

# The Political Process and Management of Economic Change

---



*Dr Joseph L S Abbey*



# **The Political Process and Management of Economic Change**

---

*Dr Joseph L S Abbey*



COMMONWEALTH SECRETARIAT

This report is part of the Commonwealth Economic Paper Series and prepared  
by Dr Joseph L S Abbey, Executive Director,  
Centre for Policy Analysis, Accra, Ghana, on behalf of the  
Economic Affairs Division of the Commonwealth Secretariat

Commonwealth Secretariat  
Marlborough House  
Pall Mall, London SW1Y 5HX, United Kingdom

© Commonwealth Secretariat, December 1998

This report is the result of the project that was funded by the  
Commonwealth Fund for Technical Co-operation (CFTC).

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system,  
or transmitted in any form or by any means, electronic or mechanical, including photocopying,  
recording or otherwise without the permission of the publisher.

The authors have asserted their moral rights to be identified as authors of this work.

The views expressed in this document do not necessarily reflect the opinion or  
policy of the Commonwealth Secretariat.

Designed and published by the Commonwealth Secretariat.

Printed in Britain by Formara Limited, Southend-on-Sea.

Wherever possible, the Commonwealth Secretariat uses paper sourced from  
sustainable forests or from sources that minimise a destructive impact on the environment.

ISBN 0-85092-559-2

Web site: <http://www.thecommonwealth.org>

# Contents

<i>Foreword</i>	5
<i>Executive Summary</i>	7
<b><u>1</u> Introduction</b>	<b>11</b>
<b><u>2</u> The Nature of SAPs and Experiences with Reform</b>	<b>13</b>
<b><u>3</u> Common Obstacles to Policy Design and Implementation</b>	<b>17</b>
<b><u>4</u> Overcoming Obstacles to Macroeconomic Reform</b>	<b>20</b>
<b><u>5</u> Reforms in a World with Limited Domestic Policy Options</b>	<b>27</b>
<b><u>6</u> The New Role of the State</b>	<b>31</b>

## Foreword

Successful implementation of economic reforms, to a large extent, is dependent on the political and social environment in which reforms are introduced. Commonwealth countries have an interest in understanding the political and social dynamics of designing, implementing and managing economic reforms. Accordingly, the Commonwealth Secretariat requested Professor Dr Joseph L S Abbey, Executive Director, Centre for Policy Analysis, Accra, Ghana, to prepare this paper for discussion at the Commonwealth Finance Ministers' Meeting in Mauritius in September 1997.

The experiences with implementing structural reforms have been mixed. Progress in some countries was slow. Changing legal and institutional frameworks, as well as attempts to alter the general structure of the productive economy, were insufficient as the process of change had to be managed within the political context.

The paper emphasises the importance of mobilising political support for the reform process. It identifies the obstacles met at both the design and implementation stages. The balancing of the interests of various interest groups represented a challenge. It also examines the nature of the political environment, information asymmetries, and the competence and capacity of the bureaucracy to manage reform programmes. The role played by donors is also taken up.

The paper stresses that political stability is a *sine qua non* to effective adjustment and economic growth. The paper discusses the new emerging role of the state and provides a range of recommendations that emphasise the need for the state to modernise its processes. Modernisation must go beyond enhancing the technical and managerial capacities of the state and encompass reform of the judicial system and administrative structures. Reforms need to be implemented without compromising the social role of the state in addressing poverty alleviation and provision of adequate social security. The author recommends that public funds to alleviate poverty and deliver social services should come from savings made by reducing the budgetary expenditure of other sectors.

The paper also highlights the necessity of creating, developing and strengthening institutions that are needed to support reforms – regulatory agencies, antitrust and antidumping commissions, export promotion agencies, consumer protection bodies, and social safety-net systems. Key institutions, such as the Central Bank, need to be given greater autonomy in order to protect them from the influences of partisan politics. The independence of such institutions contributes to greater transparency in governance. A balance, however, needs to be struck between the necessity of shielding key institutions from undue political interference and at the same time ensuring accountability and public control. The relevance of these issues has been heightened, as there is a growing awareness that good governance is fundamental to successful implementation of economic reforms.

We commend the author for producing this paper, which was appreciated by Commonwealth Finance Ministers. As a follow up to this paper, the Commonwealth has constituted an expert group to look into issues related to good governance and the elimination of corruption in economic management. It is our hope that this paper will be helpful to member governments in better understanding the complex political processes involved in effective management of economic change.

Rumman Faruqi  
*Director*  
*Economic Affairs Division*

## Executive Summary

Experiences from many countries indicate that successful implementation of economic reforms, to a large extent, is determined by the political and social environments in which reforms are introduced and their evolution over time.

- (ii) Consolidation of reforms is less a matter of specific measures than of changes in the attitude and behaviour of economic actors. Successful market reforms are possible if they generate incentives for firms and workers to direct effort to efficient production rather than winning concessions from governments. An important ingredient of such a process is the assumption that the new rules of the economic game are not likely to be reversed or radically changed. Economic actors must also increasingly come to accept the uncertainty inherent in the system, namely, that market economies provide only the rules and procedures to be followed, but do not guarantee outcomes to specific actors.
- (iii) The successive oil price shocks of the 1970s and associated debt accumulation, together with high world interest rates, slackening demand and declining commodity prices in the early 1980s were the origins of recent economic policy reforms. Growing external and internal imbalances were compounded by tightening capital markets. Starved of private capital and faced with growing disequilibrium, developing countries turned to the Bretton Woods Institutions (BWI) – the World Bank and the International Monetary Fund (IMF) – for assistance, which increasingly was offered only on the basis of structural adjustment conditionality, incorporated in the specific policy reform packages known as Structural Adjustment Programmes (SAPs).
- (iv) The implementation of structural adjustment policies have been very slow. SAPs have usually involved stabilisation efforts in the first instance, followed by structural reforms directed at the private/public sector boundary of economic activity. The stabilisation policies comprise fiscal, monetary and exchange rate reforms, while structural adjustments have involved changing legal and institutional frameworks as well as attempts to alter the general structure of the productive economy. Thus, in the civil service, for example, there were redeployment and retrenchment of workers to trim the structure of the service and to cut down the public wage bill. Other attempts to reduce the size of government included privatisation and divestiture of state-owned enterprises. In most cases the financial sector was also reformed.
- (v) The bulk of typically implemented reform was not only administratively simple but had relatively more manageable political costs which, moreover, could be handled within existing institutional arrangements. In cases where ownership of the reform programme rests with the domestic economy, local capacity has been available to implement the programme.
- (vi) Evaluations of the experience with SAPs have produced mixed results. Most of the success achieved so far has been in regard to reducing inflation and restoring economic growth. SAPs have been almost always favourable to the external account.

