requisite supply response. Indeed, a more diversified and flexible productive structure is desirable; but other things being given, the point being made is that adjustment in a relatively less hospitable international environment is more constrained, likely to be more painful and take longer than otherwise.
- 88 Aid-dependency presents a special example of reforms or adjustment in a world of limited options. It is a particularly important example in sub-Saharan Africa where donor resources are significant and critical to the initiation and sustainability of reforms.
- 89 The role of donors has been found to be central in aid-dependent adjusting countries. Donor assistance finances a large share of public expenditure in many countries – an estimated 35 per cent of total, and about 80 per cent of capital, expenditure in Africa. The incentives associated with donor assistance are therefore important for the effectiveness of key budgetary institutions. Development budget, for example, is typically nothing more than an amalgamation of donor-driven projects which do not sum up to a coherent sectoral strategy. Donors want to ensure that donor assistance promotes the allocation of expenditures in accordance with their own objectives.
- 90 Donor assistance can exacerbate the tragedy of the commons because it is in the mutual interest of line agencies and “sectoral donors” to enter into bilateral deals for enclosures of project financing. The resultant cumulative demands for counterpart funds, future demands for recurrent cost or debt service requirements may be, however, inconsistent with a stable macroeconomic framework. Admittedly, the promise of substantial and critical donor resources may serve as an incentive to address the government’s own tragedy of the commons by helping bind disparate groups to aggregate fiscal discipline.
- 91 Donor project assistance also impacts on the priority-setting process. Bilateral deals with line agencies for individual projects fragment the budget. Un-coordinated assistance from multiple donors makes projects unlikely to be mutually consistent. Donor-driven priorities undermine the breadth of consultations and the government’s own articulation of strategic priorities. The composition of expenditures becomes biased towards expenditure categories that accord with donors’ internal rules rather than adjusting the country’s requirements.

For example, a bias has been noted in the direction of capital investments traditionally financed by donors in government spending. Donor assistance in the form of non-fungible projects has undermined the priority-setting process.