- (vii) Reform programmes usually present obstacles in terms of both design and implementation. These obstacles include the politics of balancing the interests of various groups, the nature of the political environments, information asymmetry, the competence and capacity of the bureaucracy to manage reform programmes, and donor influence. In addition, the reform policies themselves present their own difficulties. For cash-strapped developing economies fiscal reform which calls for further tightening of government spending may squeeze out the social sectors and thus further impoverish their people. Moreover, financial sector weaknesses have never made monetary reforms easier for developing countries. And in a situation where there is no proper understanding between the political authorities and the reform implementing agencies such as the central bank, economic reform becomes difficult. It has been argued that central bank independence, for example, lowers inflation and promotes growth; but central bank independence has proved to be elusive to many.
- (viii) The global economy also presents difficulties to reforming developing countries. 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 geographical parts of the world is increasingly no longer an acceptable alternative.
- (ix) 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 keep from being hit by capital outflows, governments are forced to raise interest rates when slack domestic demand and unemployed productive resources would call for precisely the opposite.
- (x) In spite of all the problems faced by an adjusting country it is clear that without adjustment most economies will sooner or later collapse. The political and economic changes that have come with reform have essentially disrupted the established ways that governments have conducted business and have also proved to be incompatible with existing institutions. The ills of adjustment can be minimised, however, if a country can improve the political and strategic capacity of its economic managers to organise the means of co-operation and efficiently manage the distributive effects of uncertain outcomes, to compensate or neutralise losers from the choices that are made, to expand constituencies and build support and consensus among broader segments of the society.

### **Conclusions and Recommendations**

- (xi) Economic reforms, regardless of their aggregate effects, have distributive consequences creating benefits for some while imposing hardships and loss on others. Whether reforms succeed and are sustained can therefore hinge on the ability of the government to mobilise political support for the reform process and to manage the opposition.
- (xii) Bureaucrats, businessmen and other interest groups attempt to capture or thwart policy initiatives that are perceived by them as not being in their self-interest. For this and other reasons, it is politically difficult to implement reforms or change the regulatory environment. It is extremely naive to assume that enunciating a desired outcome is by itself sufficient to achieve it.

- (xiii) The importance of political obstacles to economic reform has led to the examination of the scope for de-politicisation of decision-making. Central Bank independence is widely accepted as one credible mechanism. There are, however, some serious reservations about how to reconcile the exercise of so much power by unelected bureaucrats with the principles of democratic rule.
- (xiv) But while politics matters, institutions are also important. Under the right institutional conditions, astute political leaders can build new coalitions of winners that crowd out those with an interest in the status quo. The evidence also points to the fact that the effects of institutions depends on the level of commitment. For example, the applicability of the rule of law is essential to the efficacy of budgetary institutions. When, as in developing countries, adherence to the rule of law is weak, liberalised financial markets have been found to be useful in exacting the necessary commitment and discipline.
- (xv) Technological breakthroughs underpinning the globalisation process, place severe limitations on the options available to reforming countries. Successful reform must consequently not only take due cognisance of the domestic political economy but also the international environment. Adjustment asymmetries between strong (surplus) countries and weak (deficit) ones make adjustment take longer and more painful. This survey of the recent reform experience and specifically the political process and reform leads us to recommend that an adjusting country should consider the following:
- ❖ Radically reorganise its state apparatus by overhauling and modernising its processes.
  - ❖ Political stability is a sine qua non to effective adjustment and economic growth. Unstable political environments make for volatile policies and short-lived management teams. Governments and political leaders will increasingly have to recognise the need to agree to protect crucial public agencies from the ravages of partisan politics and political clientelism.
  - ❖ There should be a new definition of the role of the state. Sustaining and deepening the reform process will require states to increase their technical and managerial capacities far beyond present levels. The process of privatisation and divestiture must accelerate to get the state out of functions better suited for the private sector, in order to focus more keenly on the discharge of 'core public functions': reforming the judicial system, introducing efficient government, alleviating poverty and providing efficient social security systems.
  - ❖ Governments will have to move beyond the maintenance of macroeconomic stability and move to build the organisational infrastructure of the state to deal with any potentially explosive social situation. Governments will have to move swiftly to overhaul the financing, production, and distribution of public services in many areas: education, health care, transport, justice, personal safety etc. Tax collection, banking supervision, regulation of privatised and other monopolies, social security, labour practices, export promotion, the Civil Service, the judiciary and a plethora of other areas are in dire need of more and better governmental attention.

# 1

## Introduction

- 1 Experiences from many countries indicate that successful implementation of economic reforms, to a large extent, is determined by the political and social environments in which reforms are introduced and their evolution over time.
- 2 A wide variety of political arrangements are consistent with the definition of democracy: a system that permits substantial political competition, encourages widespread political participation, and protects civil and political liberties necessary for meaningful competition and participation. Again, a wide range of economic institutions and legal frameworks are consistent with the essence of a market economy: a system that protects a broad range of property rights, relies primarily on market mechanisms to allocate resources, and is reasonably open to international trade and investment.
- 3 Consolidation of reforms is less a matter of specific measures than of changes in the attitude and behaviour of economic actors. Successful market reforms are possible if they generate incentives for firms and workers to direct effort to efficient production rather than winning concessions from government. An important ingredient of such a process is the assumption that the new rules of the economic game are not likely to be reversed or radically changed. Economic actors must increasingly come to accept the uncertainty inherent in the system, namely, that market economies provide only the rules and procedures to be followed, but do not guarantee outcomes to specific actors.
- 4 Acceptance of the rules and procedures in turn requires that certain beliefs are widely shared and sustained over time. The procedures must offer the best assurances available for avoiding the economic pitfalls most dreaded by society; that they will not produce disastrous economic outcomes for the economic actors, i.e. the costs of losing will not put them out of the economic game; and that they will be reasonably well enforced and that other economic actors will obey them.
- 5 It may be conceded that there will be individuals or groups that may not share in these beliefs and who may seek ways to evade or change them. Consolidation of the market system consequently depends critically on how widely held these beliefs are. These considerations underlie the common fear that democratic politics can abort or derail economic reforms. The evidence, however, shows that reforming governments have not always been punished at the polls. On the contrary, some leaders have been rewarded handsomely by their electorates. However, some governments have actually lost support not simply because of high costs of reform, but because delays and inconsistencies in implementation added to and prolonged the pain of adjustment.
- 6 In a similar vein, there is the fear that rapid and deep economic reforms can also undermine tentative and fragile commitments to democracy or distort

the nature of emerging democratic institutions. But where reforming governments have enjoyed the benefits of robust growth or the initial macro-economic imbalances were comparatively small, or where strong institutional structures existed, adjustments have been rapid and credible, as well as strengthened the democratic process.

- 7 From the viewpoint of the standard paradigm, the choice of policy is either exogenous or a response to concerns with efficiency. The primary focus of analysis is therefore with the effects of policy on economic outcomes. The reform experience strongly suggests that at least in democratic polities, policy is not so much a function of its intended effects as it is the outcome of the interactions among politicians, bureaucrats, and interest groups operating within a set of institutional constraints.
- 8 The focus of this paper is on analysing the political and social dynamics of designing, implementing, and managing economic reforms. The objective is to

examine the adjustment experience and determine what light may be thrown on the formulation and implementation of more effective policies in the future as it pertains to the following:

- ❖ the nature of the economic policies implemented under Structural Adjustment Programmes (SAPs);
- ❖ the obstacles commonly encountered by policy makers in designing, implementing, and managing economic policies;
- ❖ political and social obstacles – experiences and policy recommendations;
- ❖ the implementation and management of economic reforms in a global economy when the policy options available to the domestic economy have diminished; and
- ❖ the new role of governments in ensuring economic growth by reducing government expenditure, encouraging the private sector, reforming the judicial system, introducing efficient government, alleviating poverty, and providing efficient social security systems.

## The Nature of SAPs and Experiences with Reform

- 9 The successive oil price shocks of the 1970s and associated debt accumulation, together with high world interest rates, slackening demand and declining commodity prices in the early 1980s were the origins of economic policy reforms. Growing external and internal imbalances were compounded by tightening capital markets. Starved of private capital and faced with growing disequilibrium, developing countries turned to the Bretton Woods Institutions (BWI) – the World Bank and the International Monetary Fund (IMF) – for assistance, which increasingly was offered only on the basis of structural adjustment conditionality, incorporated in the specific policy reform packages known as Structural Adjustment Programmes (SAPs).
- 10 Over 70 developing countries have submitted to these adjustment packages which typically share one common characteristic – substituting open economy policies for the now discredited inward-looking ones. In certain cases the reforms were completely packaged by the BWIs and accepted passively by the reforming countries, while in other cases ownership rests with the reforming country. In Ghana, for example, an Economic Management Team comprising a small group with the finance minister as head was formed by the head of state, to think out the reforming issues. The dismantling nature of the initial decisions made it easier to formulate policies, negotiate with the BWIs and adopt these reforms with a significant degree of political autonomy.
- 11 It is convenient to separate the reform packages into two components: on the one hand, those policies aimed at the restoration of macroeconomic stability (stabilisation) and, on the other hand, those policy measures that are designed to alter the boundaries between the public and private sectors and the way in which the different sectors of the economy are structured and operate (structural adjustments).
- 12 Generally, stabilisation issues have centred on instituting policies that will lower inflation, restore positive growth in output, and regularise the external payments position. Inflation management in the SAP has usually involved maintaining a strict monetary and fiscal stance. Price controls which had restrained output growth in the years before the SAP were also liberalised. Further, SAP also realigned exchange rates to offer international competitiveness to the country's exports.
- 13 The implementation of structural adjustment policies has been very slow. This has involved changing legal and institutional frameworks as well as attempts to alter the general structure of the productive economy. Thus, reforms were introduced in institutions such as the civil service and the financial sector. In the civil service, there was redeployment and retrenchment of workers to trim the structure of the

service and to cut down the public wage bill. Other adjustment measures included privatisation and divestiture of state owned enterprises.

- 14 The bulk of reforms so far was not only administratively simple but had relatively more manageable political costs which, moreover, could be handled within existing institutional arrangements. Price level surges following devaluation or increases in unemployment that come with tighter fiscal and monetary policies are not targeted at any particular group in society and may be perceived, or at least explained, as meant to be one-shot occurrences. In contrast, layoffs in a privatised steelworks and the elimination of subsidies on fertilisers, insecticides or other farm inputs are permanent changes with costs falling on specific groups. Moreover, those affected are easier to mobilise politically than the widely dispersed segments that bear the brunt of macroeconomic adjustment.
- 15 The strategy of shrinking the state called for the redeployment of public sector employees. Previous policies adopted to assuage popular frustration, in several instances, had contributed to the dismal economic performance of the pre-reform period. Public employment had become the preferred instrument for dealing with chronic unemployment and the non-existence of social safety nets. But the result was an over-extended public sector, high indebtedness, and, eventually, bankruptcy of public finances, more poverty, and even greater inequality.
- 16 The explosive combination of mounting unemployment, high inflation, and no usable institutions to channel state support to the poor had left several governments with no alternatives but to soak up unemployment through public payrolls. The tragedy was that this very use of public employment to provide what was at best temporary respite from social ills became a barrier to more effective and sustainable solutions to these problems. How best to tackle the problem was most uncertain but what was not in any doubt whatsoever, with the launching of the reform programme, was the inevitability of massive redeployment and layoffs. Equally certain was the high political cost of labour retrenchment. Whatever the expected gains to society as a whole, it was clear to the reforming governments that those adversely affected would be badly hurt by the loss of income. And as they lost incomes they could be expected to turn against the reform process. Compensatory measures by way of end-of-service payments and retraining schemes were instituted to minimise the destabilising consequences of reform.
- 17 Compensatory measures used in SAPs have usually been either complementary policies or direct subsidies and transfers. The former, such as export incentives, have proved both reliable and non-problematic. In contrast, direct subsidies and transfers – as with trade policy – which can have positive effects, have subsequently constituted problems when they have to be reduced or withdrawn.
- 18 Evaluations of the experience with SAPs have produced mixed results. Most of the success achieved so far has been in regard to reducing inflation and restoring economic growth. The broad strategy typically followed has been focused on shrinking the state and rejecting policies that depended on the discretionary decisions of poorly-paid, poorly-trained bureaucrats. Agencies in charge of policing compliance with thousands of

officially set prices, of administering import licenses, foreign exchange controls, trade quotas, and the screening and evaluation of foreign investment proposals, for example, were done away with. Strong fiscal discipline, widespread deregulation of trade and investment, and divestiture and privatisation of state-owned enterprises contributed to an increase in price stability and the restoration of growth.

- 19 The 1993 evaluation report of the Operations Evaluation Department (OED) of the World Bank rated only 39 out of the 68 adjustment programmes as satisfactory. The report found about 57 per cent of the programmes to have low ownership. Yet, borrower ownership is widely acknowledged as a critical prerequisite for successful reform. An important finding of the OED report was that the World Bank itself, given its predominant role especially in Africa, needs to strengthen its understanding of political economy issues through regular assessments of the impact of adjustment on various constituencies and to support efforts to bring the private sector and other groups into the process.
- 20 A review of the Enhanced Structural Adjustment Facility (ESAF) in a paper published by the IMF pointed to the difficulties of measuring the impact of adjustments. It found that clear-cut conclusions for differences in adjustment performance are difficult to draw. Among other things, this is because countries faced diverse circumstances, making it difficult to disentangle the effects of insufficiently comprehensive policy changes from those of adverse exogenous factors.
- 21 Common findings in the reviews are that the implementation of SAPs has been almost always favourable to the external account; that the influence on aggregate investment has been neutral to negative, and that on balance the influence on national income has been neutral. The preoccupation with the short-term, involving the implementation of 'Stage I reforms' or what one reviewer called 'the decree-driven, hard-to-decide, but simple-to-execute macroeconomic shocks,' has also been a recurring observation.
- 22 In the area of trade reform, initiating and sustaining a rapid pace has been possible where interests that were negatively affected could be controlled or influenced by the government (Mexico). The experience with sequencing and packaging suggests that stabilisation before or simultaneously with trade reforms is likely to increase the credibility of the overall reform effort (Ghana). macroeconomic failures have often led to reversals in trade policy (Nigeria, Poland, Senegal). Gradualism provided the requisite opportunity for firms to adjust to the new environment thus constituting a form of compensation.
- 23 Contrary to the sentiments expressed in the UNICEF study : 'Adjustment with a Human Face', insulating the poor from the effects of adjustment has not been a political imperative. Social reforms, including poverty alleviation and gender focus, have had to be advocated separately for consideration, largely on moral grounds. Some advocates have argued that even if compensating the poor is not politically significant in the short-run, doing so can help create new bases for support that can be valuable to political leaders. The economic benefits of social reforms, particularly in education and technical training, have also been canvassed on the grounds of the

increasing role of human capital in the emerging technologically sophisticated production processes. Finally, giving greater attention to the productive role of women both directly and as mothers, has been increasingly advanced in the reform agenda.

- 24 Most of the reforms undertaken so far share three identifiable characteristics. First, the reform decisions centred mostly on changing the rules that determine macroeconomic behaviour. Secondly,

these macroeconomic reforms could be adopted by the executive branch in relative isolation from the rest of the political system and were administratively simple to execute. Thirdly, the new policies implied the dismantling of existing agencies without requiring their immediate replacement. The defining characteristic of Stage I reforms then is the dominance of stabilisation measures, although the relatively easier aspects of structural adjustment were undertaken as well.

## Common Obstacles to Policy Design and Implementation

- 25 Reform programmes usually present obstacles in terms of both design and implementation. These obstacles include the politics of balancing the interests of various groups, the nature of the political environment, information asymmetry, the competence and capacity of the bureaucracy, and donor influence.
- 26 A major obstacle to reform is the desire for economic security. Inasmuch as economic misfortune is perceived to be man-made, it is deemed avoidable. Economic security also has a peculiar dynamic. Every instance of providing such security leads to demands for more. If protection is given to one industry, why not to another? A most important complication is that users of the product of the protected industry pay a price higher than their foreign competitors do. To the extent that this may make them uncompetitive, it becomes justification for them also to ask for protection to offset the effects of that already given. Democratic governments also appear unable to tolerate the failure of large economic actors. But this creates a demand for the rescue of the smaller ones from their mistakes as well. A negative answer to such demands is seen as tantamount to unprincipled discrimination and double standards.
- 27 Economic security, however, guarantees those who fail that their current earnings opportunities will not disappear. But this locks in current activities and makes it difficult to shift to new products and processes that are at the heart of economic progress. Eliminating the losses of those who fail can only mean reversing the reform that is the cause of their failure. The search for economic security not only blocks reform, it produces an ossified society incapable of adjusting to new circumstances.
- 28 Reforms have suffered reverses or even failed because of the obstructionist influence of 'vested interests'. For example, the nontradeable goods sector opposes devaluation, import competing goods producers balk at trade liberalisation and farmers object to the cutting of agricultural subsidies. Politicians and bureaucrats are sensitive to these pressures because they rely on interest groups for support, votes, and money. Moreover, democratic societies permit the formation of alliances 'in which each thinks it can best protect its fortunes if stabilisation is scrapped.'
- 29 In addition, sharply unequal income distribution creates social and political divisions that undermine consensus for economic reform, increases uncertainty about the actions of future governments, and shortens time horizons. These developments produce such undesirable economic outcomes as tax evasion, capital flight, investment strikes, and unreasonable wage demands. Greater inequality of income can lead to polarisation of contending parties, undermining the co-operation required to sustain macro-economic stability. It has also been found to increase the probability of following counterproductive populist policies.

- 30 The East Asian Tigers – Korea, Taiwan, Singapore and Hong Kong – are cited as having undertaken reforms under authoritarian or administrative auspices. And China's recent reforms have been undertaken under the explicit premise that economic and political liberalisation need not go hand in hand.
- 31 The model of the authoritarian regime as a boon to developmental reform, however, has serious shortcomings. A critical assumption made is that of an enlightened despot. On the other hand two diametrically opposed strategies are possible: enlightened despotism; and predatory behaviour. Not surprisingly, therefore, economic performance varies no less among authoritarian regimes than among democratic ones. There have been military regimes that have made policy mistakes as egregious as their civilian counterparts in different parts of the world. Furthermore, there have been authoritarian regimes, e.g. Albania, Iran, Myanmar, Romania, Zaire, in which policies contributed to such spectacular failures that only a dictatorship could sustain them.
- 31 Electoral cycles have in a number of instances proven to be formidable obstacles. Good macroeconomic and trade policies yield their payoffs gradually, but the costs are borne up-front. This has led to instances in which political leadership has attempted to manipulate macro-economic policy in the short-run to maximise electoral chances, stimulating the economy at the approach of elections and stabilising after elections. There are a number of features in society that make such occurrences take place. Important among these is the myopia of the electorate. Politicians too often, are not judged by the long-term consequences of their actions. This phenomenon has been caricaturised as a model of 'a collection of rogues competing for the favours of a larger collection of dupes.' It has been claimed that with full anticipation of the consequences of unrealistic election promises the election cycle should simply disappear.
- 33 Reforms seem to require a much longer time horizon than initially envisaged. Members of Parliament and other representatives seeking re-election every few years would want to support popular reforms that bring them votes. They may not be too keen to stick their necks out for a good cause that may conflict with their careers. Even more fundamentally, reforms typically involve long periods in which costs accrue, with benefits following much later. The politician that incurs the cost is unlikely to be the one that reaps the benefit.
- 34 It must be recognised, however, that informational asymmetries between a government and its citizens can generate political business cycles, even if voters behave rationally. There may be a dearth of key institutions – independent media covering economic policy issues or autonomous policy research organisations or histories of electoral experience – that enable voters to keep the opportunism of politicians in check. And where poverty is extensive or welfare systems are non-existent, voters may be more concerned with the short-run, supporting governments that deliver short-run material benefits even if at the expense of long-run welfare.
- 35 In addition, the milieu in which the bureaucracy operates is important. Pervasive corruption can turn the

bureaucracy into a well-positioned interest group aligned against reform. There is also the problem of political interference. Inasmuch as the effectiveness of policies depends on the widespread belief that they will be sustained, delegating decision making authority to autonomous institutions can enhance credibility about commitment. This reduces the capacity to reverse decisions in response to short-term considerations. Central bank independence has been found to have beneficial effects on inflation and real growth.

- 36 External donors have also sought to influence policy through loan conditionality as typified in the SAPs. The debate about the political economy of conditionality has centred on the extent to which outside agencies actually influence the policy process. Creditors

often have power over the flow of resources which gives them great leverage. But they also tend to have multiple and conflicting goals with respect to reforming aid recipients. Concern to support a strategically important client has often overridden the interest in promoting reforms.

- 37 The reform experience also shows that where leaders are already committed to reform, additional finance may help it succeed. Sustainability is enhanced by the extra resources which allow for higher consumption without necessitating cutbacks in investment. A rather disturbing finding by the World Bank is that countries receiving substantial adjustment lending from it have shown a tendency to do better at sustaining consumption than investment.

## Overcoming Obstacles to Macroreform

- 38 The previous section dealt with some institutional, political and social obstacles to the reform process. However, at the heart of the reform process itself are fiscal and monetary issues which themselves present their own difficulties. This section discusses some attempts to overcome these difficulties.
- 39 Governments have had to reduce aggregate spending and fiscal deficits due to serious macroeconomic imbalances. The reform record shows particularly disappointing fiscal outcomes in sub-Saharan Africa. A World Bank review concluded that over 60 per cent of the countries had a poor or very poor fiscal stance, defined in terms of sustainable fiscal deficits. Only a few African countries made some progress in improving allocative efficiency and equity of expenditure composition. The evidence also points to gross technical inefficiency in the use of expenditures, manifested in the widespread incidence of 'ghost' workers, moonlighting and the collapse in the delivery of basic services, etc.
- 40 At the same time, reviews of budget reforms in OECD countries point to two key Commonwealth countries – New Zealand and Australia – as being at the cutting edge of these reform efforts. Their reform experiences illustrate how institutional arrangements – rules, norms and procedures – governing the budget process affect incentives governing the allocation and use of resources. These countries have been found to be successful in slashing expenditures and deficits where most have failed.
- 41 An examination of how these two countries reformed their institutional structures to achieve their fiscal objectives could be beneficial to other members of the Commonwealth. Malawi is reportedly making efforts to emulate the Australian experience.
- 42 Expenditure outcomes can conveniently be categorised into three basic objectives that any system needs to achieve:
- (i) to instill aggregate fiscal discipline;
  - (ii) to facilitate strategic prioritisation of expenditures across programmes and projects; and
  - (iii) to encourage technical efficiency in the use of budgeted resources, i.e. achieve outputs at the lowest possible cost.
- 43 Aggregate fiscal discipline is impeded by the "tragedy of the commons." The several claimants to the budget – interest groups, legislators, line ministries – each exert pressure to bias spending in direction of their preferences. Each demands a level of spending in excess of what is socially optimal. In the absence of constraints on the aggregate level of spending and deficits, meeting the demands of disparate claimants will result in large unsustainable deficits that translate into an unstable macroeconomic environment which can ultimately retard growth.

- 44 New Zealand, on the eve of reforms, has been described as a heavily interventionist state not dissimilar to the former Eastern European centrally-planned economies with a socialist-leaning party in office. The initial conditions and the bold reforms confirm the oft-made observation and common experience that macroeconomic crises generally induce governments to confront and scale down the deficits.
- 45 In four general stages embodied in the State-owned Enterprise Act (1986), the State Sector Act (1988), the Public Finance Act (1989) and the Fiscal Responsibility Act (1993), New Zealand embarked upon radical institutional reforms that sought to completely redefine the role and revamp the functioning of government. In the process, New Zealand provides arguably the most dramatic example of accountability and transparency mechanisms which bind the government to aggregate fiscal discipline.
- 46 The defining characteristic of the new system of financial management is the distinction between the government's ownership interests in state agencies and the 'purchase' of specified outputs. A steady shift to accrual accounting for public sector agencies was envisaged. Input controls were relaxed in favour of increased accountability for meeting agreed objectives. The reform of the institutional arrangements for state involvement in the economy increased the credibility and medium-term focus of macroeconomic policy, enabling the rapid attainment of macroeconomic stabilisation at minimum cost.
- 47 The contract of the Governor of the Federal Reserve Bank of New Zealand with the Minister of Finance is explicitly linked to inflation. The Fiscal Responsibility Act in turn binds the Minister of Finance to aggregate fiscal discipline – cutting the deficit to 1 per cent of GDP. Further, the Act requires the government to commit itself to aggregate fiscal targets through full and frequent disclosure of information. The Act thus provides the basis upon which performance is to be judged and thus upon which both compensation and tenure of the Minister depend. Moreover, the open financial market serves as a disciplinary force in a way comparable to the effect of stock markets on corporate management.
- 48 Given aggregate fiscal discipline, the next key challenge is the strategic prioritisation of the competing claims on resources. Prioritisation is essentially a political process. Politicians may attempt to set priorities on the basis of their understanding of the preferences of their constituencies. Unavoidably the underlying problem is again the tragedy of the commons which creates demands in excess of available resources. This creates a situation in which individuals and groups strive to restructure coalitions in order to enlarge their share of the 'fixed pie.' A way out of this is institutional arrangements that help build consensus among the competing groups on resource allocation.
- 49 The Australian reforms were launched after a preceding administration had been unsuccessful at reducing public spending by identifying redundant functions. A centralised, top-down Commonwealth Review of Functions had failed to identify egregious anomalies in the role of the state. Clearly overall fiscal discipline was not the issue at stake. Australian reforms consequently sought to rely on "a more

nuanced and finely surgical process of identifying savings.” They did so by focusing the budget process on changes in strategic priorities, and relying heavily on line agencies themselves to identify savings options. The underlying philosophy behind Australian reforms placed faith on trust and consensual relationships.

- 50 Australia thus offers perhaps the best example of a priority setting process. The process engenders strong focus on strategic outcomes that expenditure programmes are seeking to achieve. It also incorporates a medium-term framework linking allocations to the achievement of these outcomes.
- 51 Finally, given that aggregate fiscal discipline and prioritisation have been dealt with, there remains the principal agent problem within the government hierarchy. Information asymmetries and incentive incompatibilities can be impediments to the efficient delivery of public services.
- 52 New Zealand offers the most dramatic example of institutional reform to achieve technical efficiency. Permanent secretaries in line agencies have been removed and replaced by chief executives on fixed-term, output-based contracts. The budget is based on a purchase of output rather than inputs, and the move to accrual accounting makes transparent the assets, liabilities and net worth of line agencies on which the chief executives are evaluated. At the same time, chief executives have complete autonomy over the allocation of resources, including the right to hire and fire employees.
- 53 The examination of the reform experience of Australia and New Zealand must be placed in context. It is not meant to recommend these reforms for adoption en masse. Indeed, whilst the two reform

episodes shared some common characteristics – both sought to alter the incentives that affect the size, allocation, and use of resources, and to improve transparency and accountability by binding key players to particular fixed outcomes and making it costly for them to misbehave – they also took dramatically different paths reflecting the particular backgrounds and historical conditions driving each reform. Even if the extent of adherence can be a matter of serious disagreement, the Bretton Woods institutions have given explicit recognition to the reality of different structures and institutions in member countries. The guidelines on conditionality for the use of the Fund’s resources and for stand-by arrangements, for example, state: in helping members to devise adjustment programmes, the Fund will pay due regard to the domestic, social and political objectives, the economic priorities, and the circumstances of members, including the causes of their balance of payments problems.

- 54 These considerations raise the obvious question: under what conditions could better institutional arrangements and mechanisms for greater accountability and transparency be transferred to other settings? Learning from experience is essentially an exercise to determine what can be borrowed with profit from others and what modifications may be necessary. This naturally is a complex issue which requires in-depth comparative analysis of such fundamental underpinnings like the relative independence of the judiciary. Political factors are also clearly important. In fact, it has been stressed that in order to understand why governments behave the way they do, one necessarily has to delve into politics.

- 55 But while politics is important, institutions also matter. Institutional arrangements have been shown to systematically influence fiscal outcomes. For example, constitutional constraints to the deficit or the public debt have been shown to reduce deficits. The effect of budgetary institutions is, however, predicated on the applicability of the rule of law. The rule of law has varied adherence in developing countries – being more binding in some and less so in others. As a result, the institutional arrangements that govern the budget process in Australia or New Zealand, if transplanted, may not have comparable effects and in some countries may even be irrelevant. A possibility that can be examined, in such contexts of weak adherence to the rule of law, is the liberalisation of financial markets. An environment in which fiscal mismanagement is decisively punished by capital outflows, currency devaluation, imported input cost increases, rising inflation and high interest rates ensures that a heavy price may be demanded of fiscal mismanagement by investors requiring a risk premium to put or return their funds into the country's financial markets. Open financial markets may, as a result, serve to discipline governments by increasing the political cost of fiscal imprudence. In this way, appropriate institutions for the stated fiscal objectives may be made to function better.
- 56 Malaysia has been carrying out reforms designed to improve strategic prioritisation (the Australian reform path) since the late 1980s. These reforms have included the establishment of a budget dialogue group with business, labour and other stakeholders from civil society, greater devolution of decision making to line agencies and associated accountability mechanisms similar to those implemented in New Zealand. Malawi is initiating a coherent programme to institute a strategic approach for expenditure planning through a medium-term expenditure framework (MTEF). A systematic bottom-up process is being implemented focused on four pilot ministries – agriculture, health, education and public works/roads. The results so far on expenditure prioritisation are mixed: successful in education but weak in health. Moreover, the MTEF is, so far, restricted to recurrent expenditures only, with the recurrent cost implications of the development budget not factored in.
- 57 Aside from the fiscal issues presented above, the problem of central bank independence presents some difficulties in monetary management. Allowing autonomy to the monetary authorities to undertake monetary policy is increasingly accepted as one of the more effective means of de-politicising economic decision making.
- 58 Central bank independence (CBI) connotes two basic ideas. First, there is the freedom of the central bank to decide how to pursue its goals. This, however, does not extend to the setting of goals on its own. In a democracy, it is virtually obligatory that the political authorities set the goals and instruct the central bank to implement. Giving the central bank authority over its goals would amount to delegating excessive power to unelected bureaucrats which may be considered incompatible with democratic rule.
- 59 A second idea of CBI is that normally no other branch of government can countermand the decisions of the central bank. In the US, for example, neither the President nor the Supreme Court can

reverse a decision of the Federal Reserve Board's Open Market Committee. The Congress can, but only if it passes a law that the President will sign (or by overriding a presidential veto). Thus for all practical purposes the Federal Reserve Board's decisions are immune to reversal; and indeed have never been reversed. If a central bank's decisions stand only as long as they do not displease someone more powerful, the bank cannot be considered independent.

- 60 An important empirical finding is that, at least for the industrial countries, CBI has shown a strong positive influence with low inflation. Proffered explanations are that far-sightedness and patience (no strong suits of the political process in a democracy) are absolutely essential for effective monetary policy. The requirement for success is to look far into the future and wait patiently for results because of the lags involved. Furthermore, inflation-fighting is akin to long-term investment. The costs of disinflation are upfront, the benefits (low inflation) accrue only gradually through time. Consequently, given the temptations to reach for short-term gains at the expense of the future, it is better to depoliticise monetary policy by delegation to unelected bureaucrats with long and secure tenure of office and clear instructions to fight inflation.
- 61 The main effect of CBI is not principally to constrain the central bank to act in accordance with the government's objectives but rather to constrain the government by increasing the difficulty of its bringing pressure to bear on the central bank. This is deemed of critical importance because of the short-run trade-off between price stability and employment generation although there is no such perceived trade-off in the long-

run. Price stability has been deemed so important as to make it the only policy goal of central banks. The argument is that the short and long run trade-offs between inflation and growth differ in ways that make inflation tempting to start and costly to stop. A recent study of disinflation episodes in industrial countries concluded that a higher degree of CBI leads to both higher sacrifice ratios (output change per unit change in trend inflation) and stronger recessions. These results were attributed to the tremendous difficulties encountered in lowering wages below contract levels during disinflations especially in low average inflation economies.

- 62 Given the short-run trade-off and an initial situation of low inflation, it is claimed that a government that would prefer output growth to be above the natural rate may be tempted to run an expansionary monetary policy – making policy subject to an inflationary bias. Private agents understanding the temptation facing government will adjust upwards their inflationary expectations. In the event, inflation will rise to a level at which its cost at the margin, given that it is expected, is high enough to force the government to abandon the gamble. The outcome, however, is that the economy ends up with no gain in output but with an inflation rate that is higher than socially optimal. CBI provides society with an institutional device to avoid this self-defeating temptation.
- 63 Some have argued, however, that concentrating monetary policy on price stability is, in effect, 'throwing in the towel on unemployment.' The basis of this position is that, as Keynes observed in the 1930s, modern industrial economies are not sufficiently self-regulating. While in principle either fiscal

or monetary policy can serve as the balance wheel to keep aggregate spending in line with productive capacity, the need to reduce fiscal deficits (in the industrial countries) 'will leave fiscal policy as a drag on total spending for the foreseeable future regardless of the state of the economy.' The public, that the central bank exists to serve, cares about fluctuations in the pace of economic activity and well-executed monetary policy does have the power to mitigate such fluctuations.

- 64 Questions have also been raised as to the compatibility of central bank independence with democracy. In this regard, it has been observed, however, that democracy, at least in practice, often allows for certain provisions of law to be enshrined in Constitutions and, as it were, thus excluded from "the daily legislative struggle." These fundamental provisions are deliberately made hard to reverse because it is not deemed in the public good to be revisiting them frequently.
- 65 The insistence that CBI does not imply a right to choose goals is again of critical importance, as noted above, in a democratic polity. The goals of such a society must be left exclusively to elected politicians and not unelected bureaucrats.
- 66 Compatibility also requires credibility – matching deeds to words – on the part of the central bank. This obligation to the body politic is in return for the broad grant of power the central bank enjoys.
- 67 CBI in a democracy must require public explanation of what the bank is doing, why it is doing that, and what it expects to accomplish by its actions. Such accountability is required to remove some of the mystery that surrounds monetary policy, enable interested parties to

appraise the bank's decisions contemporaneously and allow outsiders to judge the bank's success or failure after the fact. It is after all, accountability that legitimises independence within a democratic political structure. An inability of the bank to articulate a defence of its actions may be an indication that maybe those actions are not as good as the bank thinks.

- 68 Governors of central banks in democracies must be appointed by the political authority. The elected political leadership has political legitimacy directly from the electorate. Governors, as political appointees, have political legitimacy conferred upon them by virtue of their appointment, i.e. through their holding of delegated authority.
- 69 Perhaps, most importantly, central bank decisions, in a democracy, must be reversible even if only in extreme circumstances. Reversals, however, must never become routine occurrences. Governors must also be removable from office for good cause. Delegated authority must be retrievable, not absolute.
- 70 In the context of the proposed European Central Bank, it has been argued that a successful European Monetary Union (EMU) cannot be envisaged without a political union. Without that 'no government could expect its citizens to accept the fiscal implications of the Maastricht blueprint for monetary union in the name of an inflation objective for which neither it nor any other government felt wholly responsible.' In other words, independence for the ECB would be undemocratic and as a consequence the bank is likely to find the odds stacked against it sustaining its independence in the conflict that would result inevitably from this fiscal resistance.

- 71 Given the fact that ECB would have to start with little moral authority or political legitimacy, any perception that it is the source of fiscal difficulties for the national member governments can only spell trouble for itself, European economic integration and political amity. The fragile politics of EMU are unlikely to permit either bond market discipline (by way of high interest premia on issues of deficit countries) or binding collectively agreed rules to bear on national fiscal authorities. Yet, without that fiscal discipline there would always be suspicion in financial markets that political pressures would force the central bank to ease monetary policy inappropriately, in a bid to ease any fiscal pressures on national member governments. But mere concerns
- about such pressures will push real interest rates up, further intensifying fiscal problems as growth falters.
- 72 Even though the empirical record shows that CBI in industrial countries achieves its objective, i.e. low rates of inflation, there are nonetheless concerns about whether society is best served if price stability is at the expense of painfully high unemployment. Issues have also been raised about the necessary conditions required to make CBI compatible with democratic rule. Some of these issues have also been noted in the context of the proposed European Central Bank (ECB), leading to speculation that such a central bank cannot have the political legitimacy to be independent.

## 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.

## The New Role of the State

- 92 The state apparatus needs to alter radically its organisational structure. It also needs to overhaul and modernise its organisational processes. The reform experience shows how decades of neglect, improvisation, politicisation and lack of resources have adversely affected policy planning, budgeting, personnel practices, information systems, co-ordination, control and oversight etc. Clearly these issues which determine the quality of the Civil Service and the capacity of the government to carry out its functions efficiently and effectively must receive as much attention as threats to macroeconomic stability. A distorted and unrealistic set of terms and conditions of public service – including the salary structure – is as damaging and unsustainable in the long run as an overvalued exchange rate. The creation of the enabling environment for organisational efficiency in the public sector should rank as top priority in the follow-up.
- 93 Beyond the inner workings of the state machinery, there is also the provision of indispensable public goods and services that will not or cannot be provided by the private sector – water, infrastructure, education, law and order and justice, among others. Given the prime importance of macroeconomic stability, however, it is important that care be exercised so that institution building and increasing state capacity do not become excuses for lax macroeconomic policies, or the inefficient expansion of the bureaucracy or for permissive labour practices in the public sector.
- 94 Sustaining macroeconomic stability will require that governments will have to confront ‘the politics of budget redeployment’ – taking 10 per cent from one ministry and giving it to another - which differs markedly from the politics of austerity: reducing all budgets by 10 per cent. Public funds to alleviate poverty and deliver social services will have to come from the budgets of other sectors that have traditionally enjoyed easy access to the Treasury. A view that is quite popular with the World Bank is to increase funding for primary and vocational education from the “lopsided budgets that rioting tertiary students once extorted from permissive administrations.” In addition, greater recognition must be given to private agents’ ability to produce and deliver efficiently many public goods.
- 95 But just as macroeconomic instability is a hindrance to institution-building, so also does political instability inhibit positive organisational change. Unstable political environments make for volatile policies and short-lived management teams. Governments and political leaders will increasingly have to recognise the need to agree to protect crucial public agencies from the ravages of partisan politics and political clientelism. An important example of this is the granting of legal autonomy to central banks. This serves to shield these institutions from both partisan politics as well as the influence of the administration. A balance will, however, have to be struck between the necessity of shielding key institutions

- from undue political interference and the need for proper accountability and public control under which all state organisations must operate.
- 96 Issues about the role of the state bring to the fore the need for deeper insights about the institutional and political economy aspects of reform management. A minimalist role for the state – historically seen as bureaucratic, over-extended, rent-seeking and predatory – has been described as ‘a reaction too far.’ The fundamental challenge is that of designing institutions and political frameworks that would enable a ‘developmental and altruistic’ state to emerge or evolve from the predatory patrimonial state.
- 97 Sustaining and deepening the reform process will require states to increase their technical and managerial capacities far beyond present levels. The process of privatisation and divestiture must accelerate to get the state out of functions better suited for the private sector in order to focus more keenly on the discharge of ‘core public functions’ – reforming the judicial system, introducing efficient government, alleviating poverty and providing efficient social security systems.
- 98 Without doubt political instability is attributable to a variety of causes, but the inability of the state to deliver basic public services exacerbates the situation. The acute deterioration of state capacity is a powerful destabilising force. The biggest threats to economic stability – a relapse into fiscal disarray and insufficient international competitiveness – also flow from the failure to improve the performance of existing public institutions and policies.
- 99 Moreover, unless the administrative machinery is improved, social conditions are bound to deteriorate, regardless of how much money is poured into social programmes. The new role of the state must be to support and reinforce the reform process without restoring the tendency to inflict the economic, social and moral havoc of the past.
- 100 In some instances, the dismantling of state organisations has been accompanied by the unintended and profound operational deterioration of indispensable public agencies. Fiscal collapse provoked by the drastic budget cuts needed to shrink the fiscal deficit, accelerated what admittedly has been an ongoing process of deterioration. Agencies were sometimes left without any realistic possibility of recruiting and retaining essential technical personnel or of procuring other needed resources.
- 101 The creation and development of the institutions needed to support the new policies – regulatory agencies, antitrust and antidumping commissions, export promotion agencies, consumer protection bodies, social safety-net organisations etc. – and the even more challenging task of upgrading existing public agencies devastated by decades of neglect, under-investment and ‘capture’ by special interests, will constitute the most pressing agenda issues of the ongoing reform process and constitute the new role of the state.
- 102 Governments will have to move beyond the maintenance of macroeconomic stability and an attractive environment for competitive private investment. The still precarious stability will have to be combined with building the organisational infrastructure of the state

and dealing with a potentially explosive social situation. Governments will have to move swiftly to overhaul the financing, production, and distribution of public services in many areas: education, health care, transport, justice, personal safety, etc. Tax collection, banking supervision, regulation of privatised and other monopolies, social security, labour practices, export promotion, the Civil Service, the judiciary and a plethora of other areas are in dire need of more and better governmental attention.

103 The pending reform agenda for governments has as its common denominator, the need for sophisticated public management in a context of growing, and sometimes extreme, politicisation and reform fatigue at home and internationally. The tasks depend on

cohesive state action, whether in the building of reliable social security systems or in the development of regulatory frameworks that increase confidence in the financial market, whether on the restructuring of hospitals or in the overhaul of the judiciary.

104 The objective is the evolution of the 'developmental state' from the 'predatory state.' A developmental state engenders a more meritocratic civil service and long term career rewards that heighten commitment and create a sense of corporate coherence within the state that, in turn, become a major source of autonomy. By contrast, in predatory states, the Civil Service becomes either a second-best option for the risk averse or a temporary exercise in diversification for what are really private sector careers.

## Recent Commonwealth Secretariat Economic Publications

### Commonwealth Economic Papers

Graham Bird and Tony Killick, *The Bretton Woods Institutions: A Commonwealth Perspective*, No. 24, 1996

David Greenway and Chris Milner, *The Uruguay Round and Developing Countries: An Assessment*, No. 25, 1996

Michael Davenport, *The Uruguay Round and NAFTA: The Challenge for Commonwealth Caribbean Countries*, No. 26, 1996

Economic Affairs Division, *Money Laundering: Key Issues and Possible Action*, No. 27, 1997

David Pearce and Ece Ozdemiroglu, *Integrating the Economy and the Environment – Policy and Practice*, No. 28, 1997

Robert Cassen, *Strategies for Growth and Poverty Alleviation*, No. 29, 1997

Richard Portes and David Vines, *Coping with International Capital Flows*, No. 30, 1997

Sanjaya Lall, *Attracting Foreign Direct Investment*, No. 31, 1997

M. McQueen, C. Phillips, D. Hallam & A. Swinbank, *ACP-EU Trade and Aid Co-operation Post-Lomé IV*, No. 32, 1998

Sanjaya Lall and Ganeshan Wignaraja, *Mauritius: Dynamising Export Competitiveness*, No. 33, 1998.

Report of a Commonwealth Working Group, *Promoting Private Capital Flows and Handling Volatility: Role of National and International Policies*, No. 34, 1998

Gerry K Helleiner, *Private Capital Flows and Development: The Role of National and International Policies*, No. 35, 1998

### Forthcoming Papers

Commonwealth Expert Group *Report on Protecting Countries Against the Destabilising Effects of Volatile Capital Flows*, No. 37, 1998

---

To order these or any other publication, please contact the Secretariat's distributors:

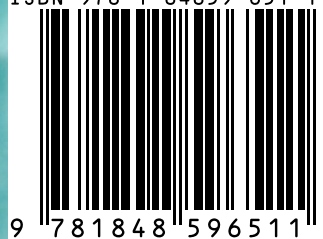
Vale Packaging Ltd, 420 Vale Road, Tonbridge, Kent TN9 1TD, Britain.

Tel: +44 (0)1732-359 387; or Fax: +44 (0)1732-779 620



Commonwealth Secretariat

ISBN 978-1-84859-651-1



9 781848 596511

